BlackRock

Classification of Money Market Funds

Considerations of the European Money Market Funds Regulations

March 2024

In brief

- European Money Market Reform took legal effect in July 2017, with full compliance required by January 2019.
- We believe money market funds play an important role in the investment strategy for many investors, and the classification as Cash and Cash Equivalents (C&CE) is an important characteristic.
- In this paper, we consider the impact of this regulation on the classification of Money Market Fund Investments.

Background

Investors frequently use money market funds (MMFs). An investment in an MMF aims to provide shareholders with a lower-risk investment option with a focus on mitigating downside risk and maintaining a high level of liquidity. However, investments in an MMF are not risk-free and the capital is at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. You may not get back the amount originally invested.

In November 2016, the European Commission, the Council of the European Union (EU) and the European Parliament came to an agreement on the draft regulations on the reform of the European money market industry (the Regulations). This was published by the Council of the EU and published in the Official Journal of the EU on 30 June 2017. The rules took legal effect 20 days following their publication in the Official Journal of the EU, meaning that they became effective for existing European MMFs on 21 January 2019, after an 18-month transition period. New MMFs that are established on or after the date the Regulations entered into force are subject to a 12-month transitional period.

This paper seeks to cover certain aspects arising from the application of these Regulations, which may impact the classification of investments in MMFs as C&CE by investors.

Source: BlackRock's interpretation of European Money Market Funds Regulation as finalised via a political agreement between the European Parliament, Council and Commission in November 2016. As at March 2024.

1. The classification of investments in MMFs as Cash and Cash Equivalents (C&CE) by investors

1. Impact of the Regulations.

The Regulations cover certain operational aspects of three different forms of MMFs, namely public debt constant NAV funds (CNAV funds), variable NAV funds (VNAV funds) and low volatility NAV funds (LVNAV funds). Certain of these operational considerations may have a bearing on the issues covered in this paper.

We also note that the Regulations allow for short-term VNAV funds, as well as standard VNAV funds. Given the profile of the standard VNAV funds, which are required to have a portfolio weighted average maturity of up to six months and a weighted average life of its portfolio of up to 12 months, the standard VNAV fund is less likely to meet the definition of C&CE. As a result, we have not considered the standard VNAV within this paper. All references to the VNAV reflect the short-term VNAV. Moreover, all references to MMF will reflect CNAV, LVNAV and short-term VNAV.

2. Issue and redemption price.

The Regulations allow for the issue and redemption price to be processed based on a floating NAV per share or on a constant NAV per share, dependent on the type of MMF. A fund calculates the floating NAV per share as the difference between a fund's assets and liabilities valued in accordance with mark-to-market models, divided by the number of shares in issue. The constant NAV per share, on the other hand, is calculated as the difference between a fund's assets and liabilities valued in accordance with amortised cost models, divided by the number of shares in issue.

The issue and redemption price of CNAV funds are processed at the constant NAV per share, while for VNAV funds, they are processed at the floating NAV per share of the fund. However, for LVNAV funds, the issue and redemption price may be processed at the constant NAV per share, where certain conditions are met. Where those conditions are not met, they are processed at the floating NAV per share of the fund. Where the constant NAV per share deviates from the floating NAV per share of an LVNAV fund by more than 20 bps, the issue and redemption price must be processed at the floating NAV. Where the deviation is below 20 bps, the issue and redemption price is the constant NAV per share.

1.3 Provisions for liquidity fees, suspensions of redemptions and redemption gates for LVNAV funds and CNAV funds.

The Regulations have also introduced liquidity thresholds for positions held by LVNAV/CNAV funds. As well as a requirement to establish, implement and consistently apply prudent and rigorous liquidity management procedures, the LVNAV/CNAV fund must also meet the specific liquidity thresholds outlined in the Regulations. When the weekly maturing assets fall below 30% of the fund and where the net daily redemptions on a single day exceeds 10% of total assets, the Fund Board must consider the application of liquidity fees, redemption gates or suspension of redemptions. If the weekly maturing assets fall below 10% of the fund, the Board must apply liquidity fees and/or suspension of redemptions. As outlined in Article 34.2 of the European Money Market Fund Regulation, when, within a period of 90 days, the total duration of the suspensions exceeds 15 days, a public debt CNAV MMF or a LVNAV MMF shall automatically cease to be a public debt CNAV MMF or a LVNAV MMF. The public debt CNAV MMF or the LVNAV MMF shall immediately inform each investor thereof in writing in a clear and comprehensible way.

2. Possible classification of investments in Money Market Funds in the financial statements of an investor

2.1 International Financial Reporting Standards (IFRS) requirements.

International Accounting Standards (IAS) 7 Statement of Cash Flows (IAS 7) provides a definition of cash equivalents which sets out criteria that must be met in order for instruments to be classified as cash equivalents.

"Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value" [IAS 7, paragraph 6].

In March 2009, the Interpretations Committee of the International Accounting Standards Board (IASB), International Financial Reporting Standards Foundation (IFRIC) discussed a request for guidance on whether investments in shares or units of MMFs that are redeemable at any time can be classified as cash equivalents.

In most cases, an MMF investment is quoted in an active market and, as such, could be regarded as highly liquid. However, this is not enough to meet the definition of a cash equivalent. As set out in paragraph 6 of IAS 7, the short-term and highly liquid investment must be readily convertible into known amounts of cash which are subject to an insignificant risk of changes in value. The IFRIC considered the issue in 2009 and confirmed that the amount of cash that will be received must be known at the time of the initial investment. Accordingly, investments in shares or units of MMFs cannot be considered as cash equivalents simply because they are convertible at any time at the then market price in an active market.
The IFRIC also confirmed that an entity would have to satisfy itself that any investment was subject to an insignificant risk of change in value for it to be classified as a cash equivalent.

In summary, an investor is required to consider all criteria in the definition of C&CE in order for an MMF investment to be considered C&CE (i.e. short-term, highly liquid, readily convertible to known amounts of cash; and subject to insignificant risk of change in value).

IFRIC considered that there might be two possible approaches that investors might take when making the assessment as to whether an MMF investment meets the criteria for classification as a cash equivalent:

Considering the definition criteria, i.e. short-term, highly liquid, readily convertible to known amounts of cash; and subject to insignificant risk of change in value in relation to the fund's stated investment policy; or

'Looking Through' the fund to consider the nature of the underlying investments and assessing whether each of these investments meet the criteria set out in the definition.

These approaches and considerations for investors when making their assessment as to whether the investment in an MMF meets the criteria for classification as C&CE are covered in more detail in section 3.

In a 2013 IFRIC Staff Paper on IAS 7 Statement of Cash Flows – identification of cash equivalents, IFRIC also observed that 'cash equivalents are held for the purposes of meeting short-term cash commitments rather than for investment or other purposes'. Therefore, it is IFRIC's view that 'the purpose for which an investment is held is the core principle in IAS 7 for determining whether an investment qualifies for classification as a cash equivalent'.

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2.2 UK Generally Accepted Accounting Principles (GAAP) Financial Reporting Standard (FRS102).

FRS 102 defines cash equivalents as:

"short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value".

As the definition of cash equivalents is the same as that set out in IFRS, the considerations for classification of investments in MMFs as C&CE under FRS 102 are the same as those set out in Section 2.1 for IFRS.

2.3 US GAAP requirements.

Paragraph 305-10-20 of Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) defines cash equivalents as:

"short-term, highly liquid investments that have both of the following characteristics:

- *Readily convertible to known amounts of cash; and*
- *are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates.*

Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month US Treasury bill and a three-year US Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations)."

Certain US MMFs are registered under the Investment Company Act of 1940 (the Act) and regulated pursuant to Rule 2a-7 under the Act. Rule 2a-7 MMFs, which are redeemable upon demand and usually allow for withdrawal by check (cheque) or wire (electronic) transfer, are examples of investments that generally can be classified as cash equivalents. The Rule 2a-7 definition of an MMF requires the mutual fund to invest in securities with minimal credit risk (e.g. US government bonds, US Treasury Bills, commercial paper). These MMFs have relatively low risks compared with other mutual funds, pay dividends that generally reflect short-term interest rates and some seek to maintain their net asset value (NAV) at $1[1] per unit.

In the US, since October 2016, institutional prime MMFs, including institutional municipal MMFs, are required to have floating NAVs that are based on the market value of the securities in their portfolios rounded to the fourth decimal place. These new rules also prescribe certain thresholds that the board of a non-government MMF must consider in determining whether to impose liquidity fees or redemption gates. Government MMFs are permitted but not required to impose fees and gates.

The Securities and Exchange Commission (SEC) has noted that under normal circumstances the adoption of a floating NAV alone will not preclude investors from classifying their investments in MMFs as cash equivalents. This is because fluctuations in the amount of cash received upon redemption would likely be small and, therefore, consistent with the concept of a 'known' amount of cash. However, if the floating NAV MMF is experiencing credit or liquidity issues, including those that cause the imposition of a fee or a gate, the investor must reassess whether its investment continues to meet the definition of a cash equivalent.

An investor reporting under US GAAP investing in a European MMF should consider the guidance by the SEC in assessing whether an investment in an MMF can be classified as C&CE. An MMF that does not meet the definition under US Rule 2a-7 should be evaluated for classification based on the fund's characteristics and requirements – this would include European CNAV, LVNAV and VNAV funds. The considerations for classification of investments in MMFs as C&CE under US GAAP would be similar to those set out in section 2.1 for IFRS.

1 $ refers to US dollars.

3. Areas that may be considered by investors in MMFs when assessing their classification of various forms of MMFs as Cash and Cash Equivalents in accordance with IFRS

The analysis set out below equally applies for FRS 102 and US GAAP, as the definitions of C&CE as set out in IFRS; FRS 102 and US GAAP are similar.

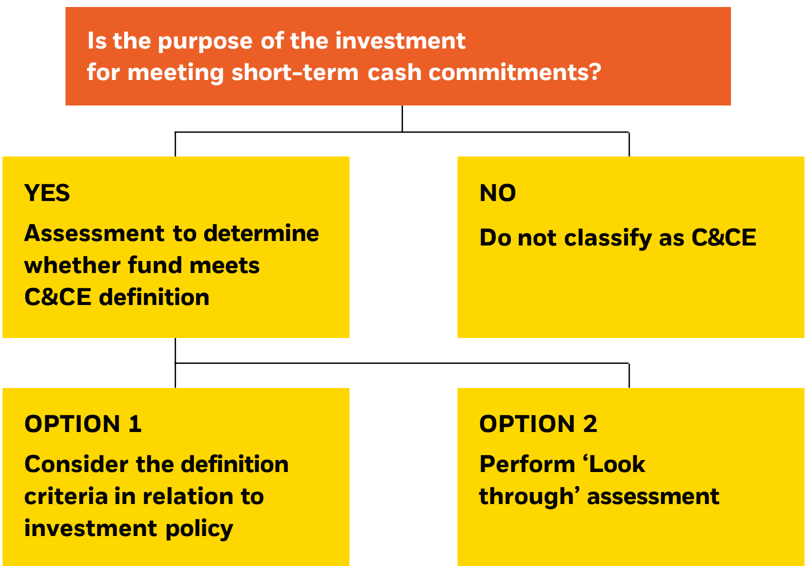
There are a number of considerations that investors may contemplate, both on initial investment and on an ongoing basis at the end of each reporting period, in order to determine whether an investment in a CNAV, LVNAV or VNAV MMF meets the definition of C&CE.

3.1 Initial classification.

At the initial investment phase, an investor will need to consider factors including the reason for making the investment, as well as the investment objective for the MMF itself.

Investments are often held for purposes other than to meet short-term cash commitments. The purpose of the investment is, therefore, a key principle for each investor to consider when determining whether classification as a cash equivalent is appropriate.

An investor may consider factors specific to the MMF and other external factors in order to conclude that the MMF meets the definition of C&CE under IAS 7.



3.2 Definition criteria in relation to investment policy.

In order to determine if the investment objective of the fund meets the criteria of C&CE, an investor would check that the MMF is consistent with the definition of C&CE under IAS 7, i.e. that the investment is 'short term, highly liquid, it is readily convertible to known amounts of cash and is subject to insignificant risk of a change in its value'.

C&CE Definition	Considerations
Short term	An investor in an MMF might conclude that their investment meets the criteria for the short term if the MMF portfolio has been constructed in such a way as to meet the requirements to have: • a Weighted Average Maturity of its portfolio of no more than 60 days; • a Weighted Average Life of its portfolio of no more than 120 days; • minimum daily and weekly liquidity thresholds.
Highly liquid investments that are readily convertible to known amounts of cash	An investor in an MMF might conclude that their investment meets this as they trade on a daily basis.
Subject to an insignificant risk of changes in value	The risk of changes in value is mitigated, where subscriptions and redemptions are processed at the constant NAV. Where redemptions are at a constant NAV per share an investor in an MMF might conclude that the investment would meet this criteria. The volatility in a VNAV is primarily dependent on the daily yield and/or price of the investments held by the VNAV fund, and these investments are subject to eligibility requirements for an MMF. An investor in an MMF where there is volatility in the NAV will need to apply judgement to set a threshold against which 'subject to an insignificant risk of changes in value' is assessed.

It is likely that an MMF, which is managed within the parameters of the Regulations, would meet the above aspects of the definition of C&CE in normal market conditions, though each investor would need to make their own determination.

3.3 'Look Through' assessment.

Where an investor performs an assessment of the MMF, they may choose a 'Look Through' of the MMF. The objective of this approach is to verify that the investments held by the MMF would meet the criteria for classification as C&CE.

As set out above, when assessing whether the change in value of an investment in an MMF can be regarded as insignificant, an investor has to conclude that the range of possible returns is very small. This assessment would therefore consider factors in relation to the portfolio of the MMF:

- The nature of investments (i.e. not subject to volatility)
- The extent of diversification in the portfolio (which is expected to be very high)
- The maturity of the investment (e.g. a maturity of less than 90 days)
- The liquidity profile of the investments (in line with regulatory requirements)
- The credit ratings of the investments (e.g. AAA or equivalent highest rating)

The nature of the investments held must comply with the requirements of the Regulations, which focus on eligibility, diversification and concentration. Similarly, liquidity requirements around daily and weekly liquidity thresholds must be complied with, and the Regulations introduce certain mechanisms where liquidity falls below certain levels. The manager of the MMF must also establish, implement and consistently apply a prudent internal credit quality assessment of its investments.

It is likely that an MMF, which is managed within the parameters of the Regulations, would meet the above criteria for classification as C&CE in normal market conditions, though each investor would need to make their own determination.

3.4 Ongoing monitoring.

Where an investor has concluded at the initial investment stage that an MMF classifies as a C&CE, they may wish to put in place a process to monitor events that may indicate that the MMF no longer meets the criteria for classification as C&CE. This would involve the identification of assessment triggers, which would result in an assessment of the MMF, in order to determine whether or not it meets the criteria of C&CE. Investors may also develop thresholds for each of the assessment triggers, which, if breached, conclude that the MMF should no longer be classified as C&CE.

Events that trigger a further assessment may include:

- suspension of redemptions
- invoking liquidity fees or redemptions gates
- volatility in NAV (including conversion of CNAV or LVNAV fund to a VNAV fund)
- downgrade in rating of MMF.

The provision of redemption gates and the suspension of redemptions is not a new concept, and is already provided for within the Undertakings for the Collective Investment in Transferable Securities (UCITS) framework. As a result, the inclusion of these mechanisms under the Regulations does not necessarily preclude a fund from being considered as C&CE.

Furthermore, the occurrence of any additional triggers does not necessarily preclude a fund from being considered as C&CE. However, investors should determine the appropriate thresholds for these assessment triggers at which an MMF no longer meets the definition of C&CE.

When setting these thresholds, consideration should be given to:

- the period of suspensions and redemption gates, which would need to be evaluated against the criteria of being highly liquid, i.e. less than three months maturity;
- the impact of liquidity fees or redemption gates on the NAV of the MMF, volatility of the NAV per share and conversion to a VNAV fund, will need to be considered against the requirement that there is an insignificant risk of change in value;
- whether there is a need to set a NAV fluctuation threshold to determine changes that are inconsistent with the criteria that C&CE represent a known amount of cash and insignificant risk of changes in value.

4. Conclusion

The criteria that must be met for classification of investments in an MMF as C&CE in the financial statements are unchanged. The potential for liquidity fees and/or suspensions as required in the Regulations may not necessarily preclude the fund from meeting the criteria for classification as C&CE, assuming no change in either the investment policy or the assets within the MMF.

Investments in CNAV and VNAV funds, which operate within the requirements of the Regulations and in normal market conditions, are likely to meet the definition of C&CE. However, where suspensions or liquidity fees are invoked, or there is volatility in the NAV, the investor should reassess whether their MMF investment continues to meet the criteria for classification as C&CE.

Where an LVNAV operates within these Regulations and in normal market conditions, it is likely that subscriptions and redemptions will be processed at the constant NAV per share and investors may classify this investment as C&CE.

Where an investment in a LVNAV MMF, meeting the criteria for classification as C&CE, moves to being classified as a VNAV fund due to fluctuations in NAV in excess of 20 bps, an investor will need to assess whether an insignificant risk of change in value continues to be met. Similar to investments in CNAV and VNAV funds, if suspensions or liquidity fees are imposed, or there is volatility in the NAV, the investor should assess whether their MMF investment continues to meet the criteria for classification as C&CE.

Investors may wish to set policies such as NAV fluctuation thresholds against which this criteria should be evaluated.

Want to know more?

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Important Information

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