The Committee of European Banking Supervisors
Floor 18, Tower 42
25 Old Broad Street
London EC2N 1HQ

25th November 2005

Dear Sir/Madam

CP07a draft guidelines on mapping ECAI's credit assessments of CIUs

I am writing on behalf of the Institutional Money Market Funds Association (IMMFA) in response to CP07a – CEBS' draft guidelines on mapping External Credit Assessment Institutions' (ECAIs) credit assessments of collective investment undertakings (CIUs).

IMMFA is the trade body that represents providers of triple-A rated money market funds – a category of CIU which is rated by ECAIs and will therefore be directly affected by CP07a. The triple-A rated money market funds sector is large and rapidly growing: funds under management for IMMFA members alone stood at approximately a quarter of a trillion US dollars as at October 2005, and is forecast to double in the next three to five years.

Unlike other types of CIUs, triple-A rated money market funds are managed in such away as to maintain a stable net asset value. Consequently they compete in the same space as bank deposits for short-term corporate treasury and other institutional monies. I have included an appendix describing the operation of triple-A rated money market funds in more detail.

The Capital Requirements Directive (CRD) will significantly improve the attractiveness of triple-A rated money market funds to banks and investment firms using the standardized approach, by permitting them to assign the same risk weight to CIUs and bank deposits which are assigned a credit quality step of 1 – i.e. a 20% risk weight. Consequently, IMMFA assigns the highest importance to ensuring that an eligible ECAI credit assessment of a triple-A rated fund should result in it being mapped to a credit quality step 1.

We are concerned that CEBS' draft guidelines will not achieve this result.

CEBS proposes that only ECAI credit assessments that meet the following three conditions will be eligible under the CRD:

- The assessment of the credit quality of the CIU must depend primarily on the credit quality of the underlying assets (for example, by using a weighted average of the individual credit assessments to derive the assessment of the CIU). Even though the rating of a CIU may not be interpreted as information about the PD of a CIU (since funds normally do not default as a whole), the credit assessment of a CIU should be comparable to a 'look-through' credit assessment of the individual assets within the fund (based on the fundamental credit assessment approach).
- Other factors, such as the volatility of the CIU or the quality of its management, must not have a material positive influence on the assessment of the credit quality of the

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fund. Any nonmaterial influence that such factors have on the assessments should be taken into account in the mapping of the assessments.

- Only assessments for fixed income CIUs should be eligible, since the CRD does not allow the use of credit assessments for other asset classes (e.g. equity) within the Standardised Approach.

We are concerned that the first condition fails to reflect how ECAIs actually carry out credit assessments of CIUs, and therefore makes their credit assessments ineligible for the purposes of the CRD. In particular, the first condition is too prescriptive in requiring the credit assessment of a CIU to be comparable to a 'look through' credit assessment of its individual assets, by, for example, simply risk-weighting the credit assessments of those individual assets. We submit two examples of other factors that ECAIs might take into account when determining the credit assessment of a CIU.

First, some ECAIs take account of the maturity of individual assets in the portfolio. That is because there is a trade-off between credit risk and maturity – the longer a security is outstanding, the greater its expected loss. That is one of the reasons[1] why triple-A rated money market funds are restricted to investing in short-dated securities, typically with a maximum maturity of 397 days and an overall weighted-average maturity of 60 days. This points to another failing in the first condition – that the credit assessment of a CIU does not provide information about the probability of default, because funds do not normally default as a whole. Whilst it is true that funds do not normally default as a whole, it does not follow that a fund credit assessment does not reflect the probability of default in the underlying portfolio. In fact, it reflects not only the probability of default, but also the loss given default, in order to provide an assessment of the expected loss. The maturity as well as the credit assessment of the individual instruments comprising the portfolio is relevant.

Second, some ECAIs take account of the effect of portfolio diversification on the credit assessment of a CIU. Triple-A rated money market funds are subject to demanding diversification requirements, which effects their overall credit rating in much the same way that the portfolio composition of a bank's loan book effects its own credit assessment. Nobody would suggest that a bank's credit assessment should be based on a simple 'look through' of its loan book, and the same is true of the holdings of a CIU.

By not taking these factors into consideration, it would be impossible for most funds to receive a triple-A rating, even though the portfolio would demonstrate the highest credit quality. We therefore recommend that the first condition should be revised.

The fundamental problem is that it is too prescriptive. We therefore recommend a simpler condition that will accommodate the different methodologies employed by different ECAIs. CEBS itself provides a better alternative (in paragraph 7 of CP07a):

> *"To be eligible, a CIU credit assessment must primarily depend on the credit worthiness of the underlying assets."*

This alternative condition is preferable because, whilst requiring that the credit assessment of a CIU should depend 'primarily' on the credit worthiness of its underlying assets, it also leaves room for ECAIs to take account of other factors such as maturity and diversification.

We are also concerned that the second condition does not properly reflect the influence that the quality of a CIU's management can have on its rating. The management of a triple-A rated money market fund must meet a certain threshold in order for the fund to be eligible for a credit assessment. It is a necessary condition. Furthermore, we understand that for some bond funds, the quality of management can even result in a modest notch movement

[1] Limiting interest rate risk is another reason.

in its credit assessment. We understand that the ECAIs will be separately writing to CEBS to express their views on this point.

We have no objections to the third condition.

We would welcome the opportunity to explain the operation of money market funds in more detail and answer any questions that may arise from our response, should further clarification be required.

Yours faithfully

Travis Barker

IMMFA Secretariat

Appendix: What are triple-A rated money market funds?

Money market funds are a type of CIU that invest in short-term debt instruments. Unlike other types of CIU (whose unit price fluctuates in proportion to changes in the value of its underlying portfolio), units in money market funds maintain a stable net asset value – i.e. units are created and redeemed for £1, $1 or €1. This enables money market funds to preserve capital whilst maintaining liquidity. So, although in legal terms they are structured as CIUs, in economic terms they are used as a substitute for bank deposits.

The Treasury Today annual survey of 'Corporate and Institutional Money Market Funds in Europe 2005' gives the following description of money market funds:

> *Today top rated money market funds are used as an alternative to bank deposits by many investors. They offer a practical means of consolidating and outsourcing short-term investment of cash. Money funds AAA credit rating is attractive to many investors. Many banks have long-term credit ratings of AA or A and are weaker credits than some of their major customers.*
>
> *There are also fewer banks as mergers take place. The number of banks is shrinking and some depositors simply find their limits with the banks they might want to deal with are full.*
>
> *There is also a fear that, no matter how strong your bank is, you should not deposit all your money with one organisation. So some form of diversification is appropriate. Money funds offer such a diversification of investment with a mixed portfolio of investments.*

Money market funds have other advantages over bank deposits. Whereas the assets of a bank are held on its own balance sheet, the assets of a money market fund are held by a third-party depositary, independent of the money market fund provider. Also, whereas banks are remunerated by the margin between the rate at which they lend and the rate at which they borrow, money market fund providers are remunerated by an *ad valorum* management fee charged to the fund. Consequently, money market fund providers are not subject to the same conflicts of interest as banks, which seek to maximise margins by lending at a riskier rate than that at which they borrow. Nor, consequently, do money market funds pose the same systemic risks[2].

Money market funds are therefore widely used in the USA and the UK (and increasingly in Continental Europe) to manage the surplus cash of corporate treasury departments, local authorities and pension schemes, and to manage client money in a variety of circumstances.

Their popularity is evidenced by the rapid growth of funds under management - in the USA, money market funds market size at end of 2004 was USD 1913 billion[3], and in the EU assets have grown from USD 50 billion in 2000 to USD 255 billion as of June 2005. Total funds as of June 2005 are shown below:

	Total non-US MMFs	***...of which, IMMFA MMFs***
US dollar (billions)	163.94	110.59
Euro (billions)	43.29	39.35
Sterling (billions)	55.76	52.94

(Source: iMoneyNet)

[2] Because of these differences, money market fund providers are subject to a different capital charge than banks, namely, an operational risk charge based on fixed overheads requirements.

[3] See ICI's 2005 Investment Company Factbook.

Another sign of the growing maturity of the money market funds industry was the establishment in 2000 of the Institutional Money Market Funds Association (IMMFA), the trade association representing promoters of triple-A rated money market funds. IMMFA's members comprise nearly all of the major promoters of this type of fund outside the USA. Membership is made up of full members (investment management firms) and associate members (including accountants, administrators and credit rating agencies). Members of IMMFA subscribe to a Code of Practice, which can be found on our website, www.immfa.org .

Regulation of money market funds

European money market funds are generally domiciled in Ireland or Luxembourg. They are regulated in accordance with the UCITS Directive[4], which, amongst other things prescribes their investment and borrowing powers (e.g. by imposing diversification requirements, investment concentration limits and by identifying eligible and ineligible assets), operational structure (e.g. by requiring the UCITS management company to maintain regulatory capital and appropriate risk management processes, and by requiring the UCITS to appoint an independent depositary) and minimum disclosure requirements (e.g. by mandating the contents of the UCITS' prospectus and simplified prospectus).

The Committee of European Securities Regulators (CESR) is preparing advice on the eligible assets of UCITS, including eligible money market instruments. The latest draft[5] (issued on 20 October 2005) permits UCITS to value money market instruments using an 'amortisation method' – i.e. if a security is purchased at a premium or a discount, one day's accretion or amortisation can be taken to income, and the price of the security is adjusted. At the security's maturity date, the price of the security is par. The effect of valuing assets on an amortised cost basis is to insulate the fund from minor, temporary market movements, and reflects money market funds' investment strategy of holding short-dated debt instruments to maturity, rather than making sales at a gain or a loss before the maturity date. Crucially, by transferring accretions and discounts to income, amortisation allows securities to be held in capital at par, and thus enables money market funds to maintain a stable net asset value – a key feature of triple-A rated money market funds.

CESR's advice permits amortisation subject to two conditions.

The first condition is that amortisation should not result in "a material discrepancy between the value of the [money market instrument] and the value calculated according to the amortization method". IMMFA members subscribe to a Code of Practice which requires them to monitor on a weekly basis, and limit (plus or minus 50 basis points) any deviation between amortised and market value. The Code of Practice also requires money market fund providers and their fund administrator to implement an 'escalation policy' to identify deviations well before the 50 basis point threshold is reached so that they can take early corrective action. For example, a recommended escalation policy would have the fund administrator notifying the fund manager at 10 basis points, senior management of the investment firm at 20 basis points, and the trustees/board of directors of the money market fund at 30 basis points[6]. We therefore believe IMMFA members will be able to meet CESR's first condition.

The second condition is that amortisation may only be used by "UCITS investing solely in high-quality [money market] instruments with as a general rule a maturity or residual

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4 Mutual funds complying with the UCITS Directive (85/611/EEC) are authorised to be sold on a cross-border basis throughout the EU.

[5] http://www.cesr-eu.org/popup2.php?id=3590

[6] We are only aware of a single instance of a money market fund in Europe actually breeching the 50 basis point limit. In 2002, Newton Investment Management announced a 2.39% fall in value of its corporate money fund, as a result of downgrade of an FRN held by the fund. Newton's parent, Mellon Financial Corporation agreed to inject funds to meet the shortfall. We are not aware of any investor losing money in any triple-A rated funds since these funds have been rated.

maturity of at most one year or regular yield adjustments in line with the maturities mentioned before and with a weighted average maturity of 60 days".

As regards the first part of this condition ("…investing solely in high-quality money market] instruments…"), money market funds are subject to guidelines issued by credit ratings agencies which ensure that they only invest in 'high-quality' instruments. Amongst other things, those guidelines provide for investment in short-dated debt instruments such as treasury and local authority bills, certificates of deposit, commercial paper, medium-term notes and banker's acceptances. Those guidelines are far more prescriptive than the corresponding articles of the UCITS Directive, and stipulate:

- The expected loss of the money market fund's portfolio;
- The credit ratings of individual securities comprising the portfolio;
- The weighted average maturity (WAM) of the portfolio;
- The weighted average life of the portfolio;
- Counterparty exposures;
- Preclusion on the use of derivatives; and
- Duration and volatility.

The effect of these portfolio restrictions is to require money market funds to invest to short-dated debt instruments which have a relatively stable market value (subject only to changes in the credit rating of the issuer or extreme interest rate movements) and therefore enable money market funds to maintain a similarly stable net asset value. Also, because of the low weighted average maturity of the portfolio, instruments are constantly maturing and therefore provide liquidity which can be used to meet client redemptions.

Money market funds which meet the guidelines issued by credit rating agencies are assigned a special rating. The precise notation of the rating differs between ratings agencies (AAAm from Standard & Poors, Aaa/MR1+ from Moody's and AAA/V-1+ from Fitch) but they are all intended to indicate that money market funds exhibit minimal credit (AAA/Aaa) or market (m/MR1+/V-1+) risk.

As regards the second part of the condition ("…with a weighted average maturity of 60 days"), the IMMFA Code of Practice restricts the weighted average maturity of their portfolio to 60 days. We therefore believe IMMFA members will be able to meet CESR's second condition.

By expressly permitting amortisation, CESR's advice recognizes the ability of money market funds to provide a stable net asset value, which is fundamental to their ability to act as a substitute for bank deposits. CESR's advice also represents a significant step forward in recognizing the distinctiveness of triple-A rated money market funds from other types of UCITS. For example, we understand that traditional French money market funds are unlikely to meet the requirements for amortization (since they invest in longer dated securities).