Be Prepared!

MMF Reform Proposals Threaten LVNAV Viability for European Treasurers

By **Ben Poole**, Columnist, TMI

While treasurers might not feel the impact of MMF reforms in Europe for years, the proposed changes currently being debated at European Commission level endanger the utility of one of the most popular forms of MMF used by corporate investors across the continent.

For corporate treasurers wanting to diversify their short-term investments, MMFs have long been an attractive instrument to use due to their ability to preserve capital, provide cash liquidity, and even generate yield.

François Masquelier, CEO, Simply Treasury, and Chair of ATEL (the Luxembourg Corporate Treasury Association), elaborates: "MMFs remain a key element of the economy, particularly for corporates with excess cash that need to mitigate their risk. To avoid concentrating it all in bank deposits, MMFs are a classic alternative instrument. We don't have many potential alternatives, given treasury asset management policies, liquidity needs, cash equivalent accounting constraints and restrictions imposed by the C-suite."

Some uncertainty has been created in Europe about the potential utility of certain MMFs in the future. This has been caused by additional regulatory scrutiny of the sector following the short, sharp liquidity shock that affected most financial markets in March 2020 due to the onset of the Covid-19 pandemic. While a review of the effectiveness of the 2017 European Money Market Fund Regulation (MMFR) was always planned for this summer, this event triggered earlier regulatory action.

In February 2022, the European Securities and Markets Authority (ESMA) issued proposals for changes to MMF regulations in Europe. ESMA's final report states that: "A number of EU MMFs faced significant liquidity issues during the period of acute stress in March 2020 with large redemptions from investors on the liability side and a severe deterioration of liquidity of money market instruments on the asset side."

ESMA has two key targets in mind with its proposals. One of them is to address liquidity-related issues seen in March 2020 by ensuring the mandatory availability of at least one liquidity management tool for all MMFs. It also suggests amendments to the daily liquid asset/weekly liquid asset ratios and the inclusion/reinforcement of the possibility of temporarily using liquidity buffers in times of stress.

The other main target of the reform proposals is to address the threshold effects for constant net asset value (CNAV) MMFs by decoupling regulatory thresholds from suspensions, gates, and redemption fees for low volatility net asset value (LVNAV) and public debt CNAV (PDCNAV) MMFs, and removing the possibility of using amortised costs for LVNAV MMFs.

Veronica Iommi, Secretary General, Institutional Money Market Funds Association, (IMMFA), comments: "It is not just ESMA, but other authorities including the European Systemic Risk Board [ESRB] also agree that the link between liquidity thresholds and the possible imposition of fees, gates, and suspensions should be removed. This link was introduced in the previous round of reforms to ensure MMFs always had sufficient liquidity buffers to meet even heightened levels of outflows. Although apparently logical and well-intentioned, this inadvertently created a 'bright line' that investors focused on and became concerned about, increasing the likelihood of redemptions as that threshold approached."

Removing the anxieties created by that link is not overly controversial. However, the second element to address the threshold effects for CNAV funds – removing the possibility to use amortised costs for LVNAV funds – has met with criticism.

"The effective prohibition of the stable NAV component of the LVNAV fund type is something that IMMFA strongly opposes on the basis that it's not evidentially supported and that it would have deeply negative implications for investors such as treasurers who value the utility of the stable NAV LVNAV," comments Iommi. "We believe it's imperative to preserve investor choice, and we do not feel that the experience of funds during the crisis warrants the effective suppression of the LVNAV fund type."

It has been a mere three years since treasurers spent considerable time and resources building their investment policies, controls, and oversight around the LVNAV product structure, which was created under the European MMF Regulation policy framework. This is also a source of frustration in the industry.

Beccy Milchem, Head of EMEA Cash Management, BlackRock, notes: "We spent much time working with our clients and educating them through that process, which is a very recent memory. We think that treasurers will share our position that a policy response that eliminates the LVNAV structure is not appropriate unless there is clear evidence that the structure itself resulted in a specific vulnerability in March 2020. We do not believe this was the case."

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Threats to LVNAV MMF survival

While the European MMF reform proposals are being made with the best of intentions to enhance the resilience of funds in the face of extreme liquidity events, the details of the proposals threaten to undermine a section of the MMF market.

"Over-regulation is the enemy of good intentions," remarks Masquelier. "Moderation in financial regulation is always advisable. You might make the product very resilient by ring-fencing it but risk also turning it into a fortress that nobody wants to enter."

The current ability for an LVNAV MMF to round the NAV per share to 1 offers investors operational utility. That utility is offset by the higher daily and weekly requirements of the product compared with the other regulatory structures

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introduced in 2019. This fund construction is popular with treasurers and other cash investors.

"The utility value of LVNAV is very much evidenced by their size, which is currently equivalent to around 46% of the entire European market," comments Iommi. "The ability to trade in and out at an agreed price of one is a vital part of the utility of the LVNAV – it is predictable, which means that the fund type can be designated 'cash or cash equivalent' for accounting purposes. Converting to a floating or variable NAV would greatly increase uncertainty around the accounting treatment."

Kim Hochfeld, Global Head of Cash, State Street Global Advisors, and Chair of IMMFA, agrees that clarification around the accounting treatment is needed as soon as possible from the regulator.

"We would hope that the regulatory authorities will address the current lack of accounting clarity in most jurisdictions as to whether a short-term VNAV MMF could be classified as cash or cash equivalent for investors," Hochfeld explains. "Unless this is resolved, it could disincentivise existing or potential investors to consider a short-term VNAV MMF as part of their liquidity management toolbox."

Much of the concern around the effective prohibition of the stable NAV comes from the fact that this change could be problematic for investors, whose internal treasury management or order management systems are usually set up for a price of the one unit, such as sterling or dollar, for example, and for the accounting classification of their MMF investments.

BlackRock's Milchem notes: "Removing the LVNAV structure would undoubtedly cause some treasurers a headache, whether that's through a rehaul of those investment policies, re-engagement and work with their auditors over the consideration of the cash and cash equivalents, and potential upgrades to the TMS or other systems used for back-office processes to handle any changes in the structures themselves."

The challenge for treasurers is that there are not many alternative instruments available, particularly with the same utility currently offered by LVNAV funds, if they want to continue diversifying their short-term cash prudently and effectively.

"Treasurers who are unable to invest in a variable NAV will have to find alternatives if these proposals become law," says IMMFA's Iommi. "When this change happened in the last round of reforms in the US, it was a factor in investors moving to government funds. However, government funds of the same scale do not exist in euro or sterling. Bank deposits are

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Secretary General, Institutional Money Market Funds Association, (IMMFA)

APPROXIMATE TIMELINE FOR POTENTIAL EUROPEAN MMF REFORMS

- **20 May 2022:** European Commission Consultation closed.
- **July/August 2022:** European Commission Assessment Report published.
- **2022/early 2023:** Amendments to 2017 European MMF Regulation published.
- **Earliest Q2 2024:** Changes published after passing through EU trilogue legal process.
- **2025/2026:** Impact of legislative changes felt by investors.

another alternative, but prudential banking regulations significantly curtailed the appetite for short-term deposits. A viable alternative that makes sense does not really exist at the moment."

The lack of alternative investment options could be further hampered if the changes to the LVNAV structure result in more niche providers either leaving the market or selling up to larger firms. This could hinder attempts by treasurers to diversify their short-term investment portfolios and increase concentration risk.

Masquelier warns: "My main fear is there will be a market concentration where the bigger players swallow the smaller players. Treasurers need the range of options available today. This diversity is so important, and often imposed by internal asset management policies. If you have €20 to €30bn of cash to place short term, it would be so difficult, and it's tricky enough to place €3 to €5bn in one fund because there are not many funds of sufficient size to take such an investment. Treasurers also need to ensure that the fund has sufficient liquidity for them to exit – if a treasurer suddenly needs to withdraw €5bn, it could be quite dramatic for the fund."

The change to the LVNAV pricing structure is also concerning from an issuer perspective. The size of the sector not only has significant implications for investors who have had to familiarise themselves with the structure after the previous reforms and how to value it but also for issuers where the private debt exposure of LVNAVs provides critical funding.

"LVNAVs invest in a wide range of non-governmental commercial paper [CP] and certificates of deposit, thereby providing that vital short-term funding, which is cost-efficient and flexible," adds Iommi. "That's something to note from a treasury perspective."

Masquelier agrees that the funding side is another important consideration in these changes: "During the March 2020 event we saw the importance of being able to borrow in the short term," he says. "Think about a market such as the NEU CP [Negotiable European Commercial Paper] market in France. It's quite an important market and MMFs are a major investor in this type of market. It is a critical element of the economy, to give the borrower and lender opportunity to meet through MMFs, to diversify and mitigate the risk."

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Call for treasury engagement

Given how the implementation of the regulatory proposals could drastically change the short-term investment options for corporates in Europe, treasurers should engage with lawmakers to offer their points of view. The European Commission's very short consultation window, which closed on 13 May 2022, was a major chance for treasurers to make their voices heard.

Masquelier continues: "The EU Commission is interested in hearing from treasurers because we are the real economy. They're keen to know what our views are."

While any potential changes seem a long way off, the critical time to engage with regulators is now. The coming months, leading up to the Commission's report in the summer, are vital.

Iommi affirms: "If treasurers want to preserve the utility of MMFs and investor choice, the key time to speak out about this is right now. I would strongly encourage investors and issuers to engage actively and ensure their voices are heard loud and clear by key regulators and policymakers."

Of course, there is still plenty of time to prepare for any changes. Treasurers can read the ESMA report and see how the potential changes may impact their current investment positions and policies.

Milchem recalls: "When we spoke with clients after the 2017 reforms were published, we encouraged everyone to do their homework on all of the regulatory frameworks and create investment policies that could stand the test of time. Treasurers now need to ensure that they are prepared for any scenario and outcome. Speak to your existing money fund providers about how operationally the different structures would work. Ensure there is an understanding that if something does happen with the LVNAV structure, you're fully prepared for it. There's a long lead time and plenty of time to do that preparation work, but understanding the operational dynamics will be key."

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