Reform Gate Risk Low for European Money Funds

Special Report

EU Money Market Fund Reform: What You Need to Know

- Effective 20 July 2017
- New funds required to comply by 21 July 2018 and existing funds by 21 January 2019
- Reforms codify how and when liquidity fees and redemption gates should be applied
- For more information visit: www.fitchratings.com/site/fam/mmfr

Reform Gate Risk Low: Fitch believes the probability of a discretionary or mandatory liquidity fee or redemption gate being imposed on European money market funds (MMFs) is low, absent a systemic shock or idiosyncratic credit event.

Weekly Liquidity Robust: There were no incidents of weekly liquidity (ie the percentage of portfolio assets maturing within one week) dropping below 10% in the European Fitch-rated constant net asset value (CNAV) MMF universe in the last five years reviewed, albeit a relatively benign credit environment. Under the July 2017 EU MMF reform measures, weekly liquidity below 10% triggers a mandatory redemption gate or fee.

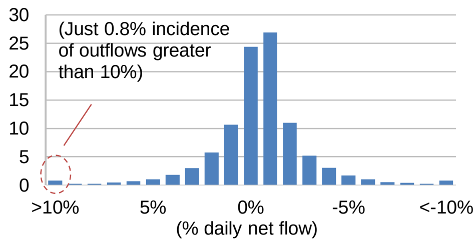
Large Outflows Highly Infrequent: Daily net outflows from CNAV MMFs exceeded 10% in only one of every 125 cases observed over the last five years. The already low probability of large outflows is even less when idiosyncratic factors such as pre-planned investor movements are excluded. Along with minimum weekly liquidity of 30%, this is a critical metric under the reforms in determining whether extraordinary actions must be taken by a fund's board.

Reform to Boost Fund Liquidity: Fitch expects Low Volatility Net Asset Value (LVNAV) funds will have very high overnight and weekly liquidity as a result of the reforms. Public Debt CNAV and LVNAV funds must maintain minimum overnight and weekly liquidity level of 10% and 30%, respectively; liquidity limits have also been introduced for the first time in Short-term and Standard variable net asset value (VNAV) MMFs.

Critical Role of Directors: Fund Boards must decide if liquidity fees or temporary suspension of redemptions should be activated in the unlikely event of a fee and gate trigger. Therefore, the reforms put more emphasis on the role of MMF Board of Directors and their independence.

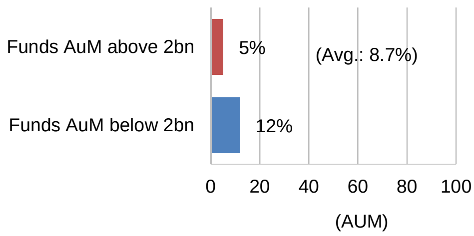
Large Outflows Highly Infrequent

(Freq, %)



Source: Fitch, Bloomberg; Study of five years of daily AUM movements in 64 European prime money market funds (EUR,GBP & USD) ending 1Q17. N = approx. 61,000 observations

Incidents Where Weekly Liquidity Dipped Below 30%



Source: Fitch; Study of weekly regulatory liquidity levels for 54 European prime MMFs (EUR,GBP & USD) as at quarter end for five yrs to 1Q17. N = approx. 681 observations

Related Research

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

Fitch: European Money Fund Regulatory Liquidity High (March 2017)

Finalised EU MMF Reform Starts Implementation Clock - Liquidity Fees and Redemption Gates Create Uncertainty (January 2017)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Probability of a Fee or Gate

- 0.07% hypothetical historic instance of triggering the discretionary threshold for imposing a fee or gate
- 0.8% historic incidence of large net outflow (greater than 10% of fund net assets) on any given day
- 8.7% historic incidence of weekly liquidity dropping below 30% at any given quarter end in the past five years
- 5% of the time, funds with AUM above EUR/GBP/USD2 billion experienced weekly liquidity below 30% (18 out of 363 observations)
- 12% of the time, funds with AUM of less than EUR/GBP/USD2 billion experienced weekly liquidity below 30% (26 out of 221 observations)

Low Likelihood of Triggering a Redemption Gate

Fitch considers the probability of a mandatory MMF reform-driven liquidity fee or redemption gate being imposed as low, barring any systemic shock or idiosyncratic credit event.

There have been no incidents of weekly liquidity dropping below 10% in the Fitch-rated CNAV MMF universe over the last five years, reflecting funds' adherence to Fitch's minimum liquidity criteria standards and successful outflow management through prudent liquidity positioning.

The 10% one-week liquidity level is significant, as this is the point at which the reforms *require* a fund's board of directors to apply a redemption gate *or* liquidity fee. Importantly, even in this mandatory scenario, the board retains discretion over whether a fee *or* a gate serves investors' interests best.

In the period reviewed, MMF managers were largely able to maintain regulatory and rating agency liquidity guidelines by maintaining liquidity buffers and anticipating large redemptions. Fitch recognises, however, that credit conditions were relatively benign in the period reviewed.

Fitch observed a one in 1,436 instance (0.07% or 7bp) of triggering the *discretionary* threshold for imposing a fee or gate based on an historical five-year dataset of highly rated European Prime CNAV Money Market Funds[1]. This reflects the fact that the test for a discretionary gate or fee is a joint event under the European reforms – ie a joint probability event – combining *both* weekly liquidity falling below 30% *and* the fund suffering a simultaneous net outflow of more than 10%. All else being equal, a joint probability is usually lower than the individual probability of two events. Fitch did not assess correlation between weekly liquidity levels and daily outflows. Depending on actual correlation levels the probability of a discretionary gate would be higher but could not be higher than the individual probabilities of a 10% outflow (0.8%) or weekly liquidity falling below 30% (8.7%), ie assuming 100% correlation. Actual correlation between these two events will be time-variable, driven both by idiosyncratic and market factors.

Smaller Funds More Vulnerable to New Measures

CNAV MMF with less than 2 billion (EUR, GBP or USD) in AUM had more than twice as many instances of dropping below the reform's weekly liquidity (discretionary) threshold for LVNAV fund types, according to the above-mentioned historical five-year dataset, without taking into consideration the magnitude of the drop in liquidity.

Smaller funds were more sensitive to redemptions, causing those rated 'AAAmmf' to hold 5%-7% more weekly liquidity than their larger equivalently-rated counterparts to manage liquidity risk, according to the same study.

The risk of a fund's liquidity deteriorating below the discretionary threshold remains low despite smaller funds being more vulnerable. Prospectively, the risk is expected to be further mitigated by fund managers increasing their weekly liquity levels, as was the case in the US following its fee and gate reform – where Prime funds now hold about 10% more weekly liquidity on average than at pre-reform levels.

Fitch's MMF rating criteria recognises that funds may temporarily deviate from portfolio attributes such as minimum liquidity thresholds. Fitch's MMF rating criteria provides for reasonably short grace periods to remedy deviations, provided the remediation plan is credible, achievable, and does not put MMF investors at risk.However, the activation of redemption gate

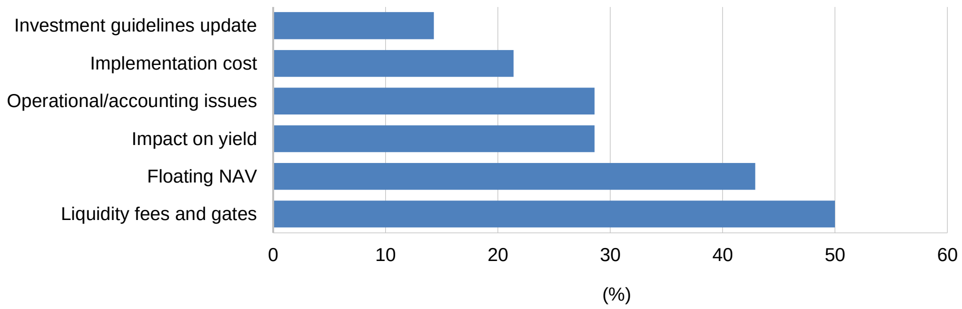
[1] Study based on Fitch and Bloomberg data looking at five years of weekly regulatory liquidity levels and daily AUM movements in 54 European highly rated prime CNAV money market funds (EUR/GBP/USD) ending 1Q17. N = over 61,000 observations. The study did not place any threshold on weekly liquidity levels ie a weekly liquidity level of 29.99% would count equally with a weekly liquidity level of 23%

or liquidity fee mechanisms would be considered a credit negative and inconsistent with a 'AAAmmf' rating.

A Step-Change in Liquidity Levels

Some investors are sensitive to fees and gates according to a recent Fitch survey, where it was cited as the area of greatest concern. Therefore, LVNAV managers are likely to hold much higher levels of weekly liquidity to position the portfolio against large unanticipated redemptions. Some fund providers and investors may also focus on short-term VNAV funds as their preferred post-reform option, as these funds will not feature reform-driven gates and fees (but will be subject to the standard extraordinary liquidity management measures authorised under the UCITS regime).

Greatest Concerns with Regards to MMF Reform in Europe



Source: Fitch

Board Independence in Focus

The July 2017 EU MMF reforms codified how and when redemption gates and liquidity fees should be applied for Public debt CNAV and LVNAV funds.

If weekly liquidity falls below 30% *and* there is a simultaneous net outflow of over 10%, a fund's Board of Directors is required to consider applying a discretionary gate or fee; if weekly liquidity falls below 10%, the Board must apply a gate or fee.

As a result, a lot of emphasis is put on the role of Fund Board of Directors and their independence, as they ultimately make the decision to take action or not – in the best interest of investors.

Limited Flows Between Fund Types Compared with the US

We do not expect to see a significant shift between fund types in Europe, as was witnessed in the US following its reforms.

Over USD1 trillion in AUM moved from prime funds to government and treasury funds[2] driven by the introduction of fees and gates in the prime MMF category. The other key driver was the compulsory switch to VNAV for prime funds.

In Europe, four important factors mitigate the likelihood of an equivalent shift:

1. The presence of reform-related fees and gates in both European government only and LVNAV funds mitigate the risk of a mass flow of assets into government-only funds, as seen in the US, given that US prime funds feature fees and gates, while US government funds do not.
2. The introduction of the LVNAV fund category can be viewed as embodying characteristics seen within the equivalent US Government and Prime fund types; specifically, the flexibility

[2] Fitch report. *2017 Outlook: Money Market Funds* (30 December 2016).

to invest in non-government securities, but permitted to maintain a stable asset value. Early indications suggest investors view this fund type as their preferred option in Europe post-reform.

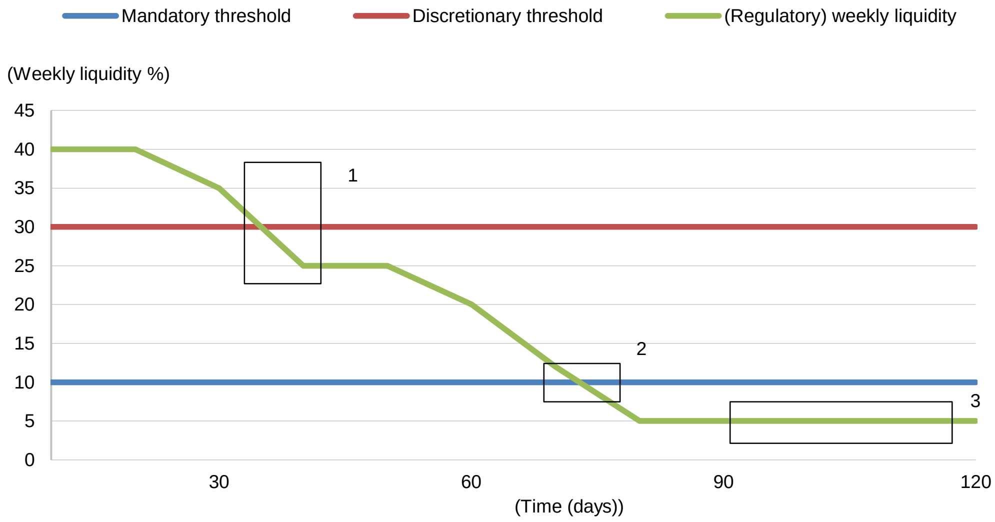
3. Liquidity fees, redemption gates and a host of other liquidity control measures already exist in European mutual fund regulations and fund prospectuses, including in MMFs. Therefore European investors are likely more accustomed to their presence than US investors who had only encountered them previously as exceptional measures.
4. We estimate only a low probability of gates and fees being triggered based on historic data. Factoring in a likely change in fund behaviour post-reform to increase liquidity reduces that probability further

Appendix: Investor Guide to Fees and Gates in MMFs

General Application of New Measures

- New measures introducing liquidity fees and redemption gates are applicable to public debt CNAV MMFs and LVNAV MMFs only. VNAV funds are not subject to these measures.
- Fund managers must comply with weekly liquidity thresholds applicable for their fund type.
- Liquidity management procedures consistent with the new measures must be clearly described in the fund rules or instruments of incorporation, as well as in the prospectus.
- In scenarios 1 and 2 set out below, fund Boards are obliged to provide details of their decisions to the competent authority of the MMF.

Weekly Liquidity Threshold Targets



Source: Fitch

Scenario 1

The proportion of weekly maturing assets falls below 30%, and net daily redemptions on a single working day exceed 10% of total assets.

Regulation: The fund manager shall immediately inform the Board, which in turn must undertake a documented assessment of the situation to determine an appropriate course of action, including deciding whether to apply one or more of the following measures:

i. Apply a liquidity fee of up to 3% on redemptions.

ii. Limit redemption to 10% of the MMF’s units on any one working day, for any period up to 15 working days.

iii. Suspend redemptions for any period up to 15 working days.

iv. Prioritise correcting the breach of discretionary threshold experienced by the fund.

Scenario 2

The proportion of weekly maturing assets falls below 10% of total assets.

Regulation: The fund manager shall immediately inform the Board, which in turn must undertake a documented assessment of the situation and apply one of more of the following measures, documenting the reason for its choice:

i. Apply a liquidity fee adequately reflecting the cost to the MMF on redemptions.

ii. Suspend redemptions for a period of up to 15 working days.

Scenario 3

If within a period of 90 days the total duration of suspensions exceeds 15 days, then the public debt CNAV MMF or LVNAV MMF shall automatically lose the fund type classification (ie convert to a VNAV fund and as such no longer be subject to reform-driven fees or gates) and must immediately inform each investor in the fund in writing.

Board Obligation: In scenarios 1 and 2 above; fund Boards are obliged to provide details of their decision to the competent authority of the MMF.