Both forwards and backwards

WHAT IS HAPPENING TO MONEY MARKET FUNDS?

Money market funds (MMFs) in the UK managed by members of the Institutional Money Market Funds Association (IMMFA) are continuing to expand, unlike similar funds in other jurisdictions. Assets managed by the US and the French industry have both decreased since January 2009 and May 2009 respectively. In its July update, IMMFA said that with yields payable on these three markets remaining at low levels, the growth in IMMFA funds had to be attributable to other reasons.

IMMFA points out that the relative maturity of these three markets is different. The US and French markets developed in the 1970s while IMMFA funds first appeared in the mid-1990s. So the continued growth of IMMFA funds relative to their US and French counterparts could be down to the fact that the IMMFA market is still maturing.

LOCATION OF INVESTMENT However, IMMFA suggests another possible answer for the disparity: the location of investments in IMMFA funds. Investments in IMMFA funds are sourced from around the globe, which means that over time there has been a reduction in the relative proportion received from the UK. An increasing proportion of the investment is from other parts of Europe, the Middle East and Africa, reflecting both greater penetration of new markets and the use of funds by new investors (see Table 1).

Although funds are witnessing continued growth, IMMFA says that the underlying construction continues to be influenced by sentiment in individual markets. For instance, when the report was being prepared, in summer 2011, IMMFA said that the ongoing sovereign debt crisis in the euro zone, combined with the interest rate rises by the European Central Bank had further depressed the duration of euro funds. This means that these funds could rapidly alter composition or facilitate redemptions if necessary. On the other hand for

IMMFA investor composition comparison

	December 2010	December 2009
US	9.6%	7.8%
Americas	8.6%	10.2%
Asia & Oceania	1.3%	1.7%
Middle East & Africa	2.0%	1.5%
UK	47.5%	48.7%
Germany	4.2%	3.8%
Benelux	17.1%	16.8%
Other Europe	9.6%	9.4%

Source: IMMFA July 2011

sterling funds, duration had extended again as expectations of an interest rate rise from the Bank of England were similarly extended.

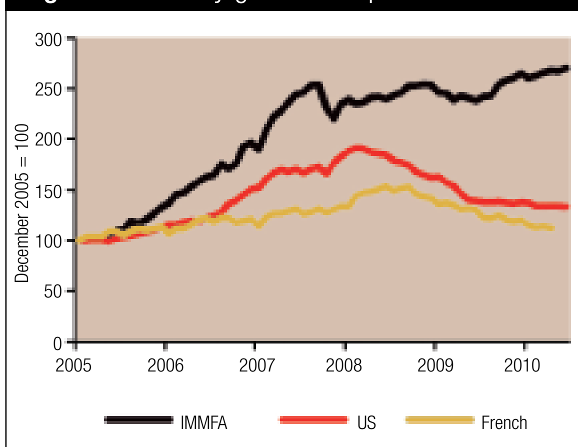
IMMFA reported that euro funds maintained the highest level of overnight liquidity. While funds had not witnessed large volumes of redemption, the ongoing fragility in the euro zone and continued press coverage were encouraging more defensive strategies for these funds.

At the same time, the elevated levels of overnight assets were also a reflection of the volatility of short-term rates. Managers were able to generate higher returns from these overnight assets. Similar levels of overnight liquidity are also held by US dollar funds but, according to IMMFA analysis, this position is more the consequence of a lack of reward associated with riskier assets.

LIMITING CREDIT AND LIQUIDITY RISKS Sterling funds continue to favour greater volumes of longer dated assets. But even these funds hold more overnight liquidity than is required by the IMMFA code of practice. The holding in July 2011 was 22%, while the code of practice recommends a 10% minimum.

Amendments to IMMFA's code of practice were agreed at the IMMFA annual general meeting in June 2011. The changes focus on new risk management requirements designed to limit credit and liquidity risks. The code includes minimum credit quality and diversification standards, as well as resource and analysis obligations. IMMFA says these complement existing requirements for all IMMFA funds to hold a AAA rating.

Figure 1: Industry growth comparison



Liquidity risk management has been strengthened with an increase in the amounts of assets which must mature within one day (now up to 10% of the fund). The idea is to increase the resilience of the funds. At the same time the risk management changes have been accompanied by greater disclosure requirements designed to allow investors to better compare, contrast and assess risk. IMMFA funds must now disclose portfolio holdings at least monthly and also provide a breakdown of the underlying credit quality of those securities in the fund.

IMMFA members have until the end of December 2011 to comply with the revised code.

Fighting to stay out of the shadows

One of the issues which emerged from the credit crisis of 2008 was the concerns of regulators over the shadow banking system, where additional risk is housed but where lower regulatory standard are in force. Although a definition of "shadow banking" is not universally agreed, a shadow bank is generally seen as any entity that performs either credit or maturity transformation. Proposed regulations would therefore include money market funds within the system.

Unsurprisingly, IMMFA has argued vociferously against the inclusion of money market funds in the regulatory definition of the shadow banking system. It says: "While money market funds do perform some maturity transformation, this is inconsequential when compared against that of any bank. The money market fund industry is also subject to an extensive set of regulations and is increasingly transparent."

IMMFA argues that if MMFs become subject to bank-like regulation – such as regulatory requirements covering the level of capital being held by the fund or the manager – then the industry and the participants will be significantly altered. IMMFA argues that any additional regulation should allow the industry to continue with its fundamental benefit of providing risk diversification.

MMFs shrug off US downgrade

As the autumn issue of Cash Management went to press, Standard & Poor's had just cut the top-tier AAA credit rating of the US. The possible adverse implications for MMFs of this move are being downplayed. According to the Investment Company Institute (the national association of US investment companies), MMFs own $684bn in US sovereign debt and hold another $491bn in repurchase agreements, most of which is collateralised by US government debts. In total, US money market funds holds assets worth $2,700bn.

The downgrade is on US long-term debt and an MMF's ability to purchase or hold a rated security depends on the issuer's short-term credit rating. According to newspaper reports, Crane Data said that in the week before US legislators had reached an agreement on the debt ceiling, investors had withdrawn $122bn from MMFs, the second largest weekly drawdown since the Reserve Fund broke the buck in 2008.

However, once the debt ceiling deal had been reached, asset inflows returned as it was seen that the credit quality on US short-term paper was unchanged so MMFs did not have to sell assets.

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