EU Money Markets: Valuation and Volatility

Cross-Border Money Markets in a Pandemic Crisis

In the first quarter of 2020, money market funds (“MMFs”) were marked by significant market volatility and much uncertainty. The COVID-19 pandemic exacerbated this situation, causing volatility at an unprecedented scale and adversely impacting MMFs yields of EU cross-border MMFs. The market responded favorably when Central Banks intervened with funding facilities, and by April, MMFs were on the road to recovery as markets rebounded following growing investor confidence and lower risk aversion. Assets under management (“AUM”) of funds overseen by the Institutional Money Market Funds Association (IMMFA) reflected this broader stabilisation, recovering by 10 percent from its mid-March nadir of €713 billion to reach a new high of €786 billion by mid-April.

Valuation in an Illiquid Market

The chart below illustrates the more recent volatility relative to year-end.

Source: IMMFA April Newsletter, 30 April 2020

---

1 The Institutional Money Market Funds Association (IMMFA) represents EU cross-border MMFs in its interactions with the regulators.
The most acute impact was felt by the US Dollar Low Volatility Net Asset Value ("USD LVNAV") funds, in which the pressure on redemptions saw USD LVNAV funds decline by 28 percent over March. At the same time, USD Public Debt Constant NAV ("Public Debt CNAV") benefitted from very substantial inflows, showing a 62-percent increase in AUM. This shift reflected a similar movement for US-domiciled MMFs where managers switched from prime to government funds.

<table>
<thead>
<tr>
<th>Fund Structure</th>
<th>% change from previous month</th>
<th>AUM as of end Feb-20</th>
<th>AUM as of end Mar-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>IMMFA MMFs</td>
<td>-3.5% ↓</td>
<td>US$740B</td>
<td>US$714B</td>
</tr>
<tr>
<td>USD LVNAV</td>
<td>-28% ↓</td>
<td>US$337B</td>
<td>US$244B</td>
</tr>
<tr>
<td>Public Debt CNAV</td>
<td>62% ↑</td>
<td>US$104B</td>
<td>US$169B</td>
</tr>
</tbody>
</table>

Source: IMMFA March Newsletter, 2 April 2020

The combination of the stress points of illiquidity, significant outflows and complex valuations created major issues for EU MMF promoters. USD LVNAV funds were affected by the EU Money Market Fund (EU MMF) regulation, which requires the deviation of the daily mark-to-market (MTM) versus amortized cost valuation not to exceed 20BPS. As market volatility and illiquidity remained and vendor pricing for short-term debt proved very challenging a number of funds did come close to the 20BPS threshold which, if exceeded, under EU MMF regulation rules would have necessitated a conversion to a variable net asset value (VNAV) fund.

When liquidity was low and a run on funds became apparent, the US Federal Reserve injected liquidity through the Money Market Mutual Fund Liquidity Facility ("Fed MMLF") restoring the bid-ask spread and MTM’s back to more normal levels, driving MTM deviations for USD LVNAV funds to normalize.

**Implication of a Lower Rate or Negative Yields**

Given the lower rate environment in the US and the UK, there is a strong chance the majority of EU MMF’s denominated in GBP, EUR and USD currencies return negative yields. To address negative rates, Euro LVNAV funds adopted in many cases a de-accumulating share class approach, which preceded reverse distribution mechanism (RDM)/share destruction model prior to EU MMF regulation in 2019.
State Street is joining the Investment Company Institute and other industry participants in exploring three potential scenarios to handle negative yields for US-domiciled MMFs.

<table>
<thead>
<tr>
<th>Scenarios</th>
<th>Proposed Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>European Model</td>
<td>Negative rates will be reported and redemptions to shareholders accounts processed, reflecting daily negative accruals</td>
</tr>
<tr>
<td>Negative Accrual</td>
<td>Negative rates will be reported daily, negative accrual recorded at shareholder level, and a payment or redemption processed monthly</td>
</tr>
<tr>
<td>Merger</td>
<td>This is a merger of the European model and negative accrual. A merger ratio is calculated to bring the shares in line with net assets</td>
</tr>
</tbody>
</table>

In all three scenarios, there are downstream impacts on the model and applications that could present significant operational risks for US-domiciled MMFs. If the GBP or USD funds do not have a solution for negative yields, MMFs will have to convert from stable NAV to an alternative. Few fund promoters are considering, in the event of negative rates, converting funds in LVNAV to a full VNAV. Our team knows this is not the preferred or popular option for investors.

If you need further information about Money Market Funds in Europe or to understand what you need to report and how, please contact your State Street relationship manager.
Disclaimer

The material presented herein is for informational purposes only. The views expressed herein are subject to change based on market and other conditions and factors. The opinions expressed herein reflect general perspectives and information and are not tailored to specific requirements, circumstances and / or investment philosophies. The information presented herein does not take into account any particular investment objectives, strategies, tax status or investment horizon. It does not constitute investment research or investment, legal, or tax advice and it should not be relied on as such. It should not be considered an offer or solicitation to buy or sell any product, service, investment, security or financial instrument or to pursue any trading or investment strategy. It does not constitute any binding contractual arrangement or commitment of any kind. State Street is not, by virtue of providing the material presented herein or otherwise, undertaking to manage money or act as your fiduciary.

You acknowledge and agree that the material presented herein is not intended to and does not, and shall not, serve as the primary basis for any investment decisions. You should evaluate and assess this material independently in light of those circumstances. We encourage you to consult your tax or financial advisor.

All material, including information from or attributed to State Street, has been obtained from sources believed to be reliable, but its accuracy is not guaranteed and State Street does not assume any responsibility for its accuracy, efficacy or use. Any information provided herein and obtained by State Street from third parties has not been reviewed for accuracy. In addition, forecasts, projections, or other forward-looking statements or information, whether by State Street or third parties, are not guarantees of future results or future performance, are inherently uncertain, are based on assumptions that, at the time, are difficult to predict, and involve a number of risks and uncertainties. Actual outcomes and results may differ materially from what is expressed herein. The information presented herein may or may not produce results beneficial to you. State Street does not undertake and is under no obligation to update or keep current the information or opinions contained in this communication.

To the fullest extent permitted by law, this information is provided “as-is” at your sole risk and neither State Street nor any of its affiliates or third party providers makes any guarantee, representation, or warranty of any kind regarding such information, including, without limitation, any representation that any investment, security or other property is suitable for you or for others or that any materials presented herein will achieve the results intended. State Street and its affiliates and third party providers disclaim any warranty and all liability, whether arising in contract, tort or otherwise, for any losses, liabilities, damages, expenses or costs, either direct, indirect, consequential, special or punitive, arising from or in connection with your access to and / or use of the information herein. Neither State Street nor any of its affiliates or third party providers shall have any liability, monetary or otherwise, to you or any other person or entity in the event the information presented herein produces incorrect, invalid or detrimental results.

No permission is granted to reprint, sell, copy, distribute, or modify any material herein, in any form or by any means without the prior written consent of State Street.

© 2020 State Street Corporation. All rights reserved.