THE POST-REFORM EUROPEAN MONEY FUND LANDSCAPE

WITH MMF REFORM A WORK IN PROGRESS, ALASTAIR SEWELL LOOKS AT KEY FEATURES OF THE MARKET

European money market fund (MMF) reform is now coming around fast. All new funds will have to comply with the reforms by 21 July. All pre-existing funds will need to convert into one of the formats prescribed by the reforms by 21 January 2019.

Post reform, the investment universe of constant net asset value (CNAV) funds will be limited to public debt (ie, government) securities only, in contrast with the broader investment spectrum of pre-reform CNAVs. Short-term and 'standard' variable NAV (VNAV) funds will continue to exist in a broadly comparable format to today's funds, with some minor differences. The reforms also introduce a new fund type, the low-volatility NAV (LVNAV) fund, which sits between future CNAV and VNAV funds.

From a fund-rating perspective, the overall structure is not the key rating driver for Fitch, rather it's the risk profile of the fund that matters. Conceptually, we can rate CNAVs, LVNAVs and short-term VNAVs at the AAAmmf rating level. The new rules will not change our approach to rating MMFs and therefore should not directly affect ratings unless funds' underlying credit, market or liquidity risks increase.

LVNAV likely to become largest European segment

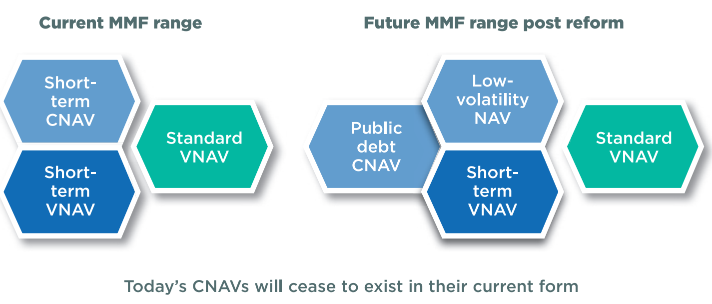
The advent of the LVNAV fund type is significant – we anticipate it becoming the largest segment in the European money fund segment post reform. LVNAVs will look and feel much like pre-reform prime CNAV funds. Nonetheless, there are important differences that we explain in more detail in our guide *European Money Fund Reform: What Investors Need to Know*.

Sterling funds: LVNAV high probability

Fitch anticipates the bulk of existing sterling prime CNAV funds transitioning to LVNAV. Sterling funds are currently dominated by prime CNAV funds with assets totalling £220bn, as of the end of 2017.

The yield incentive needed to transition away from the bounded price stability that LVNAV funds offer would need to be high to trigger material asset movement. Nonetheless, VNAV sterling funds already

Figure 1: LVNAV – the new kid on the block



Source: Fitch, Regulatory Documents

exist and may be considered by some investors.

Euro funds: European Commission statement

The regulatory status of LVNAV funds in euros was uncertain at the time of writing. The European Commission has stated to the European Securities and Markets Authority (ESMA) that share cancellation or reverse-distribution mechanisms were not consistent with the reforms. These mechanisms are necessary for euro-CNAV funds to pass negative yields on to investors while maintaining a constant share price. We are aware of a strong industry reaction on this matter and understand member states have raised this point with ESMA and the Commission.

Unless the regulatory stance on share cancellation changes, LVNAVs may not be viable in euros, at least in the short term. They could become a possibility when eurozone rates turn positive. However, this is likely to be well after the reforms are fully effective, by which point assets will have transferred to other fund categories.

Some investors may consider using bank deposits as an alternative. However, bank deposits would pose challenges to corporate investors, who would incur increased counterparty risk due to decreased diversification and greater operational risk – and cost. Furthermore, they may face difficulties to place the cash as, under Basel III, short-term wholesale is generally unattractive for the purpose of calculating bank liquidity ratios.

We therefore believe it is most likely that there will be a flow to euro short-term VNAV funds for the vast majority of assets currently held in euro CNAVs (€100bn at the end of 2017). This would require significant adaptation from an operational and accounting perspective for investors.

US dollar funds: multiple influences; public debt CNAV a real possibility

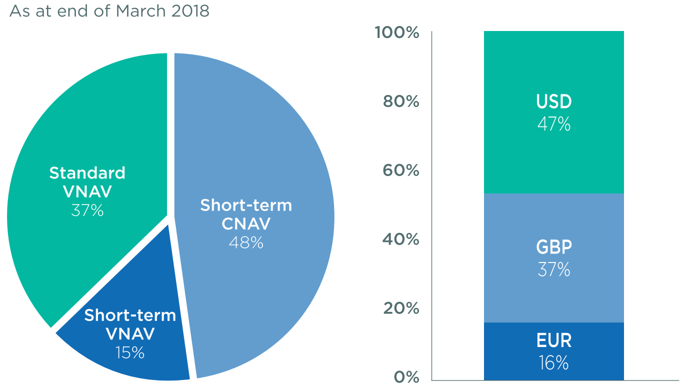
We anticipate a high likelihood of outflows in US dollar MMFs, which may prove to be significant for the overall MMF currency mix in Europe, as they represent the largest CNAV fund category. There is the potential for outflows from the US dollar segment overall, due to cash repatriation. We anticipate idiosyncratic flows as individual companies move at different speeds through their internal processes. This implies a continuous outflow from the European industry, but no sudden liquidity 'event'.

The experience of firms headquartered in the US of the US MMF reform process may be a significant factor, particularly when combined with rising US interest rates. The US reform process, which concluded in October 2016, saw $1.3 trillion flow out of 'prime' CNAV funds and into government-only CNAV funds. We do not anticipate anywhere near as significant an overall flow in Europe, even across all fund currencies, but we identify the potential for a significant flow specifically within the US dollar category.

For those investors who opted in the US-reform process to move to government CNAV, a similar move in Europe may be seen as the simplest option. However, there are important differences in Europe: unlike in the US, government CNAVs in Europe will have reform-based liquidity fees and redemption gates. We consider the likelihood of a gate or fee being imposed negligible for a government-only fund, and very low for an LVNAV. Whether these investors opt for LVNAV or CNAV, they will need to become comfortable with the prospect of the extraordinary liquidity mechanism.

Figure 2: Half of European money funds are CNAVs; and CNAV currency mix

As at end of March 2018



Source: iMoneyNet, Lipper, Fitch

Standard VNAV a major segment

'Standard' VNAV funds will be the second-largest segment in Europe post reform. Assets in this segment are already significant. They are almost entirely euro-denominated and French-domiciled, although there are a limited number of funds in other jurisdictions. We anticipate assets under management in this segment to remain broadly stable.

Corporate treasurers need to update their investment policy

Our communication with fund managers and understanding of regulatory approval processes imply a peak of fund conversions in Q4 of this year. We believe there will be an earlier flow of assets to new fund types than there was in the US (where the bulk of assets moved in the two months prior to reform) due to European public holidays in the immediate run-up to the conversion date.

Corporate treasurers will need to understand the new fund types and operational and accounting issues relating to each fund type to assess the various options available to them. Investments in new fund types will require updating their investment guidelines to accommodate the fund types they deem appropriate for cash management and ensuring their investment policy remains fit for purpose.

For more perspectives on the reforms, go to Credit Hotspot: European Money Market Fund Reform at www.fitchratings.com/site/fam/mmfr

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