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ESMA's Final Report on the Money Market Fund Regulation

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Background

Following on from its consultation in May of this year, ESMA has published its final report comprising technical advice, draft implementing technical standards and guidelines under the MMFR[1] (the "**Final Report**"). The Final Report provides welcome clarification on some of the more technical requirements being imposed on managers of MMF under the MMFR.

Technical Advices

(i) *Liquidity and credit quality requirements applicable to assets received under a reverse repurchase agreement*

In its technical advices, ESMA provides further guidance on the liquidity and credit quality requirements applicable to assets received as collateral under a reverse repurchase agreement which do not constitute "eligible" money market instruments under the MMFR. In particular, the technical advices indicate that such transferable securities or money market instruments must comply with the same quantitative and qualitative credit quality requirements which are applied by managers when assessing the credit quality of money market instruments to be acquired by an MMF. The liquidity requirements applying to collateral which do not constitute "eligible" money market instruments under the MMFR will depend on the risk

[1] Regulation (EU) 2017/1131

of the default of the counterparties to the reverse repurchase agreement and the applicable counterparty risk diversification limit. While no additional constraints will apply on the collateral received from high quality counterparties, in the case of a reverse repurchase agreement with a lower quality counterparty, a mandatory minimum haircut on collateral received by the MMF will be imposed in order to absorb the liquidity costs of liquidating assets.

(ii) Criteria for validation of the credit quality assessment methodologies

Under the MMFR, a manager of a MMF must implement an appropriate internal credit quality assessment procedure for determining the credit quality of instruments which may be acquired by an MMF. It must also validate the methodologies used as part of this procedure. The technical advices now helpfully set down specific criteria which must be taken into account when validating the credit quality assessment methodology in order to ensure that the methodology is prudent, systematic, continuous and subject to validation. In this regard, ESMA has noted that it has made certain elements more proportionate than those originally proposed in the consultation paper which were considered more appropriate to credit rating agencies than MMF.

(iii) Criteria for quantifying the credit risk of an issuer

The technical advices also set down quantitative criteria which should be taken into account in implementing the credit quality assessment process. ESMA provides that the methodology used by the manager of an MMF should take into account certain specific criteria which include bond pricing information, credit default-swap pricing information and pricing of money market instruments relevant to the issuer. Financial information relating to the issuer must also be taken into account.

(iv) Qualitative indicators on the issuer of an instrument

The technical advices also set down the criteria for some qualitative indicators on the issuer of the instrument which should be incorporated into the credit quality assessment process implemented by the manager of the MMF. Amongst others, these include an analysis of any underlying assets, analysis of any structural aspects of the relevant instruments issued by an issuer and an analysis of the relevant market including the degree of volume and liquidity.

(v) Assessment of aspects of an issuer of an instrument

The technical advices also set down the criteria which should be incorporated into the credit quality assessment process in order to assess certain specific aspects of the issuer of an instrument. Managers of MMFs will need to ensure, to the extent possible, that the financial condition of the issuer and sources of liquidity of the issuer amongst other matters are assessed. The technical advices also confirm that while a manager may override the results of a credit quality assessment, it may only do so in exceptional market conditions and where there is an objective reason for so doing. Helpfully the technical advices also provide some clarity on the circumstances in which a manager should undertake a new credit quality assessment where there has been a material change that could impact on the existing assessment of an instrument. Amongst others, these include a material change in the pricing information available on the relevant information, analysis of the underlying assets or relevant markets and the financial condition or sources of liquidity of the issuer.

Technical Implementing Standards: Establishment of Reporting Template

The Final Report also incorporates draft implementing technical standards ("**ITS**") which establish a reporting template to be used by MMF managers when reporting information to the competent authorities on a quarterly basis. While ESMA notes that due to the feedback received in respect of the consultation paper, the ITS on the reporting template have been "greatly simplified" from the reporting template included in the consultation paper, the template still runs to over 30 pages.

The ITS have now been submitted to the European Commission for endorsement. Once endorsed, the ITS will be adopted by the European Commission by way of implementing acts. The Final Report confirms that first quarterly reports will need to be submitted to national regulators in October/November of 2019 (rather than July 2018). It also confirms that there will be no requirement to retroactively provide historical data for any period prior to the starting date of the reporting.

ESMA Guidelines on Stress Test Scenarios under Article 28 of the MMFR

The Final Report also incorporates ESMA guidelines on stress test scenarios (the "**Guidelines**") which are addressed to both national regulators and MMF and their managers.

The Guidelines establish common reference parameters which must be observed when conducting the stress testing required under the MMFR. Rather than imposing specific quantitative criteria or thresholds for such purposes, the first section of the Guidelines sets down principles which must be adhered to in implementing appropriate stress testing processes in order to identify events or future changes in economic conditions which could have an unfavourable effect on the MMF.

The second part of the Guidelines sets down common reference stress test scenarios which must be conducted in respect of an MMF. The results of such stress test scenarios will need to be incorporated into the quarterly report which must be submitted by managers of the MMF to the relevant competent authority. This will allow ESMA and competent authorities to compare the results of the stress tests of the MMFs across Europe, with ESMA citing this as a "significant enhancement" to the monitoring of MMF within the EU. ESMA intends to update the Guidelines at least yearly to take into account latest market developments.

The Guidelines will apply from the transposition dates applicable to new and existing MMF set down in the MMFR.

Share Destruction

Finally, readers may recall that in its consultation paper, ESMA had indicated that it did not consider requiring information on the “destruction” of shares to be included in the quarterly reporting to competent authorities because ESMA understood that the destruction of shares was not allowed under the MMFR. ESMA has advised that in light of the feedback received on the issue of share destruction, it has sought legal advice from the European Commission on the point. It has advised that depending on the legal advice it receives from the European Commission, it may take necessary follow-up actions, which may include updating the reporting template to require managers of MMF to provide additional information in respect of share cancellation.

Conclusion

We await with interest the outcome of the legal analysis undertaken by the European Commission on the issue of share cancellation given the potential impact any positive or negative conclusions taken by it may have on the European MMF industry. In the interim, the publication of the Final Report is to be welcomed for the greater certainty it provides to MMF managers in implementing appropriate compliance frameworks in advance of the implementation date of MMFR.

For further guidance on the implementation of MMFR or on the establishment of a new MMF, please contact Brian Kelliher, Cillian Bredin or your usual Dillon Eustace contact.

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