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New EU money market fund regulation: Will growth continue?

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In the past three years, European money market funds (MMFs) have grown by an impressive EUR 260 bn to EUR 1.16 trillion in invested assets. MMFs have attracted large inflows, which have particularly gone into non-euro assets benefiting from rising USD yields. In addition, the appreciation of the dollar has led to higher assets under management (AuM) measured in euro. Yields on euro assets have been low or even negative but in line with alternative money market investments.

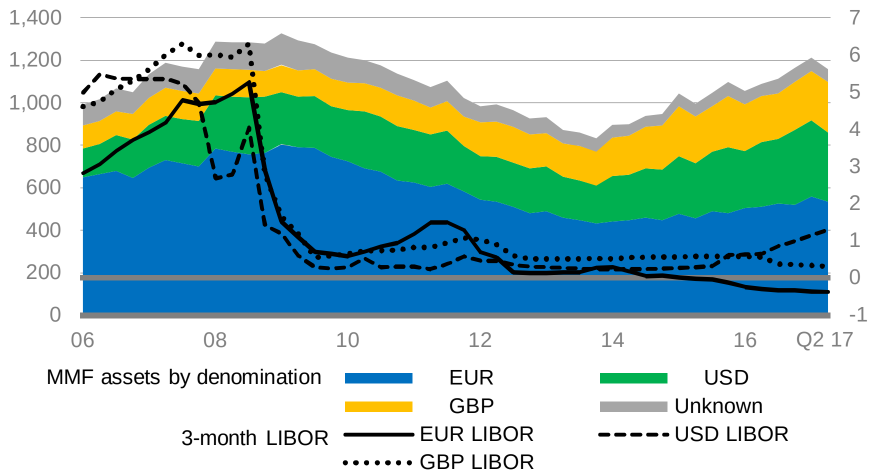
EU regulation issued in June 2017 and taking effect in 2018 aims at bolstering MMFs against financial distress. It introduces tighter rules on portfolio diversification, liquidity and transparency. Sponsor support is explicitly prohibited. Newly introduced MMF categories are likely to accommodate current investor preferences as regards accounting methods (variable or constant net asset value) as well as investment objectives (public or private debt) without triggering major market changes.

By contrast, the US MMF reform of October 2016 led to fundamental adjustments in the market. USD 1 trillion have been shifted from prime to government MMFs, driven by prevailing investor preferences for constant net asset valuation and lighter regulation on fees and redemption gates.

A "hard Brexit" could trigger a repatriation of GBP-denominated and UK-focused MMFs with approximately EUR 213 bn in AuM. Furthermore, a proprietary UK regulation similar to old EU rules could spark regulatory competition for the offshore USD MMF market. Currently, euro area MMFs manage EUR 326 bn in USD-denominated assets. USD- and GBP-denominated funds are predominantly domiciled in Ireland and Luxembourg.

Euro area MMFs attractive despite low interest rates

Assets of euro area MMFs in EUR bn (left); 3-month LIBOR in % (right)



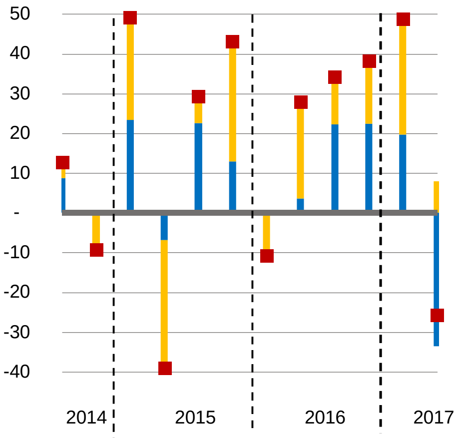
Annotation: Due to statistical reclassifications, AuM were reduced by about EUR 194 bn between Q2 2011 and Q1 2012, and increased by EUR 69 bn in Q1 2014.

Sources: ECB, WEFA, Deutsche Bank Research

New EU money market fund regulation

Net inflows in past three years 1

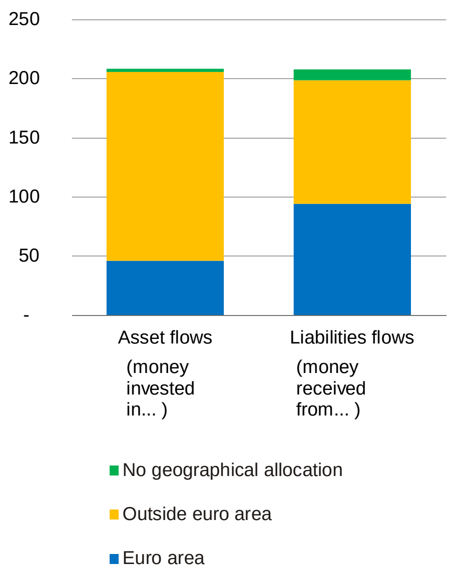
EUR bn per quarter, Q3 2014 - Q2 2017



Sources: ECB, Deutsche Bank Research

More money received from residents than invested in debt issued by residents 2

Net flows of euro area MMFs in EUR bn, accumulated in Q3 2014 - Q2 2017



Sources: ECB, Deutsche Bank Research

In June, the EU issued a new regulation on money market funds (MMFs) which will be phased in over the coming 18 months.[1] While acknowledging the importance of MMFs for short-term finance, legislators aim to mitigate the risks which MMFs can pose to financial stability in times of crisis. Regulation comes at a time when euro area MMFs, which more or less represent the total EU MMF industry, have long recovered from the decline experienced after the financial crisis. In the past three years, assets under management (AuM) have grown by EUR 260 bn to EUR 1,158 bn at the end of Q2 2017.

European MMFs have grown despite low interest rates

Net inflows of EUR 208 bn accounted for most of the increase in AuM during the past three years. Investors from outside the euro area bought MMF shares worth EUR 105 bn. It can be assumed that these investors mostly placed USD or GBP funds. With increasing short-term USD rates and thus positive returns of USD-denominated MMFs, inflows in this segment are no surprise. However, euro area investors also invested EUR 94 bn (net) of fresh money despite low and even negative euro money market rates.[2] But cash-rich investors which need to hold short-term liquidity do not have many alternatives. For companies, interest rates on bank deposits are still slightly positive on average, but individual investors are facing negative deposit rates. Moreover, prudential regulation (NSFR[3]) lets banks shy away from large wholesale sight deposits. Not least, MMFs still offer investors liquidity and risk reduction through portfolio diversification.

Admittedly, the growth in AuM has not only been due to net inflows. Over half of euro area MMFs' assets are invested in instruments denominated in USD, GBP or other currencies. Thus, exchange rate fluctuations impact the AuM when measured in EUR. Based on a back-of-the-envelope calculation, the EUR depreciation against the USD in the past three years has inflated the EUR value of USD assets by about EUR 53 bn. But the opposite development vis-à-vis the GBP has reduced the FX inflation of total assets to EUR 30 bn. As there were no statistical reclassifications, asset revaluations may be the reason for the remaining increase in AuM.

On the asset side, euro area MMFs have invested most of the net inflows in debt issued by non-residents (EUR 159 bn), and only EUR 46 bn in debt issued by euro area residents. Given that resident investors had placed EUR 94 bn, MMFs channelled about half of this money to non-resident debtors. These figures also suggest that EUR-denominated MMFs have invested to some degree in higher-yielding USD or GBP assets, as issuer residency and debt currency are usually "the same". However, the currency of investments can only be roughly estimated due to a lack of comprehensive data.

EU regulation introduces new MMF categories

The new EU regulation aims at ensuring the liquidity of MMFs in order to protect investors and to prevent contagion of the wider financial system in case a fund gets into difficulties. Tighter rules on portfolio diversification and enhanced liquidity requirements for all MMFs will strengthen their ability to always and fully meet investors' redemption requests. Sponsor support for ailing MMFs will be explicitly forbidden.

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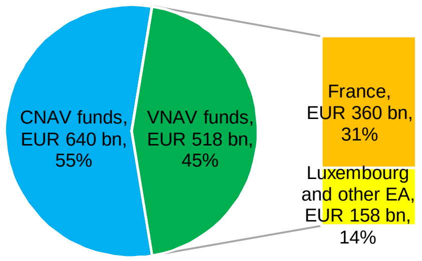
1 Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds.
2 EUR 9 bn of inflows cannot be allocated geographically.
3 Basel Committee on Banking Supervision (2014). Basel III: the net stable funding ratio. BIS, October 2014. The NSFR is part of the pending capital requirements reform for which the EU legislative process started in November 2016.

Euro area MMF market: divided between CNAV and VNAV 3

Assets under management, estimation for mid-2017



Annotation: MMFs domiciled in France, Ireland and Luxembourg account for 98% of euro area MMFs' total assets. CNAV funds are predominantly domiciled in Ireland and Luxembourg.

Sources: ECB, IMMFA, Deutsche Bank Research

According to existing and still effective ESMA guidelines[4], MMFs can be standard or short-term. Portfolio requirements (e.g. maximum asset maturity) are stricter for short-term than for standard MMFs.

From a market perspective, however, the distinction between variable and constant net asset value is more important. MMFs displaying a variable (fluctuating) share price calculate the entire fund's net asset value based on mark-to-market or mark-to-model pricing. The share price is then calculated by dividing this net asset value by the number of shares outstanding. Variable net asset value (VNAV) funds can be set up as either standard or short-term MMFs. Both VNAV types will also be allowed under the new legal regime.

Constant net asset value (CNAV) funds are able to display a steady share price (usually EUR/USD/GBP 1) because they value their portfolio based on amortised cost accounting. Amortised cost accounting is only allowed for short-term MMFs. Regulators are particularly wary of CNAV funds because investors expect them to always maintain a stable price per share. A sudden devaluation can thus easily trigger an investor run. Therefore, CNAV MMFs as they exist today will no longer be allowed. This affects about 55% of all euro area MMF assets. But as many investors prefer CNAV funds due to their easy handling, for accounting and tax reasons, the EU regulation provides for two new, close substitutes: low volatility NAV funds and public debt CNAV funds.

LVNAV (low volatility net asset value) MMFs will be allowed to use amortised cost accounting – the basis for a stable share price – for assets with a residual maturity of up to 75 days.[5] Furthermore, the constant asset price must not deviate by more than 10 basis points from the mark-to-market price of that asset.

Public debt CNAV funds are another option. These MMFs will be restricted as regards their portfolio: they will have to hold at least 99.5% of their assets in public debt, reverse repos secured with public debt, or cash. But they will be allowed to stick to amortised cost accounting and stable share prices.

Both LVNAV and public debt CNAV funds will be subject to mandatory liquidity fees or a suspension of redemptions if the share of weekly maturing assets in the portfolio falls below 10%. If suspensions are put in place on more than 15 days within a 90-day period, an LVNAV or public debt CNAV fund will be converted into a VNAV MMF. By contrast, VNAV funds are "only" subject to the UCITS regime, which puts the introduction of measures like liquidity fees or redemption gates at the discretion of the fund management board.

[4] ESMA 2014/1103 Opinion. Review of the CESR guidelines on a Common Definition of European Money Market Funds, 22 August 2014.
[5] The maximum residual maturity of an individual instrument is 397 days, but if the residual maturity exceeds 75 days, the instrument has to be valued mark-to-market.

MMF categories defined by new EU regulation 4

	Standard VNAV	Short-term VNAV	Low volatility NAV	Public debt CNAV
Accounting method	Mark-to-market	Mark-to-market	Amortised cost for assets with residual maturity of 75 days max.	Amortised cost
Eligible assets	Money market instruments	Money market instruments	Money market instruments	Public debt, reverse repos, cash
Mandatory liquidity fees/redemption gates	No	No	Yes	Yes
Maximum residual maturity of a money market instrument until legal redemption	2 years	397 days	397 days (mark-to-market valuation if over 75 days)	397 days
Maximum weighted average maturity* (WAM) of portfolio	6 months	60 days	60 days	60 days
Maximum weighted average life* (WAL) of portfolio	12 months	120 days	120 days	120 days
Minimum of daily maturing assets	7.5%	7.5%	10%	10%
Minimum of weekly maturing assets	15%	15%	30%	30%

* When calculating WAM, maturity is defined as the time remaining until the next interest rate reset date. When calculating WAL, however, the life of a floating rate instrument is the time left until it has to be redeemed.

Sources: Regulation (EU) 2017/1131, Deutsche Bank Research

Impact of EU regulation

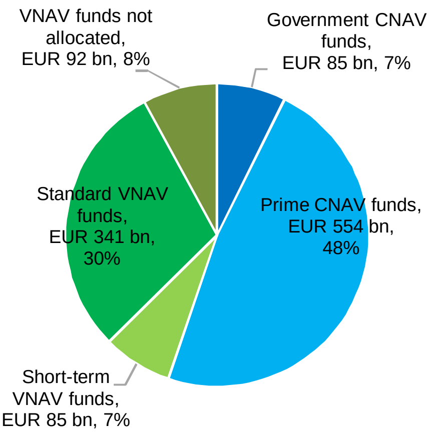
The new EU regulation forces investors and fund managers to reconsider their investment strategies and will certainly cause adjustments in the market. Nevertheless, the cautious reform is unlikely to disrupt the EU MMF market or to trigger substantial outflows from the sector as a whole. On the one hand, investors in VNAV MMFs (EUR 518 bn, 45% of the market) will see no fundamental changes due to the new regulation. However, standard VNAV funds (approximately EUR 341 bn, 30%[6]) may have to shorten the maturity of their portfolios due to the introduction of minimum requirements for daily and weekly liquidity.

On the other hand, CNAV MMFs as they exist today will disappear, which means that assets of approximately EUR 640 bn will have to be reallocated. But investors are offered relatively close substitutes with the introduction of public debt and LVNAV funds. The new type of public debt CNAV MMF will be the closest alternative for today's investors in CNAV funds focused on government debt. Admittedly, only 7% (EUR 85 bn) of euro area MMF assets are currently invested in such funds.

[6] Estimation based on figures of the ECB, Association Française de la Gestion financière (AFG), Commission de Surveillance du Secteur Financier (CSSF).

Detailed segments of euro area MMF market 5

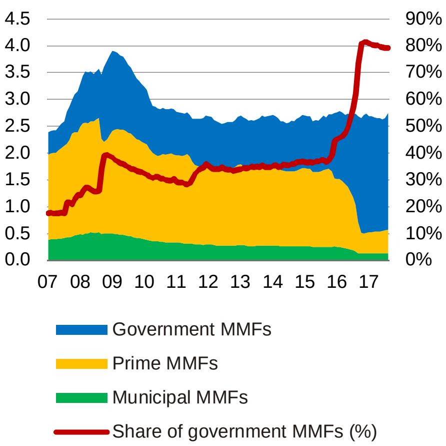
Estimation for mid-2017



Sources: Association Française de la Gestion financière, Commission de Surveillance du Secteur Financier, ECB, IMMFA, Deutsche Bank Research

US reform 2016: huge reallocation from prime to government MMFs 6

AuM in USD trillion (left), share in total industry in % (right)



Sources: ICI, Deutsche Bank Research

Almost half of all euro area MMF assets are invested in prime CNAV funds (i.e. focus on private debt). At first sight, investors in this segment seem to face a more pronounced change in the regulatory regime, as the current setup will not be possible any more. However, no major adjustments will be necessary for a current prime CNAV fund to convert into an LVNAV fund, because the requirements for the average liquidity of the portfolio (WAL, WAM) will remain unchanged. Only individual instruments with residual maturities of between 75 and 397 days will need to be exchanged for instruments maturing within 75 days. Such asset reallocations will probably be limited in size, though, because CNAV funds currently manage their portfolios with WAL (WAM) values well below the allowed 120 (60) days. The resulting effect on returns will depend on the yield curve. Overall, where investors are subject to tax and accounting regimes which favour constant share prices, LVNAV funds look like a workable alternative.

Market reaction to US money market fund reform

In the US, the new rules for MMFs adopted by the Securities and Exchange Commission (SEC) already came into force on 14 October 2016. The US MMF industry, which had been entirely CNAV-based, had to introduce fluctuating share prices for prime and municipal MMFs directed at institutional investors.[7] Moreover, all prime and municipal MMFs must now feature a system of liquidity fees and redemption gates which can – but do not have to be – implemented by the fund board in the best interest of the fund and its shareholders in times of financial distress. However, government MMFs are exempted from these new requirements.

As a result, even though the volume of USD 2.7 trillion in assets managed by US MMFs did not change significantly, the market experienced a tremendous reshuffling. During the course of 2016, about USD 1 trillion were shifted from prime and municipal funds into government MMFs, namely agency MMFs, a riskier and higher yielding sub-segment of government MMFs.[8]

The reason for the shift to government funds might simply have been the preference for the familiar status quo instead of the new regime, as government MMFs were least changed by the reform. This is somewhat surprising, though, given that US authorities and fund managers had taken legal and operational measures to make the handling of VNAV MMFs as easy as that of CNAV MMFs for investors. On the regulatory side, the SEC clarified in 2014 that investments in VNAV funds will be treated as cash equivalents under US GAAP. In July 2016, the US Internal Revenue Service (IRS) issued rules putting VNAV funds on par with CNAV funds as regards tax and reporting. On the technical side, the industry has upgraded infrastructure for VNAV funds to match the operational service level that CNAV fund clients are used to, e.g. same-day cash settlement and multiple settlement cycles per day.

However, the legal and operational uncertainties around VNAV funds – the aforementioned IRS rule was published only three months before the new MMF framework took effect – may have delayed decision-making in favour of VNAV funds on the investor side. Internal processes like treasury management systems and investment policies need to be adjusted to handle VNAV funds. Backed by legal clarity, investors may possibly come back to prime MMFs in the future, not least because they offer higher yields. Indeed, in 2017 (until August), prime MMFs

[7] Municipal MMFs invest in state and local debt and are tax-exempt. For an overview of the US MMF market and reform project, please see Mai, Heike (2015). Money Market Funds – an economic perspective, Deutsche Bank Research, February 2015.

[8] See e.g. Cipriani, Marco, Gabriele La Spada and Philip Mulder (2017). Investors' Appetite for Money-Like Assets: The Money Market Fund Industry after the 2014 Regulatory Reform, Federal Reserve Bank of New York Staff Reports, no. 816, June 2017.

did gain some ground (USD 65 bn) while government MMFs lost AuM of USD 57 bn.

A second, more structural and thus lasting factor for the shift into government funds has probably been the exemption from fees and gates provisions. Boards of prime and municipal MMFs now have the option to impose liquidity fees or redemption gates. Therefore, money invested in such funds is no longer perceived as fully liquid. Before the reform, the board of an MMF was already allowed to suspend redemptions, but the fund had to be liquidated as a consequence, which was a high hurdle. Still, with the new rule, it remains to be seen if and how fund boards will work with these discretionary powers in critical situations and how market practices will evolve.

In Europe, the introduction of mandatory liquidity saving measures will probably have a lesser effect than in the US, as investors already face the “threat” of similar – albeit discretionary – action under the existing UCITS regime. Furthermore, to benefit from the least restrictive European rules on fees and gates, investors would have to shift towards VNAV funds, which in turn would require operational adjustments. As regards the mere preference for constant net asset value accounting, this does not require a reallocation to public debt like in the US, as LVNAV funds can become “home” to current investments in prime CNAV MMFs.

Next thing to watch: Brexit

EU regulation will change the framework of the European MMF market, but it is not poised to cause a fundamental restructuring. Brexit could trigger substantial changes, though. Of course, the future relation between the EU and the UK cannot be foreseen at this point in time. The EU MMF regulation applies to any money market fund “established, managed or marketed in the Union”. In case of a “hard Brexit”, it may well be that MMFs which are essentially British and which are currently almost all domiciled in Ireland will be “repatriated”. “Essentially British” means MMFs run by asset management companies in the UK, or MMFs whose investors are predominantly UK residents. Currently, UK investors hold 45% of CNAV fund shares;[9] 90% of GBP-denominated assets are managed by MMFs domiciled in Ireland. An exodus of such “British” MMFs could reduce the total size of the EU MMF market by more than EUR 200 bn.

In addition, the EUR 300 bn-plus market for USD-denominated European MMFs could change considerably. They are so far predominantly domiciled in Ireland (EUR 192 bn, 59% of USD assets managed by euro area MMFs) or Luxembourg (over EUR 110 bn, 35%) and mostly operate as CNAV funds. Following Brexit, it cannot be ruled out that the UK could establish a proprietary regime for MMFs similar to the old EU rules. In such a case, regulatory competition for the offshore USD MMF market could evolve.

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[9] IMMFA, assets under management as at the end of 2016, retrieved August 2017, https://www.immfa.org/market-statistics/immfa-aum.html

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