INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION

IMMFA Position Paper on Money Market Funds

July 2020

IMMFA is a trade association which represents, promotes and supports the development of the European money market fund (MMF) industry. IMMFA Member funds consist primarily of Low Volatility Net Asset Value (LVNAV) and Public Debt Constant Net Asset Value (PDCNAV) MMFs which are AAA rated by one or more credit rating agency.[1]

Executive Summary

As the COVID-19 virus rose to pandemic proportions in March 2020 financial markets experienced unprecedented volatility that put pressure on all segments of the financial system, including MMFs. Despite the exceptional challenges caused by these exogenous factors, LVNAV and PDCNAV MMFs remained resilient under testing market cicumstances, demonstrating their robust structure and the effectiveness of the enhanced investor protection mechanisms introduced in European Money Market Fund Regulation (MMFR). Funds met redemptions in full and no fund was required to take any further action under the Regulations. The sizeable increase in assets under management since March, in the LVNAV sector in particular, demonstrates continued confidence in the MMF sector and the fundamental soundness of the LVNAV fund category.

Introduction

The primary objective of a money market fund is the preservation of capital and the provision of liquidity, with yield being a secondary consideration. In this regard MMFs differ from other types of investment fund. An MMF seeks to achieve its objectives by investing in very high-quality, short term money market instruments.

Money market funds perform a vital role in channelling liquidity into the real economy. On the demand side they provide investors with a vital cash management tool, enabling them to diversify their credit risk away from single-exposure bank deposits. As bank demand for short-term deposits has diminished in the aftermath of the 2008 global financial crisis, there has been an increased need for an alternative liquidity outlet, such as MMFs.[2] On the supply side MMFs provide an invaluable source of funding to a wide range of short-term debt issuers, including governments, agencies, financial institutions, corporates and other real economy players such as issuers of asset backed commercial paper. The industry collectively is often cited as the largest 'buy side' counterparty of high-quality short-term debt in the market.

European Money Market Fund Regulation

The European Money Market Fund Regulation, which was formed in consultation with the MMF industry and came into force in July 2017, sets out detailed rules on portfolio composition, liquidity, governance, stress testing and valuation, further enhancing investor

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[1] LVNAV and PDCNAV MMFs are MMF categories introduced under European Money Market Reform based on a 'Constant' NAV in contradistinction to a 'Variable' NAV. The constant NAV concept is based upon a tradeable NAV per share of one € , $ or £.

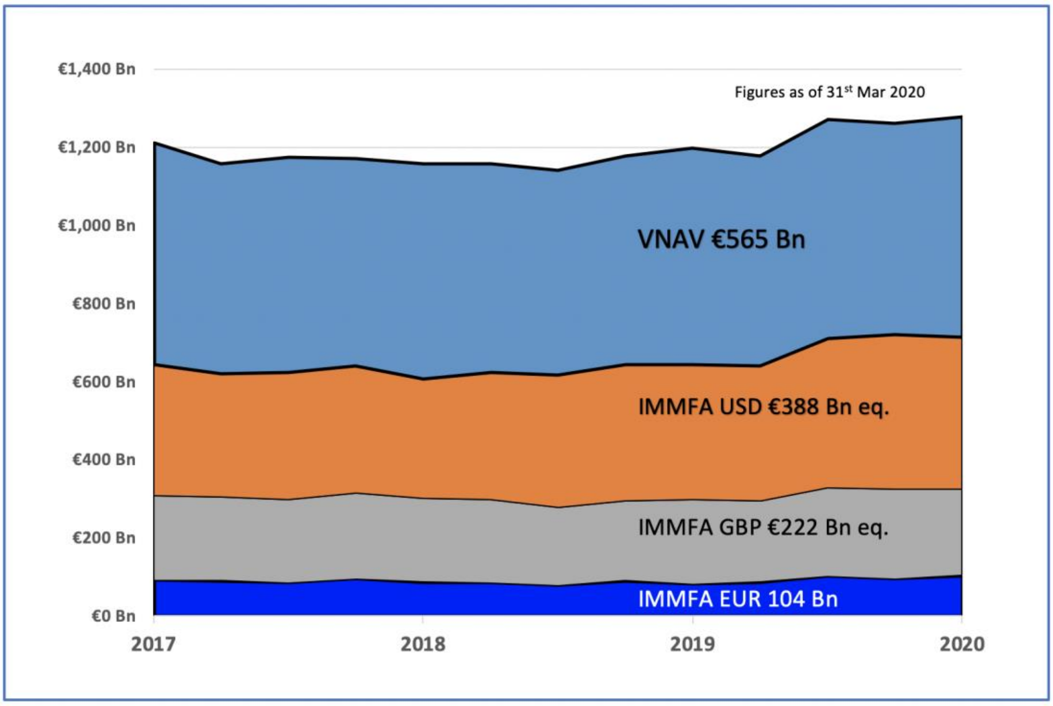
[2] Bank appetite for deposits has been impacted by post crisis prudential regulatory reforms designed to boost bank balance sheets by reducing the dependence on short term liquidity.

protection. The regulation introduced new categories of MMF, including the Low Volatility NAV (LVNAV) and Public Debt Constant NAV (PDCNAV) Funds, (so-called 'Government MMFs'). These two fund types are 'Constant NAV' MMFs and as such are subject to significantly more conservative requirements for liquidity and asset valuations relative to other types of investment funds, including Variable NAV funds. In particular, LVNAV and PDCNAV funds are required to maintain a minimum 30% in assets due to mature within one week (so-called 'weekly liquid assets'[3]) and may only trade at a constant (or 'stable') NAV if the market value of their portfolio, published daily for investors, stays within strict tolerances. Approximately 96 % of IMMFA MMFs are LVNAV or PDCNAV MMFs and all IMMFA funds are rated AAA by one or more credit ratings agency.

Money Market Fund Regulation has reinforced investor confidence in MMFs

Following the introduction of the MMFR, assets under management (AUM) in LVNAV and PDCNAV (i.e. constant NAV) funds continued to climb, demonstrating the value of the regulatory framework to investors around the globe. The total European MMF market was €1.279bn[4] at the end of the first quarter of 2020, of which IMMFA funds constituted 56 % and VNAV funds 44%.

European MMFs Post-Reform AUM in Euro and Euro equivalent



Source ECB/IMMFA/iMoneyNet

Overall performance of MMFs

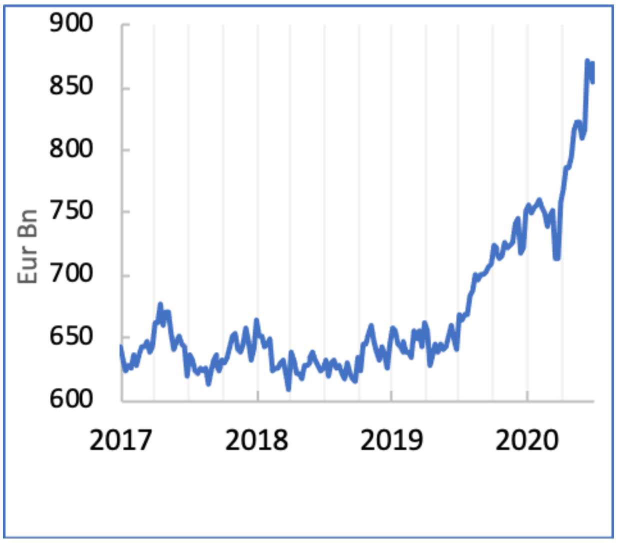
The COVID-19 pandemic rapidly led to the near systemic closure of global economies and put severe liquidity pressure on financial markets over the course of March. Consequently,

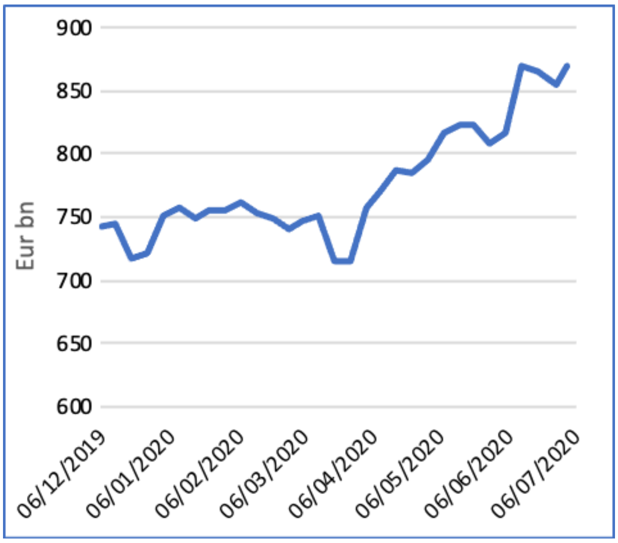
[3] MMFR 24.1 'at least 30% of their assets are to be comprised of weekly maturing assets, reverse repurchase agreements which are able to be terminated by giving prior notice of five working days, or cash which is able to be withdrawn by giving prior notice of five working days.'

[4] ECB Statistical Data Warehouse.

investors faced unprecedented changes to their business operations and increases in their margin calls.[5] Some MMFs initially faced increased redemptions, which were all met, while others saw inflows as investors increased cash balances. Once markets stabilised, IMMFA MMF AUM increased as investors reduced their exposure to other asset classes, built up cash and reinvested in MMFs. As of the 3rd July the total AUM for all IMMFA funds had increased to €869bn. This compares to a pre-crisis high of €761bn (as of 7th February) and is 22% above the March 20th low of €714bn.[6] The increase in AUM indicates a sustained flight to quality from other asset classes and illustrates the recognition of MMFs as a relatively safe haven. It also demonstrates investors' continued confidence in the utility of MMFs, their resilience and their ability to preserve capital and provide liquidity. The charts below show the post-reform growth in IMMFA funds' AUM and the recent increase, including 2019 year-end for context.

<u>Total AUM IMMFA Funds in Euro equivalent – 2017-2020 and 2020 year to date</u>





Source iMoneyNet

Challenges faced by MMFs

Like other fund classes during the height of the crisis, some MMFs faced increased liquidity pressures. However, LVNAV and PDCNAV MMFs were able to meet all redemption requests in full and continued to maintain sufficient liquidity, in line with regulatory obligations. This was achieved despite market volatility and in challenging secondary market conditions. Redemptions are typically met through an MMF's existing large liquidity holdings but when, due to exceptional circumstances, redemptions are unusually high, MMFs may seek to sell assets in the secondary market to replenish their weekly liquid assets. Daily and weekly liquid assets are key metrics for MMFs as they are indicators of the portfolio's positioning for projected outflows and market liquidity. The chart below shows average weekly liquid assets for IMMFA LVNAV funds. It can be seen that even after the funds benefitted from inflows, they continued to build and maintain very strong liquidity levels as a defence against further volatility.

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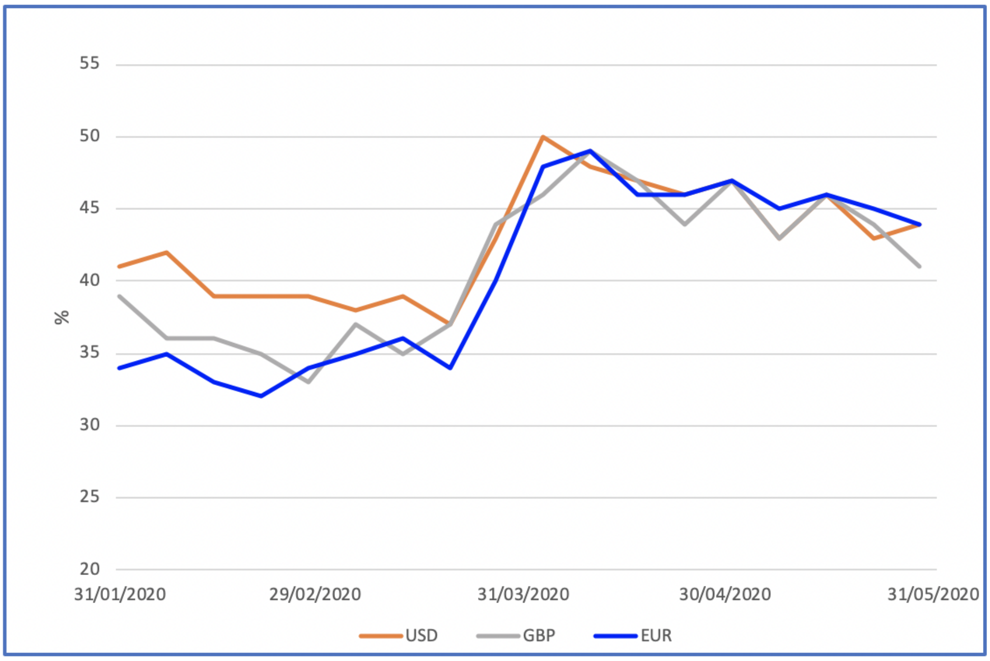
[5] ECB Paper, https://www.ecb.europa.eu/pub/financial-stability/fsr/special/html/ecb.fsrart202005_02~d48451c1cb.en.html#toc3

[6] Source IMMFA MMF Report iMoneyNet. All numbers Euro equivalent. Approximately 96 % of IMMFA funds are Constant NAV funds i.e. LVNAV and PDCNAV.

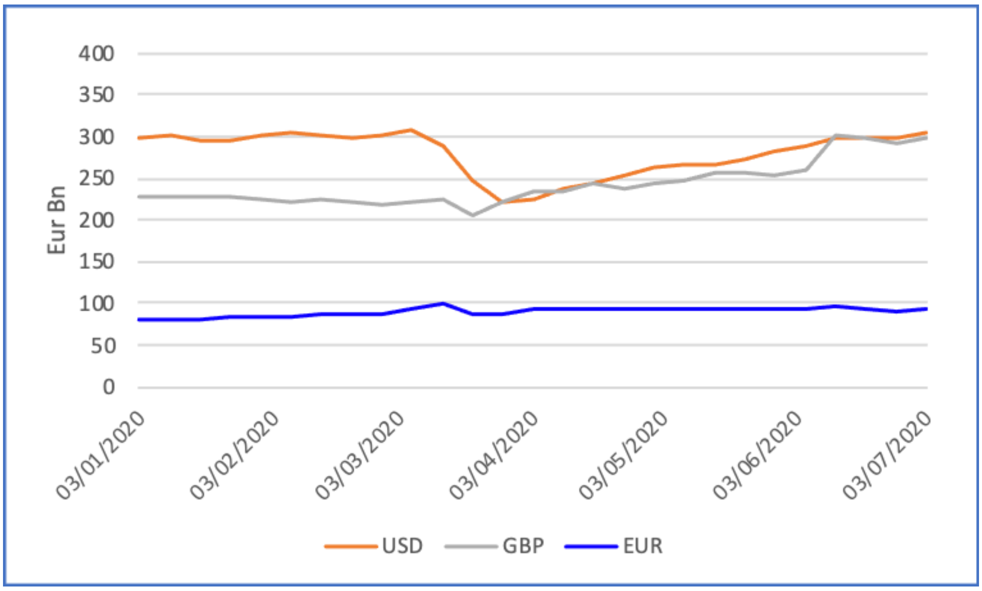
Median Average Weekly Liquid Assets IMMFA LVNAV funds



Source IMMFA

Outflows were most pronounced in USD-denominated LVNAV MMFs, for a number of reasons. USD investors typically show more fluidity and have a scalable alternative in the form of PDCNAV funds which, due to investor demand, are much more substantial in USD than in other currencies. Some USD investors shifted from LVNAV funds into the more conservative PDCNAV funds which grew during the period illustrated. Funds denominated in Sterling and Euro were also impacted, but to a lesser extent. Fund flows in Sterling and Euro were mixed: both currencies had net outflows during the first two weeks of March but resumed growth thereafter.

IMMFA LVNAV Funds AUM 2020 in Euro and Euro equivalent



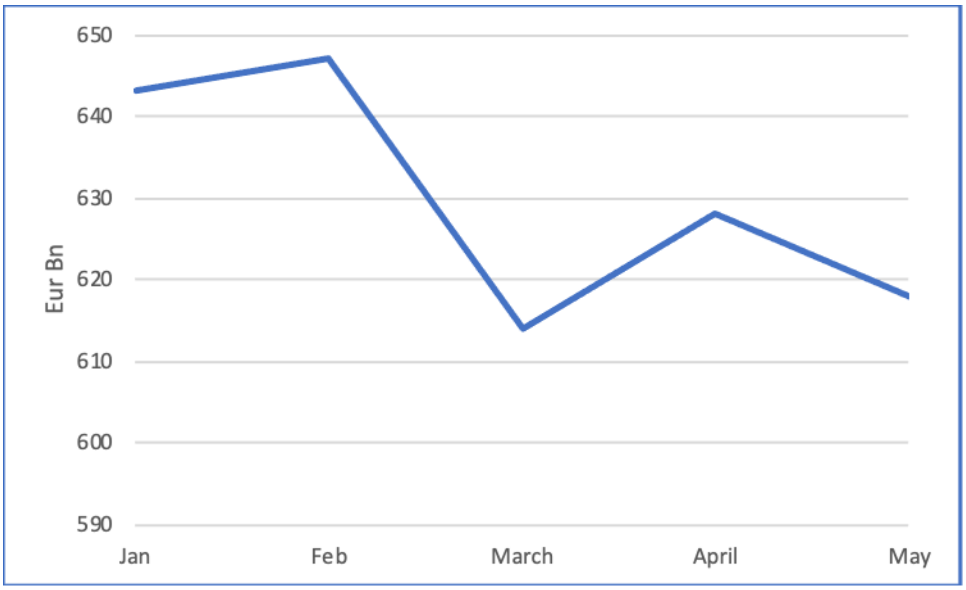
Source IMMFA/iMoneyNet

Outflows from MMFs were primarily the result of exogenous factors, in particular the increase in client demand for cash, either to support financing needs or to meet increased margin calls due to market volatility. These elements further compounded the anticipated cyclical increase in redemptions from certain investor segments managing end-of-year cashflows during this period. The outflows do not reflect a change in investor perception of the risk profile of MMFs, as illustrated by the inflows observed since the peak of the market turmoil. Indeed, we note that the ECB, in its Financial Stability Review recognises that there was no overall loss of investor confidence and that "investors were able to access their funds at all times".[7]

In response to the liquidity crisis, many Central Banks, including the Bank of England (BoE) and the European Central Bank (ECB), launched a series of interventions unprecedented in terms of their scale and size. These included USD swap lines, increased repo operations with changes to collateral rules, and asset purchase facilities. However, whilst in Europe the measures undertaken by the Central Banks and prudential regulators helped to stabilise the broader market and thereby had a second-order positive impact on the MMF sector, much of the sector's recovery was organic. The facilities offered minimal direct support to MMFs since the assets typically held by LVNAV MMFs, which consist of between 70 and 80 % financial paper, were for the most part ineligible. Both the BoE and the ECB launched corporate asset purchase facilities to provide funding to the real economy. Due to a lack of supply of highly rated corporate issuers LVNAV MMFs hold on average less than 5 % in corporate paper so were not able to utilise these facilities to any meaningful extent.[8] Finally, unlike in the US MMF market, external sponsor support is expressly prohibited under the MMFR.

It should also be recognised that the market-wide liquidity crisis presented challenges for the MMF sector as a whole and was not restricted to one type of MMF. The chart below presents the flows in the VNAV sector.

VNAV Funds' AUM 2020



Source Morningstar

[7] https://www.ecb.europa.eu/pub/pdf/fsr/ecb.fsr202005~1b75555f66.en.pdf
[8] Crane data February 29th MMFs held 3 % in corporate paper

Resilience of MMFs in March

While the fundamentals of MMFs remained unchanged in relation to their structure and the high-quality of assets in which they invest, the sector was tested by the almost complete lack of market-wide liquidity in secondary markets. Despite the unprecedented and exceptional pressure, LVNAV MMFs remained robust, highlighting the effectiveness of the framework provided by the MMFR.

In addition, the MMFR sets out a strict threshold for LVNAV funds in the form of a NAV collar. In the event that an LVNAV breaches the collar (i.e. its marked-to-market NAV deviates by more than 20 basis points from the constant NAV), the MMFR requires the fund to value its assets using variable pricing and the pricing convention to move to 4 decimal places for the purposes of the next redemption or subscription.[9] Despite the market volatility caused by COVID-19, all IMMFA LVNAV funds remained within their 20 basis point collars.[10] This is a further example not only of the robust performance of LVNAVs, but also of the **enhanced protections codified under the MMFR, for the interests of investors**.

Conclusion

The system wide liquidity crisis caused by the COVID-19 pandemic presented significant challenges for financial markets. Whilst MMFs were impacted by this, they were neither the source of market dysfunctionality, nor did they directly contribute to it, since, as shown, they continued to serve their purpose and to meet investors' needs for cash. The data and analysis undertaken reflect the resilience of MMFs, particularly LVNAV and PDCNAV funds, and the effectiveness of the EU MMF Regulation. The enhanced investor protection provisions of the MMFR ensured that funds continued to provide liquidity and full transparency to investors on a daily basis, including a full mark-to-market valuation of the LVNAV and PDCNAV portfolios.

As highlighted, LVNAV and PDCNAV MMFs were tested during the recent crisis but continued to fulfil their regulatory obligations and were able to satisfy all investor redemption requests in full. In Europe, the operational effectiveness of MMFs was maintained without recourse to various asset purchase facilities implemented by Central Banks, given the lack of asset eligibility. The growth of total European AUM, which now exceeds pre-crisis levels, demonstrates that investors continue to have confidence in MMFs, in particular the LVNAV category which continues to grow.

[9] Article 33.2 of MMFR

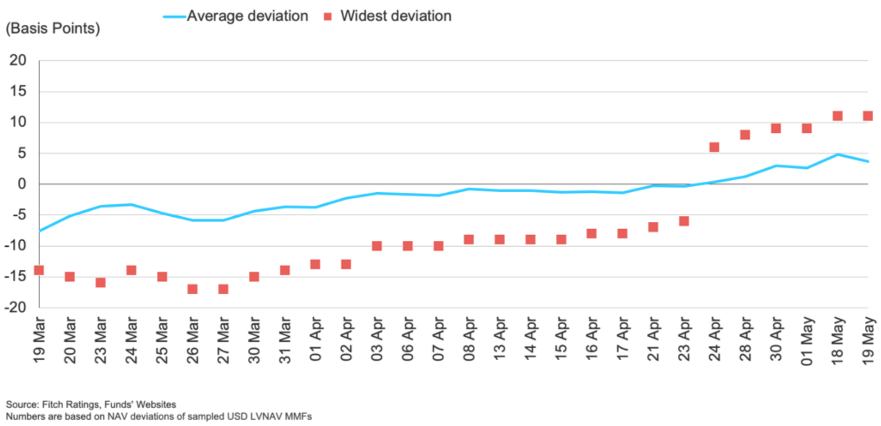
[10] See appendix for NAV deviation charts

Appendix

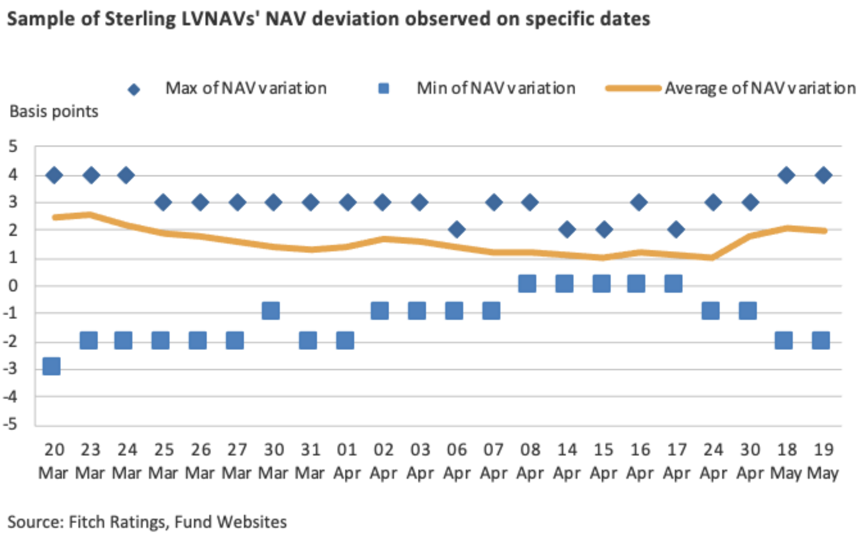
NAV deviations.

The charts below show NAV deviations for Fitch rated AAA LVNAV MMFs in USD and GBP.

USD NAV Deviations Fitch AAA rated LVNAV MMFs



Sterling NAV Deviations Fitch AAA rated LVNAV MMFs



EUR NAV deviations are not shown as due to the negative rates in Euros most EUR MMFs generate negative yields which are accommodated by offering accumulating (i.e.varying price) share classes - or more accurately “decumulating” share classes. In an accumulating share class the price of the share resets to the mark to market price of the MMF at each pricing point (typically daily), which means that the share price can only vary from the mark-to-market price to a limited extent and only for short periods of time.