Inflation, Rate Hikes and Regulatory Scrutiny Shake Up Short-Term Investments

The cash investment landscape is being disrupted by higher sustained inflation, rising interest rates, and new regulatory proposals for MMFs. Corporate treasurers not only need to evaluate the impact of these various drivers on their optimal portfolio composition – but must also be prepared to take action.

By **Ben Poole**, Columnist, TMI

The low interest rate environment of the past few years has seen corporates becoming increasingly creative when deploying their cash, as a means to chase yield. Consequently, investments in short-duration bond funds and in prime MMFs became attractive propositions. However, change is afoot as inflation now threatens to overheat economies across the globe and central banks look to rate hikes to rein in price rises. In fact, some central banks have already made telling moves. In its May meeting, the Federal Reserve raised its core rate 50 basis points, its biggest hike since 2000. This was on the heels of its quarter basis point hike in March – the first since 2018. Meanwhile, the Bank of England has raised rates by 0.25% four times since December 2021, taking UK interest rates to their highest level in 13 years.

Tory Hazard, Chief Executive Officer, Institutional Cash Distributors (ICD), comments: "We're going into a rising rate environment and, as a result, we're now seeing a decrease in demand in short-duration bond investments. Bond funds in rising rate environments tend not to do as well as MMFs which have an even shorter duration. We do have some clients in ultra-short bond funds who accept some principal risk for higher yields, but there is less demand for those products due to the expected rate increases in 2022 and 2023."

Rate rises could occur at every Federal Reserve monetary policy meeting this year, as 2022 has seen inflation continue to accelerate in the US. In March 2022, the US Bureau of Labor Statistics revealed that the Consumer Price Index – the standard measure of national inflation – had hit 8.5%,[1] the highest monthly year-on-year inflation rate since December 1981. One of the by-products of higher inflation is more cash building up on corporate balance sheets.

"Certain sectors can be more sensitive to inflation than others. Depending on the situation with a specific company, they may want to be holding on to greater amounts of cash if they feel that they're going to be more affected by an inflationary market," Hazard says.

With excess cash to manage and rates on the rise, finding investment instruments that can quickly react to higher interest rates and enhance yield is essential for treasurers wanting to make the most of their organisation's money. This puts MMFs, with their short-term focus, in a good position, and providers have planned for just such an occurrence, as Hazard outlines.

"The majority of money funds have kept their liquidity very high, many to 50% weekly liquidity, to take advantage of the next rate hike and the others that look likely to follow," Hazard says. "MMFs are very sensitive to the rate hikes. Banks can be too, although they face challenges from maintaining liquidity coverage ratios (LCR) and reduced borrowing demand anticipated in a rising rate environment."

The recently published 2022 ICD Client Survey[2] reflects the increasing attractiveness of MMFs for treasurers. Polling more than 100 treasury organisations, the survey found that 83% of firms are either maintaining or increasing their overall cash investments in MMFs.

"We're seeing a big increase in new MMF account openings, based primarily on treasurers readying themselves for the increased rate environment," confirms Hazard. "They want to have the ability to choose from a wide variety of investment options."

US regulatory reforms: a swing and a miss

Another major headline in the MMF world is the prospect of new regulatory reforms. These have been a reaction to the short, sharp liquidity shock that markets experienced in March 2020. The US Securities and Exchange Commission (SEC) issued reform proposals[3] that closed for comment in April 2022. One of the critical pillars of these proposals is to remove the 'fees and gates' structure that has been in place for MMFs.

"Decoupling the minimum liquidity with the fees and gates structure is a major win for MMFs, specifically for their resiliency," explains Hazard. "Going into the pandemic in March 2020, there were large redemptions in prime MMFs, specifically in the US. If the weekly liquidity went to 30% there was the potential for fees and gates. This exacerbated the response from investors when they saw liquidity going down to 40, then 35, then 30. It was a self-fulfilling prophecy that worked against what the SEC was trying to achieve when they put those rules in place."

At the time, the funds still had 30% liquidity but couldn't use that to take care of redemptions. The buffer that was there wasn't able to be used. "That was an unintended consequence from the last reform, and they're fixing that issue," explains Hazard. "That's definitely going to be one to watch."

A second element of the SEC's latest proposals is added liquidity, suggesting that this is raised to 25% daily liquidity and 50% weekly liquidity. "Whether we really need to go that high is debatable, but any amount higher will make funds more resilient," comments Hazard.

A far more contentious element of the SEC's regulatory proposals is the introduction of swing pricing. This effectively replaces the fees and gates structure and would see all associated costs of a redemption from a fund passed onto the shareholder carrying out the redemption. This approach has caused consternation among many players in the market, who believe it would not be enough to stop a run of redemptions in a crisis and might even precipitate such an event.

"The swing pricing proposal is something that we believe will be extremely detrimental to investors such as corporate treasurers, as well as the prime MMFs themselves, borrowers, and ESG funds," argues Hazard. "We surveyed all our clients who are invested in prime MMFs in March 2022, specifically talking about

TORY HAZARD

Chief Executive Officer, Institutional Cash Distributors (ICD)

Decoupling the minimum liquidity with the fees and gates structure is a major win for MMFs, specifically for their resiliency.

swing pricing. In the US, 78% indicated they would very likely redeem from a swing pricing fund that experienced significant redemptions due to a major market event. If this had been in place in March 2020, it would have produced the opposite of the SEC's principal reform objective to improve the resilience of MMFs. Our prime clients would have been more inclined to redeem if there were swing pricing."

ICD's survey on swing pricing also revealed that 40% of the company's prime MMF clients would stop investing in prime MMFs, or reduce their positions in these products, due to uncertainty over potential hidden costs due to swing pricing.

"For swing pricing to operate efficiently, institutional prime MMF providers would need to reduce strike pricing to once per day, and it would have to be early, so that changes the functionality of the product for many investors who would like to trade later in the day," adds Hazard. "Then another effect of swing pricing would be a reduced yield due to the higher costs for fund companies managing the swing pricing in their funds. Both of these consequences will have the net effect of further reducing demand for these funds. Also, as prime MMFs have contributed to a major growth in ESG focused investments in this space, the impact to demand for these funds will marginalise those ESG goals."

With swing pricing appearing to worsen the problem that the SEC is trying to solve, it is to be hoped that the regulator listens to the comments provided as part of the consultation process by industry participants. The comment period ended in April, and ICD was one of those to send a comment letter outlining concerns about the swing pricing proposals.

"We're hopeful that the SEC will enact the proposals that will strengthen the resiliency of prime MMFs, and that they will not enact swing pricing, which will be contrary to everything they're trying to achieve," says Hazard.

European regulatory reform: careful navigation required

The European Commission is reviewing similar proposals from the European Securities and Markets Authority (ESMA), which published its final report in February 2022.[4] The key addition in the European proposals is the intention to remove the stable net asset value (NAV) from low volatility net asset value (LVNAV) funds through the abolition of amortised cost and two-digit "penny" rounding. ESMA argues that these changes would remove 'first-mover advantage,' something that was blamed for contributing to a run on funds during the liquidity event of March 2020. However, there is evidence to suggest that LVNAV MMFs are more resilient than their variable net asset value (VNAV) counterparts, as Hazard explains.

"ICD looked at inflows and outflows from 1 March to 31 March 2020," he says. "We saw significantly more pronounced outflows of VNAV funds in the US – 30% – versus LVNAV funds, which was 11% in Europe. This was partly because of losses captured due to the temporary dislocation of the mark-to-market. This was not replicated in Europe, where the funds are still valued at amortised cost. We saw, through ICD client data and industry data, that overall the VNAV structure exacerbated the dash for cash."

The move to VNAV MMFs in the US has also contributed to a decline in investments in prime funds. According to Crane Data, a year before the previous MMF reform (31 October 2015) prime fund assets were around $863bn. Following the reforms to switch to VNAV, prime assets were down to $676bn by 31 May 2021, diminishing the instrument as a practical investment tool for treasurers. The danger is that European MMFs could go the same way if the proposals to change LVNAV funds go ahead.

The ICD 2022 Client Survey revealed that most European treasurers (94%) are invested in or plan to invest in short-term LVNAV MMFs, far more than short-term VNAV funds (47%) or standard VNAV funds (27%). Eliminating the current LVNAV MMF pricing structure would remove a popular investment vehicle that proved to be resilient during the liquidity event of March 2020.

"Europe got it right when they came up with the LVNAV concept as those funds performed much better than VNAV funds in the pandemic," adds Hazard.

ESG investments on the radar

An area of finance that arguably could benefit from some additional regulation is the ESG space. Sustainable and socially responsible finance is of increasing importance in the world of corporate treasury management, and the short-term investment arena is no exception. For the most part, the ESG funds are in the prime MMF sphere.

"Our clients have been extremely interested in ESG investing," says Hazard. "We've seen increasing engagement with these funds through the years. The 2022 ICD Client Survey revealed that 56% of our clients are investing in, or planning on investing in, ESG or socially responsible products this year. Last year, that number was 41%; the year before it was 32%. There is definitely a growing momentum in this space."

At the most recent TMI Treasury4Good Awards, ICD won Best Technology Solution[5] based on its work with fund companies to offer investors better visibility into which funds or platforms are designated as ESG funds, including sustainable and socially responsible investment funds, and why they're designated as such.

"When we're talking about our platform with corporates, understanding the specifics of what they are investing in, particularly relating to ESG, is something that they're extremely interested in," notes Hazard. "Currently, in the US you have to count on the fund companies and how they're describing what they're doing with the environmental or social impact the funds provide that are classified as ESG. They do a pretty good job at explaining that, but we're expecting that standards similar to the SFDR regulations in Europe will soon come about so that investors can compare

> *The right technology solution creates a superstore for investments.*

and contrast, via an independent third party, the impact these funds are having."

This is a space to watch as government entities and ratings agencies increase their oversight on the ESG arena.

Slicing and dicing investment data

As highlighted in the case study of ICD's Treasury4Good awards win, technology plays a vital role in enhancing the visibility of ESG-linked products in the short-term investment space. But ESG is far from the only area where new and improving technologies enhance treasury investment policies.

"Treasury management systems and ERPs are becoming more powerful, while portal technology is also becoming increasingly important today," says Hazard. "To get ahead, it is critical to integrate the various technologies, so treasurers have visibility of all the information, efficiently, whenever they want it. This is so important strategically, especially when it comes to supporting organisational decision-making."

Technology also has a pivotal role to play in the current environment of interest rate hikes. Treasurers have various investment products to consider against the backdrop of rate increases. Within those investment product categories, they also need to look at the vast array of investment providers with options in those areas.

"The right technology solution creates a superstore for investments," enthuses Hazard. "Being able to look at them all in a normalised fashion, in one place, and to research them to see if they fit with your specific investment objectives and risk tolerance, is key."

From that point, treasurers can then study the performance of different instruments and select a portfolio that optimises their investment strategy. Technology now enables this and provides comprehensive reporting and analytics. "This can all be in one place if that information can be sent in real-time through APIs to various TMS, ERPs, and banks," adds Hazard. "That's the exciting part for treasurers, being able to have everything at their fingertips."

The ability to use technology to drill down into investments and to see their underlying holdings is also crucial for corporates wanting to understand their counterparty exposures to different companies or countries. This functionality has become extremely topical in 2022.

> *"It's an interesting time and technology will help guide treasury leaders to make the decisions that are best for their organisations."*

"When Russia's invasion of Ukraine began [on 24 February], many clients got in touch asking if they had any exposure to Russia," recalls Hazard. "Through our technology and our exposure analytics application, the portal's dashboard provides an exposure map. Treasurers can scroll over any country and see what their exposure is. They can also drill down and see the securities that are invested in the funds that make up that exposure. Thankfully, the funds that our clients had invested in had zero sponsor exposure to Russian counterparties, but that was the kind of question that treasurers and CFOs worldwide were asking. That's what technology can do for you."

This functionality can also be deployed when first building a portfolio, of course. Hazard explains: "Naturally, treasurers build their investment portfolios based on their risk tolerance and objectives to ensure that they do not have any uncomfortable counterparties or exposures. Crucially, this needs to be monitored regularly. Today, technology enables this, ensuring that unwanted counterparties or countries can be kept out of a treasury investment portfolio."

Equally, if a market event happens that increases a treasurer's counterparty risk, they can make decisions to extricate themselves from investments that they are uncomfortable with or that no longer meet their objectives. "That's a major part of the ongoing optimisation of portfolios – you have to pay attention to current events, from the geopolitical through to the interest rate environments," adds Hazard. "Certain investment vehicles, and certain investments within those vehicles, will perform better. You have to look at the regulatory environment and ask if that is going to have an impact on different products. It's an interesting time and technology will help guide treasury leaders to make the decisions that are best for their organisations."

Stay vigilant

After a prolonged period of low interest rates, the new macro dynamic of higher and sustained inflationary pressures combined with a rising rate environment could change the corporate approach to investments. Treasurers should thoroughly evaluate their short-term investment portfolios to ensure that the current investments still meet treasury policy while also exploring the possibility to earn better returns generated by the rate hikes.

"Right now, it is all about treasurers evaluating the wide spectrum of available investments and having them available in an efficient way," concludes Hazard. "This level of easy access supports treasurers' ability to trade efficiently and provides real-time information to ensure that their portfolio is optimised. With the right tools in place, treasurers can make adjustments to this based on what happens daily – ensuring an agile approach to managing their short-term investments." ■

Notes

1 https://www.bls.gov/news.release/cpi.nr0.htm
2 https://icdportal.com/resources/icd-surveys-trends-in-institutional-money-markets-treasury-technology/
3 https://www.sec.gov/rules/proposed/2021/ic-34441.pdf
4 https://www.esma.europa.eu/sites/default/files/library/esma34-49-437_finalreportmmfreview.pdf
5 https://treasury-management.com/articles/how-icds-technology-is-making-a-genuine-difference/