



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

28<sup>th</sup> October 2005

Dear Sir/Madam

**CEBS CP10: IMMFA response**

The Institutional Money Market Funds Association (IMMFA) welcomes the opportunity to comment on CEBS' Consultation Paper 10 "Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches" (CP10).

IMMFA represents promoters of triple-A rated money market funds. IMMFA has 33 members covering nearly all of the major providers of this type of fund outside the USA. Our members' clients include banks, pension funds, local authorities, corporates, other institutions and high net worth individuals. Total assets in IMMFA members' funds amounted to approximately a quarter of a trillion USD as of October 2005. You may obtain further information on our website, [www.immfa.org](http://www.immfa.org).

As explaining in the attached appendix, the draft Capital Requirements Directive (CRD) will improve the attractiveness of money market funds to banks and investment firms. The CRD permits banks using the standardized approach to assign the same risk weight to triple-A rated money market funds as is assigned to a deposit with a similarly rated bank – i.e. a 20% risk weight. However, the CRD requires banks using the IRB approach to 'look through' a CIU to its underlying portfolio in order to assign a risk weight.

We understand that the costs of looking-through a CIU may outweigh the benefits, in which case IRB banks may prefer to continue to apply the standardized approach using the 'partial use method'. This paper recommends how CEBS' CP10 guidelines might be adapted to ensure that partial use results in an equitable outcome for IRB banks' holdings of money market funds.

**What are triple-A rated money market funds?**

There are two types of money market funds that meet different investor needs namely "all-in-return" (investment) funds and "stable-capital" (treasury) funds and that the latest CESR Eligible Assets Definitions consultation paper recognises this difference. Money market funds are a type of Collective Investment Undertaking (CIU) that invests 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 depository, 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 valorem 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<sup>1</sup>.

Money market funds are therefore widely used in the USA and increasingly in Europe to manage the surplus cash of corporate treasury departments, local authorities and pension schemes, and to manage client money in certain 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<sup>2</sup>, and in the EU assets have grown from USD 50 billion in 2000 to USD 249 billion as of October 2005. Total funds as of October 2005 are shown below:

	Total non-US MMFs	...of which, IMMFA MMFs
US dollar (billions)	169.57	109.89
Euro (billions)	42.64	38.30
Sterling (billions)	54.14	51.88

(Source: iMoneyNet)

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](http://www.immfa.org).

<sup>1</sup> 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.

<sup>2</sup> See ICI's 2005 Investment Company Factbook.

## 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<sup>3</sup>, 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 depository) 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<sup>4</sup> (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:

- 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<sup>5</sup>. We therefore believe IMMFA members will be able to meet CESR's first condition.
- 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 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

---

<sup>3</sup> Mutual funds complying with the UCITS Directive (85/611/EEC) are authorised to be sold on a cross-border basis throughout the EU.

<sup>4</sup> <http://www.cesr-eu.org/popup2.php?id=3590>

<sup>5</sup> We are only aware of a single instance of a money market fund in Europe actually breaching 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.

notes and banker's acceptances. Those guidelines are far more prescriptive than the corresponding articles of the UCITS Directive, and stipulate:

- The credit ratings of individual securities (>50% A1+/P1, balance A1/P1);
- The weighted average maturity of the portfolio (maximum of 60 days);
- The maximum final maturity of individual securities (13 months for fixed rate instruments and 12-24 months for floating rate notes);
- Counterparty exposure (maximum of 5%);
- Preclusion of derivatives; and
- Duration and volatility models.

The effect of these portfolio restrictions is to require money market funds to invest in 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 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 and are "all-in-return" investment funds).

### **Triple-A rated money market funds and the CRD**

As described above, although in legal terms money market funds are structured as CIUs, in economic terms they are used as a substitute for bank deposits. That difference is effectively recognised in the Capital Requirements Directive (CRD), which, broadly speaking, affords holdings of money market funds a similar capital treatment to deposits. The minimum regulatory capital charge prescribed by the CRD for credit risk (in the case of money market funds held in the banking book) is as follows<sup>6</sup>:

---

<sup>6</sup> The CRD also requires firms to hold regulatory capital against foreign exchange risk taking into account "the actual foreign exchange positions of the CIU" (CAD Annex III paragraph 2 for banks on the standardised approach and CAD Annex V paragraph 13 for banks on the IRB approach). In the case of money market funds, because all positions are denominated in the same currency (or else swapped into that currency), the foreign exchange position is easy to calculate. The CRD also requires firms to hold regulatory capital against position risk for CIUs held in the trading book. However, because money market funds are unlikely ever to be held in the trading book, we have ignored that part of the analysis.

The CRD (CBD Annex VI paragraph 72) permits firms that use the standardised approach to assign the same risk weight to triple-A rated money market funds as is assigned to a deposit with a similarly rated bank – i.e. a 20% risk weight. Consequently, the minimum regulatory capital charge for credit risk is 1.6% (i.e. 20% x 8%).

Exposures in the form of CIUs for which a credit assessment by a nominated ECAI is available shall be assigned a risk weight according to Table 7 in accordance with the assignment by the competent authorities of the credit assessments of eligible ECAIs to six steps in a credit quality assessment scale.

Credit quality step of CIU	1	2	3	4	5	6
Risk weight	20%	50%	100%	100%	150%	150%

The situation for firms that use the Internal Ratings Based Approach (IRB) is a little more complicated, since the Directive requires them to 'look-through' a CIU to its underlying portfolio in order to calculate credit risk (CBD Article 87 paragraphs 11 and 12). IMMFA has discussed the practicalities of applying the look-through approach to triple-A rated money market funds with a number of major banks. We have concluded that, whilst it is possible for money market funds to meet the conditions of the look-through treatment, the cost of doing so (i.e. of obtaining and processing information on the underlying portfolio of the fund) may outweigh the benefit (i.e. a more sensitive - and probably lower - risk weight than provided by the standardized approach). Furthermore, since money market funds tend to invest in low-default portfolios, firms may, in any event, be unable to use the look-through data in their IRB calculations. We therefore believe that firms using the IRB approach may prefer to calculate the credit risk of money market funds under the standardized approach, using the 'partial use' method (CBD Article 89).

The Directive permits credit institutions using the IRB approach to calculate the credit risk of certain exposures using the standardised approach, including 'claims or contingent claims on institutions' (CBD Article 89 paragraph 1c). Since triple-A rated money market funds are used as a substitute for bank deposits, we believe that CEBS' CP10 guidelines should specify a similar treatment.

There are two ways this might be achieved.

First, triple-A rated money market funds might be treated as claims or contingent claims on institutions for the purposes of Article 89. We note that the CIUs are not an exposure class in their own right for the purposes of Article 89, because exposure classes for the purposes of the IRB approach, which are listed at Article 86, exclude CIUs. We therefore believe there is scope to redefine certain CIUs as being equivalent to claims or contingent claims on institutions. Furthermore, CESR's draft advice on eligible assets provides a clear way of distinguishing triple-A rated money market funds from other types of CIU for those purposes. For example, a definition might read:

- "Money market fund", means a collective investment undertaking that complies with the conditions necessary to enjoy the rights conferred by the Directive 85/611/EEC (UCITS-Directive), or which is subject to supervision of the competent authority of a Member State on a national basis, and which satisfies the following conditions:*
- (a) the collective investment undertaking has been given the highest possible credit rating;*
  - (b) the collective investment undertaking provides liquidity through same day or next day settlement;*
  - (c) The primary investment objective of the collective investment scheme is:*
    - (i) to maintain the net asset value of the collective investment scheme constant at par (net of earnings); or*

- (ii) to maintain the net asset value of the collective investment scheme at the value of investors' initial capital plus earnings;*
- (d) In order to pursue its primary investment objective the collective investment scheme invests exclusively in cash or high-quality [money market] instruments with as a general rule a maturity or residual maturity of at most one year or regular yield adjustments in line with the maturities mentioned before;*
- (e) The collective investment scheme undertakes to abide by the following conditions:*
  - (i) not to allow the assets held in the collective investment undertaking to exceed a weighted average maturity of 60 days;*
  - (ii) not to invest in equity or securities with characteristics similar to equity; and*
  - (iii) on a basis of marking-to-market at least weekly, not to permit a material discrepancy between the value of its investment and the value calculated according to the amortisation method.*

Alternatively, if triple-A rated money market funds cannot be treated as claims on institutions for the purposes of Article 89, IRB credit institutions which want to use the standardised approach for calculating the credit risk of triple-A rated money market funds will have to treat them as (CBD Article 89 paragraph 1c):

Exposures in non-significant business units as well as exposure classes that are immaterial in terms of size and perceived risk profile

The key point to note is that immaterial exposure classes have two characteristics – their size and their perceived risk profile. This makes sense because there is a pay-off between quantity and quality. For example, because money market funds have such a low risk profile, there is less need to be concerned about the size of money market fund exposures, whereas because equities have a relatively high-risk profile, the size of the equity exposure is more important.

CEBS could therefore specify that any amount of investment in money market funds (defined as above) would be deemed an immaterial exposure, for the purposes of Article 89(1)(c).

Failing to address this issue will give rise to unintended consequences: (i) that credit institutions using the standardized approach will have an advantage over credit institutions using the IRB approach in respect of holdings of triple-A rated money market funds; and (ii) that inter-bank deposits will have an advantage over triple-A rated money market funds in respect of credit institutions using the IRB approach, notwithstanding that these two products are economically substitutable.

Once you have had an opportunity to read and reflect upon our argument, I would appreciate the opportunity to meet with you and determine a way forward. We look forward to hearing from you and working with you to resolve this issue.

Yours sincerely

Travis Barker  
IMMFA secretariat

CC: Donald Aiken, Chairman IMMFA, Head of Cash Services, Scottish Widow Investment Partners  
Joanna Cound, Chair, IMMFA Distribution Committee, MD Institutional Business, Merrill Lynch Investment Managers  
Gerard Fitzpatrick, IMMFA Secretary General