# CLARITY

The newsletter from Clear Path Analysis

AUTUMN 2015

## What renewed volatility in world markets means for asset owners and asset managers

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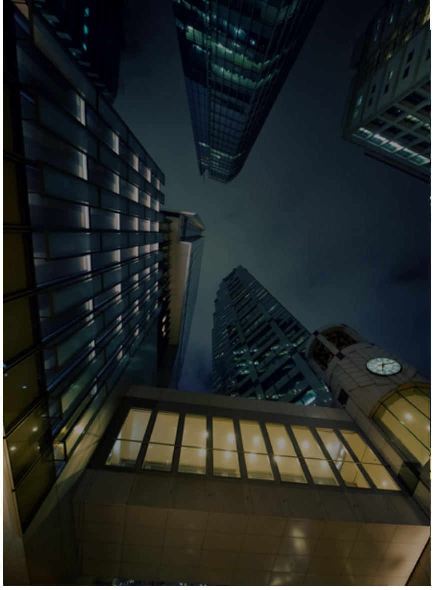

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**Noel Hillmann**
*Managing Director.*
*Clear Path Analysis*

Welcome to the first edition of **CLARITY**, our new newsletter for subscribers to the Clear Path Analysis stable of industry reports and surveys. This is a new way for us to provide our regular readers with fresh insight from leading financial service and institutional investment professionals.
For this first edition of **CLARITY** we've created two unique pieces of content:

- An insight from the IMF as well as a leading economist and fund managers on **What renewed volatility in world markets means for asset owners and asset managers**

- We interview the European Commission's Director for Financial Institutions on **How upcoming European money market reforms will impact treasurers and cash managers across the UK and Europe**

Also in this first newsletter, we highlight some of our **recent reports** and those to be released shortly that you can get your hands on, plus ones we're preparing where new contributors and sponsor partners are being sought.

For feedback on future reports you'd like to read, please do get in touch at **clarityfeedback@clearpathanalysis.com**.

Of course, should you want to find out more about what we're up to or provide your feedback on our reports, then please do get in touch.

Kind regards,

Noel Hillmann

Noel Hillmann,
Managing Director,
Clear Path Analysis

Clear Path Analysis
Sharing Financial Knowledge

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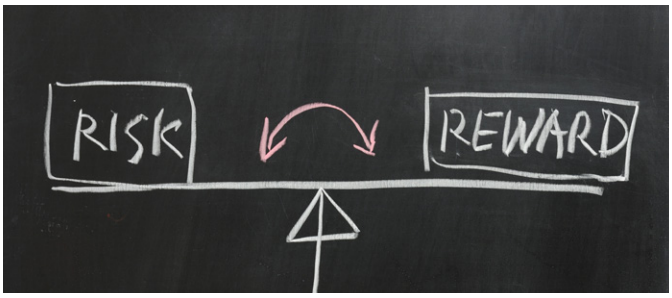


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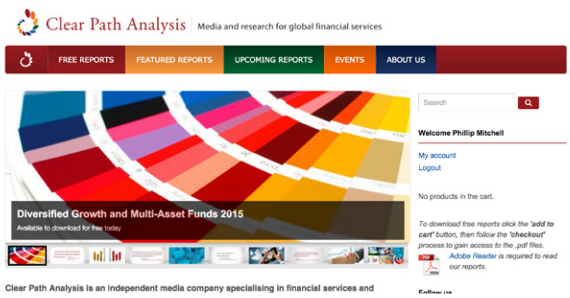


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## ECONOMICS DEBATE

# What renewed volatility in world markets means for asset owners and asset managers

**Moderator**

**Noel Hillmann**
*Managing Director. Clear Path Analysis*

**Panellists**

**Carl R. Tannenbaum**
*Executive Vice President and Chief Economist, Northern Trust*

**Panellists**

**Colm McDonagh**
*Head of Emerging Market Fixed Income, Insight Investment*

**Ian Coulman**
*Chief Investment Officer, Pool Reinsurance*

**Laura Kodres**
*Division Chief, Asian Division, Institute for Capacity Development, International Monetary Fund (IMF)*

**Binqi Liu**
*Portfolio Manager, Emerging Market Debt, HSBC Global Asset Management*

**Noel Hillmann: Would the panellists please introduce their role and responsibilities and give a brief overview of their respective organisations to help to position each person's comments?**

**Colm McDonagh:** I look after emerging market fixed income for Insight Investment. We deal in corporate, government credit, interest rates and currency strategies, both long and short.

**Laura Kodres:** I am in charge of the IMF's macroeconomic and financial training in Asia, at our Singapore training institute and also our training program in Dalian, China. Between 2007 and 2013 I oversaw the analytical chapters of the IMF's Global Financial Stability Report.

**Carl R. Tannenbaum:** I am the Chief Economist for the Northern Trust here in Chicago. We are a global asset manager and servicer. In addition to forecasting and writing commentary, I am also active in our asset allocation process, I sit on our capital committee and I also do quite a bit of risk management work.

**Ian Coulman:** I am the Chief Investment Officer (CIO) for Pool Reinsurance, which is the UK terrorism insurance pool that provides insurance cover for commercial property against terrorist damage in Great Britain. As the CIO I am responsible for the investment strategy which includes asset allocation and implementation. We operate a fairly outsourced model, utilising the expertise of different managers across corporate and government bonds, equities, commodities and multiasset credit, which includes high yield, emerging markets and senior loans.

**Binqi Liu:** I am a Portfolio Manager in the Emerging Market (EM) Debt Investment team at HSBC Global Asset Management. We manage about US$20bn in emerging market fixed income; so we have strategies in external and local debt, total return as well as blended, within EM fixed income.

**Noel: Is the Federal Reserve's (the Fed) prolonged holding of rates causing more harm than good to the world economy?**

**Colm:** I would make the distinction between the world economy and financial assets; and if you do make this distinction then prolonged holding of rates is creating a wide differentiation between the impact that they are hoping for, i.e. the recovery of the world economy, and the reality. Unfortunately the trickledown effect from financial assets, or the wealth effect from financial assets, has not had the impact on the world economy that policy makers would have wanted.

It is creating a huge distortion and this, at some point, needs to be unwound. The difficulty is that people can' t have full visibility of the world economy; had the Fed not engaged in holding rates down so low the consequences would have been far worse, but the policy has created some unintended consequences that are difficult to remedy

**Laura:** The Fed, whose formal mandate is on inflation and full employment for the domestic economy, has tried to keep rates low to encourage lending and investment; and for the US economy it has been somewhat successful in that regard. At the same time, the low interest rates have increased the probability of financial instability going forward.

Governor Yellen has acknowledged that they have been looking at the global economy, and taking into account the effects that developments in the global economy might have on the domestic real economy an approach both appropriate and positive. Even so, at some point the elevated financial risks will have to be dealt with, either through macro-prudential policies or through a gradual and wellanticipated increase in rates.

**Carl:** I worked for the Fed for 4 years from 20082012 so, as you might expect, I will mount a little bit of defence of what they have been doing. I remember when we went to 0% interest rates and then began Quantitative Easing (QE); there was concern that, down the road, it would invite financial excesses in leverage and markets; but we felt that those were a better class of problems to have than a world economy that was in a very bad condition. When you have such a recession, accompanied by a financial correction, it takes a long time to stabilise so central banks need to be patient.

In addition, if you are worried about the excesses in emerging markets, I would point to the comments of international policy makers, including Christine Lagarde, who have consistently urged the Fed to remain easy in order to allow the repair needed by some of those emerging markets that have borrowed in dollars. Certainly you can't dismiss the possibility that inflation or asset market excesses might appear and become problematic, but the benefits of remaining cautious seem clear.

**Ian:** The prolonged period of low rates, with yields being so low, has forced many investors to seek out additional, riskier, assets in order to try and enhance returns. This causes a number of problems, in particular that some of the asset classes that investors are going into wouldn't have been on the radar screen 45 years ago. This is a potential problem from a financial bubble perspective; when investors decide to get out of these investments, there will be many who take the decision at the same time and I am not sure to what extent there will be sufficient liquidity.

I agree with Carl that the Fed did have to do what they did at that time in order to ensure the world economy wasn't going to go into a depression. With more recent action from the Fed, however, I do feel that they have missed an opportunity; they have created greater uncertainty within the market. Markets don't like uncertainty and investors may become concerned that the Fed know more about the potential fragility of the global economy than they are letting on.

**Binqi:** Another way of looking at this question is by asking a question: would it be better if the Fed hadn't done this? I can't really answer 'yes' when we think about what has happened in the world over the past few years, we had a deflationary period with banks and households having to repair their balance sheets. Given the environment, low interest rates and QE did help the global economy; but nothing is perfect and, especially for policy makers, decisions are very hard to make, especially ones that are not without costs.

I agree with Colm and Laura about further financial stability being jeopardised by the financial markets. Lower rates have been good for the global economy and, if you consider the macro perspective, since 2009 the US current account deficit has reduced from 5% of Gross Domestic Product (GDP) to 2.5% of GDP; in the Eurozone, the current account situation has improved from a deficit of 1.5% to a surplus of 2.5%. These two currencies are global reserve currencies, meaning that, just from a currency current account deficit point of view, there is a very large global tightening of liquidity. To this extent, QE and low interest rates have largely served to mitigate this tightening effect.

I also agree with Ian that, because of what happened in September, there have been more difficulties and uncertainties because they didn't go through with the rate hike. It is really a good time to do it now.

**Noel: How can institutional asset owners, like pension plans and insurers, position their portfolios for prolonged volatility and uncertain rate changes?**

**Ian:** The answer goes counter to what I previously said in the last question – that, from an insurer's perspective, it is about trying to seek out yield-enhancing strategies – since, the core part of an insurance company's portfolio is going to be fixed income. It can be a combination of fixed income assets, but it will predominantly be a mixture of government debt, investment grade corporate debt and securitised instruments and, realistically, in trying to produce sufficient returns, there may be a combination of other yieldenhancing strategies and asset classes.

The overriding objective will continue to be matching duration of assets with liabilities, as required by the regulatory requirements of Solvency II. However, within certain ranges, insurers can certainly add value with incremental shifts in duration, but it is imperative that they have the resources and expertise to be able to make these tactical decisions.

To some degree, some of the investors have made these changes to diversify across other risk assets. In addition to the traditional equity component that many insurance companies have and pension plans obviously have a larger portion of this the other risk assets to consider will be alternatives or hedge funds, real estate, infrastructure and even areas like catastrophe bonds. A diversified bucket of relatively uncorrelated assets should be able to weather the volatility reasonably well.

The caveats are that in a financial crisis, as we saw in 2008, most asset classes do become closely correlated. Furthermore, for insurance companies the impending Solvency II requirements will require them to consider return opportunities relative to the capital charge that will be incurred for those different asset classes.

Carl: We have pension and retirement clients all over the world and I am under a great amount of pressure because the one thing that helps funded ratios, universally, is high interest rates so I have been trying to engineer those for a very long time.

A point that was made earlier about moving to liabilitydriven strategies and focusing on the longterm is important. In many cases pension regimes lost their way and went to asset allocation instead of focusing on their underlying obligations; so they are now struggling, to a greater or lesser degree, with funded ratios that may not be where they would like them or without the ability to index where their beneficiaries are expecting it.

Another area that deserves attention is the demographics of the underlying benefit base. The longevity of many plan participants has been surprising, to some, and so have seen a lot of regimes trying protect themselves against people living longer. Continuing to focus on contribution rates and benefit formulas, so that the assets and the plans satisfy what is promised and expected, is really the best thing that regimes can do in this environment.

"...no matter what the volatility and the uncertainty of returns are, if you are well diversified you will be better off"

**Laura:** Having a welldiversified portfolio is still relevant: no matter what the volatility and the uncertainty of returns are, if you are well diversified you will be better off; it is an obvious point but I am amazed at how many institutions take very concentrated positions in different types of asset classes, some of which they don't fully understand.

There is an underappreciation, in both the insurance and pension worlds, of liquidity issues. In the past, these sorts of institutions didn't worry too much about liquidity issues; but we are in a new regime where there is a run risk in some types of insurance products and I suspect that the low yields mean that pension funds might also have liquidity issues in paying out near term pensions. Having a more liquid portfolio, and in particular building up some reserves over time, would be good for pension plans. In order to even understand this you need good risk management policies in place; so the ageold advice of knowing your portfolio and how it reacts to shocks cannot be underestimated.

I am surprised at how many pension plans don't use stress testing. Just examining what happens when all the asset classes are perfectly correlated, predicting what will happen and how much money you might lose helps. Making a reserve plan with the idea of building up a reserve to a certain level, where maybe that proportion is based on some sort of valuerisk, or stress test scenario, would be very helpful. Even if this isn't an easy task for many pension funds, if you don't have a direction then certainly the prolonged volatility is only going to make the job harder.

**Noel: How do fund managers work with their clients to help position them?**

**Binqi:** From an emerging market fixed income perspective, some of our clients have been complaining this year that local emerging market debt, in particular, hasn't been great. This is true and we have been seeing more volatility. However, especially with the selloff, EM fixed income as an asset class does have value to offer, particularly given the yield. From a mediumterm point of view, even with highyield higher U.S. rates and slightly higher spreads on current levels, you will get a respectable positive annualised return in the next 3 - 5 years.

The trend that we have been seeing in interest from the community is to look for something that can capture the upside of EM fixed income and minimise the downside of the market. In this demand the total return strategy does fit very well in terms of the flexibility of choosing the most valuable subEM indices. If we look at this year, the local bond index was down 14% but the external bond index was up by 0.5%. Within one index you have one bond up by 20% whilst another drops by 20%, so there is a lot more divergence happening within the EM fixed income as an asset class.

Given the current environment, the sound path to take is a strategy that gives the flexibility to achieve the most valuable assets at the bond level. With total return strategies, unlike benchmark strategies, you can also choose your duration exposure; so in a rising interest rate environment, if you don't want to have a longduration exposure, you can keep the duration lower in a portfolio than in benchmark strategies. In a more volatile environment, EM is not a big beta play, but rather an alpha play you have to pick the winners and differentiate the losers between the two, try and capture the upside and avoid any assets or countries that will give you a more difficult time.

**Colm:** It is definitely an issue, particularly for the more cautious pension plans, since, ultimately, all of those institutions have liability streams and these liability streams require them to have a return hurdle, say 5%. In an environment where we have negative yields and certainly negative deposit rates, we have distorted the definition of what 'risk free' is.

If you continue the search for yield the options to institutional asset owners are to go down the liquidity curve, perhaps go down the credit curve and in some cases, people are looking to use some leverage. The latter is the least attractive, though each of these options does have pros and cons.

Another opportunity would be a change in the structural financing nature of markets. Globally, we are seeing a huge transfer of balance sheets from the banking sector. Corporates used to finance via bank loans, now there are asset classes which previously may not have had sufficient liquidity. The EM corporate bond space is an example. It is an asset class that is in excess of US$2 trillion, mostly because of the transfer of balance sheets from banks since the global financial crisis. This is an area rich in opportunity to explore, with caution.

The institutional asset owners are becoming far more calibrated, particularly insurance companies, where they target a certain return and tolerance for risk and allow asset managers to try and achieve that within certain rules like Solvency II. There are different ways that institutional asset owners can position themselves in the markets which have been increasing in volatility in an extraordinary way over the past 12 months or so. In this environment, managing and calibrating your risk profile is going to be key.

**Noel: Has the focus on China's sell-off and the U.S. programme of QE, been a mask for problems in other key growth regions such as Brazil and Africa?**

**Carl:** We tend to look at emerging markets on a more granular basis, even though some products tend to lump them together. We are looking for countries that have stability, put away money in reserves, maintain good balance in their trade relationships, protect the independence of their central bank, and promote transparency in their business dealings.

The extended expansion that we had prior to the financial crisis actually made some EM countries look better than they were and now that we are in retreat, a lot of the flaws that remained in those business models are still apparent. We are watching countries which borrowed in currencies other than their own, both in the public and private sector. We are looking at countries which became over-reliant on one client, in some cases China, and, of course, we are looking at corruption.

The two markets that concern us the most are Brazil, which has been through a terrible corruption scandal and Malaysia. Malaysia's reliance on China as a client and the scandal surrounding their shadow sovereign wealth fund are both negatives.

**Binqi:** Both Africa and Brazil, as well as some other regions, have benefited from commodity prices. These countries and regions are part of the China commodity boom. Then China has started to rebalance and we don't have this commodity boom anymore; but still have the Fed's QE so that, even when their terms of trade have reduced massively since 2011, the current account deficits of all of these commodity countries are still at a historic high.

When there is QE everywhere these deficits can be funded; but when the QE stops and global rates start to rise we are likely to see these countries being forced to adjust their current accounts, either through tightening monetary or fiscal policies, letting the currency depreciate, or we will see a much slower growth from the private sector, or even see some defaults rising in these sectors - it depends on the country's policy mix and the quality of the governance of the country.

Brazil and Africa are examples of where we need to see more structural reform and better governance in order to improve productivity and help regain investors' confidence.

**Ian:** I don't think you can simply blame the situation on China and U.S. QE – they mask a myriad of problems elsewhere. We know that QE has been going on elsewhere, although not on the same scale – for instance, Japan and Europe.

It is those emerging markets that had less focus on structural improvement and the underlying nature of things like fraud and corruption that are likely to suffer. Those countries who have put in place the structural improvement and reforms will in turn succeed. Places like Russia and Brazil are probably under the greatest pressure and we are clearly seeing that at the moment. Overall you have to be very selective, especially if you are looking at EM in particular.

**Colm:** China's market volatility has had a huge amount of press - probably in excess of the actual worry that people should have about it. Everything is interconnected and the flow of capital that we have seen in the past number of years has been driven by commodity booms, investment, or QE - and that means that a reversal of those capital flows is going to impact countries everywhere, whether they have made structural reform or not. Due to this QE environment, companies and countries have had the opportunity to borrow at levels that might best be described as excessively optimistic from an investor perspective. Some issuers were enjoying a free lunch.

There has been a lot of reform fatigue over the past couple of years and whilst theoretically you shouldn't have reform fatigue, it is understandable. Brazil is clearly in much difficulty at the moment, yet not so long ago was forced to restrict the amount of capital flowing into the country. From that perspective the market was not providing corrections for policy decisions, as might have been the case in previous EM cycles. It is too easy to say that QE or China is masking these issues and really it is just a natural consequence of some of the things that are taking place.

Africa has also a multitude of investors happy to lend to issuers at wildly optimistic levels and we have more concern across the African economies that have borrowed in U.S. dollars since they are relatively newer borrowers and have not yet had the experience of paying back through the interest rate cycle. Quite a few of them are experiencing balance of payments crises and clearly, if they are borrowing in dollars then we are returning back to the original sin of major EMs in the 1990's. That is an area of concern for us.

It would also be wrong to treat Africa as a single entity: there is a huge level of differentiation between the types of issuers and their relative economic strength. All of this is interconnected and when you get a reversal of capital flows, for whatever reason, there will be varying impacts on economies who have prepared for a rainy day and those who have not.

**Laura:** There has been excessive focus on China's sell-off in the stock market and on the U.S.; in part this is because they are the world's two largest economies and they affect other economies. Whether the stock market sell-off in China should receive such attention is not so certain; people are now aware that the equity market in China is still relatively small, in the sense of having a wealth effect on its own economy and also foreign ownership of Chinese equities is relatively small. So far, its financial markets are not as well connected to the global markets as those of many other countries, but they are becoming more connected; and people are worried that it is a signal about what is happening in the real economy in China more than anything else.

U.S. QE finished some time ago but the after effects are still there. The impact on different emerging market countries is relatively important, and we need to spend more time differentiating which countries have utilised the low interest rate environment to the benefit of their economies and populace and which have taken advantage of low interest rates in a way that will potentially be more risky. It does seem that, in every cycle, countries get lumped together. It would help if people were to look at the underlying fundamentals and make differentiating decisions based on those.

**Noel:** Which are the bright spots that will drive growth and return?

**Binqi:** Valuation wise, the good news is that from an EM fixed income perspective, things are much cheaper; so Foreign Exchange (FX) is weaker, spreads and rates are higher and if you think about the long-term point of view, there is a lot of value in EM fixed-income assets.

When we see so many bad things about China, we need to contextualise the situation. Korea and Japan both experienced collapsed investment growth in the 70s and 90s – and this is when they reached urbanisation ratios of around 70%. China's urbanised population is around 50%, so it still has a long way to go. China still has an intrinsic engine of growth and we just need to remind ourselves of that when we become too negative on China.

**Laura:** The bright spots are really countries that are nimble, have robust policymaking apparatus, and leaders who are forward-looking and accommodating the future of their citizens.

The issues to examine to make this judgment include dealing with ageing populations, climate change, infrastructure investment, education and gender equality. Countries that address these areas will be where investment is going to pay off and have high returns.

**Ian:** From an overall perspective, given the slowdown in China, we are going to have to accept that we are in a period of low growth and probably low inflation for a lengthy period of time. I don't think that China is going into any kind of recession - there is the reported 7 - 8% growth and even if it falls to 5% it is still positive growth.

## "We don't think there will be a meltdown in China. There are 3.5 trillion reasons why"

There are some bright spots in the developed world, particularly in the U.S. and UK, with Europe sluggish but, from what we see, there is improving value. Given the sell-off that we have seen in EM there is significant value in many of these areas. There is a need to be more selective in allocations to EM - rather than as in the past where investors might simply invest in a broad group of EM. It goes back to the point of being selective of those who have put in place the right kind of infrastructure and structural changes that are going to be better for their economies in the long-term.

**Colm:** The fact that a lot of EM currencies have weakened so substantially is a very important safety valve from an economic perspective that didn't exist 10 - 15 years ago. This isn't across all EMs, but the major ones, and for the prospects of growth going forward it is quite helpful.

The commodity rebalancing is very painful for many countries but it is a necessary condition of future growth. We look for policy action that is proactive and positive – which we are seeing across some emerging economies but far more need to participate. In terms of valuation, at some point, risk premiums need to be sufficient in order to take these risks again.

**Carl:** We don't think there will be a meltdown in China. There are 3.5 trillion reasons why: that figure represents the size of China's official reserves, which should be sufficient to spackle holes in the banking system, stabilise markets and also to promote economic activity.

We see Europe coming along, although it is a slow process, but lending in Europe is back to year-on-year growth and the QE seems to be working. Deleveraging at household level in the U.S. and UK is well along, enabling those two countries to grow and to support imports from the rest of the world.

I don't believe that the secular stagnation hypothesis is correct over the long-term, since a good bit of recent sluggishness is due to continued repairs since the financial crisis. We do need to be wary of the impact of demographics on performance and I am also glad to see that there is a little bit less austerity in budget policy, allowing greater investment in human and physical capital.

QE is still very much with us in the U.S. and although we aren't adding to it here, balance sheets in the central banks are large and in aggregate, getting larger. Central banks seem committed, in the major developed world, to try and sustain growth. Whilst there are certainly challenges and we have enumerated a number of them in this discussion today, this is not 2008. We have come a long way since then.

**Noel: Thank you all for sharing your views on this subject.**

"QE is still very much with us in the U.S. and although we aren't adding to it here, balance sheets in the central banks are large and in aggregate, getting larger."

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The sixth annual report bringing together Heads of Finance, HR Directors, Pension Managers and Senior Company Directors to discuss the challenges of scheme design, investment choice, employee communication, member governance and costs of auto-enrolment implementation and remedial work.

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## Collateral Management & Securities Lending, North America 2016
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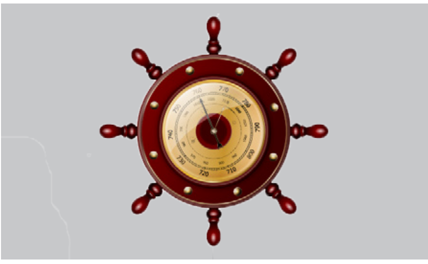

## Insurance Asset Management, Europe 2016
*Published 7th March*

The fourth annual report where those charged with investment activity within UK and European based insurers come together to examine the challenges of asset allocation in light of renewed market volatility, meeting regulatory demands on investment choice and developing operations

## Treasury & Cash Management, North America 2016
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The second annual report where North American treasurers and corporate finance professionals debate and outline the evolving issues facing treasury departments as they seek to generate optimal returns in a low interest environment, considering the impact of Money Market Fund reforms, managing liquidity and optimal use of cash and reducing risk and operational complexity.

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# Examining the latest regulatory standpoint on money market funds where are we?


**Interviewer**

**Noel Hillmann**
*Managing Director.*
*Clear Path Analysis*

**Interviewee**

**Martin Merlin**
*Director, Financial Markets, European Commission*


**Noel Hillmann: Thankyou Mr. Merlin for taking time to share your views with me today.**

**I'd like to begin by asking, what plans do European regulators have in relation to money market funds?**

**Martin Merlin:** The commission in September 2013 adopted a proposal to reform the operations of money market funds. This proposal is now being debated in council and parliament.

The main issues addressed in the commission's proposal are asset maturities and liquidity, so we propose that portfolio maturities have to be such that sensitivities to interest rates are minimised as well as rules on diversification. This is to ensure market stability in case a Money Market Fund ("MMF") issuer is downgraded or faces default. This is the type of experience that we had when Lehman went bust.

The commission proposal contains tight limits on the maturities of MMF investments. These are designed to avoid rapid decreases in the value of MMF portfolios once interest rates rise. The rules on diversification are there to mitigate more specific risks linked to the financial situation of an MMF portfolio issuer.

Also, in order to better apprehend specific risks associated with MMF that redeem at the stable price, the so called NAV funds, the commission has proposed a capital buffer which should be established by these funds. This proposal has been debated in parliament and council and the parliament has issued a report on the MMF proposal. The parliament proposes to replace our capital buffer for CNAV funds, with a new model, the low volatility MMF's, which can still redeem at a stable price. But they would have a smaller band before they need to float the redemption price.

In the council for the moment little progress has been achieved and it is fair to say that members are divided notably on what to do with constant NAV funds. We hope that the Luxembourg presidency will manage to strike a deal in the coming months.

**Noel: Do they intend to increase strictness to the same level of US counterparts?**

**Martin:** The rules that I mentioned on maturity and liquidity reflect the existing international standards applicable to all MMF's and are identical to those that prevail in the U.S under the new regime. However, in addition to rules on liquidity and maturity, in the U.S the Securities & Exchange Committee ("SEC") in 2014 issued rules on the operation of CNAV funds. The SEC has decided that MMF's who invest in corporate debt have to float a redemption price to reflect the market value of the portfolio. On the other hand, MMFs that invest almost exclusively in short term government debt may continue to operate at CNAV.

The treatment of CNAV in the E.U is still under negotiation. One has to bear in mind that the market structure in Europe is different. For example, we have almost no government debt CNAVs in Europe. What we proposed for corporate debt CNAVs was a capital buffer to compensate losses when redemptions continue at €1 per share, even though the market value can be lower than this. The parliament prefers the introduction of low volatility CNAVs and the council has not yet taken a view on the treatment of CNAVs.

I would be surprised if we ended up with exactly the same rules as the U.S.

**Noel: How will it affect the NAV rate?**

**Martin:** The parliament is in favour of establishing a narrower threshold before the CNAV MMF breaks the buck. The parliament has proposed 20 basis points.

The advantage of a narrower threshold is that the MMFs losses that result from redeeming at a Euro are limited with a 20 basis point band. Losses for the remaining investors would be less than half of those suffered with the 50 basis point model. On the other hand, the parliament wants the new low volatility NAVs to be limited in operation for a term of five years and the commission during those five years should assess whether the low volatility NAV model can continue or whether it has not resulted in mitigating the risks associated with CNAV MMFs.

This is how the NAV rate could be affected but again this is only the text of the parliament and we have no final legislation yet.

**Noel: There then is the feeling that this is only step one of others in money market fund reforms?**

**Martin:** Frankly we would be happy to finalise the ongoing negotiations so that we can complement the existing regulations, which are enshrined in the UCITs framework, with more tailored made rules for MMFs. If we manage to do this with the Luxembourg presidency then I would be surprised if we would open that file again in the very near future.

**Noel: You do then wish to put this to bed for a while at least but what situation would trigger a review of the way that MMFs are regulated?**

**Martin:** I wouldn't mention very specific triggers. What we want to see is stability and resilience in the sector and we want investors to be satisfied with the way in which money market funds operate in general terms.

At the moment we are focused on finalising the proposal. If the proposal is adopted as requested by the European parliament then there will be a review after a certain number of years, during which the commission will be asked to assess the way in which money market funds operate and in particular CNAV funds or low volatility NAV funds. We will look at all aspects that are conducive to stability and resilience.

**Noel: Should corporate treasurers continue using them and if not, what alternatives can treasurers explore?**

**Martin:** Some but not all corporate treasurers want to keep the stable redemption or CNAV funds notably for accounting and taxation reasons. It is up to them to decide in light of the applicable rules what type of funds they want to use or not.

The disadvantage of stable redemption funds is that the spread between the redemption value and the real value of the share will have to be borne by the investors that do not redeem. This is especially acute for those investors who redeem after the MMF has broken the buck. For the moment there is no capital buffer to absorb these losses so this does have to be borne in mind.

This is why corporate treasurers may have to start thinking about alternatives which are low volatility NAVs or MMFs that price their assets daily and redeem daily prices that reflect true value. The main advantage here is that all investors are treated equally and also with such funds, there is a lesser spread between redemption and market value.

People have to look at the applicable rules and within that framework decide what fits with their business.

**Noel: Thank you for sharing your thoughts on this subject.**

## "What we want to see is stability and resilience in the sector and we want investors to be satisfied with the way in which money market funds operate in general terms."

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