

AERIAL VIEW

ACCESS A BROADER MARKET PERSPECTIVE



**SHAKEN,
NOT STIRRED**

BY LYNN STRONGIN DODDS

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New rules that reshaped the European money market fund universe this spring have barely dented investor appetite for the EUR1.3 trillion industry, and in fact could increase its size as firms look to diversify away from bank deposits, some industry experts say.

The regulations—which were delayed until March, two months after the original Jan. 21, 2019 deadline—are aimed at improving transparency, disclosure and liquidity in the funds following deficiencies seen in the 2008 financial meltdown.

Investors took the new rules in stride, in all fund types and in every currency, in part because the changes were well flagged and fund managers were able to prepare by shortening their exposures and raising additional liquidity in anticipation of any potential capital flight.

In the end, cash transitioned in an orderly fashion, primarily out of short-term money funds with stable values into new low volatility vehicles. “On the date of changeover it was just like a normal business day,” said Michelle

Price, associate policy and technical director for the Association of Corporate Treasurers in London.

The re-categorization and launches of new funds make it difficult to track what money went where, but it is clear that assets in euro and U.S. dollar-denominated European money market funds have fallen year-to-date in 2019, according to Crane Data. Still, investors on the side lines are expected to tiptoe back in.

It is early days and the European rules will take time to bed down, but institutions with large liquidity balances are already back to scouting for fruitful places to park their cash. Money market funds could see an increase in their assets if benchmark deposit rates set by the region’s central bank continue to stay negative. Cash is expected to come trickling back in, just as it left money funds and returned when interest rates in Europe first went negative in 2014.

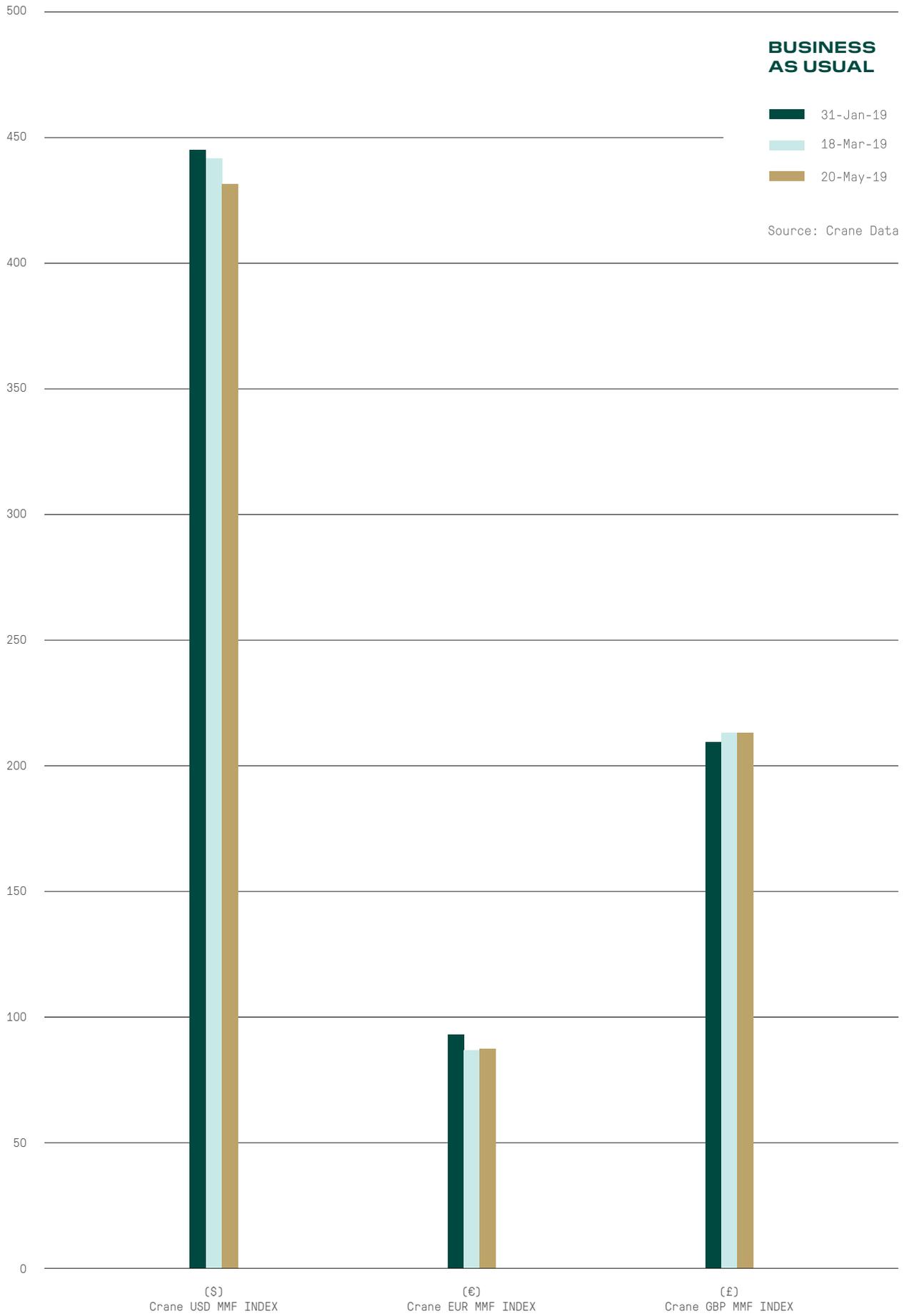
Bank deposits have traditionally been the preferred investment option for corporate treasurers in the UK and Europe, according to the ACT, but money market funds continue to be attractive.

For one thing, interest rates on deposits tend to lag increases in benchmark rates because they are set by bank committees, unlike money rates that immediately reflect increases in marketplace rates. Another reason is that some banks do not want to attract heavy cash deposits when they are costly to hold under post-crisis liquidity ratio regulations.

Even customers who continue to wait it out by investing in bank deposits or directly in cash-like securities may come back to money funds, because of their stability and attractive yields, some experts say. They offer a diversification of counterparties; a wide-ranging pool of underlying investments; and, in the case of almost all short-term European funds, triple-A ratings.

Given the low interest-rate environment in Europe, there are few places where corporates can park their cash safely. “We’re not seeing cash leaving money market funds into bank deposits,” said Robert O’Riordan, institutional business development director at BNY Mellon’s Insight Investment, a specialist asset manager. Clients with

BILLIONS



large cash balances are increasingly looking to diversify away from single counterparty exposure to a few relationship banks,” he adds.

MULTIPLE CHOICE

Post-reform, investors have a new mix of choices for their money fund investments, including a new one called a short-term low volatility net asset value fund, whose price should remain stable under normal conditions but can fluctuate within a 20 basis point collar before investors experience a change in value on their shares. If that collar is breached, the fund’s price must be expressed in four decimal places instead of two.

The low-volatility net asset value (LVNAV) funds generally replaced another category called short-term “prime” constant net asset value (CNAV) funds, for investing in corporate and government debt. Meanwhile, short-term Treasury CNAV funds are now categorized as “Public Debt” constant net asset value (CNAV) funds and they must invest the vast majority of their holdings in government debt.

A third option, available before and after reform, is variable net asset value (VNAV) funds. These funds’ prices may fluctuate daily and must always be displayed out to four decimal places.

Both the short-term low volatility funds and public debt funds are subject to the most conservative daily and one-week liquidity minimums, as well as liquidity fees or temporary gates on withdrawals if a fund’s liquidity and/or redemption levels meet certain thresholds. By contrast, variable NAV funds are not subject to these new provisions.

The low volatility funds are seen as the “missing link” between constant NAV and variable NAV funds and in most market conditions will offer a stable unit value, says Alastair Sewell, senior director for fund and asset management at Fitch Ratings.

“People have generally shown a preference for the LVNAV fund type because the end user experience in normal markets will be much closer to the former CNAV (prime) or stable funds,” Sewell notes.

ON THE MENU

Investors have new choices in the wake of the European money market fund reforms. Here’s a look at their options:

LOW VOLATILITY NET ASSET VALUE (LVNAV)

A new category that enables investors to redeem at a stable NAV, calculated to two decimal places, provided the fund’s actual NAV compared to its mark to market value does not deviate by more than 20 bps. Investments can go out to 397 days but the fund’s weighted average maturity must be 60 days or less. Investments include money market instruments such as certificates of deposit, repos, corporates and sovereign debt. They are subject to liquidity gates and fees.

PUBLIC DEBT CONSTANT NET ASSET VALUE (CNAV)

Public debt funds must invest 99.5% of their portfolios in cash, government debt or reverse repurchase agreements secured by government debt. They are subject to liquidity gates and fees.

VARIABLE NET ASSET VALUE FUNDS (VNAV)

These have a floating NAV based on market-to-market pricing, calculated to four decimal places, and come in two options, short-term and standard. The short-term variable net asset value fund can invest in short-term securities maturing in 397 days or less and the fund’s weighted average maturity must be 60 days or less. The second is a standard variable net asset value fund that can invest in securities maturing in 2 years with a 397 day maximum reset date and the fund’s weighted average maturity up to six months. Gates and fees are at the discretion of the fund management board, but strict diversification requirements apply.

TIMELINE OF EU MONEY MARKET FUND REFORM

Proposal
announced

SEPTEMBER 4, 2013

Council position
agreed

JUNE 15, 2016

APRIL 28, 2015

Parliament position
agreed

SOURCE: BNY MELLON

As of April 19, many investors in CNAV funds had switched seamlessly out of their original prime funds into the low volatility funds, Fitch data show. The ratings agency is forecasting positive euro money market fund rates by the end of 2020.

By the end of May, the low volatility LVNAV funds accounted for 83% or EUR548.7 billion of the European money market fund marketplace. Another 13% or EUR84.7 billion was in public debt CNAV funds and the remainder was in variable NAV funds.

Outflows this year were broadly stable and not unusual in the context of temporary seasonal fluctuations, Fitch said. The funds' net asset values also have not shifted much because market conditions are benign.

"The broad blip is muted," said Sewell. If anything, more of a risk of outflows could come from the lagging effects of US tax reform and the potential for investors like US corporations to redeem cash held overseas in Europe and repatriate that in the US, he adds.

GROWTH STORY

Some important lessons in Europe were adopted from similar regulations implemented in the US money market fund industry in 2016, which caused investors to pull around \$1 trillion from prime funds in favour of government-only funds.

Since then, money has slowly started to come back into US prime funds, given a more favourable US interest-rate environment and comfort around small price variations in institutional money funds. But as of June 4, US prime funds still hold only \$659.3 billion in assets, according to iMoneyNet, versus \$1.5 trillion in October 2015 one year before the US compliance deadline.

The Europeans "have been a little bit more creative" by adding the new low volatility fund option, which was not an option in the US reforms, notes Jonathan Spigel, Global Head of Liquidity and Segregation Services for BNY Mellon Markets.

Their underlying goal was the same but U.S. regulators adopted a tougher

stance because the market there, at roughly \$3 trillion, is almost three times the size of Europe's. There is also a cultural element to the EU's efforts in that market participants in the region are more accustomed to gates and fees because they are embedded in the Undertakings for the Collective Investment in Transferable Securities (UCITS) directive that governs many money market funds.

Although the European experience has been more seamless than the US one, there were roadblocks along the way, most notably the future of a mechanism that enabled funds to retain their stable unit value while interest rates in the bloc are negative. This mechanism, called the share cancellation mechanism (SCM) or reverse distribution mechanism (RDM) - worked by cancelling shares to maintain a stable value per share.

In what some called a surprise eleventh-hour move, the regulators said the mechanism was no longer compatible for negative yielding funds, and required the industry to remove



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**MICHELLE PRICE,
ASSOCIATION
OF CORPORATE
TREASURERS**

it. On one side was Luxembourg’s Commission de Surveillance du Secteur Financier (CSSF) and the Central Bank of Ireland who were in favour of the mechanism and on the other was France’s Autorité des Marchés Financiers, which reportedly opposed it in alignment with the European Commission.

The European Securities and Markets Authority (ESMA) that was rolling out technical standards for the new money market reforms sided with the Commission and announced in December, 2018 that the mechanism would no longer be permitted. Institutions asked for a six-month extension to implement the change, but ESMA granted only two months, putting it right over the top of an earlier deadline for Brexit negotiations.

As the dust settles, investors have a multitude of products to choose from. Despite all the reforms, money market funds continue to provide institutional and retail investors with daily liquidity, diversification, competitive yields and stability of principal, according

to Tracy Hopkins, Chief Operating Officer of BNY Mellon Cash Investment Strategies at BNY Mellon Investment Management.

“Assets continue to stay in the asset class they were in prior to reform, and from that perspective, EU market funds continue to grow, despite all the noise,” she notes. ●

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