HSBC Global Liquidity Funds

Fund update

30 March 2020

The demise of LIBOR and transition to Risk Free Rates

In July 2017, it was announced that the overseeing authority would no longer require banks to submit rate contributions for the calculation of LIBOR from the end of 2021. Authorities had determined that LIBOR, and more widely IBOR, were no longer reflective of the lending rate between banks; a risk to financial stability since the pricing of trillions of dollars of financial instruments rested on rates only evidenced by a few transactions or observations of transactions and evidence that LIBOR had been manipulated in some cases prior to the introduction of benchmark regulation. As a result, authorities are transitioning financial markets away from LIBOR to Risk Free Rates (RFR). The RFRs in the key jurisdictions will be overnight (O/N) rates based on observable underlying transactions. By using a large volume of underlying transactions, the RFR will be more representative and robust.

Money Market Funds to update reference rates

Historically Money Market Fund (MMF) managers have typically used short-term LIBOR rates, for example a 7-day LIBID rate, as a comparator of performance which many investors would have been familiar with. Unlike a benchmark which is a target for return based on an index of securities, a reference rate is purely a comparator. In March 2020, we updated our factsheets to reflect the RFRs which will replace short-term LIBOR rates. This update is designed to help familiarise investors with the differences between the rates.

Key takeaways

- A reference rate is purely a comparator of performance
- MMFs are not managed to an index / benchmark
- Transitioning the reference rates to the new RFRs;
  - will not alter the way we manage MMFs
  - will not impact the performance of our MMFs

Rate calculation

The calculation of the RFRs differs to IBORs, and varies by currency;

USD	Secured Overnight Financing Rate (SOFR)	◆ SOFR is determined as the average rate of significant O/N repo transactions ◆ The covered transactions are 1 day repurchase agreements collateralised (at 102%) with US Government securities. This benchmark is hence a mostly US Government 1 day risk, and is then significantly different from an overnight deposit rate
GBP	Sterling Overnight Index Average (SONIA)	◆ In the past, SONIA was determined as the (trimmed) average of all significant O/N interbank deposit transactions ◆ Since the interbank O/N deposit market size is only a fraction of the overall O/N deposit market (made by non-bank institutions), the benchmark was not deemed to be a valid RFR in GBP ◆ Since April 2018, SONIA encompasses deposits made by financial institutions at large with banks
EUR	Euro Short-Term Rate (€STR)	◆ €STER is determined as the (trimmed) average of all significant O/N deposit transactions with banks made by financial institutions at large ◆ €STER takes into account a broader range of transactions than EONIA which was derived from interbank O/N deposits

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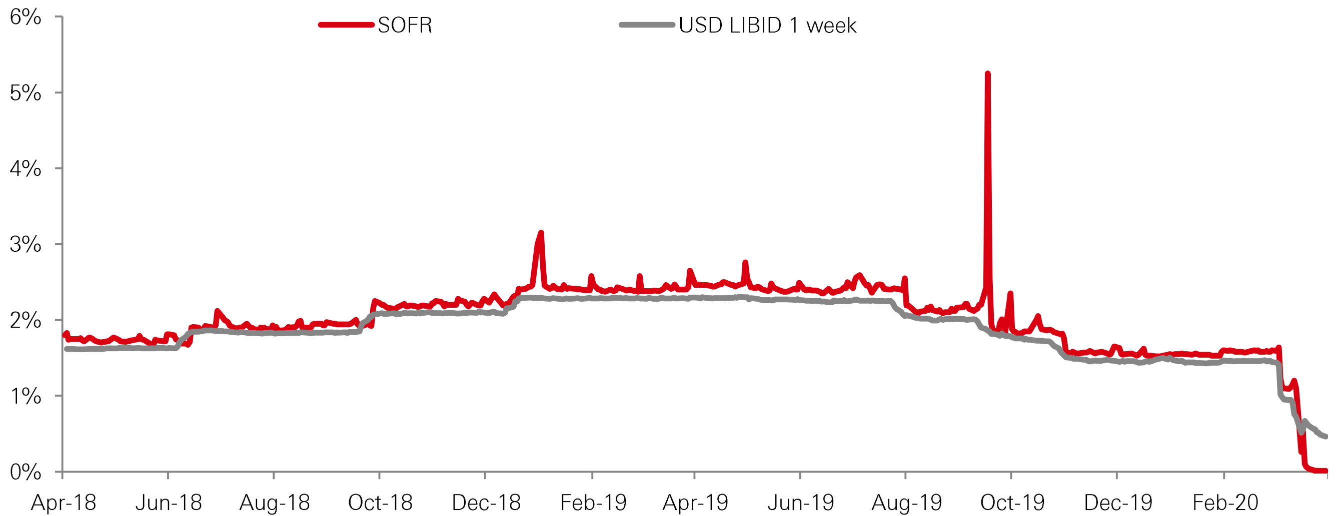
HSBC US Dollar Liquidity Fund & HSBC US Treasury Liquidity Fund

Figure 1: USD 7-day LIBID vs Secured Overnight Financing Rate (SOFR)

As referenced in the table on page one, SOFR is calculated using actual transactions and is considered a broad measure of the cost of borrowing cash overnight collateralised by Treasury securities. Consequently since its launch in 2018, SOFR has had a more volatile return profile by comparison to 1 week LIBID, typically experiencing swings at quarter-ends as large financial institutions seek funding to adjust balance sheets. MMFs invest in securities out to 397 days, this has a smoothing effect on the yield of the fund vs SOFR meaning we will potentially observe bigger one day variances differences between the funds 1 day performance and SOFR as illustrated below.

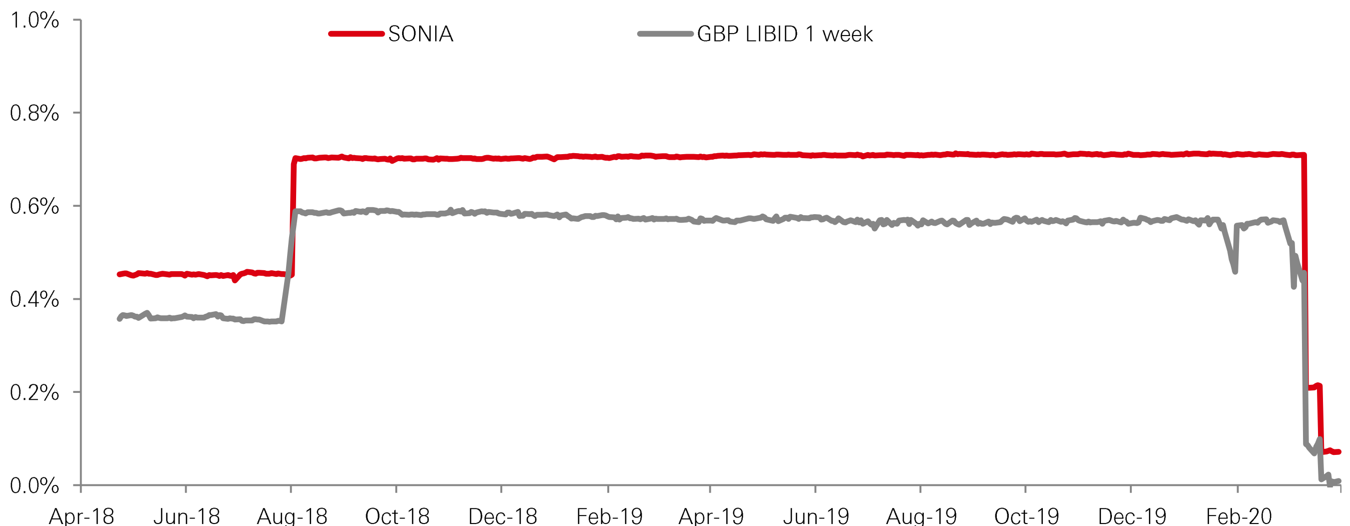


Source: Bloomberg from 2 April 2018 to 30 March 2020.

HSBC Sterling Liquidity Fund & HSBC Euro Liquidity Fund

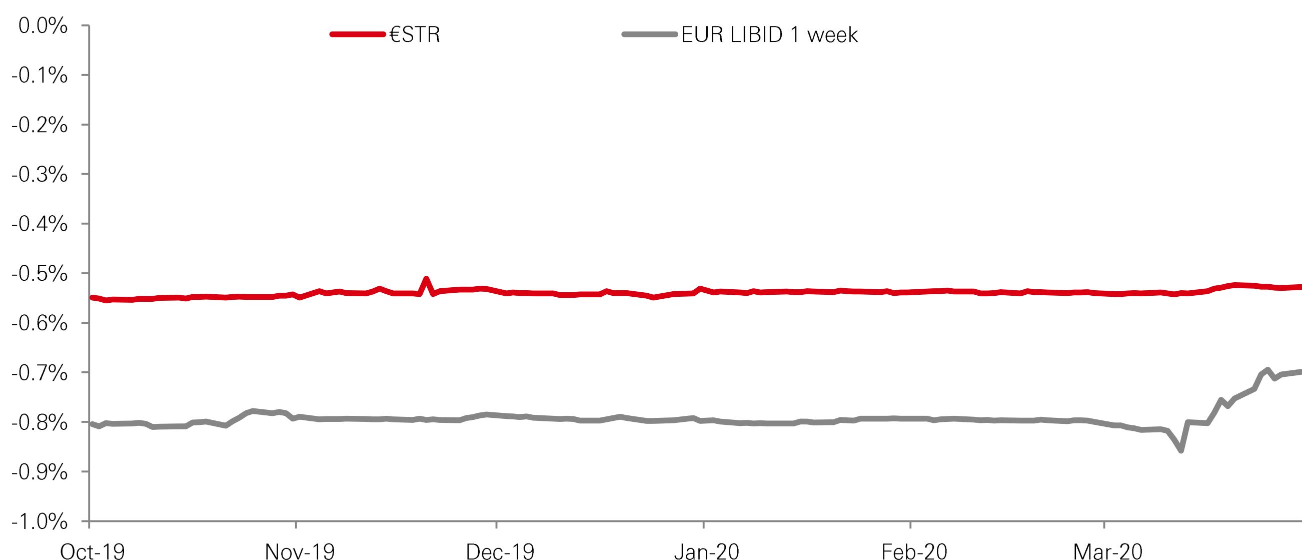
By contrast to SOFR, neither SONIA nor €STER are truly risk free rates as they are not based on collateralised lending, but unsecured lending across a broad range of professional market participants including MMFs. The observed differences between 7 day LIBID and the new SONIA and €STER rates in figures 2 & 3 below can be accounted for by a) SONIA and €STER are both based on actual transactions whereas LIBID is the implied rates banks are willing to pay for deposits, and b) the difference in duration between the two reflects the cost of borrowing for a longer period. Despite these differences the use of an overnight reference rate going forward will be more consistent with a daily liquid product.

Figure 2: GBP 7-day LIBID vs Sterling Overnight Index Average (SONIA)



Source: Bloomberg from 23 April 2018 to 30 March 2020. LIBID is calculated as LIBOR – ⅛ %.

Figure 3: EUR 7-day LIBID vs Euro Short-Term Rate (€STR)



Source: Bloomberg from 1 October 2019 to 30 March 2020.

In Summary

Whilst the transition to RFRs represents a significant event in the wider global financial services industry, it has no impact on the way we manage MMFs or our expectations on their performance relative to other short-term cash investment products. From March 2020 we shall use the RFRs as a comparator for performance on our factsheets to help investors familiarise themselves with the RFRs well in advance of LIBORs demise.

What should I do if I still have questions?

Please don't hesitate to contact your Liquidity sales specialist.

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What are the key risks?

The value of investments and any income from them can go down as well as up and investors may not get back the amount originally invested.

- **Asset backed securities (ABS) and mortgage backed securities (MBS) risk. ABS and MBS typically carry prepayment risk,** as well as having potential for default. The securities can carry an above-average risk of being hard to value or to sell at a desired time and price
- **Counterparty risk.** The possibility that the counterparty to a transaction may be unwilling or unable to meet its obligations
- **Credit risk.** A bond or money market security could lose value if the issuer's financial health deteriorates
- **Derivatives risk.** Derivatives can behave unexpectedly. The pricing and volatility of many derivatives may diverge from strictly reflecting the pricing or volatility of their underlying reference(s), instrument or asset
- **Exchange rate risk.** Changes in currency exchange rates could reduce or increase investment gains or investment losses, in some cases significantly
- **Investment leverage risk.** Investment leverage occurs when the economic exposure is greater than the amount invested, such as when derivatives are used. A Fund that employs leverage may experience greater gains and/or losses due to the amplification effect from a movement in the price of the reference source
- **Liquidity risk.** Liquidity risk is the risk that a Fund may encounter difficulties meeting its obligations in respect of financial liabilities that are settled by delivering cash or other financial assets, thereby compromising existing or remaining investors
- **Money Market Fund risk.** The fund's objective may not be achieved in adverse market conditions. During times of very low interest rates, the interest received by the Fund could be less than the costs of operating the Fund
- **Operational risk.** Operational risks may subject the Fund to errors affecting transactions, valuation, accounting, and financial reporting, among other things

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HSBC Global Liquidity Funds are Money Market Funds (MMF) and therefore:

a) are not a guaranteed investment

b) are different from an investment in deposits and there is a risk that the principal invested in an MMF may fluctuate;

c) do not rely on external support for guaranteeing the liquidity of the MMF or stabilising the NAV per unit or share;

d) the risk of loss of the principal is borne by the investor

The MMF have availed of the derogation provided for under Article 17(7) of the Money Market Fund Regulation and accordingly a Fund may, in accordance with the principle of risk-spreading, invest up to 100% of its assets in different money market instruments issued or guaranteed separately or jointly by the European Union, the national, regional and local administrations or their central banks, the European Central Bank, the European Investment Bank, the European Investment Fund, the European Stability Mechanism, the European Financial Stability Facility, a central authority or central bank of a third country, the International Monetary Fund, the International Bank for Reconstruction and Development, the Council of Europe Development Bank, the European Bank for Reconstruction and Development, the Bank for International Settlements, or any other relevant international financial institution or organisation to which one or more member states of the European Union belong.

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