Investments of Money Market Funds

in Securitizations and ABCPs under upcoming EU Regulation

Background

In response to the effects the financial crisis had on Money Market Funds (**MMF**), in 2013 the European Commission (**Commission**) proposed a regulation on MMF. On 20 April 2015 the European Parliament adopted amendments to the Commission's proposal and on 15 June 2016, the Council of the EU agreed its "general approach". Trilogue negotiations concluded on 7 December 2016, when the Permanent Representatives Committee approved, on behalf of the Council, an agreement with the European Parliament on the proposed regulation (the **Regulation**). The Regulation was adopted by the European Parliament on 5 April 2017 and by the Council on 16 May 2017. The Regulation is now due for publication in the Official Journal of the EU. The Regulation will enter into force on the twentieth day following that of its publication in the Official Journal.

The Commission's intention in proposing a regulation was to improve MMFs' ability to weather stressed market conditions. The financial crisis in 2008 highlighted several weaknesses of MMFs, in particular issues relating to instantaneous redemption and value preservation when the prices of assets in which MMFs are invested start to decline. Large redemption requests could force MMFs to sell some of their investment assets in a declining market, potentially fuelling a liquidity crisis. This could lead to wider consequences for financial institutions or the economy because of money market issuers struggling with funding difficulties.

The Regulation tries to reduce these risks mainly through establishing a capital buffer, introducing conditions on portfolio structure, addressing over-reliance on external credit rating agencies and improving their internal risk management, transparency and reporting.

This article discusses investments of MMFs in securitizations and ABCPs.

Investments in Securitizations and ABCPs

The Regulation gives specific guidance on the circumstances under which future investments in securitizations and ABCPs will be permissible for an MMF.

An MMF is generally entitled to invest in a securitization or ABCP if several conditions are met. A securitization or an ABCP has to be sufficiently liquid, it must have received a favourable credit quality assessment and must meet requirements relating to maturity. A securitization must also comply with the Level 2 B requirements for highly liquid securitizations as set out in Article 13 of Commission Delegated Regulation (EU) No 2015/61. ABCP can be an eligible asset if it is issued by an ABCP program are also which is fully supported by a regulated credit institution, is not a re-securitization and the exposure underlying the securitization at the level of each ABCP transaction does not include any securitization position and does not include synthetic securitizations. Simple, transparent and standardized (**STS**) securitizations and ABCP are also classified as eligible assets under the Regulation.. The text of the regulation which contains the framework and criteria for STS securitizations (including ABCP) is still being negotiated under the trilogue procedure (the **Securitization Regulation**). The Regulation provides for an amendment to be made to the provisions detailing the requirements for eligible securitizations and ABCP by way of a delegated act (the **MMF Delegated Act**) once the Securitization Regulation has been finalised to incorporate appropriate cross references to the STS criteria.

The Regulation distinguishes between "Short-term MMF" and "Standard-MMF". This distinction is relevant tor permitted investments in securitizations and ABCP.

A short-term MMF is only entitled to invest in securitizations or ABCP if the legal maturity is less than or equal to 2 years and the time remaining until the next interest rate reset date is less than or equal to

397 days, the residual maturity or the legal maturity at issuance is 397 days or less and if the securitization is an amortizing instrument and has a weighted average life of less than or equal to 2 years. Whilst such rules in general also apply to a Standard MMF, a Standard MMF is not entitled to invest in securitizations the residual maturity or legal maturity of which is at issuance 397 days or less.

Although the initial proposal of the Commission did not prohibit investing in securitizations or ABCPs, the ability to actually invest in a securitization or ABCP was rather limited due to restrictive provisions prescribing the nature of the underlying assets and their maturity. However, following their discussions with the industry, the European institutions acknowledged that the focus on the legal maturity of an instrument does not appropriately match the risk profile of an amortizing securitization. Such a difference is also of importance for investments of an MMF. A MMF is generally intended to invest in short-term finance instruments. However, the legal maturity of a securitization is usually five years or more. During the trilogue process, the European institutions realized that strict adherence to the legal maturity falls short of the actual risk profile of a securitization. One has to take into account that the weight average life (**WAL**) of a securitization with a legal maturity of five years is in the area of 1.2 years. Such WAL actually determines the point in time when the substantial part of the risk associated with a securitization has disappeared. Therefore the WAL is the correct figure to determine whether a securitization is suitable for an investment by an MMF. Accordingly, the Regulation now sets out two thresholds on WAL for permitted investments by MMFs in securitizations. Firstly, the WAL of the securitization itself will be crucial going forward, due to the fact that an MMF is only entitled to invest in securitizations with an WAL of less than or equal to two years. Secondly, a portfolio of a Short-term MMF shall have a WAL at all times of no more than 120 days and a portfolio of a Standard MMF a WAL at all times of no more than 12 months.

The Regulation includes limits on the percentage of assets that a MMF may invest in securitizations and ABCP. Until the MMF Delegated Act comes into effect (which depends upon when the Securitization Regulation is finalised), the aggregate of all exposures to securitizations and ABCPs must not exceed 15% of the assets of a MMF. After that date, the aggregate of

all exposures to securitizations and ABCPs shall not exceed 20% of the assets of a MMF whereby up to 15% of the assets of a MMF may be invested in securitizations and ABCPs not compliant with the criteria for the identification of STS securitizations and ABCPs. The Regulation also contains provisions detailing diversification requirements and concentration limits for investments of MMFs. A MMF must invest no more than 5% of its assets in money market instruments, securitizations and ABCPs issued by the same body and may not hold more than 10% of the money market instruments, securitizations and ABCPs issued by a single body.

Future prospects

With this new Regulation, investment by a MMF in a securitization or ABCP is still possible in a broad way. For those corporations that fully supported ABCP programs being excluded from the securitization limits to ensure better investment opportunities, the Regulation is a suitable compromise between the EU institutions desire to further regulate the financial markets and the need of MMF to invest in highly rated securitizations and ABCP.

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