# European Money Market Fund Reform

Questions from Investors

## What is Changing

**Four Money Fund Types:** The “prime” constant net asset value (CNAV) money-market funds (MMFs) commonly used by corporate and public-sector treasurers will no longer exist in their current form. Instead, investors will need to choose between four different MMF types. These will include two new variants: the low volatility net asset value (LVNAV) MMF; and the public-debt CNAV MMF, both of which will be classified as “short-term” funds. Short-term and standard variable net asset value (VNAV) funds will continue to exist with limited changes. The new fund types have specific characteristics in terms of liquidity thresholds and valuation.

**Ratings Expected to Remain Stable:** The main risk European money market fund reforms pose to ratings is from unexpected disruption during the transition process. However, we expect fund managers to take steps to mitigate risks, including strengthening liquidity during the transition. The new rules will not change our approach to rating MMFs and therefore should not directly affect ratings unless funds’ underlying credit, market or liquidity risks increase.

The reforms were signed into law in July 2017 and will become effective for new funds in July 2018 and existing funds in January 2019. Understanding the reforms and the new fund types will be a priority for investors.

In this report we address the following frequently asked questions.

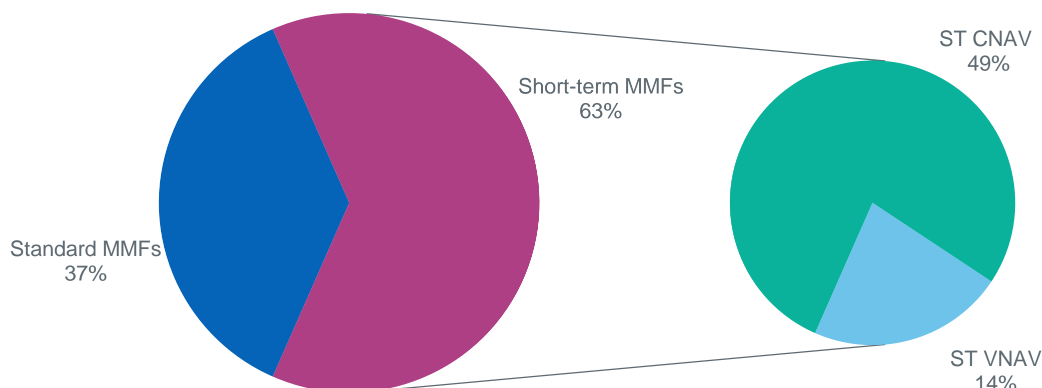

- What do the MMF reforms change for investors?
- Will the reforms change Fitch’s rating approach?
- How does liquidity risk factor in the reforms?
- How does Fitch’s rating approach differ from the reforms?
- Are there differences in rating agency methodologies?
- How do reform-driven liquidity fees and redemption gates work?
- How would Fitch respond to a gate being imposed?
- Will we see significant reform-driven MMF asset flows, similar to the US?
- How will the reforms affect competition in the industry?


Throughout the report there are links to our relevant research and commentary, which provide more information and our credit views on the relevant topics. Our dedicated *Credit Hotspot* on European MMF reform contains regular updates on the reforms. Our interactive tool, *European MMF Reform Made Easy*, provides investors with an overview of, and insight into, the details, mechanics and effects of European MMF reform.

## What do the MMF reforms change for investors?

European "Prime" CNAV MMFs will cease to exist in their current form when the reforms become effective. European corporate and public-sector treasurers who are accustomed to CNAV funds will experience the greatest change, although the new LVNAV fund type will, in many ways, look and feel much like pre-reform prime CNAVs. Those investors using Short-Term and Standard VNAV MMFs will experience less change. We estimate total assets under management in the European MMF industry at EUR1.3 trillion as of end-June 2017.

**European MMF Fund Type**
As at 31 June 2017




Source: Fitch, Lipper, AuM of MMF domiciled in Europe

Investors will need to understand the new fund types and update their investment guidelines to accommodate the fund types they deem appropriate for cash management. One likely consequence of reform is further downward pressure on MMF yields as funds increase weekly liquidity levels. As such, some investors may also consider other cash management products to complement post-reform MMFs. For example, some treasurers are selectively adding short-term bond funds to their cash investment policies driven by improving forecasting capabilities and cash segmentation on the one hand, and the combination of persistently low-to-negative yields on the other.

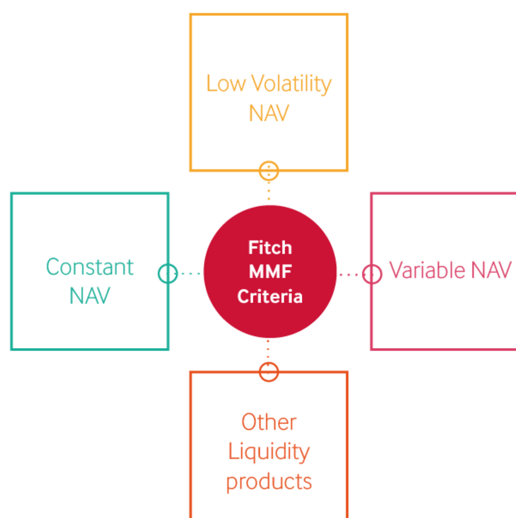
## Will the reforms change Fitch's rating approach?

The reforms will not change Fitch's rating approach, which is described in its *Global Money Market Fund Rating Criteria*, dated 27 April 2017. The rating criteria already address the MMF types which will be available in Europe after the reform. Fundamentally, an MMF's risk profile drives its rating over its accounting treatment. Fitch's rating approach is identical for all short-term money-market fund types.

> "Fitch's MMF criteria are applicable to CNAV, variable/floating net asset value, and European LVNAV funds as the focus is on a manager's ability to provide timely liquidity and avoid losses through limiting credit, market and liquidity risk rather than the particular accounting convention used to calculate net asset value. The criteria are also applicable to other liquidity/cash management products, such as separately managed accounts that have comparable investment objectives."

We review our criteria periodically in accordance with Fitch's policies and applicable regulatory requirements.

**The Post Reform Cash Landscape**



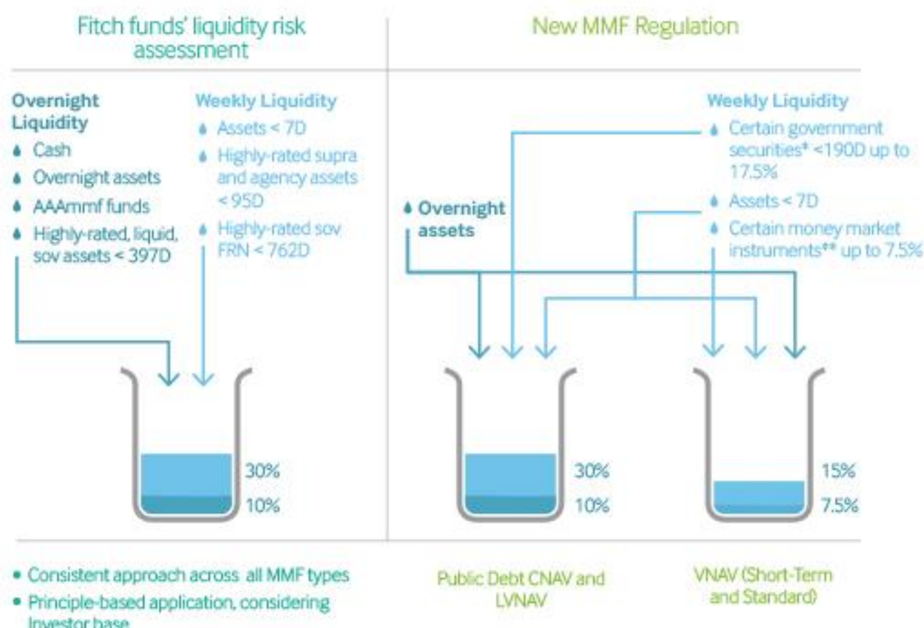

Source: Fitch

## How does liquidity risk factor in the reforms?

Liquidity risk is a central factor in the reforms and a central pillar of Fitch's rating criteria. The reforms introduce specific, minimum liquidity requirements for MMFs which did not exist – from a regulatory perspective - pre-reform. That is not to say that funds are/were not highly liquid pre-reform: funds can only achieve the highest rating if they meet specific overnight and weekly liquidity thresholds under Fitch's rating criteria. When we estimated the post-reform liquidity levels of the Fitch-rated (based on current portfolio composition) we found that the vast majority of rated funds already had liquidity levels well in excess of the post-reform regulatory minimums. See: *Fitch: European Money Fund Regulatory Liquidity High*, dated 15 March 2017.

The minimum liquidity requirements are substantially higher in public-debt CNAV and LVNAV funds than VNAV. The reforms set minimum liquidity thresholds of 10% and 30% for overnight and weekly liquidity respectively for LVNAV and public-debt CNAV funds. In contrast, the minimum levels for VNAV funds are 7.5% and 15% for overnight and weekly liquidity, respectively.

**Comparing and Contrasting Fitch's View on liquidity with the Reforms**




Source: Fitch, Regulatory Documents
Notes: *includes government securities (including third-country), supranational bodies such as the EIB or IMF and others
**money market instruments which can be converted into cash at T+5 settlement. Includes other MMFs

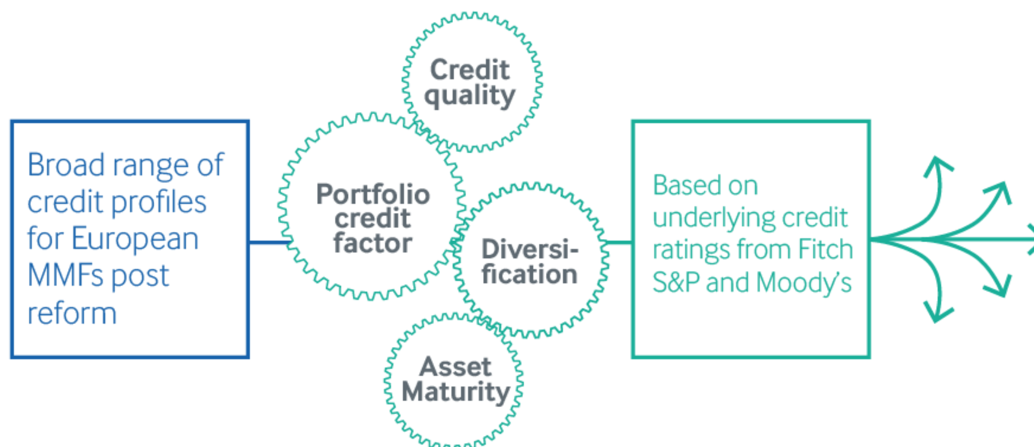
## How does Fitch's rating approach differ from the reforms?

Fitch's rating criteria are aligned with the reforms in some areas – for example weighted-average maturity and weighted-average life limits. However, there are material differences.

### Ratings

Credit ratings on the instruments held in a fund's portfolio serve as a primary input to Fitch's rating approach, whereas the reforms only consider ratings and rating changes as a factor to be addressed in the credit approval processes used by investment managers' in determining whether an asset receives a "favourable" credit assessment. The use of instrument-level credit ratings to drive our overall credit analysis of a fund brings transparency and consistency to our approach. Fitch establishes minimum credit quality guidelines, based on ratings, which ensure highly rated MMFs do not have exposure to lower credit quality issuers. Fitch's Portfolio Credit Factor, which is driven both by ratings and maturity profile further limits funds' ability to take excessive risk.

### Fitch's Fund Credit Risk Assessment




Source: Fitch

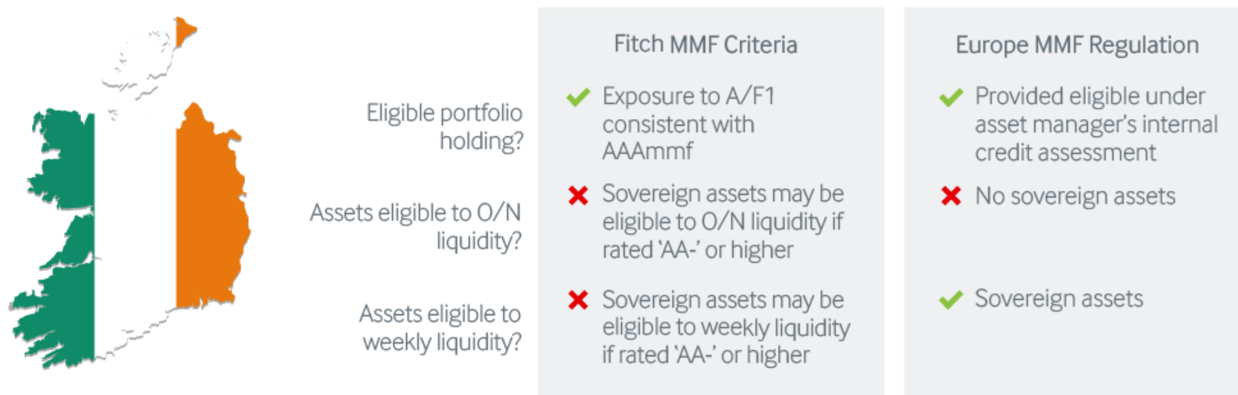
### Liquidity

Fitch's baseline liquidity thresholds for 'AAAmmf'-rated funds are the same as those set out in the reform for public-debt CNAV and LVNAV funds. However, Fitch also takes into consideration investor concentration in its assessment of liquidity.

There are also important differences between the reforms and Fitch's rating criteria in terms of assets considered "eligible" for inclusion in weekly liquidity. Fitch sets specific credit quality (rating) and maturity limits for assets to be treated as eligible for weekly liquidity. In contrast, the reforms set longer acceptable maturity limits than Fitch's rating criteria *and* require only that the asset in question has a "favourable" credit assessment by the investment manager. This could lead to wide disparity in the composition of unrated fund's eligible weekly liquidity assets.

For example, short-dated Irish sovereign debt would be deemed an eligible investment for a 'AAAmmf'-rated fund, but would not count towards weekly liquidity under Fitch's rating criteria. On the other hand, the same Irish short-term debt would potentially count towards weekly liquidity under the reforms, provided an investment manager had a "favourable" internal credit assessment on Ireland.

### Eligible Assets for Liquidity – Case Study on Ireland ('A/F1')



| | Fitch MMF Criteria | Europe MMF Regulation |
|---|---|---|
| Eligible portfolio holding? | ✔ Exposure to A/F1 consistent with AAAmmf | ✔ Provided eligible under asset manager's internal credit assessment |
| Assets eligible to O/N liquidity? | ✘ Sovereign assets may be eligible to O/N liquidity if rated 'AA-' or higher | ✘ No sovereign assets |
| Assets eligible to weekly liquidity? | ✘ Sovereign assets may be eligible to weekly liquidity if rated 'AA-' or higher | ✔ Sovereign assets |

Source: Fitch, Regulatory Documents;
Note: image refers to sovereign assets which would not otherwise count towards overnight or weekly liquidity due to maturity dates longer than one day (O/N liquidity) and seven days (weekly liquidity) respectively.

## Are there differences in rating agency methodologies?

Fitch's rating criteria explicitly addresses MMF's ability to achieve *both* principal preservation *and* provide timely liquidity. Accordingly, Fitch's rating criteria sets objective, quantitative rating limits for the three risks (credit, market *and* liquidity risk) which can influence a MMF's ability to achieve this dual objective.

Standard & Poor's takes a very different approach. Its MMF ratings are primarily concerned with principal preservation. As such, a fund may still be rated 'AAA' by S&P despite throwing up a redemption gate (up to five business days) or imposing a liquidity fee. That is, S&P will maintain a 'AAA' rating on a fund that has failed to provide timely liquidity.

It is important, in our view, that investors fully appreciate the fundamental differences in rating methodologies that exist when developing investment guidelines and investing in rated money-market funds.

## How do reform-driven liquidity fees and redemption gates work?

Liquidity fees and redemption gates are not new in Europe. All UCITS funds already feature an array of extraordinary liquidity management techniques which are documented in their prospectuses. For example, fund boards often have the ability to apply discretionary suspension of redemption or to apply liquidity fee or dilution levies. Some can also apply daily redemption limits or meet redemptions in kind rather than in cash above certain thresholds and for certain client types.

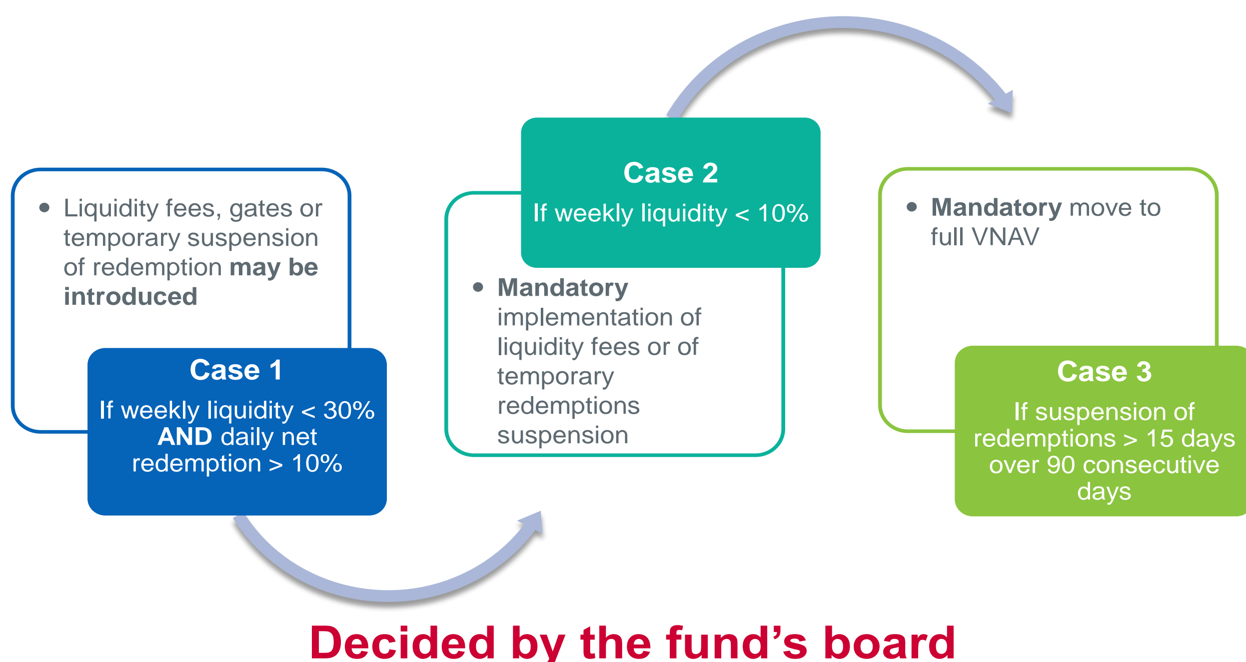
The reforms introduce additional gates and fees above and beyond those which already exist, tied to specific liquidity metrics. These *only* apply to public-debt CNAV and LVNAV funds.

**Case 1:** if weekly liquidity drops below 30% *and* simultaneously the fund experiences daily net redemptions of more than 10%, then the fund's board must consider if a liquidity fee of up to 3% or a redemption gate should be applied. This is a discretionary step.

**Case 2:** if weekly liquidity drops even further to below 10% then the board must apply a liquidity fee or redemption gate. This is a mandatory step, although the fund's board retains discretion over whether a fee or a gate is in investors' best interest.

**Case 3:** if redemptions are suspended for more than 15 days in any consecutive 90 day period the fund is forced to convert to a VNAV fund.

### Liquidity Fees and Redemption Gate Mechanics




Source: Fitch, Regulatory Documents

## How likely is a reform-driven fee or gate?

In the absence of a systemic shock or an idiosyncratic credit event, Fitch considers the risk of a mandatory fee or a gate being imposed as relatively low. The agency reviewed the most recent five years of data on weekly liquidity levels across the entire universe of rated European CNAV funds and could not find a single instance of fund liquidity falling below 10%. Clearly highly rated funds run high liquidity levels, but on the other hand the fact that liquidity levels never dipped too low indicates that fund managers have been managing in- and outflows effectively. However, it is not impossible that a fund's weekly liquidity could drop below 10%, particularly were credit conditions less benign than in recent years.

The probability of the board of directors needing to consider applying a fee or gate is higher, although still very low. The discretionary fee or gate requires a joint probability event, which, all else being equal is lower than either of the two events in isolation. Fitch estimates a probability (using the same five-year data) of about 7bp of a fund experiencing a net outflow of 10% at the same time that weekly liquidity has dropped below 30% on any given day. In other words, that is a one in around 1,500 event.

In the US, we observed fund managers increasing liquidity levels in response to reform, to 40%-50% in many cases. If we see the same behaviour in Europe, then the probability of gates or fees being triggered will be lower still.

## How would Fitch respond to a gate being imposed?

While the presence of liquidity fees and/or redemption gates features on their own in an MMF does not affect the fund's rating, the activation of these mechanisms is not viewed as consistent with a 'AAAmmf' rating. Activating redemption gates or imposing a liquidity fee would have negative rating implications.

## Will we see significant reform-driven MMF asset flows, similar to the US?

We do not expect European MMF reform to trigger anywhere near as significant asset flows as we saw in the US where over USD1 trillion (or about a third of the industry) shifted from prime CNAV to government CNAV funds. There are structural differences with the US reforms as we describe in our *Why Forum* article: *Why European Money Fund Reforms Will Differ from the US*, dated 20 February 2017.

## How will the reforms affect competition in the industry?

We believe that European MMF reform may spark further consolidation in the industry in response to increased regulatory cost and the challenge of developing and timing the launch of new or conversion of existing funds to the new fund types (see *Fitch: EU Money Fund Reform May Spark Further Consolidation*, dated 3 July 2017). Conversely, and notwithstanding the events of the financial crisis of 2007-08, there has been relatively little change in the industry. The disruption engendered by the reforms may enable new and potentially disruptive market entrants.

## Related Research

| European MMF Reform Made Easy |
| --- |
| Fitch: EU Money Fund Reform May Spark Further Consolidation |
| Why European Money Fund Reforms Will Differ from the US |
| Fitch: European Money Fund Regulatory Liquidity High |

## Analysts

**Alastair Sewell, CFA**
+44 20 3530 1147
alastair.sewell@fitchratings.com

**Evangelia Gkeka**
+44 20 3530 1829
evangelia.gkeka@fitchratings.com

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: HTTPS://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2017 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004.
Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001.