IMMFA
Institutional Money Market Funds Association

CEBS
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Dear Sir/Madam

CEBS Questionnaire on the survey of market practices on large exposures

The Institutional Money Market Funds Association (IMMFA) is grateful for the opportunity to comment on CEBS survey of market practices on large exposures (LEs). Having reviewed the questionnaire, which focuses on practices by firms when undertaking exposures, we believe it to be more appropriate for us to highlight the key issues with regard to the fund itself as an exposure rather than the situation where a fund has exposures to counterparties affected by the large exposure rules.

IMMFA is the trade body representing promoters of triple-A rated money market funds[1] and covers nearly all of the major promoters of this type of fund outside the USA. Triple-A rated money market funds are bought primarily by institutions to manage their liquidity positions and not for 'total return' investment purposes. They are used as an alternative to bank deposits by many investors as they offer a practical means of consolidating and outsourcing short-term investment of cash. Total assets in IMMFA members' funds as at May 2006[2] were in excess of €210 billion. You may obtain further information on triple-A rated money market funds from our website, www.immfa.org.

We would ask you to note that, in many regards, money market funds are similar to other investment funds. As such, we concur with the response from the UK Investment Management Association to the survey of market practices. We note the IMA comment that some of its members and other institutions place some of their own money in Triple-A rated Money Market Funds under existing rules this would be considered to be a large exposure. As Triple-A rated Money Market Funds are liquid with the additional benefit of diversification and a credit rating better than many banks, IMA believe that positions in Triple-A rated Money Market Funds should be exempt from the large exposures requirements.

There are some characteristics that differentiate Triple-A rated Money Market Funds. First, the size of the funds, where assets under management are extremely large in comparison with other types of fund. Second, the type and quality of the diversified asset portfolio, combined with the restrictions imposed by the rating agencies as part of the Triple-A rating award, all help to ensure that the product lies on the very low end of the risk spectrum,

[1] References to triple-A rated money market funds in this letter means funds rated, specifically, AAAm by Standard & Poors, Aaa/MR1+ by Moody's and AAA/V-1+ by Fitch.
[2] Source: iMoneyNet IMMFA Money Fund Report.

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even for UCITS funds. Third, unlike other types of UCITS (whose unit price fluctuates in proportion to changes in the value of its underlying portfolio), units in triple-A rated money market funds maintain a stable net asset value – i.e. units are created and redeemed for £1, $1 or €1.

From an investor's perspective, triple-A rated money market funds therefore compete in the same space as deposits. However, 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[3].

Fund characteristics – diversification and ring fencing

As noted in the questionnaire, the Commission's call for advice refers to the measurement and management of single name and other concentration risk. We note that whereas the exposure to a fund is to a single name, effectively it is not to a single counterparty. The characteristics of a fund differ significantly from those of a typical LE as the exposure is to a diversified pool of assets and the assets themselves are ring fenced. For a money market fund, the level of diversification typically has up to 100 differentiated underlying instruments and there are specific requirements to ensure an appropriate level of diversification. Limits of this kind are designed to prevent a fund from being negatively impacted by problems with the underlying assets.

Funds registered as UCITS must operate within the diversification requirements set out in UCITS legislation (Directive 85/611/EEC). This normally limits exposure to a single issuer to a maximum of 10% of fund assets which is typically reduced to 5% to comply with the requirements associated with the triple-A rating award. As part of the rating process, rating agencies regularly review the diversification of fund portfolios and will raise concerns with investment advisers should this become necessary.

The assets are not held by the fund manager, rather they are placed in a depository which looks after the assets on behalf of the client. This safekeeping role is well established and the depositories themselves are well established financial institutions. Regulation requires the separation of these assets so that in the event of the insolvency of a fund the assets would not be able to be used by the manager to meet other financial liabilities. The role of the depository means that the fund is totally separate entity from the provider of that fund. For example, a fund provided by Barclays or HSBC should not be considered as an exposure to these entities rather it is a separate standalone entity. While it is possible that part of the funds assets may consist of instruments issued by that entity, they will be subject to the

[3] 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.

diversification requirements noted above and would therefore only have a partial effect on the fund.

In addition, funds do not take positions on own account nor do they lend money. As a result they do not expose the funds to risk as a result of propriety exposure. When considering money market funds, the constant NAV requirement means that funds principal should not vary and the amortised valuation should not diverge from its market value by more than a tiny amount. This is supported by rating agency requirements along with internal monitoring and escalation procedures.

Currently, the standalone nature of the diversified asset portfolio is not taken into consideration when determining the size of the exposure to the fund, which results in a treatment whereby the fund is given 100% weighting (ie any exposure to the fund is considered as full exposure). What this means in practice is that a default by a single counterparty would not reduce the fund value to nil; instead the impact would be on only a fraction of the fund. This suggests that it would be more appropriate to consider a percentage of the exposure as the real exposure, with this exposure determined by the expected loss as a result of the failure of an individual counterparty. This might be appropriately set at between 5-10% to reflect the effect of diversification. Reporting large exposures at 100% of value is unrealistic as this could only arise from a systemic meltdown in the global financial markets. In this case, all financial institutions would be severely affected.

Fund level exposure and look-through

For regulatory purposes it would seem appropriate for the exposure be considered at the fund level rather than requiring a look-through to the underlying assets. This is computationally simpler to achieve and would appear acceptable for the standardised risk-based approach within the Capital Requirements Directive. Under the CRD standardised approach the capital requirement is based on the rating whereas the IRB approach allows for a look-through to the underlying assets.

However, instead of relying on a general expected loss limit, there may be in some circumstances, a commercial case to apply 'look-through' to the underlying assets within the portfolio and calculate the exact exposure by individual investor. This would be consistent with the intention to build exposures from 'first-principles' as described by the internal risk-based approach ('IRB') in the Capital Requirements Directive. Thus, while it appears unnecessary to impose look-through as a regulatory requirement, there may be cases whereby it is commercially viable to undertake this approach and we suggest it should be permitted as a specific case.

Umbrella and sub-funds

In certain cases, there is also a need for a distinction to be made between the exposure at umbrella fund and sub-fund level. Triple-A money market funds in Europe generally offer funds in Euro, Dollar and Sterling. A typical example is an umbrella fund that comprised three sub-funds each in a different currency. If the investor was to buy units in a Euro fund the exposure may be segregated to that fund not to the other currencies held in the sub-

fund. In both Dublin and Luxembourg, where the majority of Triple-A money market funds are domiciled, there are specific legal requirements to provide for segregated liability between sub-funds which are in the process of being implemented by some funds. Thus, as far as the real exposure in segregated funds is concerned it is with the sub-fund not the umbrella. This is particularly important with regard to intra-group flows where an umbrella fund may be used by a parent bank to manage its surplus liquidity needs.

IMMFA suggests that CEBS consider the issues set out above when progressing its work on large exposures. We would welcome the opportunity to explain money market funds in more detail and would be very pleased to meet to further explore these issues should clarification be required.

Yours faithfully,

Gerard Fitzpatrick
Secretary General, IMMFA