MONEY MARKET FUNDS

Liquidity funds are coming of age

Kevin Thompson, head of money market funds at Standard Life Investments, tracks the rise of the funds over the past 10 years and how regulatory intervention interferes with their development. Also, as the products proliferate, a grey area has formed over exactly what constitutes a money market fund

For many years, cash management played second fiddle to other asset classes. However, since the turn of this century, we have seen a dramatic shift in sentiment. Several factors have brought about this change, not least the greater volatility seen in global markets. Driving this new era in cash management has been the US 2-a7 style, Aaa rated money market Funds.

Designed to look and feel like bank deposit accounts, they offer greater security, same day access and potentially higher returns. It is therefore no surprise that any product that can reduce risk while enhancing returns is likely to become ever more popular and the growth of those funds that operate under the Institutional Money Market Fund Association (IMMFA) banner is shown in figure one.

IMMFA was established in 2000 and is the trade association for European providers of Triple A rated institutional money market funds. Unlike in the US, where the SEC regulates money market funds, European funds have no similar regulation. Consequently the term ‘money market fund’ in Europe covers a multitude of different structures, most of which are in fact short-term bond funds.

IMMFA members self regulate by maintaining and adopting a code of practice designed to ensure that members offer a consistent high quality product and service to all investors. This approach has clearly been successful in setting standards of best practice, providing a consistent approach to valuing funds and giving greater flexibility, as the code can easily be revised to reflect market or industry changes.

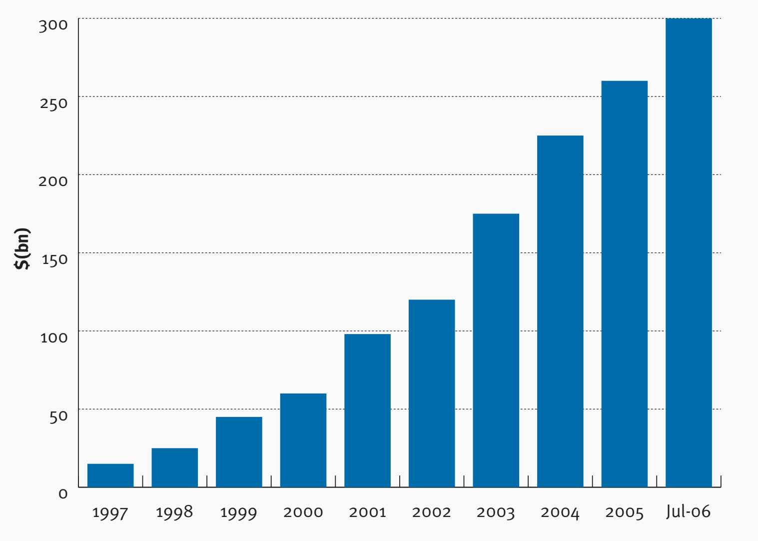
However, the industry as a whole recognises that as the market continues to mature and develop, changes need to be undertaken. Debate is already underway looking at the pros and cons of domestic regulation versus the current code of practice approach.

It is vital if the market is to continue its rapid growth and fulfil predictions of a trillion dollar market within the next three years that the confusion over the definition of the term ‘money market fund’ is resolved. This confusion and misunderstanding has led to inappropriate regulatory conclusions, as regulatory changes have potential detrimental impacts on the industry.

Recent developments by the Committee of European Securities Regulators (CESR) concerning eligible assets for investments in Ucits III, the MiFID directive re safeguarding of client funds, the Capital Requirements Directive on regulatory bank capital, to name but a few, all means that we are slowly, but surely being indirectly regulated by Europe. By actively seeking regulation, besides providing additional investor comfort and greater product transparency, it would mean that the industry would be far better placed to influence future European regulation and hence have a better handle on shaping its future.

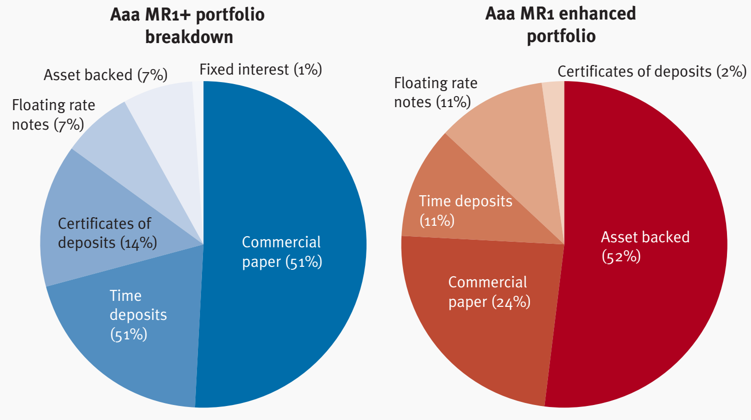
Cash managers have clearly started recognising the fact that these funds optimise the balance

Figure one: growth of money market funds



Source: iMoneynet Inc.

Figure two: asset portfolio breakdown



between safety, liquidity and yield. But the growth anticipated over the next few years is exceptional.

If we look at those sectors of the market that utilise these funds there still remains great room for further growth. For example, almost 50 per cent of corporate treasurers see cash management as the most important area of their treasury department. Despite the obvious benefits, the majority still heavily rely on the bank deposit market as a way of managing short-term liquidity. This is despite a rapid decline in bank credit quality over recent years.

Comparing Europe to the US, it can be clearly seen that potential growth for these 'pooled' investment vehicles is significant. However, the greatest recognised potential impact in terms of funds under management is the changes taking place in 2007 with the introduction of Basle 2.

Under the current regime, it is far more capital efficient for all

Figure three: regional differences in surplus cash allocation

	UK	Europe	US
Bank Dep.	62%	68%	15%
Direct Inv.	10%	15%	37%
Pooled Inv.	28%	16%	48%

Source: JPM Asset Management Global Cash Mgt Survey 2005

banks to trade in the wholesale markets between themselves rather than utilise money market funds. This is due to the fact that such deposits are 20 per cent risk weighted for regulatory capital purposes rather than 100 per cent risk weighted, as is the case if the bank invests in a money market fund.

Under the new system, the cost of capital will reflect the creditworthiness of a market counterpart. Two methods are being introduced – the Standardised Approach and the Internal Risk Based approach (IRB). Consequently external ratings or internal models will drive this new risk based assessment.

Under Basle 2, therefore, Triple-A rated funds will be risk weighted at 20 per cent under the "Standardised Approach" and potentially lower using the IRB method. Therefore they will be immediately viewed as a capital efficient alternative to the interbank deposit market and not surprisingly we anticipate far greater utilisation from the financial sector.

A new breed of triple A funds are now emerging. Aimed at offering the ever-growing investor base with alternative pooled vehicles, they maintain the Triple A rating but adopt slightly more market risk in order to provide enhanced returns. Consequently, in terms of the advantages for balance sheet management under the new capital regime these products fulfil all the necessary requirements, but can also deliver three-month Libor plus returns.

Figure three shows the typical portfolio breakdown for both types of fund. On average, an additional 12 basis points of yield is achieved by increasing the exposure to asset backed and floating rate notes. All such assets reset periodically and hence the funds can enhance returns without taking large interest rate bets.

Triple A rated funds have come a long way since their introduction in Europe in the mid-1990s. Helped by a changing landscape, their use and acceptance as a best practice cash management tool continues its strong momentum. The product is fast 'coming of age' and the future looks extremely bright.

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