Strategy
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Offshore Money Market Funds in an Age of Change

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Abstract

- *Offshore institutional money market funds (MMFs) have largely sat in the periphery for US-centric liquidity investors, but European reform and repatriation of overseas profits may result in transformational changes.*
- *Offshore fund investors will have few alternatives other than low volatility net asset value (LVNAV) funds. Public debt funds may not accommodate large inflows. A new EC ruling on share cancellation will be challenging for euro funds.*
- *Repatriation of overseas profits may be more manageable as a large part of "trapped cash" is in fixed income securities outside the realm of MMFs.*
- *A separately managed portfolio may provide flexibility not available to commingled funds. While many questions remain unresolved, multiple liquidity solutions can help to cope with change.*

Introduction

Even for US-centric institutional cash investors, developments in the offshore money market fund space are difficult to ignore. The interconnectedness of global financial markets results in domestic and offshore liquidity funds sharing a common set of debt issuers and market liquidity. Many US-based treasury organizations also have offshore subsidiaries or affiliates with investments in offshore funds that require attention.

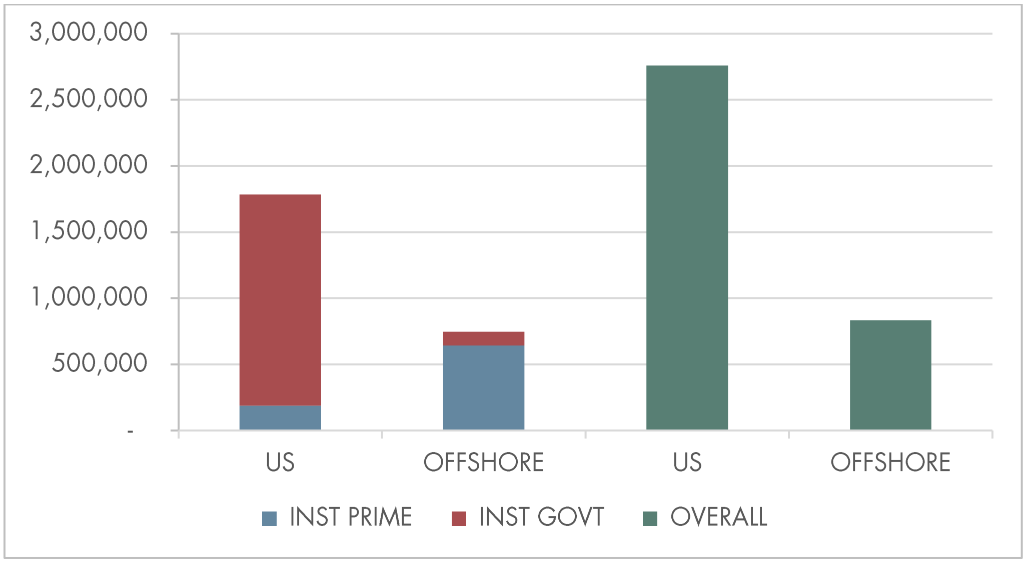
Interest in offshore liquidity has intensified in recent months due to several key developments: the passage of MMF reform in Europe, a new tax law in the US, and Great Britain's imminent exit from the European Union (Brexit). For institutional liquidity purposes, we will focus on funds belonging to the Institutional Money Market Funds Association (IMMFA), a trade association representing the European MMF industry.

Since our interest is primarily on dollar-denominated (USD) funds, we will skip the Brexit topic here. Likewise, institutional funds domiciled elsewhere are significantly smaller in size and are not the focus of this article.

A Survey of Offshore Market Share

Compared to the $2.7- trillion domestic US MMF market, the combined dollar, sterling (GBP) and euro offshore fund market is a modest $833 billion in size (Graph 1) as of March 2018, according to fund data firm iMoneyNet. IMMFA funds, with self-enforced standards of conduct comparable to US MMF standards, garnered $747 billion.

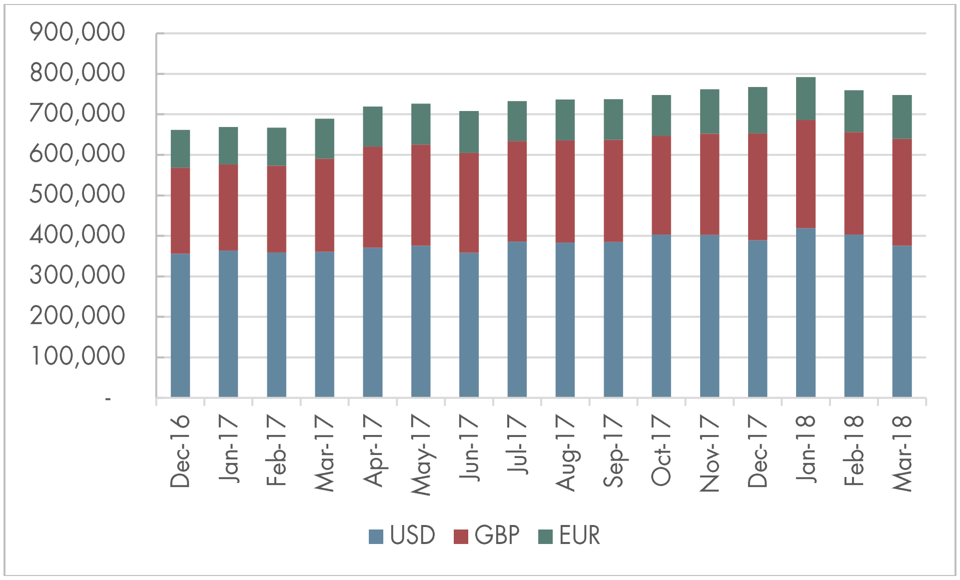
Graph 1: US and Offshore MMF Balances as of March 2018



Source: iMoneynet.com Offshore Market Share as of March 2018

Graph 1 also shows that, as an aftermath of US reform that forced institutional prime funds to adopt variable net asset values (VNAVs), government fund assets currently dominate the domestic institutional landscape. Prime assets represented only 10%. By comparison, the IMMFA group assets are mostly in prime funds (86%).

Graph 2: European MMF Assets by Currencies



Source: iMoneynet.com Offshore Market Share as of March 2018

Graph 2 provides a recent history of offshore MMF balances by currency, which had a generally upwards trend until last January. The graph also indicates that over half of fund assets (50-54%) are denominated in US dollars. Sterling funds account for roughly 1/3 of the balances, while euro funds make up the rest (13-15%).

US-based treasury organizations may have more balances in USD funds than the other currencies. The European fund reform will cause changes in funds of all currencies, but EUR funds will likely feel the most pinch from a regulator's new interpretation. The US tax reform should affect USD funds more than EUR and GBP funds.

European MMF Reform Highlights

The European initiative traces back to 2008, when the G20 countries agreed to reform the money market fund industry in the wake of the financial crisis. Compared to efforts by the SEC in the US, reform in Europe moved at a slower pace due to multiple entities and jurisdictions. After the European Commission's draft legislation in 2013, their Regulation on Money Market Funds was finalized in December 2016 and became enforceable on July 21, 2017. The new law applies to new funds as of July 21, 2018, and existing funds have until January 21, 2019 to transition to the new framework.

For US-centric institutional investors, European stable (constant) NAV funds equivalent to the US convention are called short-term MMFs. Of these, government funds will be converted to public debt CNAV funds, and prime funds can choose to be converted to either low volatility NAV (LVNAV) or variable NAV (VNAV) funds.

At the risk of over simplification, one could think of the CNAV and the VNAV funds as equivalent to the post-2016 government and prime funds in the US. LVNAV is a new creation, which allows a fund to stay as a CNAV fund so long as its market "shadow" NAV stays within a collar of 20 basis points (0.0020 in either direction) of a dollar, euro or pound sterling. It is assumed that most of today's stable NAV prime funds will want to be converted to LVNAV, not VNAV.

Two main items to take away are: 1) both LVNAV and public debt CNAV funds are subject to redemption fees and gates while VNAV funds are not; and 2) if the 20-bps collar on a LVNAV fund is breached or if the fund suspends redemptions for more than 15 days, it automatically becomes a VNAV fund.

Similar to the lead up in regulatory events in the US, shareholders need to determine how to understand and respond to the changes before the new rule takes effect. For example, how will they be affected if their current prime fund adopts VNAV? Or, if their prime fund turns into LVNAV, should they switch into a public debt CNAV fund or be comforted by the 20-bps collar protection? And, can public debt CNAV funds accommodate the inflow from prime assets like in the US? Since most fund companies likely will bring their funds into compliance in the third quarter of 2018, cash investors will need to have a game plan before then.

ESMA's New Wrinkle on Euro Funds

For investors in euro funds, a consultation paper by the European Securities and Market Authority (ESMA), the collective body of EU securities regulators, posed a surprising and existential threat to euro funds.

In a November 13, 2017 paper provided to the European Commission on technical implementation details, the ESMA concluded that "the destruction of shares is not allowed under the MMF regulation." The so-called share destruction (also known as reverse distribution or share cancellation) is a unique mechanism for removing shares in a negative yielding fund to pay for the negative charge instead of eroding the principal and jeopardizing a fund's CNAV.

In the ultra-low and/or negative yield environment of the past few years, it was customary for funds to adopt share cancellation as a coping strategy. Today, short-term interest rates in the US and the UK are substantially above zero, so yield on dollar and sterling funds are positive. With comparative bank deposit rate of -0.40%, euro funds continue to use share cancellation today.

In a letter to the ESMA's request for clarification on January 19, 2018, the European Commission stated that the share cancellation "mechanism is not compatible with the MMF Regulation." This ruling could make euro prime to LVNAV conversion inoperable as the erosion of negative yield on the principal will soon cause the market NAV to fall by more than 20 bps below stated NAV.

Although market consensus calls for the European Central Bank to raise the deposit rate in 2019, euro zone short-term interest rates are not expected to return to positive before 2020, long after the mandatory conversion date of January 2019. Short of a workable alternative solution, shareholders of euro funds should be prepared to see their funds become VNAV, not LVNAV funds, in the coming months.

Impact from Tax Cuts Act Remains a Mystery

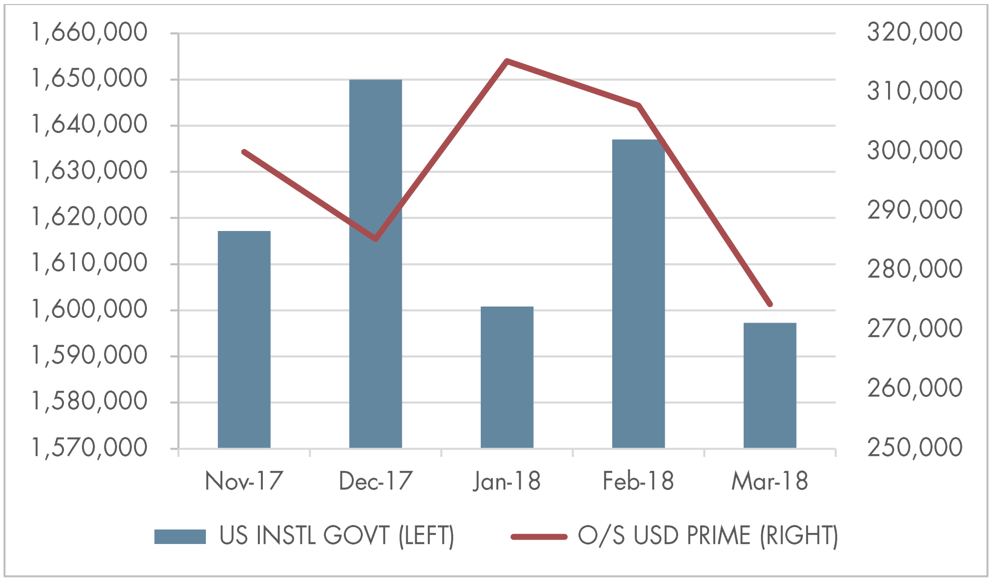
The Tax Cuts and Jobs Act (TCJA) Congress passed in December 2018 received widespread attention with respect to repatriation of foreign profits. However, the impact of the new law on offshore MMF balances is hard to quantify. How the multiple cross currents from the new law will shape the future of this market remains a mystery. Still, this is an important puzzle for both US and offshore fund investors to solve as the two markets are often intertwined.

For this article, we will ignore the possible macro and indirect impact of tax cuts on corporate profitability, and will instead focus on the movement of cash (liquid assets) in the near to intermediate term.

Off-shore Prime vs. US Government MMFs Trade-off Not Apparent: Conventional wisdom says that repatriation of offshore earnings should cause off-shore prime balances to decline as corporations bring their foreign profits homebound. Concurrently, one should expect domestic institutional government fund balances to grow as companies deliberate on how best to use the cash.

As Graph 3 indicates, the US government vs. offshore prime fund levels before and after the tax reform have yet to validate the conventional wisdom. While offshore USD prime balances declined for the last two months, it is difficult to tell whether the movement is attributed to repatriation or concerns with euro MMF reform. Balances in domestic institutional government funds also do not show a pattern. Time will tell whether and how the off-shore to on-shore fund balance trade-off will develop.

Graph 3: Domestic and Offshore MMF Balances

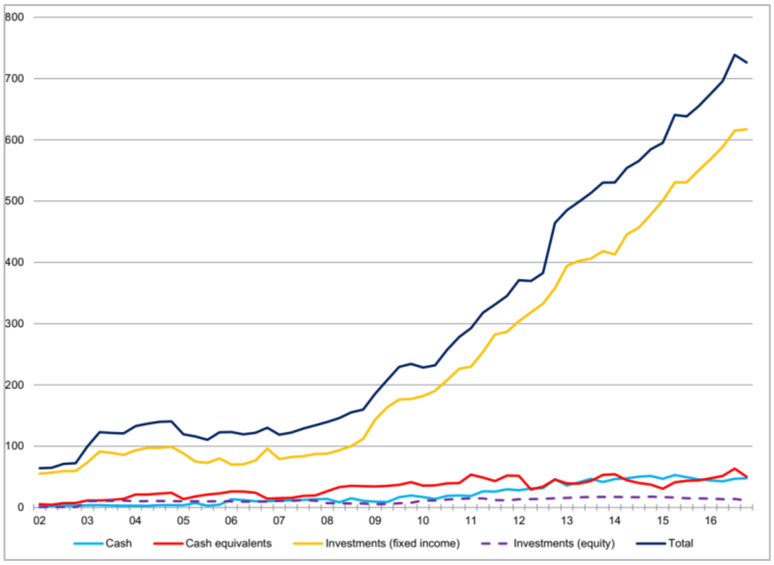


Source: iMoneynet.com Offshore Market Share as of March 2018

Off-shore MMFs Not A Major Source of Funds: Another popular theory stipulates that since offshore earnings represent "trapped cash" not meant to be brought back to the US soon, the funds are likely invested in longer term fixed income instruments such as offshore bond funds and separate portfolios in corporate, Treasury and asset-backed bonds, not in money market instruments or offshore MMFs.

A January 2018 Wall Street research report on corporate repatriation showed that, after reinvestments in business expansion, US corporations had about $1.0 trillion in liquid offshore assets as of March 2017, of which $600 billion were concentrated in the largest 10 firms[1].

Graph 4: Major Investment Categories by "Top Ten" Firms with Total Savings



Source: Credit Suisse. See footnote.

[1] Zoltan Pozsar, Global Money Notes #11 Repatriation, the Echo-Taper and the €/$ Basis, Credit Suisse, January 29, 2018.

Based on public filings on investment holdings of the Top Ten firms, Graph 4 provides a summary of investments by categories. Of the over $700 billion domestic and offshore investments, fixed income investments accounted for the lion's share. The combined balance in cash and cash equivalents stayed relatively constant at roughly $100 billion.

From this observation, one may infer that repatriation of offshore profits may impact fixed income assets more than cash and cash equivalents, including offshore MMF shares. In fact, an opposite phenomenon may develop in which, as firms let their fixed income instruments mature or choose to liquidate their bond portfolios, offshore fund balances may rise for a period before cash is redeployed for other purposes.

Expect Lower Balances but Exact Impact Unknown: The deemed nature of repatriation tax means that not all offshore balances need to or will be repatriated so long as the tax is paid. Share repurchases, debt repayment, mergers & acquisitions, capital investments and increased hiring are some ways to deploy cash. Some balances may also stay offshore for liquidity and business purposes.

Tax remittance could be another reason for offshore balances to deplete. Industry estimates put total tax owed on offshore profits up to $250 billion. Firms can pay this tax in installments over eight years with the majority coming due in later years, thus outflows in any given year should be manageable.

Considering these factors together, one can expect offshore MMF balances to decrease when repatriation is well under way, but the full impact is hard to estimate and may be less severe than initial gut reactions. Since a significant portion of offshore profits may already be in US Treasuries and US bank deposits, overall supply and demand dynamics on short-term debt instruments for both domestic and offshore funds may not be a major cause for concern.

Conclusion: A Market at the Verge of Change

While MMF reform dominated US fund discussions for much of the last decade, offshore funds largely sat in the periphery for US-centric liquidity investors. With imminent implementation of European fund reform and repatriation of overseas profits, offshore funds are bracing for transformational changes. Investors in the offshore markets will no doubt be impacted. Domestic investors without an offshore presence should also take note because of the overlap of common debt issuers and market liquidity in these markets.

Offshore MMF investors will have few alternatives when their prime funds become LVNAV funds. Unlike in the US, public debt (government) funds may not accommodate large inflows. The situation could be particularly challenging for euro funds in a negative yield environment since the EC has ruled that share cancellation will not be allowed for CNAV or LVNAV funds to protect principal.

Repatriation of overseas profits may be more manageable, as a large part of "trapped cash" is in fixed income securities outside of the realm of MMFs. Still, the trend is to redeploy offshore savings and reduce liquid balances. The trend may take some time to develop and is not expected to upset the supply and demand dynamics in the near term.

As investors with managed portfolios already know, a separate account can provide flexibility not available to commingled fund shareholders in managing uncertainty. It helps avoid the regulatory tight rope of market NAV stability and/or liquidity gates and fees triggers. Investors may allow certain securities to mature and sell others to satisfy repatriation, tax or debt repayment. While many questions remain unresolved today, it helps to have multiple liquidity solutions on hand to cope with change and deal with unforeseen liquidity needs.

About Us

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