BNY MELLON MARKETS

Money Market Funds as Collateral

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At a recent webinar, BNY Mellon and experts from the asset management industry discussed the drivers, mechanics and challenges of using money market funds as collateral.

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SHORT-TERM MONEY MARKET FUNDS – A PRIMER

Money market funds are popular with institutional investors for many reasons.

– operational ease including T+0 settlement

– investment diversification across a number of underlying issuers vs. having counterparty risk to a single bank or small group of banks

– AAA rating from at least one of the major rating agencies

– competitive returns when compared to other overnight investments

Institutional investors who use money market funds tend to invest in two distinct strategies depending upon their risk and return preferences i) government/treasury style funds, with exposure to treasury bills or government paper, or ii) prime/liquidity funds which have exposure to very high quality, short-dated financial and corporate debt issuances such as commercial paper, certificates of deposit, time deposits, repo, etc. Therefore, government/treasury fund strategies have the more conservative form of exposure hence they tend to generate lower yields than prime/liquidity fund strategies.

Money market fund investment managers charge a management fee for their services which include credit analysis, portfolio management and the operational administration of the fund. Generally, the objective of these funds is to preserve capital and provide daily liquidity whilst earning a market-related return.

HOW DO INVESTORS PURCHASE MONEY MARKET FUNDS?

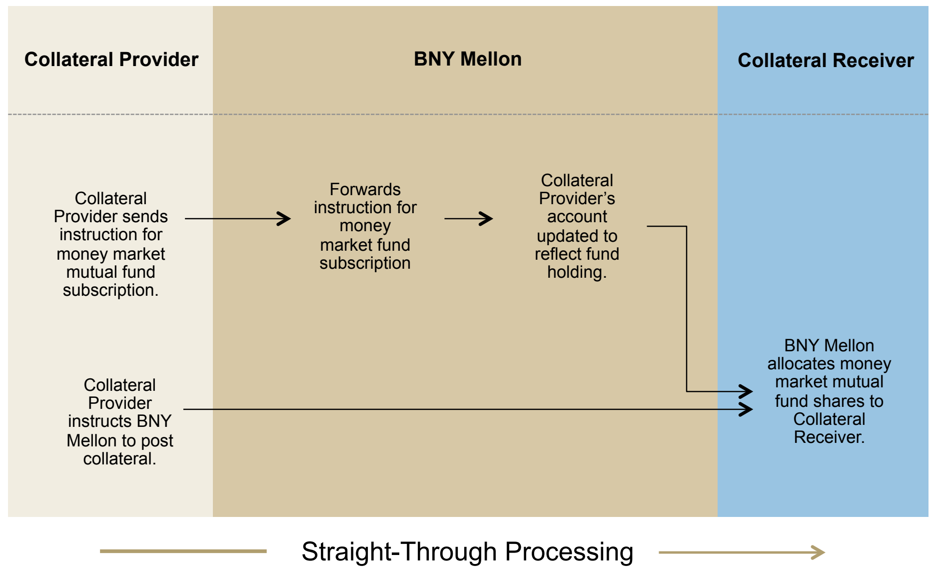
Investors can purchase shares in money market funds by either

– going directly to an individual fund company or

– leveraging an industry platform such as BNY Mellon's Liquidity DIRECT[SM]

Liquidity DIRECT is a global, multi-fund, multicurrency online platform. Fund shares purchased through Liquidity DIRECT are held in custody at BNY Mellon. These fund shares are then available to be used as collateral in any type of collateralized transaction (e.g., repo, stock loan, etc.) upon approval by the parties to the transaction. Through BNY Mellon's platform, investors send cash to invest in money market funds, and the funds are then purchased through a variety of methods including SWIFT. Settlement occurs in a straight-through processing (STP) environment, and collateral allocation is based on agreed collateral schedules.

USING MONEY MARKET MUTUAL FUND SHARES AS COLLATERAL – KEY PROCESS STEPS



MONEY MARKET FUNDS AS COLLATERAL – PROOF OF CONCEPT

SG Newedge UK purchased money market fund shares using the Liquidity DIRECT platform. These fund shares were held in custody at BNY Mellon. SG Newedge UK then entered into an open repo transaction in which it received euro cash and provided money market fund shares as collateral, and the collateral receiver had the right of reuse. The money market fund shares moved from SG Newedge UK's account at BNY Mellon to the collateral receiver's account, which was also at BNY Mellon. The collateral receiver was then in a position to use the money market fund shares as collateral in tri-party transactions with an agent lender where money market funds were part of the collateral schedule. One week later, the transaction was closed out, and the shares were successfully returned to SG Newedge UK's account. BNY Mellon's Liquidity DIRECT platform facilitated the transferability of the money market funds shares between the different parties.

MARKET DEMAND

Regulatory pressures and market dynamics are creating a demand for non-cash collateral as opposed to cash collateral particularly for cleared and non-cleared derivatives as well as securities lending transactions. However, some institutional investors do not have the infrastructure to efficiently post non-cash collateral for these types of transactions, so using money market funds as collateral may make sense from a resource, timing and technology perspective. This also may provide a solution for inter-affiliate positions where one side of the transaction is not used to posting anything other than cash.

THE CCP CHALLENGE

In Europe, collateral pledged to Central Clearing Counterparties (CCPs) must fulfill certain liquidity requirements under the European Securities and Markets Authority (ESMA) technical standards, including evidence of a secondary market for money market funds, to be deemed a transferable security. This poses a challenge for money market funds which are not currently traded on an exchange. In the US, money market funds are being used as collateral on the CME's IEF2 (collateral management) platform, but there is currently no such activity in Europe. Posting cash collateral can at times prove difficult for clearing members and can also present challenges for CCPs in terms of reinvestment. There is a real desire in Europe to work toward a solution of increasing the available options that can be accepted by CCPs.

ADVANTAGES OF USING MONEY MARKET FUNDS AS COLLATERAL

Money market funds could offer many advantages when used as collateral. They are a mature product used by a large number of market participants across a range of industry sectors.

The scale and diversification of a money market fund provide comfort to the collateral giver and the receiver. In addition money market funds are more liquid compared to other options. In the event that a borrower defaults on a loan transaction, collateral receivers may generally liquidate that particular holding of a money market unit on the same day or next day, depending on the cut-off time. Money market funds are also governed by a strong control structure including requirements from ESMA, various rating agencies and the Institutional Money Market Funds Association (IMMFA).
In addition, all IMMFA money market funds are UCITS and fall under that control structure. The structure of money market funds can also help market participants with increasing transparency requirements, that provide look through to the underlying portfolio holdings on a regular basis which can therefore help provide capital relief. Lastly, the yield could be often more favorable versus cash.

MONEY MARKET FUNDS – IS NOW THE TIME?

In today's market, the non-cash collateral mix predominantly consists of equities and bonds, but with regulatory requirements and the predicted collateral scarcity, market participants need more options. Money market funds have a large industry presence and could provide collateral providers and receivers ease of use, transparency and other advantages. Now is the time to explore using money market funds as collateral.

GET TO KNOW US

Our Collateral Universe gives you a multi-dimensional understanding of your collateral through market leading technology and experts who care about your distinct requirements. Our approach is global in scope, regional in design and local in delivery. But don't just read about it. Let us show you.

To learn more, please contact your local Relationship Manager or any of the following individuals:

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