AN ANALYSIS OF THE EU’S REGULATION APPLICABLE TO MONEY MARKET FUNDS AND ITS IMPLICATIONS FOR MALTA

UNIVERSITY OF MALTA

A dissertation submitted to the Faculty of Economics, Management and Accountancy in partial fulfilment of the requirements for the Degree of Bachelor of Commerce (Honours) in Banking and Finance

May 2014

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ABSTRACT

Although Money Market Funds are known to be safe because of their high liquidity, the financial crisis during the fall of 2007 attested that these funds are not resilient enough to be immune to financial turmoil. During the Financial Crisis, a U.S. based money market fund had to be liquidated because of its dependence on a major bank that went bankrupt. This turmoil in the U.S. together with uncertainties in the European Union Financial system, made investors uneasy and reduced confidence even in the “safety” of Money Market Funds. This led governments to step up and guarantee the constant net asset value to prevent runs on MMFs.

Witnessing these events unfold, in September 2013 the European Commission put forward a proposal on Money Market Funds entitled ‘Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds’. The exposure of MMFs to systemic risk experienced during the financial crisis and later during the Sovereign Debt Crisis triggered debate on an international and European level by policymakers which resulted in the issuance of guidelines and subsequently the proposal. Thus the proposal aims at mitigating the risk and the vulnerability of these funds during future financial crises.

The dissertation will be a study of how the proposal put forward by the European Commission would affect the Maltese Money Market funds if it will be implemented. The purpose of this dissertation is to help the reader understand important aspects
of the European Commission’s proposal which proved to be rather debatable by the relevant economic and banking associations. Furthermore, the study includes an extensive research about the Money Market Funds in Malta and the impact of the new proposal on the mentioned funds from the perspective of the MMFs managers in Malta. Such research will be mainly provided by interviews to local practitioners. Therefore, the research aims at providing a holistic view to the reader about the current and the future direction of Money Market Funds, focusing mainly on the local funds.

This dissertation is a study of how the proposal would affect the Maltese Money Market funds if it is to be accepted and implemented in Malta as one of the member states of the European Union.

Keywords: Money Market Fund, Financial Crisis, Financial Regulation, Shadow Banks
To my beloved parents and sister
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DECLARATION OF AUTHENTICITY

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Course: Bachelor of Commerce (Hons.) Banking and Finance

Title of Dissertation
An Analysis of the EU’s Regulation Applicable to Money Market Funds and its Implications for Malta

I, the undersigned, declare that this dissertation is authentic insofar as it is the result of my own study and personal research and no part of the dissertation has been copied without being duly referenced. I confirm that no portion of this work has been in support of an application for another degree or qualification of this or any other university or institution of learning.

CLAUDETTE GRECH
Signature of Student

May 15, 2014
Date
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<tr>
<td>MMF</td>
<td>Money Market Fund</td>
</tr>
<tr>
<td>NAV</td>
<td>Net Asset Value</td>
</tr>
<tr>
<td>CNAV</td>
<td>Constant Net Asset Value</td>
</tr>
<tr>
<td>VNAV</td>
<td>Variable Net asset Value</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>U.S.</td>
<td>United States</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>ESMA</td>
<td>European Securities and Markets Association</td>
</tr>
<tr>
<td>CESR</td>
<td>Committee of European Securities Regulators</td>
</tr>
<tr>
<td>UCITS</td>
<td>Undertakings for Collective Investment in Transferable Securities</td>
</tr>
<tr>
<td>FSB</td>
<td>Financial Stability Board</td>
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<tr>
<td>ESRB</td>
<td>European Systemic Risk Board</td>
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<tr>
<td>IOSCO</td>
<td>International organisation of Securities Commissions</td>
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<tr>
<td>SIFI</td>
<td>Systematically Important Financial Institution</td>
</tr>
<tr>
<td>IMMFA</td>
<td>Institutional Money Market Funds Association</td>
</tr>
<tr>
<td>MFI</td>
<td>Monetary Financial Institution</td>
</tr>
<tr>
<td>OMFI</td>
<td>Other Monetary Financial Institution</td>
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<tr>
<td>MFSA</td>
<td>Malta Financial services Authority</td>
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<td>ECON</td>
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Chapter 1 Introduction
1.1 Background

This dissertation examines the potential impact that the Money Market Fund regulations proposed by the European Commission in September 2013, may have on the Money Market Funds domiciled in Malta. It identifies and analyses the local practitioner’s concerns that emerge from applying the proposed rules to all EU member states. This study is focused primarily on Money Market Funds established in Malta because despite it being the smallest state in the European Union, Malta is an international financial centre and a jurisdiction of choice for the establishment of international funds. MMFs in Malta have the potential to grow and high standards of regulatory oversight make Malta an ideal jurisdiction to domicile and operate funds on the island.

1.1.1 What are Money Market Funds?

A Money Market Fund is a conservative investment option for risk averse investors and a temporary cash repository. It is a collective investment scheme where money is raised by issuing shares or units to the public. These are short term debt financing instruments which are usually considered safe and stable because of their high liquidity. MMFs are open ended funds where investors pool their cash in a fund in order to buy money market securities such as commercial papers, repurchase agreements and short term bonds (Peirce & Greene, 2014). As illustrated in figure 1.1 below, these funds are commonly used by institutions, governments and corporate to invest their short term excess cash and thus satisfying the demand for
short term cash. In many instances, money market funds are close substitutes of deposit accounts (Commission, 2009, p. 76). Nonetheless, bank deposits may be less appealing to these investors because putting all the excess cash in one bank account would subject the investor to default risk. On the other hand, when an investor invests the large excess cash into a money market fund, the risk is minimised due to the diversified portfolio of these funds (Commission, 2013). Moreover, Money Market Fund investors expect to redeem their money at any time without incurring any losses on their purchase price.

Figure 1.1: Money Market Fund Structure
Source: (Baklanova, 2012)

The main objective of money market funds is to provide liquidity while preserving capital. In fact most money market funds seek to keep the €1 per share when investors redeem or purchase their share meaning that the fund is keeping a
constant net asset value (CNAV). In order for a fund to maintain its price at €1 per share while providing for fluctuations in the market, the fund has to amortise its costs to value its assets. However, some money market funds follow the practice of mutual funds and employ the Variable Net Asset Value (VNAV) whereby; shares are purchased or redeemed at market value after deducting the funds liabilities. For this reason a Variable Net Asset money market fund is subject to market fluctuations (Commission, 2013).

Furthermore, money market funds are operated by asset management companies which are granted permission from money market regulators. The majority of these fund managers are sponsored by banks mostly commercial banks which creates a high degree of interconnectedness between banks and Money Market Funds.

1.1.2 History of Money Market Funds

In the early 1970s, the United States (US) imposed a limit on interest rates on deposits, which led banks and financial institutions to create deposits which could offer similar returns but without limits on the yielded interest rate. Thus the need for a close substitute to deposit accounts prompted the beginning of money market funds. These funds provided investors higher rate of returns since they used the market returns rather than the limited rate set by banks.
The first regulations on the US Money Market Funds were issued in 1983 by the Securities and Exchange Commission (SEC). These regulations were essential to minimise potential risks at the time. Further regulation was introduced in 2010, aiming primarily at improving liquidity, credit quality, maturity and transparency (ICI, 2012).

In the 1980s, MMFs were introduced in France for the same reason they were introduced in the U.S., that is, to get higher market return than commercial banks were offering. This service quickly spread all over Europe to the extent that these funds have grown so much that today one fifth of short term government debt securities in the EU are held by MMFs. In money terms, it is estimated that Money Market Funds manage over 1.3 trillion Euros of assets in the EU (Brunsden, 2013). Despite the size of this financial area, up to this day, there were no harmonised regulations amongst EU member states regulating these funds. It was after the bankruptcy of Lehman brothers; more specifically after the Reserve Primary Fund (RPF) “broke the buck” that debate on a harmonised set of regulations on MMFs started to take place in the EU. Initially the Committee of European Securities Regulators (CESR) and the European Securities and Markets Authority (ESMA) issued guidelines and set a common definition to all European MMFs. The mentioned guidelines came into effect in August 2011 and are aimed at improving investors’ protection. UCITS and non-UCITS funds that promote themselves as money market funds have to follow these guidelines. The UCITS directives are not specifically aimed at regulating Money Market Funds but they do provide a certain level of protection to MMF investors (Baklanova, 2012). Therefore, in order to
enhance investors’ protection and to reduce systemic risk, in September 2013 the European Commission proposed a number of regulations on MMFs to be discussed by the European Parliament and the European Council. The proposed rules are found in the document entitled ‘Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds’.

The financial sector was also analysed on an international level by boards such as the Financial Stability Board (FSB), the International Organisation of Securities Commissions (IOSCO) and the European Systemic Risk Board (ESRB). The general conclusion drawn from these analyses is that Money Market Funds are exposed to systemic risk especially the MMFs that guarantee a stable share price. In this regard, the mentioned international bodies issued recommendations which seek to assist regulators issues related to MMFs (Commission, 2013).

1.1.3 Why the need for the Commission to regulate MMFs?

Due to the presumption that MMFs are liquid, they are considered safer than other investments, however, the financial crisis during the fall of 2007 proved that these funds are also susceptible to systematic risks and may not serve their purpose during times of distress. In fact during the 2007 Financial Crisis the Reserve Primary Fund in the US had to be liquidated because of its dependence on a major bank that went bankrupt. This turmoil in the US together with uncertainties in the
European Union Financial system, made investors uneasy and reduced confidence even in the “safety” of Money Market Funds. This led governments to step up and guarantee constant net asset value to prevent runs on MMFs.

Witnessing these events unfold, and because of the enormous exposure to systemic risk during the financial crisis and later during the Sovereign Debt Crisis, the European Commission put forward a proposal on Money Market Funds. Thus the new rules were proposed with the aim to mitigate the risks and reduce the vulnerability of these funds during future financial crises. The European parliament and Council are expected to vote on the proposal by the end of the second quarter of 2014. If it will be approved by both the Parliament and the Council, the rules are expected to be adopted into European Law during the second and third quarter of 2014.

Money Market Funds represent more than 15% of the European Fund Industry thus integrity and stability of these funds are essential for the European economy to remain strong and competitive. The commission states that harmonised rules among EU member states should make MMFs more resilient especially when large numbers of investors redeem their investments at once (Commission, 2013).
1.1.4 An overview of the Proposal

Following the financial crisis of 2007, various off-balance sheet products became under regulatory scrutiny, including shadow banking and more specifically money market funds. Such scrutiny came from both international bodies and European Union bodies represented by Financial Stability Board (FSB) and the European Commission respectively. The proposal published on 4th September 2013 by the European Commission, aims at structuring harmonised regulations on Money Market funds domiciled, managed or promoted in the European Union. The proposal sets out requirements on: the authorisation, the eligible assets, diversification, the internal assessment procedure, credit ratings, stress testing and valuation of Money Market fund's Assets. It includes also a 3% cash capital buffer which is applicable to the Constant Net Asset Value (CNAV) funds. Furthermore, the proposal defines the obligations and the power of the European Securities and Markets Authority (ESMA) within this sector. Under this legislation it will have the responsibility to draft the technical standards regarding MMFs (Commission, 2013).

1.2 Research Questions

This dissertation is examining a European Commission’s proposal which is still to be approved and implemented. Thus, this study seeks to identify the benefits or otherwise that the proposed rules may have on MMFs. To identify such traits the study answers the following research questions:
• To what degree would these regulations mitigate systemic risks on MMFs?

The answer to this question should indicate the level of protection that the investors have at the time but more importantly how much protection would they get if these regulations were to be implemented. In other words, this dissertation will analyse the potential addition value this proposal will add to the current EU regulation framework and guidelines related to MMFs. The answer is expected to demonstrate whether these new rules will actually decrease the possibility of future runs on MMFs.

• Will the proposed rules cause a change in the form of current MMFs in the EU?

The answer to this question should analyse the possible changes that the new rules may cause in terms of form or size of the MMFs. The answer could explain whether the constant net asset value funds will have to transform into variable net asset funds due to the constraints the new rules will impose. Furthermore, by answering this question the dissertation will analyse whether the MMFs are likely to increase in number or decrease. In addition, the study will also analyse whether the size of the funds will change due to the new rules.
• Will the proposed regulation have an impact on the liquidity of the MMFs?

The answer should determine whether the new rules would affect the liquidity of Money Market Funds in the EU but particularly in Malta since the market is smaller. The answer should examine whether due to the constraints and the cash capital buffer proposed by the Commission, the MMF will remain as liquid as they are believed to be to this day.

• Does the proposal create more investor confidence in MMFs?

The European Commission published the proposed rules with the expectation that investors will be more protected. Thus the answer to this question should establish whether the new rules will actually add more protection to the investors. It will also analyse whether the investors are likely to be more confident investing in MMFs once these new rules are implemented.

1.3 Hypothesis on the Impact

A priori it is expected that the regulations proposed by the Commission would decrease the probability of future runs since the new rules oblige fund managers to put aside a percentage of the money in the fund for a rainy day. On the one hand, this measure may boost the confidence of the investors and on the other it may
discourage investors from investing their excess cash in MMFs because the returns will be lower than they are now due to the idle cash.

Moreover, administrative expenses are expected to increase and this may create difficulties to keep the net asset value stable in the case of CNAV MMFs. Therefore, it is expected to have a number of Constant NAV MMFs transform into variable NAV MMFs. A priori the researcher also expects that the MMFs in Malta are more likely to make this shift than other large European MMFs.

The researcher also expects the liquidity of MMFs to increase due to the introduction of the cash capital buffer. Moreover, the new rules are expected to increase the investors’ protection because the proposal limits the amount of money that can be invested by the fund with one issuer. This measure implies diversification in the assets of MMFs, thus the exposure to one bank will be loss, and hence MMFs are expected to be less susceptible to runs.

1.4 Aims and Objectives

The Commission’s proposal has been published a few months ago, and it is still in the process where it can be amended before these regulations are accepted and adopted by the EU countries. However, there has been a strong reaction in response to the proposal. Therefore the aim of this dissertation is to study how the
proposed regulations are expected to affect the Money Market Fund sector particularly the funds in Malta.

The core objective of this dissertation is to determine potential impact of the proposed MMF regulations on MMFs in the European Union and in Malta. In order to obtain this, a number of objectives have to be addressed:

- A general understanding of the proposed MMF regulations has to be obtained.
- Determining how the EU and Malta are or will be preparing for the Commission’s proposal
- Determine the benefits and the consequences of the proposal
- Analyse the impact on local funds
- Determining the future prospects of MMFs in Malta

The purpose of this study is to contribute to the literature in this study area by trying to analyse the impacts of the proposal with the aim that the results would contribute to the understanding of what one should expect had these regulation be enforced. Also this paper aims at contributing in the amending process in order to have a better regulated market but without threatening its existence.
1.5 Dissertation Overview

This dissertation is spread over five chapters. The purpose of Chapter One was to introduce the reader to the main features of Money Market funds, their history and their significance in the financial system. This chapter defines the main aim and objectives of this study whilst giving a general outline of its structure.

The second chapter discusses literature related to the Money Market Funds and outlines regulatory differences between the US and the EU while recounting the recent events that distort investors’ confidence in MMFs. This chapter also looks into the MMF sector in Malta.

Chapter Three discusses the procedure of how data was collected in order to achieve the results for this study. This chapter also include the limitations of this study.

The fourth chapter is a detailed analysis of the research findings from the interviews conducted while the last chapter draws the conclusions from the analyses of the findings.
Chapter 2 Literature Review
2.1 Introduction

After the financial crisis that both the EU and the US have experienced the Literature about Money Market Fund has grown extensively. The research on MMFs has increased so much because MMFs were affected badly by the Financial Crisis. The lack of investor confidence in MMFs worsened the financial situation at the time because of their interconnectedness with major banks. Thus, this chapter will be reviewing some literature that describes and analyses the effects of the financial crisis on Money Market Funds. This discussion will be followed by an extensive explanation of the Commission’s proposal highlighting the most controversial rules in the proposal. An analysis of the reactions of major stakeholders of the proposed regulations will follow. Since this dissertation focuses on MMFs in Malta the literature review will conclude by an overview of the Maltese MMF sector.

2.2 Reserve Primary Fund “Broke the Buck”

Prior to the last financial crisis the Reserve Primary Fund was one of the largest Money Market Fund in the US. Similar to other MMFs, during the initial stage of the financial crisis (August 2007), the fund was generating above average returns because the fund managers took advantage of investors’ confidence by taking substantial risks. One of the major risks taken by the fund was the sudden
expansion in its Commercial paper\(^1\) holdings which increased by 59% within one year. By July 2008, the fund increased significantly its inflows and the acquired assets more than doubled.

Following the bankruptcy of Lehman Brothers in September 2008, the Reserve Primary Fund had to write off $785 million holdings of Lehman Brothers which included Commercial Paper and medium term notes. Due to the fall of Lehman and because the fund lacked any sponsor the fund lost 0.5% of its assets consequently the Net Asset Value fell below the dollar to an NAV of $0.97 (Felix Thierfelder, 2012).

The Reserve Primary Fund breaking the buck led to the equivalent of a bank run, that is, excessive shareholder redemption occurred at once. This event was used as an indicator by shareholders that other funds may be in trouble due to their exposure to other large banks even though most MMFs had sufficient reserves and good assets (Bullard, Neely, Wheelock, 2009). As a result shareholders shifted their investments from MMF to government funds which were considered the safest investment at the time. The news on 16\(^{th}\) September 2008 triggered sudden redemptions from MMFs in the U.S. which amounted to $3.45 trillion. Redemptions stopped three days later when the US government announced that deposit redemptions would be guaranteed.

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\(^{1}\) Commercial Papers are unsecured short term debt instruments. They are financial instruments which are negotiable promissory notes sold on the open market to raise capital at short term interest rates. On the other hand the investor receives a slightly higher return than treasury bills (Calomiris, et al., 1994).
insurance to investments on MMFs would be provided (Kacperczyk & Schnabl, 2009).

This event had a ripple effect on both the US and the EU financial system. Research conducted by Baba et al. (2009) shows that non-US banks enjoy ample benefits particularly from high liquidity offered by US MMFs. Despite these benefits these banks experienced large losses when the Reserve Primary Fund broke the dollar. Thus, research shows that such funds were not designed to serve as global repositories of cash in times of severe financial distress. Therefore, in order to mitigate the possibility of future runs, it was recommended to utilise public funding to back up MMFs (Baklanova, 2010).

2.3 MMFs do not pose treats to the Financial System

Papers that form part of a symposium titled “Do Money Market Funds Create Systemic Risk?”, sponsored by the American Enterprise Institute, claims that Money Market Funds do no impose systemic risk because of various reasons. The paper entitled “Money Market Funds, Systemic Risk and the Dodd-Frank Act” recounts that MMFs may have provided diversity, transparency and market discipline as a response to the systemic shock in an environment where financial organisations are systematically risky and less efficient than MMFs. The author insists that these funds serve a wide spectrum of people and it is very rare for a MMF to break the
buck. Moreover, if a U.S. MMF’s NAV fall below $1 the fund will immediately close thus it will not generate further losses. In the history of MMF only two funds have dropped below the dollar and in both cases the investor retrieved most of their investments. Thus they have a history of being safe funds even though they are not government guaranteed. Regulatory bodies are trying to regulate MMF under shadow banking however, the author demonstrates how Money Market Funds are not unregulated and do not form part of shadow banks. Instead of taking deposits MMFs issue securities and they do not make commercial loans nor create leverage or off-balance sheet liabilities; due to these characteristics MMFs lack the features of a shadow bank\(^2\).

The author also argues that MMF regulation in the U.S. is stronger than banking regulation in certain key aspects. These differences include limits on portfolio maturity whereby MMFs have to ensure that they ‘maintain a weighted average portfolio maturity of 60 days or less and a weighted average portfolio life of 120 days or less’. Banks are not subject to such rules thus MMFs are required to be liquid. In addition to this, MMFs are more transparent because apart from providing the prospectus to its shareholders, MMFs in the U.S. are obliged to provide extensive information on their website about every investment in their portfolios. Banks on the other hand, are not obliged to provide similar information about their loans and investment portfolios.

\(^2\) Shadow banks are non-bank financial intermediaries which, however, their operations are similar to those of commercial banks. They serve as intermediaries to channel savings into investment. These financial intermediaries are not subject to regulatory oversight (Bernanke 2010).
The paper explains that the Fed should be in a position to monitor closely MMFs they provide extensive information to the public and to the SEC. Thus it is unnecessary to subject MMFs to additional regulation which will increase their expenses and risk their existence. MMFs are excluded from the proposed rules in the Dodd-Frank report because MMFs are not eligible candidates for SIFI\(^3\) status. The report does not mandate or authorise supervision on MMF by the Fed (Fein, 2012).

2.4 Comparison between U.S. and European regulatory framework

2.4.1 Differences

While the EU has two types of MMFs which are the Constant NAV and the Variable NAV, the U.S. model includes only the stable NAV funds. Important features of a U.S. MMF include investments in high quality short-term securities, daily accumulation and rounding to the next cent. A significant difference is that the U.S. gives a lot of importance to credit rating agencies when measuring the creditworthiness of an instrument while in the EU, many other factors are considered alongside credit ratings. Also, a crucial difference is how the gap between the amortised cost which is accounted for daily and the mark to market shadow price is

\(^3\) A systemically important financial institution (SIFI) includes banks, insurance companies, or other financial institutions. The failure of one of these institutions might trigger a financial crisis.
tackled; in the case of a U.S. fund if the gap is one half of one percent then the board of the MMF may have to consider breaking the buck. In contrast, in the EU the fund manager would be required to narrow the gap if the variance is beyond a present limit. Further dissimilarities are found in the way liquid assets are regulated. Unlike the EU guidelines, the U.S. imposes rigid requirements regarding the amounts of liquid assets held by MMFs.

2.4.2 Similarities

Requirements on high asset quality, diversification, maturity and liquidity tend to be similar in both regulatory regimes, for example MMFs in the European Union and their equivalent in the U.S. are required to have a weighted average maturity of 60 days. Another similarity is that MMFs in both continents are required to give detailed information to the clients which must include daily calculation of the NAV along with monthly and quarterly data (Brown, 2013).

2.5 Reforms in the U.S. regulatory regime

Similarly to what is happening in the EU, the U.S. authorities are reforming the regulatory system that governs MMFs. Currently, the US MMFs are regulated under the federal securities law which was re-drafted post the crisis. The first rules on MMFs post the crisis were approved by the Securities and Exchange Commission
(SEC) on January 27, 2010. The new restrictions included: a daily and weekly minimum percentage of the fund’s assets in highly liquid instruments, higher credit quality, shorter maturity limits, “know your investor” procedures and introduced the requirement for periodic stress tests (SEC, 2010).

On June 5, 2013, the SEC proposed additional reformatory measures. The proposed rules aim at reducing the vulnerability of MMFs in the U.S. to large redemptions. It is also anticipated that the proposed rules will be able to manage the ripple effect of such runs as well as enhancing transparency. The rules also seek to preserve the benefits and the characteristics of MMFs. The proposal includes two alternatives:

“One requires a variable net asset value for prime institutional money market funds whilst the other alternative is to allow the use of liquidity fees and redemption gates in times of stress.” (SEC, 2013, p. 1)

In addition to this, more diversification rules and disclosure rules are being proposed. These would be applicable to either alternative (SEC, 2013).
2.6 Money Market Funds in the U.S. and the EU

Money Market Funds are important for the financial system to act as parking funds for retail or institutional investors who have temporary excess cash. The liquidity and the short term nature of the funds make them popular with investors in fact the total MMFs in the world is €3.6 trillion of which 55% belongs to the United States while 29% are domiciled in the EU as shown in Figure 2.1.

![Figure 2.1: Sizing the Industry](image)

Source: (Baklanova, 2013)

At the end of 2008, MMF in the United States held a total of $3.8 trillion in assets; institutional investors accounted for $2.5 trillion will the remaining are accounted for
by retail funds. Although the EU has less MMFs they are still significant. Balance sheet total of EU MMFs was around €1.1 trillion. MMFs in the U.S. experienced sharp declines from 2008 whilst assets managed by EU MMFs remained constant with the exception of a slight decline as of 2009 as figure 2.2 illustrates (ECB, 2012).

Figure 2.2: Euro area and US MMFs Total Balance Sheet
Source: ECB, 2012
2.7 An extensive Explanation of the European Commission's Proposal

The proposal targets Money Market funds which are domiciled managed and/or marketed in the European Union. The guidelines provided by international institutions such as the IOSCO and the ESRB are the basis of the European Commission MMF proposal. After the proposed rules are agreed upon by Parliament and the council, any Money Market Fund has to honour the minimum requirements in order for the fund to be authorised in an EU Member State.

The minimum requirements set by the proposed rules require the fund to invest in money market instruments, deposits with credit institutions, financial derivatives instruments and reverse repurchase agreements and it is not allowed to participate in short selling money market instruments, gaining exposure to equity or commodities. The proposal also prohibits MMFs to borrow and lend cash, to engage in repurchase agreements and forbids securities lending or securities borrowing agreements. To ensure diversification, the Commission suggests that MMFs should be allowed to invest a maximum of 5% of the assets in instruments issued by a single issuer, not more than 5% of assets can be invested in deposits with the same credit institution and not more than 20% of the assets could be invested in reverse repurchase agreements with the same counterparty.
An important clause in the proposal is the credit quality criterion which requires the money market fund manager to apply “prudent and rigorous internal assessment procedure for determining the credit quality of money market instruments, taking into account the issuer of the instrument and the characteristics of the instrument itself”. It is important for investors to know the credit quality of the fund to make informed decisions as to where to invest, thus the data given by MMF managers has to be correct and reliable. For this reason, ESMA is responsible for the development and issuance of technical standards specifying guidelines which managers have to follow when determining the credit quality of the instruments. Moreover, the proposed rules require supervising of a manager’s internal credit quality assessment process from senior management.

As part of the Risk Management Requirements, the proposal suggests the following minimum portfolio composition requirements for the short term money market funds and for the standard money market funds:
<table>
<thead>
<tr>
<th>Portfolio Characteristic</th>
<th>Proposed Short-Term MMF Requirement</th>
<th>Proposed Standard MMF Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum weighted average maturity (WAM)</td>
<td>60 days</td>
<td>6 months</td>
</tr>
<tr>
<td>Maximum weighted average life (WAL)</td>
<td>120 days</td>
<td>12 months</td>
</tr>
<tr>
<td>Minimum in daily maturing assets</td>
<td>10%</td>
<td>20%</td>
</tr>
<tr>
<td>Minimum in weekly maturing assets</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>CNAV or VNAV Pricing</td>
<td>CNAV only with 3% NAV buffer or VNAV</td>
<td>VNAV only</td>
</tr>
</tbody>
</table>

Table 1: Minimum Portfolio Composition Requirements for short term MMFs and standard MMFs (Goldman Sachs, 2013)

Money Market Fund Managers should have a procedure in place to conduct due diligence and should exercise it in order to get to know and understand the investors in the fund. This exercise is necessary to be able to anticipate correctly the effect of simultaneous redemptions on a number of investors.

In addition to this, the proposal requires the manager of every MMF fund to conduct stress testing on a regular basis while managers should also develop contingent
plans for any possible scenario. The proposed rules state that stress testing should be carried out at least yearly, however, the board of directors could decide to do it more often but the frequency is at their discretion. The results of these stress tests should be submitted to both the board of directors and regulators who would then forward the report to ESMA. The rules specify that the stress test to be carried out should assume hypothetical changes in the level of liquidity of the assets, changes in the level of credit risk of the assets held in the portfolio, as well as hypothetical movements in the levels of redemption and in interest rates.

The rules state that CNAV MMFs should be valued using the amortised cost method. Furthermore, MMF’s assets are required to be valued at least every day. The valuation is expected to be done using the mark to market when possible.

CNAV funds have additional requirements under the proposed regulations, one of which is that these funds should maintain a NAV buffer to at least 3% of the total value of the fund’s assets. This requirement should be satisfied by all EU MMFs within three years from the final rule. The buffer is held in a separate account from the Money market fund and it can only be in the form of cash. MMF managers may only use the buffer when the market net asset value is lower than the fund’s stable NAV. In a scenario where the buffer falls below 3%, ESMA and the competent authority of the respective fund have to be informed immediately and the buffer has to be topped up.
The commission’s proposal does not allow external support for Money market funds. However, in “exceptional circumstances justified by systemic implications or adverse market conditions”⁴, external support may be permitted given that the external support is limited both in terms of amount and time (Goldman Sachs, 2013).

2.8 Problems in Money Market Funds

Money Market Funds are known for being a convenient tool for investors to park their cash for a short period of time. Investors tend to utilise these funds because they are similar to bank deposit and also because they would have immediate access to liquidity and stability of value. However, if investors suspect that the MMF is struggling or will not be keeping its promise, they will start to redeem their money, which could potentially lead to a run.

An investor run could be dangerous for a MMF since assets have to be sold in an attempt to meet the outstanding redemption requests. On the other hand, this could be the reason for a spiral decline in the net asset value of the fund which would trigger fear that the fund is unstable.

⁴ Amendments 212-433 of the Committee on Economics and Monetary Affairs of 12th December 2013, Article 24a
When investors redeem large amounts at once, the fund has to dispose of the most liquid assets prior attempting to sell less liquid assets which are generally associated with higher liquidity costs because of higher redemption pressure. As redemption pressure persists, the MMF will sell more of its assets and the share price will keep falling (Commission, 2013).

In the event of a gap between the liquidity of the fund’s assets and the liquidity being offered to the investors, the investor lose confident in the fund and redeems his money as soon as possible. The first shareholders to redeem their money from the fund are said to obtain the first-mover advantage because first-movers tend to incur less liquidity cost and are likely to redeem at a stable NAV thus making more profit than those who redeem their investments at a later stage (IOSCO, 2012).

Liquidity cost depends on the quality of the fund which is determined by the maturity of the asset and its credit quality. Liquidity mismatch is attributable to both qualities thus it is important to manage both qualities properly. MMFs usually invest in high quality short term instruments such as government short term bonds, commercial paper and bank deposits. Nonetheless, during financial distress, these instruments can be affected and their quality may deteriorate (Commission, 2013).
2.9 Views of important institutions about the Proposal

2.9.1 Institutional Money Market Funds Association (IMMFA)

Despite that the Institutional Money Market Funds Association (IMMFA) agrees with the proposed rules for due diligence and enhanced transparency, it criticised the proposal because the proposed rules may force CNAV MMFs to transform into VNAV, which the association says it is of a detriment for the investors, the issuers and the economy. Furthermore, the association does not consider the 3% Capital buffer for the CNAV MMFs as a tool which will enhance systemic stability. On the contrary the association believes that it may create problems between the investor, the fund manager and the CNAV fund. IMMFA also believes that the buffer is uneconomical for the asset manager and as a result CNAV MMFs would convert into VNAV MMFs leaving investors with fewer choices. Also IMMFA noted that an arbitrage opportunity could be created if the EU uses the proposed capital buffer because American authorities (SEC) have rejected the use of capital buffer (IMMFA, 2013).

In January 2014, IMMFA published its recommendations in relation to the Commission’s proposal on MMFs. IMMFA is suggesting the introduction of redemption gate and/or fee provisions on CNAV MMFs. The association argues that if first mover loses the advantage over other investors, client redemption during financial distress will be mitigated. The redemption gate should apply only when weekly liquid assets decreases to 10% or more.
while liquidity fees should apply until the minimum weekly liquidity requirements are met (IMMFA, 2014).

2.9.2 Lobbyists

After the Commission published the proposal on MMFs, many lobbyists aired their views about it, and most of them complained about it. MMF providers in particular claim that the introduction of capital and cash requirements would eventually ban CNAV funds. These concerns were also raised by various authorities in a number of EU member states and were supported by the Finance Ministers of France and Germany.

The lobbyists’ complaints resulted in delays in the approval process of the proposal as the Economic and Monetary Affairs Committee (ECON) abandoned the proposal so that it will be voted on by the new parliament elected in May (Henn, 2014).

2.10 Money Market Funds in Malta

Over the last few years, Malta has been establishing a robust regulatory framework for financial services activities. Improvements are a constant process in order to
allow the country to offer a modern, flexible and principle – based business environment to the financial services sector. Malta is committed to enhance its financial sector and this resulted in an increase in the NAV of funds domiciled in Malta which according to a study by Ernst and Young, increased by 78% to a total of €8.7 billion from the year 2006 to 2007 while the total of licensed investment funds in Malta increased by 48% (Ernst & Young, 2009).

Although resident MMFs have grown the market share of MMFs in Malta has remained small compared to the Monetary Financial Institution (MFI) sector as a whole. In view of this and also because more statistics on this sector are now being collected, the Central Bank of Malta is now including data about MMFs with other MFI. This adjustment brought about only a moderate impact on the M3\(^5\). For example in June 2010, the inclusion of MMF deposit liabilities in M3 data resulted in an increase of 0.5% in OMFI (Central Bank of Malta, 2010).

\(^5\) As defined by the Governing Council of the ECB, M3 consists of the following components: holdings by euro area residents of currency in circulation plus certain liabilities issued by MFIs and, in the case of deposits, liabilities issued by some institutions which are part of the central government. These include: overnight deposits, deposits with agreed maturity up to 2 years, repurchase agreements, money market fund shares, money market paper, and debt securities with maturity up to two years (GÜNTER & VEGA, 1999).
Chapter 3 Methodology
3.1 Introduction

The purpose of this study is to examine the money market fund sector and analyse how the new regulations proposed by the European Commission would affect the sector particularly the Maltese MMFs. For this purpose it was essential to perform an extensive research to gather accurate data. The research design utilised to achieve the necessary data includes both desk research and sample selection. This chapter will include an elaborate explanation of these methods together with the respective limitation of both methods.

3.2 Data Collection Methods

Various methods were utilised to generate the secondary and primary data for this research. The majority of information gathering was for the purpose of building the literature review for this dissertation and to give a general background about MMFs. However, further research mainly by using primary data, was conducted to examine the view of MMF fund managers and financial lawyers on the possible impacts of the new proposal issued by the commission of the European Union to protect the investors of MMFs.
3.3 Secondary Data

In order to achieve the aim of this dissertation, the collection of secondary data will initially be utilised to identify the size of MMFs in the EU and in Malta. This data will be collected from documents issued on the matter by the European Commission and other documents issued by associations such as the EFAMA, which is the representative association for the European investment industry.

3.4 Primary Data

In order to fulfil the overall objectives of this dissertation a number of interviews were conducted. The interviewees include two MMF managers in Malta to analyse the views of local practitioners about the proposed regulation and the possible impact if any on the local market. Three financial law firms were also interviewed. This exercise is aimed at obtaining their view of how they think the future of MMF would change both in the EU and in Malta with respect to the proposal.
3.4.1 Personal Interviews

Personal Interviews is the method chosen to obtain the data necessary for this research because it gives the researcher the flexibility of clarifying answers and discuss issues with professional people in the sector. Thus, by interviewing the fund managers in person allowed the researcher to obtain the necessary information relevant to achieve the objective of this dissertation which was not published or documented before. Therefore any other form of collecting data would not have provided the researcher with the required data relevant to achieve the objectives of this study. This research method provide the researcher with a number of benefits which include the fact that questions could be explained to the interviewees in order to obtain more accurate answers as well as providing the possibility to the researcher to investigate deeper into the responses provided by the interviewees. The participants of these interviews are MMF fund managers and financial lawyers in Malta.

3.5 Criteria for Sample Selection

To conduct the necessary research, all the fund managers of MMF in Malta had to be interviewed. However, due to the restricted number of MMF managers it was decided to interview also a number of advocates who are familiar with EU financial directives.
Since the industry is small the fund managers interviewed are employees of large organisations in Malta. Also, because the research focuses on the current local situation, only local practitioners were chosen for this study. Thus the study shall reflect the opinion of the whole industry in Malta. On the other hand, financial lawyers were randomly chosen based on their experience in financial law and EU directives.

In Malta there are a large number of financial law firms, eleven of them were selected randomly to participate in the research, however, the majority of them declined to participate. Some declined participation stating that since none of their clients manage a Money Market Fund, they are not fully aware of the current situation. Some said that although they are aware of the proposed rules on MMFs they are not following closely the developments regarding the matter thus they are not knowledgeable enough to identify the impact that the Commission’s proposal may have on the Maltese MMFs. Therefore, only three law firms agreed to participate in this study.

Contact details of the interviewees were provided by MFSA officials however such details are also available on public domain mainly on the website of the organisation they work for.
3.6 Research Limitations

The limitations of this research mainly rely on the subjectivity of the information obtained from both the secondary and primary data because the interviews were based mainly on opinions and past experiences of the interviewees. Another drawback of the method could be the fact that the industry is very small in Malta thus although, the results achieved in this dissertation may apply to Malta, they may not necessarily apply to other countries in the EU. Furthermore, the regulations are still being debated and have not been accepted nor implemented in any country yet thus certain interviewees may not have the full knowledge or understanding of the proposed regulations nor its implications on the sector. Therefore, the researcher could be restricted as to the amount of information one could get because no evidence could be provided to sustain their views since the proposal is not legislated to date.

While all MMFs in Malta participated in this research not the same can be said for financial law firms thus limitations of this study include the small sample of financial law firms that participating in this study. The small sample may not be a good representation of all the legal firms in Malta and thus may distort the results.
Chapter 4  Research Findings and Data Analysis
4.1 Introduction

This chapter presents the information collected from face-to-face interviews conducted with a number of major local practitioners. Five structured interviews were conducted in order to achieve the objectives of this dissertation and thus this chapter explicitly expresses the views and opinions of the interviewees who accepted to be part of this study. The field research was conveyed according to the research methodology detailed in chapter 3. The interview questions can be found in Appendix B of this dissertation.

The experience of the interviewees varied over an extensive range; some of the respondents are relatively new to the market whilst others have a vast experience. For this reason and because the proposal has not yet been agreed upon or implemented some respondents did not have the full knowledge or experience to provide adequate detail for particular questions. Thus a number of respondents either refrained from commenting or tackled the question from a more general point of view.
4.2 Respondents

4.2.1 Fund Managers

In Malta there are three Money Market Funds, two of which are managed by the Valletta Fund Management company whilst the other fund named Maltese Money Market Fund is managed by HSBC Global Asset Management Ltd. All three funds are relatively small compared to other European MMFs. La Valette Sterling Money Fund is the smallest fund in Malta and the fund is dominated in the Sterling currency. It only holds £9.56 million (approx. €11.61m) and it is a feeder\(^6\) investing in a liquidity fund. The top holdings of the underlying fund are European but it is highly exposed to the UK’s economy. On the other hand, the second MMF managed by Valletta Fund Management is La Valette Euro Malta Money Fund, which is the largest MMF in Malta at €186.5 million. This fund only invests in Maltese securities thus the choice of assets to buy is limited.

On the other hand the Maltese Money Market Fund managed by HSBC Global Asset Management (Malta) Ltd has a pool of funds that adds up to €14.5 million. It differs from other MMFs in Malta because it allows for a maximum of 15% of total assets of the fund to be invested in non-Maltese assets; however, the base currency is in Euro.

\(^6\) A master fund is a fund which serves as an umbrella to other funds. The feeder funds receive the profits on a pro-rata basis in proportion to their investment (Investopedia, 2014).
4.2.2 Financial Services Lawyers

The researcher conducted interviews with financial services lawyers to understand how the implementation of the proposal (if approved by parliament) would affect MMFs from the legal perspective.

One of the law firms that specialises in financial law is Simon Tortell & Associates who has been involved in this sector for a long time. As a matter of fact, Simon Tortell & Associates have been the legal advisers of the first professional investor fund in Malta to be structured as a limited partnership. Another participant is a representative of CDF Advocates. The law firm specialises in funds and fund management, taxation and company law. Ganado Advocates also agreed to participate in this research. They are ranked as top-tier law firm by clients and peers alike (Finance Malta, 2014).
4.3 Findings

4.3.1 Local MMFs’ Internal Guidelines

The two fund managers were asked whether they have any internal guidelines in place specifically for MMFs and if they do have they were asked to mention a few. Both fund administrators said that they do have internal guidelines in place. HSBC’s Money Market fund manager, Mr David Lanzon said that as a global group the best practice is followed; they monitor the fund and its operation. Best practice also includes ensuring that the objectives stated in their prospectus are achieved to give the best service to their client.

On the other hand, Mr Anatoli Grech, the head strategy and regulatory affairs and Ms Dorianne Tabone who is the Investment Manager at Valletta Fund Management explained that the governance structure of the fund includes the fund manager, the custodian, the directors, and an audit on the SICAV\(^7\). The company has investment and the risk committees in order to monitor the outflows and inflows of the fund. Moreover Valletta Fund Management also has an Internal Risk Rating Mechanism that establishes a number of limits in terms of where to invest, and how much to invest in a particular bank. These limits depend on the bank’s financial situation, its deposit base and the liquidity ratio. These are soft limits, that is, guidelines to the

\(^7\) A SICAV is an open-ended collective investment scheme common in Western Europe.
fund managers; however they can be exceeded if there is a valid reason. In addition

to the mentioned quantitative analysis, the management is also adding the
qualitative aspect to the monitoring mechanism. This includes meeting the bank’s
officials to discuss the risks aspects, the governance structure of the bank and the
plans for the future and the strategy of the bank.

4.3.2 The necessary preparation to implement these new rules

The respondents were asked to give their view as to how Malta will be or is
preparing to implement the rules being proposed if they are approved by the
European Parliament and the European Council. Interviewees had different
opinions about how Malta will be preparing. Some said that since it is still a proposal
there is little to do at the moment other than keeping updated with any amendments
which might occur during the approval process. Dr Katya Tua from Simon Tortell &
Associates also stated that if it is approved, then Malta has to comply and this is
usually done in a timely manner by the local authorities and no exception for these
regulations should be expected. Moreover, Dr Chetcuti Dimech, a lawyer at CDF
advocates, pointed out that although it will have a direct effect in all EU member
states, the rules will not be transposed into MFSA Rules because it is a proposal for
a Regulation not for a Directive. However, Mr James Farrugia noticed that the
MFSA will have to amend its rules to be in synch with the proposed regulations.
From the perspective of the industry, Mr Farrugia said that it might not make a large
impact in Malta because there are few MMFs in Malta and they just have to abide by the rules.

On the other hand, the representatives from Valletta Fund Management explained that in preparation of the implementation of these new rules they are working to enhance their internal guidelines and to improve the monitoring system as explained in the previous answer. Moreover, the La Valette Euro Money Market Fund which currently a non-UCITS fund will be transformed into a UCIT fund and thus will have to follow the UCITS directive which means that it will follow more regulations than it currently does.

Both administrators stated that although more time is being dedicated at understanding the proposed requirements and to strengthen their internal guidelines, no extra staff were recruited or is planned to be recruited. However, more resources are being allocated at looking closely at the proposed regulation and to ensure that their funds are in line with the regulations.

Currently MMFs in Malta are following the developments of this proposal while evaluating and analysing the proposed requirements. The fund managers in Malta are ensuring that their funds are able to comply with the proposed rules, however, no major action have been taken so far because both funds are already following strict internal guidelines. Moreover, Malta can participate in discussions and make
recommendations through EU financial associations in order to air its views on the proposed regulations. However, if the proposed rules will be approved by the parliament and by the EU council, Malta has to abide by them.

4.3.3 The impact on the relationship between the Fund Manager and their clients

Most of the interviewees explained that the fund managers of MMFs do not have direct contact with clients; clients usually invest in MMFs through intermediaries. Others suggested that managers might have to alter the parameters of the fund because the new rules may be more stringent than UCITS directive. The impact of this may be harmful to the relationship between the client and the fund administrators because investors are used to more flexibility. Dr Katya Tua also indicated that ultimately the expenses to adhere to the new rules will have to be borne by the investor thus the investor will decide whether to invest in MMF or find other alternatives. However, it is not believed that these rules will kill the MMF market. On the other hand, Mr Grech, said that the rules should not impact the relationship between the client and the fund manager because from the company’s past experience although most of the clients are aware of the rules, they are not knowledgeable enough about such regulations. In this regard the company is taking the initiative to inform and educate the clients about the management of the fund, the requirements and the rules that safeguard the interest of the investor.
All in all, it is not believed that the proposal will change the relationship between the money market fund managers and their clients; nonetheless, managers assume the responsibility to inform the clients with the currency developments in the market and ensure that their client’s investments are safe.

4.3.4 How would MMFs in Malta change?

As shown in Figure 4.1, the majority of the respondents believe that MMFs will still continue to be used as parking funds despite the proposed regulations. The interviewees acknowledge that a number of changes are positive and can help strengthen the MMFs in the future. Thus the general opinion is that there will be minimal impact on the MMFs in Malta if the proposed regulations were to be implemented.

![Figure 4.1: How MMF in Malta would change](image-url)
Moreover, clients are aware of the benefits that such parking funds offer, however, if the regulations bring the fund in a situation where returns are lower, then the funds may become less attractive. An example of a negative regulation in this regard pointed out by Mr Grech is the 3% cash capital buffer; this means that part of the investors’ money remain parked and idle thus the fund will yield lower return.

There are fears that if the proposal was to be implemented, the market will be killed but in reality it has to go through a process of amendments and then it has to be approved by the European Parliament and the European Council. The proposal will not be approved if any of these two European institutions believe that it might kill the market because ultimately the scope is not to kill the market but to safeguard the markets’ participants.

Mr Farrugia also explained that the MMFs have to change in terms of their composition in order to be able to fulfil the requirements and to remain sustainable. Since the funds in Malta are small the impact on Maltese MMFs will be small thus less people will bear the impact of these requirements. This scenario contrasts with the one found in Ireland which is home to large MMFs whereby the impact is expected be big because of the large number of funds and their large size.
4.3.5 Would Malta be at a disadvantage?

If proposed rules are issued as Regulations they will be directly applicable to all EU member state thus there will be no option other than to abide by them. It is also expected that member states will put pressure on other member states to implement these regulations. Furthermore, ESMA has the power to ensure that regulations are implemented and if not it has the power to look into why they were not implemented.

However, the main problem identified by respondents is that Maltese funds invest mostly in local instruments and due to the small size of the Maltese financial sector the availability of local short term money market instruments is limited. Dr Chetcuti Dimech adds that the regulation is designed for the big funds and not the small ones like the Maltese.

Some respondents do not think that the proposal will put Malta at a disadvantage because the rules are to be implemented across all the EU member states, in fact the purpose of these rules are to have a level playing field. However, Dr Tua pointed out that the EU has to be careful that implementing these rules would not mean losing competition to U.S. Although the EU has to ensure that investors are protected, it also has to ensure that the returns that European MMFs yield are competitive with US MMFs otherwise MMFs would shift to the US. The following figure summarises the opinions of the respondents:
Three from five respondents believe that Malta will be disadvantaged because most of the Maltese MMFs invest in local MMF instruments which mainly constitutes of short term bank deposits and treasury bills. Current MMF managers in Malta are already finding it difficult to find adequate instrument to invest in which are in line with the EU guidelines and the internal guidelines thus further restrictions may further reduce the options thus return may be lower than other MMFs which has a wider range of instruments to choose from.
4.3.6 Respondents’ views on the Commission’s proposal

Two of the interviewees think that the proposal is good and it addresses a number of issues that the market has faced over the past few years, particularly in the case of a run when the financial markets are in distress. If the clients withdraw their money from a MMF, the fund has to withdraw the money from their investments thus such runs have a ripple effect on other financial institutions. The recommendation will be addressing these issues of shadow banking and systemic risks amongst others. The recommendations made so far are based on large funds thus a small market with small funds like Malta may find it difficult to fully abide by these rules. Some respondents suggested that these rules should be flexible enough to allow regulators of small states like Malta to widen the parameters.

However, others disagree with the proposal on the basis that most MMFs are regulated under the UCITS directive or the AIFD and the CESR guidelines, thus adding another level of regulation to UCITS and AIFs amounts to regulatory overkill. Some respondents also argued that there is not enough evidence to substantiate the need for specific and more rigorous regulations on MMFs. The proposal also regulates the product rather than the service provider or investor qualifications to invest. It is protecting mainly institutions that do not need any more protection.
The overall view on the proposal is that it is not necessary to add further regulation to the current directives which already covers MMFs, namely UCITS and AIFMD. The funds are already subject to rigid regulations and additional rules can only serve to limit the opportunities and reduce the returns to the investor.

4.3.7 Will the benefits outweigh the expenses?

During the interviews the respondents were asked to give their views on whether or not the benefits derived from the proposal will outweigh the expenses that have to be incurred to abide by the new rules. As Figure 4.3 demonstrates, 60% of the respondents believe that the benefits will not outweigh the expenses that have to be incurred for funds to abide by the new regulations. All respondents agreed that adding another level of regulation means that compliance costs have to increase.
Some think that because of these additional costs it is likely that small to medium size MMFs will be killed. This may happen because the return of MMFs is already small. Since management fees are low and compliance costs are increasing, it will not be worth running a MMF.

Two of the respondents insisted that Malta will not be at a disadvantage because all EU MMFs will have to incur more compliance costs, thus the costs of running such funds will increase in all EU member states. Mr Farrugia also pointed out that in the case of Malta, the compliance costs are cheaper than foreign compliance costs, but on the other hand, the size of the funds in Malta are much smaller compared to similar funds abroad. Therefore, the returns of MMFs are expected to decrease in all EU member states in proportion to the size of the fund.
It was also noted that although already established funds may cope with the increase in expenses to run the MMF, it is more difficult to open a new MMF because the set up costs will be much higher than it is today. Thus, although many believe that the current MMFs will not close, the probability that the number of MMFs in Malta will increase is slim.

Some of the respondents recounted from their experience, how the implementation of new rules will lead to an increase in the fund’s expenses thus the return for the shareholders is constantly decreasing. In the case of Constant NAV, where prices has to remain stable, the manager may bear parts of the costs but in the case of Variable NAV funds the expenses are always borne by the shareholders which may result in higher volatility that leads to less investor confidence.

It can be concluded that adding new rules on MMFs does not seem beneficial for the investor who is seeking to earn returns on his temporary excess cash. If the return earned from MMFs falls considerably, investors may start using bank deposits or other parking funds as an alternative to MMFs.
4.3.8 The effect on MMFs’ liquidity

By nature Money Market Funds have to be highly liquid offering daily liquidity. These funds are managed in a way that if a shareholder withdraws a large sum of money overnight the fund will be able to pay the shareholder when the redemption request is made.

When interviewees were asked whether they think that the liquidity of MMFs will be affected by the proposed regulations, respondents gave different answers. Some stated that the rules are encouraging more liquidity; the capital buffer is an example of this initiative. However, the regulations are increasing the restrictions on alternatives where to invest. Others stated that by default MMFs are probably the most liquid funds in the market thus the new rules will not make the funds more liquid.

Other said that local Money Market Funds are already investing in overnight securities to ensure high liquidity thus these rules are not expected to affect the liquidity of Maltese funds. Another respondent said that it is too early to comment about how the liquidity will be affected, however, the rules are aimed at increasing liquidity.
4.3.9 Will future runs be mitigated?

All respondents agree that the new regulations are proposed on the premise that they will mitigate systemic risk, however, not all respondents believe that these regulations can actually reduce the possibility of future runs on MMFs. MMFs are serving their purpose, thus imposing additional rules on the product is not the solution at this stage.

Many believe that there are initiatives which may lead to fewer situations that create high outflows. However, the risk of runs is always present. Mr Grech explained that there is always the possibility of large redemptions but these regulations should decrease the impact that such redemptions may have on the financial system. For this purpose one of the measures proposed by the Commission is the limit on how much a MMF can invest in one security. The proposal suggests that MMF invest a lower percentage of the total assets with one issuer than it is currently allowed. In this way, the ripple effect of large redemptions is minimised.

Another respondent also explained that in the case of Malta the potential of a run is low thus the proposed rules may only mitigate the risk slightly. However, from an EU perspective, the regulations are more likely to mitigate the risk, because other EU MMFs are more exposed to risks than the Maltese MMFs. The respondent observes that EU clients in general are more aware of what is happening in the markets than
Maltese investors particularly retail investors. Thus, if EU investors notice that the markets are not performing well they are more likely to redeem their money than Maltese clients.

One of the respondents was unsure whether the proposal would actually mitigate the possibility of a MMF run. 40% of the respondents said that the proposed rules are likely to result in lower possibility of runs, however they emphasised that systemic risk is and will always be present; the rules help to prevent such events. On the other hand 40% said that they don’t think that the proposal will mitigate MMF run; they argue that overregulation may create more obstruction to the investor and to the fund manager.

4.3.10 Was the proposal necessary?

All the respondents acknowledge the importance of MMFs in the financial system as well as the importance of being properly regulated but only 60% agree that the proposal was necessary (see Figure 4.4). Some of these respondents also added that although it is essential to have the necessary regulation in place they seem to be a bit excessive.
The difficulties and the impact of large outflows on the banking sector and the financial system in general are believed to be mitigated if these rules are implemented. However, some respondent noted that it would be better if the proposed rules are not implemented to the full extent particularly for small funds. It was suggested that the rules will be less rigid for small funds and provide wider limits in order for small MMFs to remain sustainable and competitive.

Moreover respondents differentiated between the needs of the EU MMFs and the needs of the Maltese funds. In the Maltese scenario the regulations are not likely to make the funds safer because they are already complying with the CESR guidelines and additional internal limits. On the other hand, the EU needs to have these
regulations because they enhance the integrity MMFs and thus they keep the market stable.

Nonetheless, 40% of the respondents believe that these regulations are not necessary because MMFs by nature are not risky. In addition to this they are already regulated by other directives such as the UCITS, AIFs and EU guidelines thus it is already unnecessarily over regulated.

Therefore, while many agree that regulation on MMFs is necessary, the debate as to how to regulate these funds remains. One respondent suggested that instead of regulating the product the EU should regulate the selling of the product because the product is already overregulated. There are other rules regulating the selling of investment products such as MiFID and PIFs however, the respondent argue that new rules have to clarify further what type of disclosure the fund should provide to the investor and to ensure that products are not mis-sold.
4.4 Conclusion

To conclude, this chapter analysed the views of local practitioners about various aspects of the proposal. All in all, the respondents are aware of the problems that MMFs have been encountering particularly in the rise of the financial crisis; however, there is no general consensus that the proposed rules are the solution to the problems especially for the Maltese funds because the problems and the needs of local funds are different from other large EU funds.
Chapter 5  Conclusion
5.1 The impact on Maltese MMF

The Maltese financial industry is striving to maintain its high standards in the financial services and the MMF sector is no exception to that. All three Maltese MMFs have internal structures to monitor both the operations and the conduct of the administrators. Even though the CESR guidelines are not enforced by law, the Maltese fund administrators seek to adhere to the guidelines thus the MMF sector in Malta is believed to be sound and further regulation may create more problems.

The research singled out one main problem which is unique for small funds, this is the lack of choice of domestic short-term deposits and treasury bills that meet the requirements of a MMF and follow the internal guidelines of the respective fund. This is currently already an issue for a number of reasons:

i. most of the funds invest in local short-term deposits only

ii. Not all banks meet the necessary ratio requirements

iii. Difficult to find short-term deposits or treasury bills to keep the fund liquid.

Therefore, further regulation would decrease the number of securities that match the requirements of a local MMF this means less options will be available for the fund manager. Furthermore, the research also shows that compliance costs can put strain on the return to the shareholders. Therefore lack of choice where to invest
and decreasing returns may force changes in the structure of MMFs in Malta. They may have two alternatives to survive which are: either transforms CNAV to VNAV funds or else to invest in foreign deposits and treasury bills.

5.2 Impact on EU MMF

Since the liquidation of the Reserve Primary Fund, MMFs in the EU have been subject to a number of European and International guidelines, however, this is the first time that the EU has proposed rules to be adopted as regulation. This means that all EU member states have to adhere to these rules. This is a measure by the EU for all EU MMF to be in a level playing field in terms of standards. However, local have expressed concerns that due to the small size of the sector, Maltese MMF may find it difficult to compete with EU Money Market Funds in terms of yields.

The analysis also concludes that on an EU level it is unlikely that the proposed rules cause significant changes in the form or size of MMFs. Although it is more difficult to keep a stable NAV when more rules are enforced the research does not show that shifts from CNAV funds to VNAV funds will increase following the implementation of the proposal. This can be said for both the EU and the Maltese MMF.
5.3 General Conclusions

All in all, the research demonstrates that there are different views about the proposal and some of them are contradicting. Most respondents think that Malta will be disadvantaged because of its size, which may translate in diminishing investor confidence; however, the study shows that the impact of the proposed rules on Maltese MMFs will be minimal.

Other incongruent views revealed in this research is that the benefits resulting from the proposed rules will not outweigh the compliance costs, nonetheless, the study shows that it is still necessary to have these regulation to govern EU MMFs.

5.4 Further Research

An extension of this study might be a research studying the impact of the proposal in all EU member states to get the views of all the practitioners in the EU. In this way one could have a good grasp of how the proposed rules will affect the MMFs in the union. Also, a wider study will identify whether the problems of Maltese MMFs that may be encountered due to the new proposal are found in other states.
The main focus of this dissertation was how Malta and the EU in general will be affected by the European Commission’s proposal if implemented. However, a further extension of this study could be the comparison between the EU proposal and the US regulations on MMFs. A study of the differences and the similarities of the proposed rules of both EU and U.S. will measure the competitiveness of the funds in both jurisdictions.
APPENDIX A  LIST OF INTERVIEWEES

Mr Anatoli Grech  
and  
Ms Dorianne Tabone  

Mr David Lanzon  
HSBC Global Asset Management (Malta) Ltd  

Dr Katya Tua  
Simon Tortell and Associates  

Dr Frank Chetcuti Dimech  
CDF Advocates  

Mr James Farrugia  
Ganado Advocates
APPENDIX B  NUMERICAL RESULTS OF THE FINANCIAL PRACTITIONER’S PERSPECTIVE

1. Do you have internal guidelines in place to protect your clients

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<tbody>
<tr>
<td>Yes</td>
<td>2</td>
<td>100%</td>
</tr>
<tr>
<td>No</td>
<td>0</td>
<td>0%</td>
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</table>

2. How is Malta preparing or will be preparing for the implementation of these new rules?

<table>
<thead>
<tr>
<th>Initiative</th>
<th>1</th>
<th>20%</th>
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</thead>
<tbody>
<tr>
<td>Initiatives are underway</td>
<td>1</td>
<td>20%</td>
</tr>
<tr>
<td>No need to transpose the rules into MFSA (it's not a proposal for a Directive)</td>
<td>1</td>
<td>20%</td>
</tr>
<tr>
<td>Amendment of MFSA rules will be necessary</td>
<td>3</td>
<td>60%</td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>100%</td>
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</table>
3. Do you think that the proposed regulations (if implemented) would change the relationship fund manager with their clients?

<table>
<thead>
<tr>
<th>Detrimental Impact</th>
<th>2</th>
<th>40%</th>
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<tbody>
<tr>
<td>No direct relationship between the two</td>
<td>2</td>
<td>40%</td>
</tr>
<tr>
<td>No impact</td>
<td>1</td>
<td>20%</td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>100%</td>
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</tbody>
</table>

4. If the proposed regulations were to be implemented, how do you think the MMF sector in Malta would change?

| MMF may become less attractive | 1  | 20% |
| Very Negative Impact on Local MMF | 1  | 20% |
| Minimal Impact                | 3  | 60% |
|                            | 5  | 100%|
5. Would Malta (compared to other EU member states) be at a disadvantage if these regulations are implemented?

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<tr>
<td>Yes</td>
<td>3</td>
<td>60%</td>
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<tr>
<td>No</td>
<td>2</td>
<td>40%</td>
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6. What are your views about the commission’s proposal?

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<tbody>
<tr>
<td>Good</td>
<td>2</td>
<td>40%</td>
</tr>
<tr>
<td>Not Necessary</td>
<td>2</td>
<td>40%</td>
</tr>
<tr>
<td>No view at this stage</td>
<td>1</td>
<td>20%</td>
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<tr>
<td></td>
<td>5</td>
<td>100%</td>
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7. Do you think that the potential benefits of this proposal will outweigh the new expenses that will have to be incurred to abide by these new rules?

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<tr>
<td>Yes</td>
<td>1</td>
<td>20%</td>
</tr>
<tr>
<td>No</td>
<td>3</td>
<td>60%</td>
</tr>
<tr>
<td>Not sure</td>
<td>1</td>
<td>20%</td>
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8. Would these new regulations affect the liquidity of MMF in Malta?

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<tbody>
<tr>
<td>Positive Effect</td>
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</tr>
<tr>
<td>Negative Effect</td>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>No Effect</td>
<td>2</td>
<td>40%</td>
</tr>
<tr>
<td>Is yet to be seen</td>
<td>1</td>
<td>20%</td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>80%</td>
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9. Do you think that these regulations will mitigate the possibility of future runs?

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<td>Yes</td>
<td>2</td>
<td>40%</td>
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<tr>
<td>No</td>
<td>2</td>
<td>40%</td>
</tr>
<tr>
<td>Not sure</td>
<td>1</td>
<td>20%</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>5</strong></td>
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10. Do you think that there was the need for this proposal? Why?

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<td>Yes</td>
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<td>60%</td>
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<tr>
<td>No</td>
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<td>40%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>5</strong></td>
<td><strong>100%</strong></td>
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</table>
BIBLIOGRAPHY


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SEC, 2013. *Money Market Fund Reform; Amendments to Form PF*, s.l.: SEC.