CASH INVESTMENT AS REGULATIONS CHANGE

THE MONEY MARKET FUND INDUSTRY IS SET TO CHANGE DUE TO THE INTRODUCTION OF A NEW REGULATION. ROBERT O'RIORDAN REPORTS ON THE EFFECT THIS WILL HAVE ON CASH INVESTORS

SHUTTERSTOCK

A new regulation is set to transform the European money market fund (MMF) industry. It is now close to being published in the *Official Journal of the European Union*, which will make it binding under European law. There will be an 18-month implementation period, but due to the structural changes outlined in the regulation, the impact on the MMF industry will be felt some time before this period ends. This changing landscape is leading investors and asset managers to consider new approaches to how they manage cash.

LESSONS FROM THE US

In the US, a new MMF regulation introduced in October last year has had a substantial impact on the MMF industry there. Under the new regulation, prime funds, which invest predominantly in unsecured short-dated credit, have converted from constant net asset value (NAV) to a variable NAV with gates and fees.

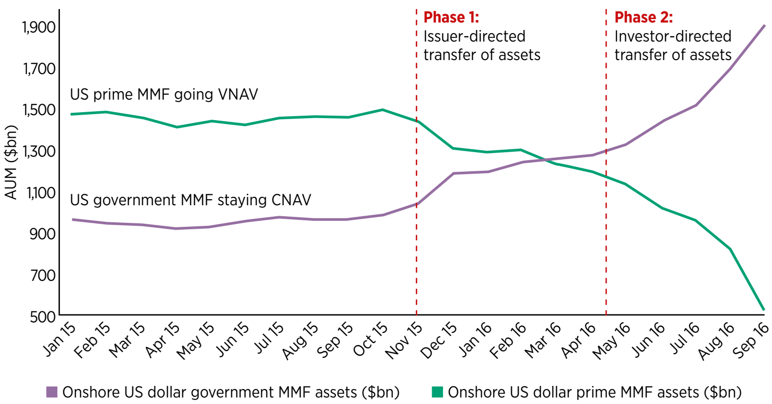
Government funds, which invest in government debt or repos secured against government debt, have maintained their constant NAV status. As a result of these changes, more than $1 trillion of assets moved from prime funds to government funds. (See Figure 1.)

A SIMILAR IMPACT IN EUROPE?

In Europe, a key concern for many investors is whether there will be a similar impact on European MMFs once the regulations go live. As a result, they are already considering how to maintain all the benefits they enjoy from current cash investments – in other words, whether there are approaches that can maintain a constant NAV along with other characteristics, such as diversification, liquidity and yield.

Under the proposed European regulation, government funds will be able to maintain a constant NAV. However, prime funds will either have a variable NAV status, or be categorised as

FIGURE 1: IMPACT OF US MMF REGULATION



Source: iMoneyNet as at October 2016

‘low volatility variable NAV’ (known as LVNAV) funds. (See Figure 2 for details.)

FIGURE 2: PROPOSED EUROPEAN REGULATION INTRODUCES NEW CATEGORY

	Pre-regulation	Post-regulation		
	IMMFA MMF	Government CNAV	Prime low volatility	Prime variable
Fund type	CNAV	CNAV	LVNAV	VNAV
Accounting methodology	Amortised cost	Amortised cost	Amortised cost up to 75 days	Mark to market
Maximum weighted average maturity (WAM)	60 days	60 days	60 days	60 days
Maximum weighted average life (WAL)	120 days	120 days	120 days	120 days
Maximum individual security maturity	397 days	397 days	397 days	397 days
Minimum daily liquidity	10%	10%	10%	7.5%
Minimum weekly liquidity	20%	30%	30%	15%
Gates and fees	Gates (UCITS/ prospectus)	Gate & fees (regulation)	Gate & fees (regulation)	Gates (UCITS/ prospectus)
Eligible investments	Money market instruments, govt debt	Govt debt, reverse repo, cash	Money market instruments, govt debt	Money market instruments, govt debt

Source: Insight Investment. For illustrative purposes. IMMFA stands for Institutional Money Market Funds Association

Compared with the US regulation, the big difference in the European regulation is the introduction of LVNAV funds as a category. These funds will be able to publish a constant NAV if tight criteria are met. However, in stressed market conditions, such as a credit crisis similar to 2008, some LVNAV funds may not be able to operate within those strict criteria – and would therefore be forced to publish a variable NAV. The probability of this occurring in a difficult market environment is exacerbated by the decision to ban sponsor support of MMFs under the proposed regulation.

Yields could also be affected under current proposals. For LVNAV funds to publish a constant NAV, they will be required to greatly shorten the maturities in their portfolios. The funds will only be able to value securities as constant NAV if they have maturities of up to 75 days, which has been greatly reduced from 397 days. For securities between 75 and 397 days, they will need to use mark-to-market pricing methodology. An LVNAV fund will only be able to publish a constant NAV if the overall portfolio NAV remains close to the constant NAV. These restrictions effectively mean LVNAV funds will need to hold securities that mostly mature within 75 days, and the resulting shortening of portfolio maturities would reduce potential yields. Because the repositioning would need to happen well before the end of the 18-month implementation period, investors are likely to feel the effects much earlier than the final deadline.

With so much uncertainty ahead for prime funds, many investors are looking at traditional constant NAV government funds as defined under the draft regulation. But they offer materially lower yields relative to prime funds, which has historically deterred investors.

IS THERE A BETTER WAY?

Traditional government funds are typically reverse-repo funds with banks as counterparties. Funds lend cash to the banks in return for gilts or government bonds as security, similar to a secured loan. The banks source the gilts or government bonds from other non-bank counterparties where they do a similar secured loan, but this time they are the borrowers of the securities.

In other words, banks are the middlemen profiting from the difference between the amount of interest they receive from the non-bank counterparties and the amount they pay out to the government funds. But this spread has widened greatly in recent years, as a result of the capital requirements outlined under the Basel III banking regulation, meaning that cash investors receive a lower yield for their investments and it is more expensive for non-bank counterparties to access cash.

Some cash investors are now opting for a government constant NAV MMF that cuts out the banks as middlemen and interacts directly with non-bank counterparties, allowing them to avoid the large banking spread introduced by Basel III. This approach offers significant yield enhancement relative to traditional government funds and, in practice, a yield comparable to prime funds.

A related point is that cash investors have struggled in recent years to diversify their cash investments away from banks. This has been high on the agenda of many cash investors since the credit crisis, as banks have experienced many aftershocks, heightening concerns that all their cash may be overexposed to bank credit risk. A non-bank government fund allows investors to diversify their cash away from banks as counterparties, reducing their overall exposure to the sector.

A NEW APPROACH

At Insight, we recognise clients are looking for vehicles that could still maintain a constant NAV, while not having to sacrifice yield or liquidity. A non-bank government liquidity fund can fulfil these criteria and also offer the added benefit of increased security, via gilts or government bonds, with the ability to diversify cash investments away from bank risk.

Some cash investors are opting for an MMF that cuts out the banks as middlemen

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