Making the most from money market funds

William Johnson of Aon explains how the multinational's decision to set up money market funds has helped it to meet its short-term investment needs.

One of the key challenges a multinational such as Aon faces is the development of an efficient cash management process which enables a centralised treasury function to exert control, while ensuring that the operating firms arable to meet their local obligations.

This article concentrates on our approach to the management of our short-term investment portfolios through the use of money market funds.

Centralised policy

The two key principles in the policy are:

- **counterparty security –** we set out strong requirements in terms of counterparty credit ratings and diversification; and
- **low interest rate risk –** the level of interest rate risk allowed at local level is restricted by only allowing investment into short-term assets.

At first sight, this policy may seem unnecessarily restrictive. But Aon faces a wide range of currency and interest rate risks across the world, which are identified and managed centrally. The risk profile of its short-term investment portfolios is factored into its overall risk profile and the net balance managed accordingly.

Central investment vehicle

Having put in place the general framework by which the short-term investment portfolios are to be managed, an efficient process had to be established to minimise the overall level of resource required to manage the portfolios.

This issue was resolved by Aon in the US many years ago through the creation of a money market fund. This is a separate company, with external regulators and auditors. Fund administration and custody is provided by a specialist bank. Instead of the business units having to maintain and develop local investment expertise and resource, they simply invest all available cash directly into the fund.

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There are many benefits from this approach, including:

- having all assets under one umbrella provides greater control. The additional level of oversight provided by the regulator, custodian and auditors supplements this;
- the amalgamation of a large number of small portfolios improves overall liquidity, so allowing Aon's dealers to more actively manage the short-term yield curve;
- enables Aon to access a much wider range of investments and counterparties ensuring that proper levels of diversification can be achieved;
- the review of market trends, interest rate risk and credit exposure management is left with the portfolio management team, which is specifically employed to provide this expertise; and
- investment income and returns are available on a daily basis.

Operating firms benefit through:

- the reduction in local resource required to manage investments;
- simplified accounting – companies now hold units in the fund as opposed to a range of individual investments; and
- improved liquidity – the funds offer daily dealing.

Developments in Europe

Two key events occurred within Europe that have enhanced the ability to create investment pools for the co-mingling of portfolios:

- **the launch of the euro –** we had a large number of small to medium-sized portfolios denominated in the various legacy currencies. The creation of the euro provides the ability to invest in a single investment pool without currency risk; and
- **General Insurance Standards Council (GISC) –** the regulator for Lloyd's of London, GISC, introduced new guidelines for insurance intermediaries with regard to the management of fiduciary cash The strong requirements for keeping fiduciary cash segregated from operating funds remains in place. However, the previous guidelines in relation to the types of assets that fiduciary funds can be invested in were very much out of date and not in tune with current market practices.

The new rules were established after consultation with the industry and provide clearer guidance on minimum credit ratings, maximum maturities and also allow investment in money market funds and bond funds, provided they meet certain criteria.

GISC definition of an approved money market fund – key points

The key points are that it must:

- be an approved undertaking for collective investments in transferable

securities (UCITS). Money market funds based in European Union countries can apply for registration as a UCITS. This is now recognised as the main standard of a Fund being an acceptable product in terms of investor protection. As legislation and regulations develop across Europe, the primary standard will be UCITs;
- be recognised by the FSA (Financial Services Authority); and
- have a minimum credit and risk rating of Aaa and MR1+ by Moody's, AAAm by Standard & Poor's or AAA/V1+ by Fitch IBCA.

It should be noted that the regulations governing the management of fiduciary funds in Europe is much looser than in the UK. In general terms, insurance brokers must be able to meet regulatory solvency tests but outside of this there is little in the way of specific regulations setting out how fiduciary funds are to be managed.

Our experience in the US had already convinced us of the merits of money market funds and we decided to establish investment pools denominated in euros, dollars and sterling to be the central investment point for all Aon companies in UK and continental Europe.

An option would have been to utilise money market funds now being offered by banks and asset management companies. While the use of money market funds in the US is long established, with more than $2trn under management, it is a relatively new phenomenon in Europe. But this is now a fast growing market with assets invested in these funds growing significantly (see *Figure 1*).

Aon's own scheme

However, the amount of Aon investments that were to go into the fund persuaded the company that we could pealistically develop our own scheme and successfully manage our cost ratio. We also felt that our knowledge of the cashflows for the companies would allow us to be more flexible than an external fund in managing the average maturity of the funds.

The establishment of this facility was undertaken within Aon International Funds plc (AIF), an investment company with variable capital based in Dublin. AIF is regulated by the Central Bank of Ireland, with administration and custody services being undertaken by one of the specialist service providers operating out of the International Financial Services Centre (IFSC) in Dublin. Money market funds operating in off-shore locations such as Dublin pay little or no tax themselves and all distributions from the Fund are paid gross.

FIGURE 1

Money market funds in Europe

US$ funds	$36.2bn
Sterling funds	£10.6bn
Euro funds	¤ 9.1bn

Source: European Money Fund Report', iMoneyNet Inc.

The AIF funds are now fully operational and are being utilised by Aon companies in UK and continental Europe and we now enjoy the same benefits as our US office. In practical terms, it has greatly simplified our investment management process:

- we now have three portfolios to manage rather than a large number of small ones;
- current fund sizes total in excess of $1bn and it would make little practical difference in terms of workload if these fund sizes were to dramatically increase;
- our cash managers now report the daily net investment per fund to our dealers, who manage accordingly. The dealers are indifferent to how this net investment is compromised in terms of the number of underlying investors;
- the improvement in liquidity provides the opportunity to our dealers to be more flexible in their management of the yield curve;
- our fund administrator maintains the shareholder register and provides details on each operating company's holding within the scheme;
- performance is now completely transparent and simple to calculate. This greatly improves the level and timeliness of management information, and ensures we can properly monitor the performance of our dealers; and
- there is a reduction in resource required at local level to manage investments.

We do not see many disadvantages but you need to adhere to the external disciplines imposed

Regarding the disadvantages, we do not see many, but you do need to ensure that you can adhere to the external disciplines imposed:

- prospectus requirements, such as investment guidelines;
- UCITS requirements;
- the regulator of the fund, who oversees that the company is managing its operations in line with the Prospectus and Memorandum & Articles of Association;
- Ratings agencies such as Standard & Poor's, regarding fund rating;
- the board of directors of AIF;
- FSA (our dealers are employed by Aon Advisors UK which undertakes the investment management services for the funds); and
- Institutional Money Markets Funds Association (IMMFA) – established to promote and regulate a code of practice for bank's and fund management companies offering money market funds.

We view these external disciplines as a positive influence adding to the integrity and security of our operations.

Continuing development

Our use of money market funds has been a great success and has convinced us of the merits of this type of vehicle for simple and efficent cash management.

The development of Aon International Funds has also left us well positioned to accept thrid-party invesmtents into the funds and we see this as a natural development to further enchance the AIF product. ■

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