Morgan Stanley

INVESTMENT MANAGEMENT

Perspectives on the New European Union Money Market Fund Regulations

LIQUIDITY | GLOBAL LIQUIDITY TEAM | 2019

After many years and much negotiation, the long anticipated new rules for European Union (EU) money market funds (MMFs) have been agreed upon by the Council of the EU and the European Parliament.[1] While designed to increase the liquidity of MMFs and promote stability of their structure, the draft regulation introduces notable changes that may require fund investors to modify their policies and procedures. The flexibility that fund investors might have in making such amendments will be influenced by the approach taken by fund managers and intermediary platforms. Fortunately, the new rules allow for an 18-month transitional period for existing MMFs, which should provide key stakeholders ample time to prepare and adapt.[2] While many of the technical elements have yet to be clarified, the following Morgan Stanley Investment Management perspectives seek to provide investors with a helpful starting point for developing an approach that best fits their organisation.

Summary of the New EU Regulations

The introduction of a variable net asset value (VNAV) fund and specific trigger-based liquidity fees and redemption gates are the two primary structural changes impacting short-term money market funds. While these are two core elements of the new U.S. money fund rules, the EU approach diverges significantly from the U.S. approach in some fundamental ways. Most notably, EU VNAV funds are not subject to trigger-based liquidity fees and redemption gates and the EU regulations allow for a low volatility NAV (LVNAV) money fund option.

New European Short-Term Money Market Fund Structures[3]

	PUBLIC DEBT CONSTANT NET ASSET VALUE (CNAV) FUNDS*	LOW VOLATILITY NET ASSET VALUE (LVNAV) FUNDS	VARIABLE NET ASSET VALUE (VNAV) FUNDS
NAV/ Accounting Method	• Constant 1.00 NAV • Full use of amortised cost accounting with fund pricing to two decimal places	• Constant 1.00 NAV, with limitations • Limited use of amortised cost accounting with fund pricing to two decimal places – Limited to assets with residual maturity of <75 days and when price deviation compared to mark-to-market is below 10 basis points (bps) • If the portfolio NAV deviates more than 20 basis points from 1.00/share, the fund must use an NAV per share rounded to the nearest basis point (four decimal places)	• Variable NAV • No amortised cost accounting with fund NAV/share rounded to nearest basis point (four decimal places)
Fees and Gates	Yes	Yes	No
	Should the weekly liquid maturing assets in the fund fall below 30% on a given day and whenever the net daily redemptions on a single business day exceed 10% of the total fund assets, the board of the fund may apply liquidity fees or impose a redemption gate for up to 15 days.		–

* Must invest a minimum of 99.5% of its assets into government issued or government guaranteed debt instruments, reverse repurchase agreements collateralized by government issued or guaranteed debt instruments or cash

[1] As of 07/12/2016.

[2] The new rules governing European money market funds go into effect on 21 January 2019 for existing money market funds. Any new funds launched will be required to comply with the regulations starting from 21 July 2018.

[3] Source: Council of the European Union Final Compromise Text of the European Parliament and the Council on Money Market Funds. The European Securities and Market Authority (ESMA) defines two types of MMFs, short-term and standard MMFs. There are several key differences between these two categorizations. Short-term MMFs must have a maximum weighted average maturity (WAM) of 60 days and a maximum weighted average life (WAL) of 120 days. Additionally, short-term MMFs are required to have a maximum residual asset maturity of 397 days. Standard MMFs must have a maximum WAM and WAL of 6 and 12 months, respectively. Standard MMFs can have a maximum residual asset maturity of up to two years.

The fees and gates provision will have a profound impact on how the CNAV and LVNAV funds are managed and will likely determine whether investors accept these fund types. Weekly maturing assets will become a key metric for investors to track, and fund managers will likely manage these portfolios at levels significantly greater than 30% weekly liquidity to avoid the gating trigger, which will limit yield potential.

Public Debt (Government) CNAV Option

The public debt/government CNAV Fund is the most conservative option from an investment risk standpoint and retains most of the operational and administrative simplicity that clients currently experience. Public debt CNAV funds may be a viable alternative for investors who cannot support a VNAV fund or may reject the complexity and uncertainty embedded in the LVNAV option. However, public debt CNAV funds will present cash investors with a number of new complications and potential trade-offs:

KEY CONSIDERATIONS

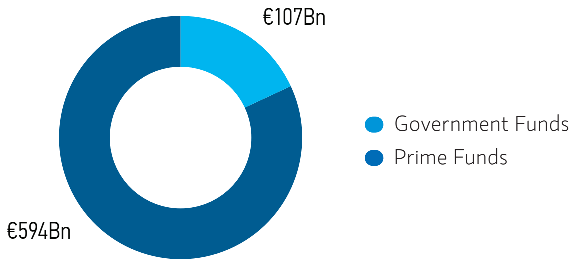
- **LIMITED PRODUCT RANGE –** There are few managers that currently offer government funds across all three major currencies: EUR, GBP and USD. This could change as a result of the new rules but supply and attractiveness of public debt instruments could be a limiting factor in the availability of CNAV funds.
- **SMALL FUNDS –** Will investors be comfortable if the ability to execute larger transactions is limited and their concentration of assets in the portfolio is high?
- **LOWER YIELDS –** Yields are likely to be less than investors have historically benefitted from in prime funds.
- **POTENTIAL FEES AND GATES –** Although we believe the likelihood of triggering liquidity fees and redemption gates is remote, the mere existence of this possibility may be a nonstarter for some investors. At a minimum, we would expect investors to focus closely on the weekly liquid assets metric which adds work to their routine tracking and due diligence processes.
- **SUBJECT TO REVIEW –** The European Commission is mandated to review the adequacy of the new rules in five years and, in particular, whether changes to Public Debt CNAV money market funds are appropriate. While there is no way to forecast if changes will be pursued, up to and including the elimination of this structure, the review process itself introduces a degree of uncertainty around the long-term viability of this fund structure.

Related Insights From U.S. Money Market Reform

We believe the experience of U.S. investors amid U.S. money market fund reform is very instructive. U.S. money market regulatory change resulted in two main fund types for institutional investors: CNAV government funds with no fees and gates and VNAV prime funds with fees and gates. In anticipation of the implementation of the new rules, over $1 trillion moved out of prime funds (VNAV) and into government funds (CNAV). This occurred despite the fact that government fund yields were significantly lower than prime fund yields. Other than a lower yield, investors who switched to government funds were not impacted by the new regulations.

Total EU Domiciled Short-Term MMF Assets of €700Bn

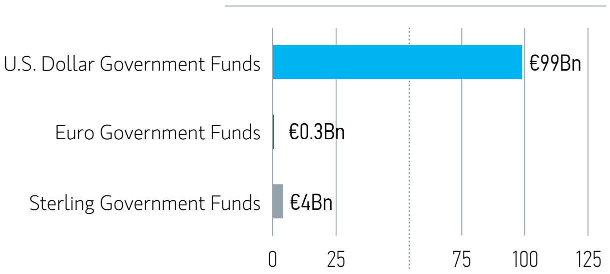
Converted to euros



Source: iMoneyNet. Data as of 10 November 2017.

Government Short-Term MMF AUM (EU Domiciled)

Converted to euros



Source: iMoneyNet. Data as of 10 November 2017.

In Europe, we believe Public Debt CNAV funds will be of most interest to investors who value a CNAV more than yield potential, provided they are willing to accept the remote possibility of the fund imposing fees or gates and are willing to take on new tracking and due diligence tasks. Even for investors who prefer the Public Debt CNAV option, the possibilities for investment may be limited, especially for certain currencies, due to a small universe of small funds.

LVNAV Option

As described above, the LVNAV structure allows managers to deliver a constant NAV if portfolio and individual security pricing collar requirements are maintained. The key requirement is that the mark to market NAV[4] of the portfolio in aggregate cannot vary from the limited amortised cost value by more than 20 bps. This comparative calculation is required each day and determines whether the fund can continue to transact at $1/€1/£1 or must immediately convert to VNAV. On the surface, LVNAV funds appear to operate similarly to existing short-term money market funds, but there are challenges and trade-offs to consider:

KEY CONSIDERATIONS

- **COLLAR REQUIREMENTS –** We anticipate that most managers will strive to avoid breaching the 20 bps portfolio NAV collar. However, there is no guarantee that they will be able to do so even if they limit the portfolio to securities with less than a 75-day maturity, which some may do to maximize the potential use of amortised cost valuations. Once the collar is determined to have been breached, the next transaction is required to occur at a NAV rounded to the nearest basis point (four decimal places).
- **POTENTIAL FEES AND GATES –** Although we believe the likelihood of implementing fees and gates is remote, it is arguably less remote for an LVNAV fund than for a Public Debt CNAV fund. The mere existence of this possibility may be a nonstarter for some investors.
- **ADDITIONAL TRACKING AND DUE DILIGENCE –** We expect investors will closely monitor both the mark to market NAV and the weekly maturing assets and establish their own benchmark level for each respective metric. Should the value of a respective metric fall below the benchmark, the investment may no longer be considered suitable.
- **LOWER YIELD –** Since LNVAV funds will be required to be managed more conservatively than existing short-term money market funds, their yields are expected to be relatively less attractive. This is due to the greater reliance on shorter dated securities necessary to use amortised cost and the desire to stay well above the 30% weekly liquid asset threshold.
- **LIMITED AVAILABILITY –** The operational requirements necessary to instantaneously shift from CNAV to a NAV rounded to four decimal places may require significant development resources from both fund managers and intermediary platforms. Decisions will have to be made about whether the development costs, is commercially viable.
- **SMALL FUNDS –** Even if the LVNAV structure appeals to investors, small fund sizes may limit their attractiveness. Few money market fund investors are likely to expose their liquidity to any concentration risk in a new untested fund structure. This could be a challenge to getting clients to invest in an LVNAV fund.
- **SUBJECT TO REVIEW –** The Commission is mandated to review the adequacy of the new rules in five years, specifically if the changes to LVNAV money market funds are appropriate. While there is no way to forecast if changes may be pursued up to and including the elimination of this structure, the review process itself introduces a degree of uncertainty around the longer viability of this fund structure.

KEY METRICS TO FOCUS ON:

– Mark to Market NAV[4]

– Weekly Maturing Assets

[4] The **Mark to Market NAV** is a calculation of the underlying aggregate value of the securities in a fund's portfolio using current market quotes or other performance metrics. It is important to note this is being provided for informational use only and investors cannot transact on the mark to market NAV. The Morgan Stanley Liquidity funds continue to operate at a stable net asset value in their distributing shares utilising amortized cost accounting.

Related Insights From U.S. Money Market Reform

With regard to LVNAV, drawing some parallels to the U.S. experience is also instructive. Shortly after the announcement of money market fund reform in the U.S., several managers promoted the potential benefits of a 60-day maximum maturity fund. Similar in concept to the new EU rules, U.S. prime funds can value securities with residual maturities of 60 days or less at amortised cost if the mark-to-market value approximates the amortised cost value. U.S. fund managers believed that if they limited portfolio holdings to securities maturing in 60 days or less, they would be unlikely to breach the limits that would require them to abandon the amortised cost price. In essence, they could maintain a CNAV even though the fund is VNAV by definition. While the 60-day maximum maturity fund concept initially seemed appealing to some, when reviewed in detail, most determined that the potential limitations on supply would constrain both capacity and yield. This, along with uncertainty as to whether the fund would always be able to transact effectively at a CNAV, discouraged investors from adopting the 60-day maximum maturity fund option.

VNAV Option

VNAV funds are the only one of the three structures that are not subject to liquidity fees and redemption gates. Therefore, VNAV funds represent the least constrained option among the three new short-term money market fund structures. While investors are likely to view this very positively, there are number of fundamental questions and issues investors will have to contend with when evaluating whether VNAV is a viable option:

KEY CONSIDERATIONS

- **DOES VNAV IMPLY GREATER INVESTMENT RISK? –** Whether the fund is VNAV, LVNAV or Public Debt CNAV, the investment objective to seek to provide liquidity and a competitive rate of return to the extent consistent with preservation of capital should prevail. All three categories must still be managed within the context of the money market fund rules concerning eligibility, portfolio duration, and transparency among other requirements. Additionally, VNAV funds will be able to invest in a broader universe of securities than Public Debt CNAV funds. While VNAV funds will still be managed within a weekly liquidity target, these funds will likely be run with longer average durations and if the market continues to warrant, lower weekly liquidity levels than the other two fund structures precisely because VNAV funds will not be constrained by the fees and gates regime. This greater relative flexibility VNAV funds will have to respond to market conditions within the framework of preservation of capital and liquidity is anticipated to have a materially positive impact on return.
- **NAV VARIABILITY? –** The dynamic of mark-to-market pricing out to four decimal places means that inevitably there will be some NAV movement, however de minimis, even when a fund is managed to preserve capital. Since the implementation of institutional prime fund VNAV in the U.S., fund NAV movement has been minimal, remaining at $1.0000 or slightly above with limited exception.
- **REDUCED INTRA-DAY LIQUIDITY –** In the current CNAV environment, during fund business hours, proceeds from redemption wires are generally released within one hour of the trade being received. This can be accomplished because the price of the transaction is known to be 1.00. In a VNAV environment, however, the NAV must be struck to determine the price at which a trade will transact and each trade will receive the next determined NAV. There are operational limitations to how many times a day this NAV strike process can occur. As a result, intra-day liquidity will not be as immediate as it is today.
- **ACCOUNTING AND TAX CONSIDERATIONS –** Short-term money market funds have historically met the definition of cash or cash equivalents and this likely will continue to be the case. However, from a tax reporting standpoint, it is not yet clear if any simplified tax accounting rules will be in place to address whether it will be necessary to report the gain or loss on each individual transaction.
- **GREATER AVAILABILITY –** This structure, being less constrained from an investment universe standpoint, will have access to a greater supply of investable securities. Additionally, given that this structure does not have the degree of complexity embedded in the fees and gate regime or need the dexterity to flip from CNAV to VNAV, we expect most intermediary platforms will support VNAV. This structure is the only one which is not subject to review in five years, so it will remove the uncertainty inherent in the CNAV and LVANV options. For these reasons, amongst others, we believe the VNAV structure will achieve broad acceptance across all relevant currencies.

YIELD DIFFERENTIAL BETWEEN PRIME AND GOVERNMENT FUNDS[5]

As of 10 November 2017.

U.S. Dollar: 30 bps

Sterling: 12 bps

[5] Source: IMMFA average of 7 day simple net yield

Related Insights From U.S. Money Market Reform

Unlike in the U.S., EU VNAV funds will not be subject to trigger based liquidity fees and redemption gates. This is the primary reason we believe EU VNAV funds will be more attractive to investors than they have been in the U.S to date. A significant proportion of the U.S. investors who responded to our 2016 survey and who participated in our roundtable discussions indicated that fees and gates were a significantly greater concern than VNAV. In addition, European investors are generally more familiar with VNAV structures to start, in particular because many existing standard money market funds operate with a VNAV.

Beyond concerns about fees and gates, the embedded complexities and fundamental uncertainties in the new LVNAV structure may cause investors to pause and become more positive about the simpler and perhaps more transparent construct of the VNAV option. Furthermore, VNAV funds are likely to deliver a yield premium versus LVNAV and Public Debt CNAV fund options which many investors will find attractive.

What Path Will Investors Take?

It is very difficult to draw any definitive conclusions at such an early stage and it will take time for all of the key stakeholders to evaluate the new requirements. We anticipate that as investors dig deeper into the new options, their initial impressions may change and new questions will arise. Many will need time and assistance to determine their requirements, priorities, and resources with respect to adopting the new product range. It is also very important to note that investors may face more limited choices than expected based on the fund type(s) supported by fund managers and intermediary platforms.

There are several key overarching questions that will drive what the final landscape will look like. For example, will investors accept or reject the LVNAV and VNAV structures? If they are rejected, will government funds pick up the slack as was the experience in the U.S.? Will investors hang onto current product structures until almost the last possible moment or will the availability of new structures entice them to move sooner? Will there be any new product innovation beyond the new regulatory defined structures?

The short-term money market status quo is changing and there will be no direct substitute for the CNAV funds that many of you have come to rely on. Our goal over the coming 18 months is to establish Morgan Stanley Investment Management as your preferred partner to assist you in undertaking the analysis and changes necessary to navigate the new product range. We look forward to sharing our views and addressing your questions as we work towards the implementation deadline.

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$139B	$29B	$103B
AUM IN MONEY MARKET MUTUAL FUND GLOBAL PLATFORM[6]	**AUM IN CUSTOMIZED SOLUTIONS[6]**	**INSTITUTIONAL LIQUIDITY FUNDS NET INFLOWS SINCE 9/30/2011**

For more information, please visit www.morganstanley.com/liquidity, contact your Morgan Stanley Investment Management Relationship Manager or Kim Hochfeld, Head of Global Liquidity EMEA distribution, at +44 20 7677-6161.

[6] Data as of 31/10/2018.

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