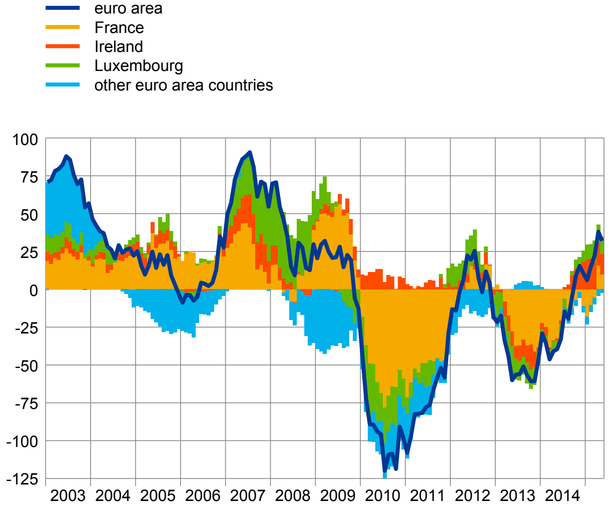
Box 5
The impact of negative short-term rates on the money market fund industry

The prolonged period of low – and recently negative – short-term interest rates poses challenges for the money market fund (MMF) industry.[1] However, while low returns dampen demand for these funds and reduce the overall size of the industry, conditions seem to have stabilised since the middle of 2014, with holdings of MMF shares in M3 showing positive flows. This box provides an overview of recent developments in the sector and analyses changes in the returns of these funds in the context of the low interest rate environment.

The issuance of shares/units by euro area MMFs to the euro area money-holding sector has increased since mid-2014 following a long decline. Chart A shows that annual flows of money market fund shares issued to the euro area money-holding sector increased from -€33 billion at the end of June 2014 to €32 billion by the end of May 2015. The chart focuses on developments in France, Ireland and Luxembourg, as these countries account for over 95% of the total assets of all MMFs in the euro area. The chart shows that annual flows have generally increased in all countries since mid-2014 and have been positive on aggregate since the beginning of 2015, adding support to the growth of M3.

Chart A
Shares/units issued by euro area money market funds included in M3

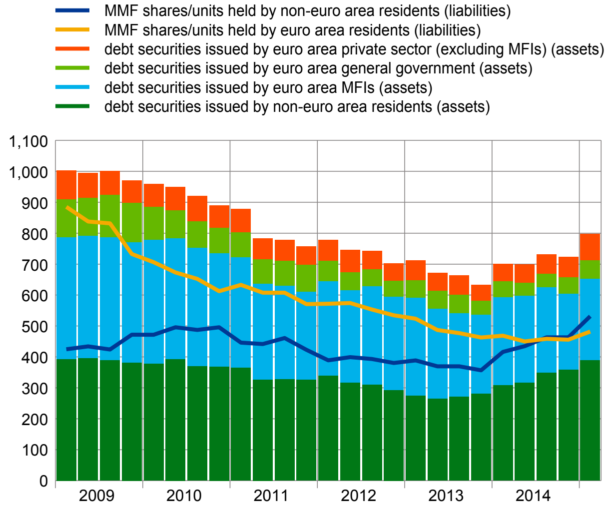
(EUR billions; annual flows; euro area non-MFIs excluding central government sector)



Source: ECB.
Note: The latest observation is for May 2015.

Chart B
Assets and liabilities of euro area money market funds by counterparty sector and area

(EUR billions; outstanding amounts)



Source: ECB.
Notes: The bars denote MMFs' holdings of debt securities, while the lines denote MMFs' liabilities. The latest observation is for the first quarter of 2015.

[1] The ECB defines a money market fund as a collective investment undertaking that primarily invests in money market instruments and/or other transferable debt instruments with a residual maturity of up to one year, and/or that pursues a rate of return that approaches the interest rates on money market instruments.

Of the main assets and liabilities of MMFs resident in the euro area, the issuance of shares to non-residents in the second half of 2014 was greater than that to residents and also coincided with an increase in MMFs' holdings of external debt securities over this period (see Chart B). MMFs in Ireland and Luxembourg are mostly focused on non-euro area residents, while in France the industry carries out a predominantly domestic intermediation function. MMFs' holdings of debt securities issued by euro area MFIs declined from €280 billion at the end of the second quarter of 2014 to €263 billion by the end of the first quarter of 2015. While this is broadly in line with the decreased overall MFI issuance of debt securities over this period, the current share of MMFs' holdings of outstanding MFI debt (around 6%) remains below the levels seen up to 2010 (around 8%), indicating that the relevance of MMFs for the funding of euro area MFIs has diminished.

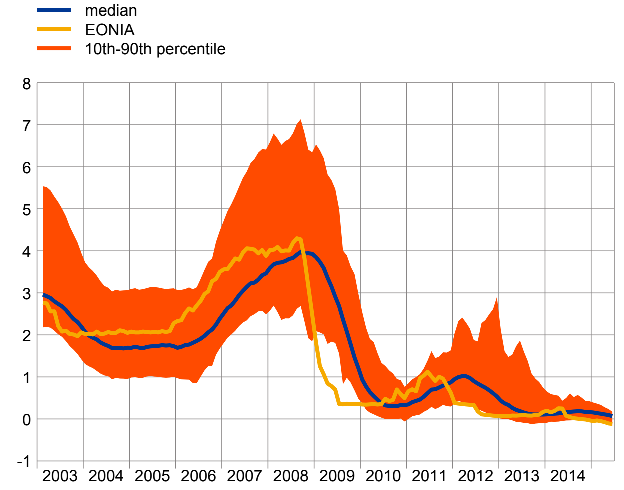
The contraction in the MMF industry since 2009 coincides with the decrease in returns offered on these funds over the period (see Chart C). While the median return is still slightly positive, a substantial proportion of MMFs are yielding negative returns. By the end of June 2015 22% of the funds showed negative returns, but these funds only accounted for around 5% of the total assets, suggesting that larger funds tend to offer higher returns.

The median return has remained relatively stable since the end of 2013 and has in fact increased in comparison with the interest rates on similar investment opportunities. For instance, since the introduction of negative deposit rates in the middle of 2014, MMF returns have been higher than the EONIA and the three-month EURIBOR, and the difference between MMF returns and interest rates on deposits with a maturity of up to one year has decreased steadily since 2013 (see Chart D).

Chart C

Total returns of euro area money market funds

(year-on-year total return)

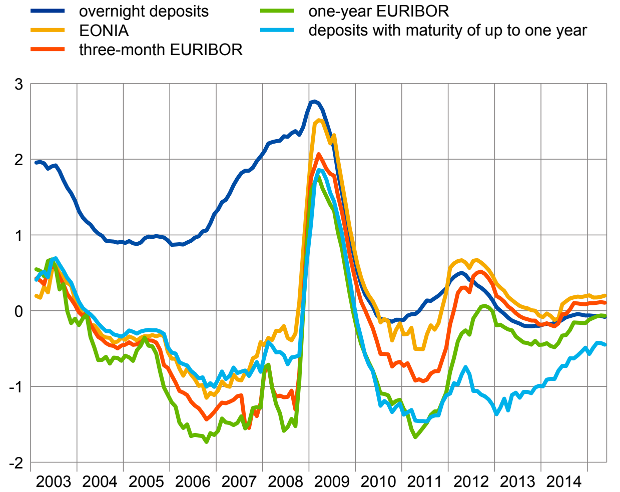


Sources: Bloomberg, ECB and ECB calculations.
Notes: The sample includes 518 funds, all of them denominated in euro. Total returns take account of the price appreciation and dividends reinvested. The latest observation is for June 2015.

Chart D

Returns of euro area money market funds relative to other interest rates

(percentage points)

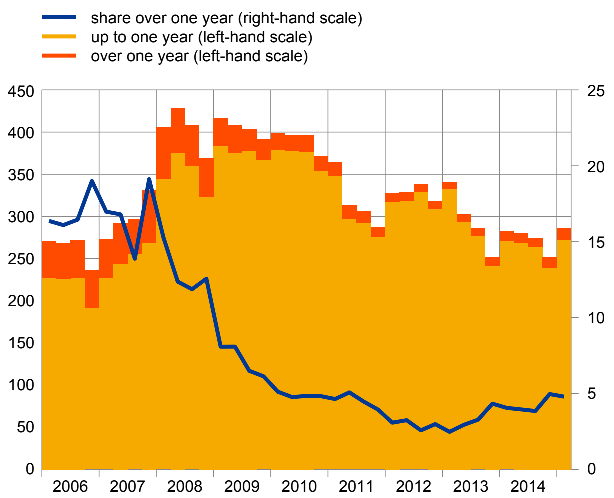


Sources: Bloomberg, ECB and ECB calculations.
Notes: Expressed as the median total returns of euro area money market funds less the respective interest rate. The latest observation is for May 2015.

Chart E

MMFs' holdings of debt securities with an original maturity of up to and over one year

(EUR billions; percentage share of total holdings)



Source: ECB.
Note: The latest observation is for the first quarter of 2015.

There is no clear evidence that MMFs have sought to increase returns by extending the maturity of their investments. Chart E shows the share of securities held with an original maturity of over one year as a percentage of total holdings. These broad data do not permit an in-depth analysis of changes in the residual life or maturity of MMFs' holdings, but they can give some indication of the trends in the types of securities they hold. The chart shows that euro area MMFs decreased their share of holdings of debt securities with a maturity of over one year from 2008 to 2013, when the share increased marginally. However, since the second half of 2014, after the ECB's deposit facility rate turned negative, there has been no major change with respect to the original maturity of the debt securities they hold. It is important to remember that there are regulations on the weighted average life of securities that MMFs are permitted to hold, and their ability to adjust the maturity of their holdings can therefore be limited. Overall, there has not been a perceptible increase in the original maturity of MMF holdings since the deposit facility rate turned negative.

In conclusion, the environment remains challenging for the euro area MMF industry, though developments appear to have stabilised. However, the relevance of MMFs for euro area MFI funding has diminished. Recent increases in issuance, and correspondingly in assets, are predominantly driven by non-euro area counterparties. The stabilisation in issuance vis-à-vis euro area residents is likely to be due to the relatively steady returns on these funds over the past year, especially in the context of declining interest rates on comparable investment opportunities. An analysis of the original maturity of the debt securities that MMFs hold indicates no obvious change. This would suggest that MMFs have weathered the low interest rate environment by taking advantage of the ongoing adjustment in relative prices and returns across the board, rather than by changing their business model.