Your questions answered - What happens if GBP goes Negative?

JUNE 2020

Why are we talking about negative rates and what are the implications of negative rates on Money Market Funds?

It can be said the global spread of Covid-19 has led to a sudden and unprecedented stalling of the global economy. This has happened at a time when global growth was already operating below trend and significant central bank stimulus from the preceding Global Financial and Sovereign Crisis has not yet been unwound. Interest rates have been low for many years and for some central banks (such as the European Central Bank), negative.

In the last 3 months we have seen drastic and prompt semi co-ordinated action from central banks and governments from around the world to limit the long-term impacts from this pandemic. Whilst monetary easing has been significant, it is widely believed that more will be needed to curb rising unemployment, the possibility of deflation and a sustained recession. With interest rates already very close to zero in the UK and the USA, there have been increasing discussions on whether the Bank of England and the Fed will follow the ECB, Denmark and Japan to take interest rates negative.

Money Market Funds (MMFs) which operate under the VNAV (Variable Net Asset Value) structure, as many Euro MMFs are, will continue to float with a Variable NAV that decreases in line with the negative rate on the fund together with changes to the market value of the underlying assets.

Money Market Funds which operate under the LVNAV (Low Volatility Net Asset Value) structure have a number of options available:

- To remain as an LVNAV fund they can either;

  a) discount the management fees to ensure a positive or flat yield to investors or,

  b) move existing investors into accumulating share classes.

  Option a is only sustainable whilst the negative yield on the fund is less than the management fees chargeable as sponsors may be unable to support MMFs directly because of the European Money Market Fund Reform Regulations of 2018. With option b (an accumulating share class) the accrual/ dividend is capitalised each day. The share price will therefore rise in a positive rate environment and fall in a negative rate environment.

- To convert from an LVNAV to a VNAV fund structure when the yield of the fund turns negative. This would be a longer-term solution.

Government/Treasury Money Market Funds which operate under a CNAV (Constant Net Asset Value) structure will need to convert to either LVNAV or VNAV.

Has the wider MMF sector come under increased scrutiny from rating agencies and regulators since COVID-19?

In short, yes. We at Aviva Investors have certainly been fielding more calls than usual from both the rating agencies and regulators, as well as oversight teams internally. We operate in a highly regulated industry and need to ensure that market changes don't have an impact on our investors As our investors require liquidity and capital preservation from our MMFs we have increased our reporting to the ratings agencies and regulators to almost daily in some cases to ensure confidence in our product. The regulators have been very proactive in ensuring managers have appropriate processes in place to manage complications such as negative interest rates. From this we are seeing increased investor comfort in our products and expertise.

What do we expect to happen to interest rates in the UK and the USA in the near future?

UK

Richard Hallett, Head of UK Liquidity Portfolio Management

If you had asked us at the start of the crisis what the likelihood was of the Bank of England moving to negative interest rates in the UK then we would have said highly unlikely. The Monetary Policy Committee (MPC) have been very vocal in their opposition to negative rates with the previous governor himself stating that the lower bound for interest rates was close to above zero. As recently as May the 14th the new governor, Andrew Bailey, expressed in a webinar that the MPC were not currently considering using negative interest rates.

Interest rates have been negative in the Eurozone since 2014 and we as a sector have experienced how they have had a negative impact on bank profitability due to margins being squeezed. This in turn impacts bank balance sheets and their ability and willingness to lend money rather than the desired outcome of increasing lending and consumer spending to stimulate growth.

On reflection, however investors and issuers alike managed to get more comfortable with the Euro being negative and Euro investments are now on the rise, which gives us hope for the UK longer term if we do go negative.

Since the middle of May 2020 the rhetoric from members of the MPC has changed markedly. Firstly, Andy Haldane, Chief Economist said in an interview with the Sunday Telegraph that they were looking more urgently at both extending quantitative easing to buy riskier assets and the possibility of utilising a negative bank rate. Silvana Tenreyro, another MPC member commenting in a seminar hosted by the London School of Economics, said “negative interest rates have had a positive effect (in Europe) in the sense of having a fairly powerful transmission to real activity”. And even the governor himself changed tack at the Treasury Committee when he did not rule out negative interest rates as a tool for monetary easing and that they were still up for discussion.

We expect further conversations to continue internally at the Bank of England, there also may well be some divergence in opinion between the members of the MPC on the value of moving to below zero which creates uncertainty with understanding on where the new lower bound is (or whether it has changed at all). There are mechanisms that can be adopted to reduce the effect of negative rates on banks profitability and these will be discussed. The Bank of England will need to address the added complication of the UK Financial Institutions in relation to building societies, who are wholly reliant on retail deposits to fund their lending. They could certainly struggle to attract deposits at very low interest rates.

In the past month we have seen erratic pricing in the markets on the back of this. Gilt yields have been moving between positive and negative territory as the demand for assets has spiked: in May the Government sold negative yielding gilts (in a 3yr tenor) for the first time ever. This demonstrates that investors are becoming more comfortable with negative rates in the UK. If markets fiercely price into the curve further bank rate cuts below zero, the MPC may well feel that their hand is forced to complying.

The market (and we) are unclear whether we will see negative interest rates in the UK, but it would be prudent to prepare for them. In our Sterling Government Liquidity Fund (LVNAV) we have been buying longer dated T-Bills to lock in the rates for as long as possible. In the Sterling Liquidity Fund (LVNAV) we have also been adding T-Bills as well as buying very high quality banking credits for up to 6 months, balancing this with an increase in short-dated assets to maintain high degrees of liquidity.

USA

Katie DellaMaria, Liquidity Portfolio Manager

As the economic damage caused by COVID-19 became more apparent the discussion of negative interest rates in the US gained momentum after the Fed (Federal Reserve) began taking swift emergency measures.. Even though Federal Reserve officials have said repeatedly that they are not considering cutting interest rates below zero, by early May, the Fed Funds futures market was pricing in a negative Federal Open Market Committee (FOMC) policy rate in 2021. Federal Reserve Chairman Jerome Powell has warned that additional policy measures may be required to ease market stress and support the economy. Powell stressed that the Fed is ready and willing to act further, but that additional fiscal stimulus would likely be necessary. However, he also clearly stated that a negative policy rate is not something the FOMC is considering. They had previously discussed and ruled out negative rates in October 2019, officials have stated that their view has not changed.

The Fed did not make any additional policy changes at the April meeting. As expected, they left the policy rate unchanged at 0%-0.25% target range. The FOMC emphasised that they were not looking for a swift pull back from the unprecedented levels of accommodation, and that the current policy would remain in place until the US economy appears to be well on its way to meeting the objectives of full employment (4-5%) and target inflation ~2%.Powell also indicated that the Fed remains ready to act if additional policy accommodations are required to further ease credit conditions. Citing “considerable risks” to the economic outlook over the medium term, the statement signalled that the Fed do not expect a V-shaped recovery. Powell held off on any concrete forecasts regarding the extent of the economic damage and timing of policy changes given the uncertainty of the situation.

One vocal supporter of negative interest rates is President Donald Trump, who has insisted that negative rates are a “gift” that policy makers should embrace. While Powell has resisted thus far, it is important to keep in mind that the Fed has in the past acted fast when under political pressure, for example cutting rates in 2019 after the President had called for it and markets were pricing it in.

At the same time, the majority of Wall Street analysts are not predicting negative interest rates. Many have said that the Fed has more attractive options at their disposal to spur economic growth before they would consider cutting rates to zero, and that would be as a last resort. The Fed has already expanded their balance sheet to a record $7 trillion through various bond buying programmes. Bank executives have argued that the benefits to the economy are uncertain while the harm to the banking system is significant. JPMorgan Chase CEO Jamie Dimon has said that negative rates would have “huge adverse consequences”.

While we do not think it is a likely scenario, there is still a tail risk that we see a negative policy rate from the Fed in the coming years. We think that the Fed will utilise the full extent of their balance sheet and urge further fiscal support before considering this option, however. Given the level of uncertainty that still remains about Covid-19, we should be prepared and not rule out the possibility of negative interest rates.

What are we at Aviva Investors doing to prepare for the possibility of negative rates?

We have put in place some options to ease the stresses of a negative rate environment. For short term or temporary negative yields, we have a process in place that allows us to discount or waive our management fees in the existing distributing share classes in the funds. This would avoid the requirement to flip the fund structure from LVNAV to VNAV or move investors to accumulating share classes which we don't believe would be beneficial as a short-term solution.

If the negative yields are expected to last medium to long term we will give investors the option to switch their holdings with us from the distributing share classes to newly created accumulating share classes within the same fund or to redeem their holdings or move to a different fund within our range.

We expect to utilise these share classes at or close to the point that the net yield on the share class turns negative. Share class switches are common and simple for funds and their administrators to manage and there is no cost to the investor to process.

If negative yields are to be a long-term solution, then we have the mechanisms in place to flip the LVNAV funds to VNAV in line with the EU Money Market Fund Reform Regulations of 2018. The Sterling denominated funds would then run similarly to the existing VNAV Euro Short Term Money Market Funds. Whilst converting our LVNAV funds to a VNAV structure is a viable option, it is a more complicated transition operationally. Therefore, we believe that moving investors to an accumulating share class is the most straight forward option for our investors and don't expect to convert our LVNAV funds unless required for a more permanent solution.

We have put together the below FAQ section formulated from questions we have received from investors and third parties to date in relation to stress scenarios also:

Stress scenario

1. **How will you communicate that a Liquidity Event has occurred – either a Liquidity Fee, Collar Breach on LVNAV, or imposition of a Redemption Gate (either Partial or Full), Fund suspension?**

   An email notification will be sent by the Administrator to all investors using contact details stored on the Fund's Share Register. The Aviva Investors team also have dedicated relationship managers for each investor who will assist with communications. Contact to the trading portals and platforms will also be done by the Administrator via email with follow up from the relationship managers at Aviva Investors.

2. **Will you implement this End Of Day, Start of Day or Intraday?**

   Interim payment runs would be suspended at 15 basis points deviation.

   When the Fund breaches the 20 basis points threshold the NAV (Net Asset Value) will flip from an LVNAV to a VNAV (both with 4 decimal precision).

   The Collar Breach (Constant NAV deviating from the Mark To Market NAV by +/- 20basis points) will be determined at the point of NAV calculation at the end of the day T+0.

   All intra-day liquidity will then be halted on the following business day until the NAV is re-calculated to determine if the Collar is still broken and the VNAV calculated.

   If the collar is still broken on the following business day, any trades received during the day are processed using the VNAV price. Intra-day liquidity continues to be ceased each day while the Collar is broken, and redemptions are processed at the close of business using the VNAV.

   If a Breach occurs all unprocessed trades will be rejected and all Investors will be required to re-instruct the trades. Communication will be made by the administrator and your relationship manager in this scenario.

Unit Subscription Dealing

The ability to accept unit deals will be switched off once the email notification to investors has been successfully sent:

(a) Unit Subscription Deals received before the NAV has flipped will be considered in good order and deals will be processed

(b) Unit Subscription Deals received after the NAV has flipped but before Client issued Investor Communications have been communicated will also be considered in good order and will be processed

(c) Unit Subscription deals received after investor correspondence has been sent will not be processed and trades should be rejected.

3. In the event of a Partial Redemption Gate, how are the residual portions of deals treated and carried forward?

The residual portions will be treated as separate orders with distinct order IDs. If we advise the administrator to place 50% of the trade, they will enter 50,000 of a 100,000 trade and carry over the remainder of the order to the next day.

4. How are SWIFT trade messages impacted?

In the stress event, STP dealing will be invoked. Dealing activity, where allowed, will transition to manual operations. Please see below for the types of dealing that would be available during a stress event. Please also note that under FAX dealing this also covers EMAIL dealing. If you are not setup for Email dealing please contact your relationship manager.

Stress Event	Subscriptions			Redemptions		
	SWIFT	FAX	Phone	SWIFT	FAX	Phone
Full Suspension	X	X	X	X	X	X
Outflow Suspension	X	✓	✓	X	X	X
Partial Gating	X	✓	✓	X	✓	✓
Liquidity Fees	✓	✓	✓	✓	✓	✓

5. When will you consider an order valid/received? When the client's trade is received/time stamped by the intermediary or when your TA receives the trade from the intermediary?

At the point when the TA receives the trade from the intermediary. Trade cut-off times are disclosed in the **Fund prospectus** and any changes to those are published on the **web-site**.

6. Will you net the fee amount out of the liquidation proceeds?

Yes – a liquidity fee will only be deducted from redemption orders. Redemption statement/contract note will disclose amount deducted for fees.

7. How will you report the fee transaction to the intermediary and what information will be provided?

Notifications will be sent out via email recorded on the shareholder register at the beginning of the business day which will identify the fee amount to be levied that day.

8. Will you accept purchases if there is a fee or gate in place?

Unless stated otherwise on the investor's/fund notice, purchases will still be accepted into the fund In case of outflow suspension or partial gate, subscriptions can be accepted only either by fax/email* or phone. In case of liquidity fee applied – all dealing channels remains available.

9. Are dividends subject to/impacted by fees?

Dividends will not be impacted by liquidity fees.

Find out more

For further queries please do not hesitate to contact us:

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