European Money Market Fund Gate Risk Low

Outflows of Over 10% a Rare Occurrence

Special Report

Reform Gate Risk Low: Fitch Ratings considers there to be low likelihood of a discretionary redemption gate being triggered on a European LVNAV or CNAV fund following the impending money market fund (MMF) reform, barring a systemic shock or idiosyncratic credit event affecting one or more widely held issuers.

Joint Probability Trigger Event: The test for applying a discretionary redemption gate or liquidity fee in a CNAV or LVNAV fund is a joint probability event, the probability of which will be lower than that of either individual event. If weekly liquidity drops below 30% and there is a simultaneous net daily flow of more than 10% of a fund's assets, the fund must consider applying a fee or gate.

Large Outflows Highly Infrequent: There has been a 60bp incidence of outflows of more than 10% over the last 10 years. This shows that MMFs encounter such large outflows very rarely.

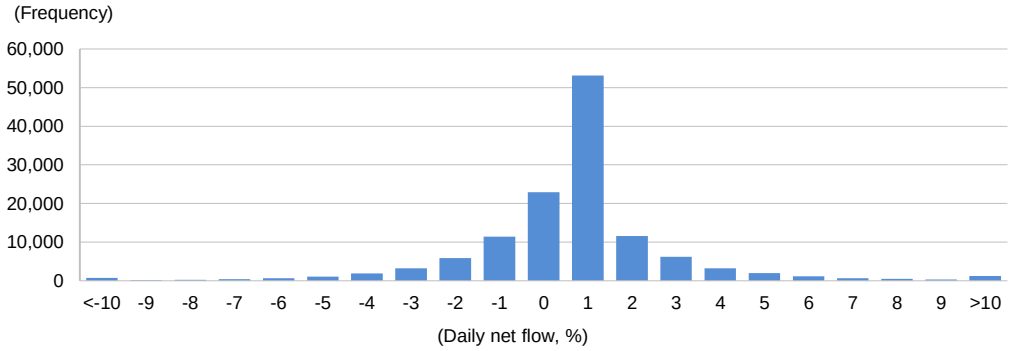
Unexpected Outflows Probably Rarer Still: Fitch's data set does not adjust for planned outflows, such as a large investor entering a fund with a pre-determined exit date. Excluding such situations would probably result in an even lower incidence of unexpected large outflows.

Smaller Funds More Vulnerable: Smaller funds are more vulnerable to large outflows than larger funds. However, even for smaller funds the incidence of daily outflows of above 10% remains very low. US dollar-denominated funds also incur a higher incidence of large outflows than sterling or euro funds, although again actual incidence is low.

Weekly Liquidity High: Funds must hold at least 30% of their portfolios in securities maturing within one week or securities eligible for weekly liquidity to be rated 'AAAmf' under Fitch's rating criteria. The European reforms introduce a minimum weekly liquidity level of 30% for all LVNAVs and Public Debt CNAVs.

Higher Liquidity Likely: Fitch expects fund managers will increase the liquidity of their funds once the reforms take effect. Funds in the US increased liquidity dramatically following the advent of MMF reform there, well above the 30% regulatory minimum in most cases.

Outflows Above 10% Highly Infrequent



Source: Fitch, Bloomberg

Related Research

Governance of Money Funds to Face Greater Scrutiny (July 2018)

European MMF Reform: July 2018 Dashboard (July 2018)

The Post-Reform European Money Fund Landscape (April 2018)

What Investors Need to Know: European Money Market Fund Reform (September 2017)

Reform Gate Risk Low for European Money Funds (October 2017)

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LVNAV	Low-volatility net asset value fund
CNAV	Constant net asset value fund

Joint Probability Reduces Likelihood

The test for applying a discretionary liquidity fee or redemption gate in a public debt CNAV or LVNAV fund under the European MMF reforms coming into effect for existing funds in 2019 rests on a joint probability event. This is important as a joint probability is always lower than an individual probability, barring 100% correlation between the two events. Specifically, the board must consider applying a liquidity fee or redemption gate if weekly liquidity drops below 30% and there is a simultaneous net daily flow of more than 10% of a fund's assets. The board has discretion over whether a fee or a gate best serves investor interests (see *Governance of Money Funds to Face Greater Scrutiny*, dated 23 July 2018).

Outflows and liquidity levels will be highly correlated in some situations, but they will not always be perfectly correlated.

Large Outflows Are Highly Infrequent

Large outflows are a rare occurrence in European short-term money funds. Fitch calculates a historical incidence of daily outflows of above 10% of 60bp during the 10 years from April 2008 to April 2018 across all European "prime" CNAV money funds. This is a meaningful assessment period as it covers not only the global financial crisis of 2008-2009, but also the eurozone sovereign debt crisis of 2010-2012.

In statistical terms Fitch's data suggest that investors can be above 95% confident that an outflow of above 10% will not occur on any given day (or the inverse, that an outflow of above 10% is almost two standard deviations from the mean).

The 60bp incidence in Fitch's expanded data set compares with the 80bp incidence Fitch calculated in its previous study covering five years of data (see *Reform Gate Risk Low for European Money Funds*, dated 4 October 2017). The expanded data set and resulting reduced historical incidence figure support Fitch's view that such large outflows are rare.

Minor Differences Across Currencies

Funds denominated in US dollars have suffered a greater incidence of outflows of above 10% than funds denominated in euros or sterling. However, in all cases incidence is low. US dollar funds registered a historical incidence of outflows above 10% of 87bp. This is broadly in line with Fitch's initial industry-wide estimate of the incidence of large outflows. In contrast, euro and sterling funds had incidences of 49bp and 43bp, respectively. Fitch has not identified any discernible pattern in these flows.

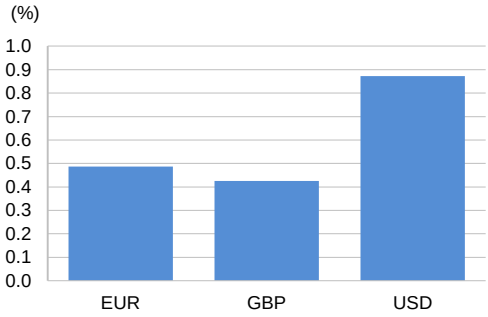
Fund Size Also Affects Propensity for Larger Outflows

Smaller funds are almost three times as likely to suffer large outflows as larger funds. However, the likelihood of suffering a large outflow remains very low, even in small funds. Small funds suffered a historical incidence of outflows of above 10% of 71bp, compared with 25bp for larger funds. Fitch defined larger funds as those in the top quartile for size at end-December 2017 and small funds as those in the bottom quartile.

Related Criteria

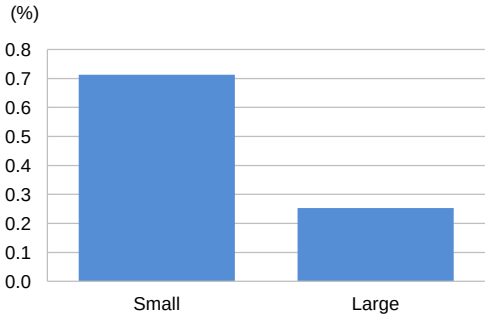
Global Money Market Fund Rating Criteria (November 2017)

Marginally Higher Chance of Large Outflow in US Dollars



Source: Fitch, Bloomberg

Large Outflows More Likely in Smaller Funds



Source: Fitch, Bloomberg

Actual Incidence Probably Even Lower

Fitch's data set does not capture planned outflows. For example, an investor may enter a fund with a large balance and a pre-determined exit point. Assuming the investor exited the fund on as planned there would be a large outflow on that date. However, the fund manager, in full knowledge of this planned outflow, would have built liquidity in the fund to readily accommodate it. Excluding such flows would probably reduce the historical incidence of large outflows.

A more acute challenge for a fund in such situations is when the investor's requirements change, leading to an unplanned and potentially large outflow. Controls on large investor balances are rarely contractual, typically relying instead on robust oversight of the client relationship by the fund manager. Fitch is aware of incidents of MMFs turning down client subscription requests due to "hot money" concerns.

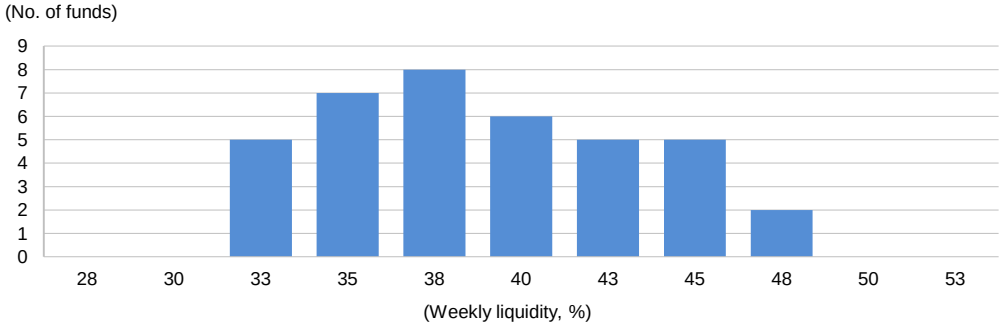
The reforms reinforce the requirements for fund managers to know and manage their client exposures. In extreme cases the fund is protected by its ability under UCITS rules to honour redemptions in kind where the redemption exceeds a pre-determined threshold and relates to an institutional investor. In such cases, instead of honouring the redemption in cash the fund would honour the redemption through a vertical slice of its portfolio assets. Such mechanisms are operationally complex and therefore a last resort, but they give remaining investors protection from the action of any single large investor.

Fitch has not cleaned the data in any meaningful way. Therefore there may be some inaccuracies, for example, relating to the assets of one share class not being counted towards total fund assets under management on a given date but then being reported correctly on a subsequent date. Excluding such inaccuracies would most likely lower the actual incidence of large outflows further.

Weekly Liquidity High and Likely To Rise

Under Fitch's rating criteria funds must hold at least 30% of their portfolios in securities maturing within one week or securities that are eligible for weekly liquidity in order to be rated 'AAAmmf'. This means almost all Fitch-rated funds already have at least as much liquidity as is required by the reforms. The European reforms introduce a minimum weekly liquidity level of 30% for all LVNAVs and Public Debt CNAVs.

Funds Already Ahead of Regulatory Minimums
(As of April 2018)



Source: Fitch; liquidity calculated according to the provisions set out in the reforms

There are some differences between the way Fitch assesses liquidity and the requirements in the reforms. Fitch is more conservative in its assessment in two areas: first, Fitch sets a floor on credit quality at 'AA-' for eligible assets for inclusion in the weekly liquidity bucket, whereas the reforms require only that the issuer in question has a "favourable" credit assessment from the manager of the fund. This means that some fund managers may count lower credit-quality issuances as eligible liquidity than others or as specified under Fitch's rating criteria at the 'AAAmmf' rating level (at least in unrated funds). Second, Fitch's maximum maturity limit for agency securities to be eligible for inclusion in the weekly liquidity bucket is 95 days for 'AAAmmf' rated funds, compared with the 190 days afforded by the reforms.

Fitch anticipates fund managers increasing the liquidity profiles of their funds once the European reforms take effect. Following the advent of MMF reform in the US, funds there increased liquidity dramatically, well above the 30% regulatory minimum in most cases. This was driven by increased sensitivity to gate trigger points in the US. As the trigger point is a joint probability event in Europe sensitivity is likely to be lower. Even so, Fitch still believes fund managers will exercise high levels of caution, at least initially, and manage to buffers well above the 30% level.