Money market funds have become a vital tool in many a treasurer's tool chest. So how does the market operate and how did it get started?

Money market phenomena

MONEY market funds (MMFs) are a relatively new phenomenon in Europe. The funds were developed in the US at the start of the 1970s and first regulated by the Securities and Exchange Commission (SEC) in the US in 1983. However, they didn't make an appearance in Europe until the mid-1980s, when they first appeared in offshore European centres such as Dublin, Luxembourg and the Channel Islands. Since then, however, growth has been stellar. Funds under management within Europe grew from less than $1bn in 1995 to more than $130bn at the end of 2002, according to trade body The Institutional Money Market Funds Association (IMMFA), and that growth shows no sign of slowing.

At its most basic, a money market fund is an open-ended mutual fund that invests in relatively secure, short-term debt instruments – such as certificates of deposit, commercial paper (CP), floating rate notes (FRNs), repos, short-term government notes and time deposits. They are made up of two basic types: the stable or constant (or stable) net asset value fund (CNAV), which is most common in the US; and the accumulating net asset value fund (ANAV), which is increasingly popular in Europe.

An CNAV fund, as its name implies, issues shares that have a constant face value: returns are accrued daily in a separate dividend account and are either paid out or used to buy more shares at month-end. In ANAV funds – which are also known as roll-up funds – income is not paid out, but rather the face value of shares rises to reflect returns. In both instances, money can be withdrawn or invested on any given day with same-day settlement. Most funds tend to charge an annual management fee but generally they do not charge a start-up fee and returns are typically quoted and are paid net of fees.

MMFs offer a low-risk, highly-liquid investment instrument with the returns of a long-dated deposit while still maintaining the flexibility of an overnight deposit – all of which makes them an invaluable tool for daily cash and liquidity management and a great friend to the corporate and institutional treasurer.

The public sector joins in

In the UK, this group has now been joined by a new investor segment, which could see the size of the market grow rapidly in the coming years. Last year, MMFs were added to the list of approved investment instruments for local authorities. Authorities will be permitted to only invest in AAA-rated funds – which, however, accounts for most of the market within Europe.

Approved investment funds include sterling MMFs domiciled in London or anywhere within the EU. But, as of last year, there was only one MMF based out of London and it was not AAA-rated. >>>

***Denise Bedell** is a freelance journalist and regular contributor to* The Treasurer
denise.bedell@t-online.de

WIN - WIN

EXCELLENT LIQUIDITY *and* EXCEPTIONAL RETURNS

LiquidityFunds *from* BARCLAYS GLOBAL INVESTORS

Barclays Global Investors offers a range of Aaa-rated sterling liquidity funds. Each fund has a distinct investment profile so we are able to meet the diverse objectives of the corporate market.

As the largest[1] and one of the best-performing funds available[2], our Sterling Liquidity First Fund excels in providing both the return and liquidity that large corporate investors require.

	2000	2001	2002
Fund size (£m)	**2,463**	**3,434**	**5,257**
Net annualised return for 12 mths	**6.03%**	**5.16%**	**3.94%**
iMoneyNet ranking for the year	**2nd**	**1st**	**2nd**

Aum from BGI as at 31 December each year, other data from iMoneyNet

FOR MORE INFORMATION ON BGI'S LIQUIDITY FUNDS,
PLEASE CALL +44 (0)20 7668 8770 OR VISIT www.bgicashfunds.com

BARCLAYS GLOBAL INVESTORS

[1] AUM as at 14 March 2003 was £6,173m.
[2] Source: iMoneyNet Inc. - European Money Fund Report Award 2000 and 2001, IMMFA Money Fund Report Award 2002.

This advertisement has been issued by Barclays Global Investors Limited, authorised and regulated by the FSA. This Fund is not regulated by the FSA, it is authorised by the Central Bank of Ireland. Any investment in these Funds is made subject to the terms of the appropriate Fund prospectus, which is available from the Manager or the Investment Manager. Investors maybe required to agree to the Manager's Terms of Business. February 2003 © Barclays Global Investors Limited. All rights reserved.

While most countries have some regulatory framework set up, no comparably stringent regulations exist within Europe

Regulatory environment

AAA-rated funds offer a high level of security but, as with any type of investment, there is always some risk, and understanding how and why MMFs are regulated and rated is key to understanding those risks. In the US, funds are guided by rather stringent SEC regulations – namely, the SEC2a-7 regulations – set up in 1983 to define and standardise MMFs. While most countries have some regulatory framework set up, no comparably stringent regulations exist within Europe and so the credit ratings of European MMFs are of the utmost importance.

Within the European Union, MMFs now fall under the guidelines set out by the Internal Market Commission (IMC) for the regulation of investment funds. European funds follow these guidelines, laid out in European Commission Directive 85/611/EEC on Undertakings for Collective Investment in Transferable Securities (UCITS). The UCITS Directive outlines common standards on investment restrictions, structures, borrowing powers, prospectuses, and reporting arrangements.

MMFs within the EU now enjoy some of the advantages offered to traditional debt instruments under the single market, such as the use of a single prospectus for all EU countries and other aspects of the 'single passport', along with the opportunity to market products across jurisdictions. MMFs are regulated by the Financial Services Authority (FSA) in the UK.

However, as with the SEC2a-7 regulations in the US, the UCITS directives provide a base from which to begin to evaluate funds, rather than a complete picture of risks and advantages of investing in a particular fund, and the type and quality of instruments in which they invest. For that one must still turn to the rating agencies. Rating agencies that offer MMF ratings include Moody's Investors Service, Fitch Ratings and Standard & Poor's.

Development of institutional liquidity funds. US vs Europe

Figure 1 US money market growth
$bn year to date

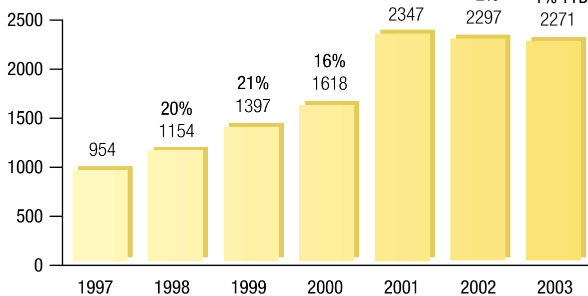
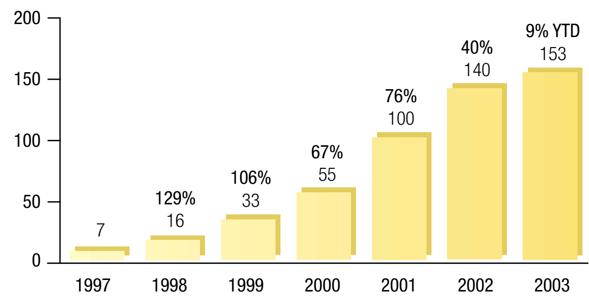
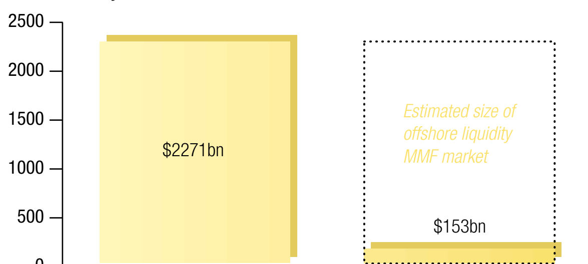


Figure 2 European money market growth
$bn year to date



Current institutional liquidity fund position

Figure 3 Overview of US market compared to Europe
$bn year to date



Source: Money Fund Vision 98™, Moody's, ICI statistical release as of 27/03/2003. iMoneyNet "European money Fund Report" as of 31/03/2003. JPMorgan Fleming internal reporting

Understanding ratings

As the goal of a fund is always to keep a constant or stable net asset value (NAV) – or in the case of an ANAV maintain an increasing NAV – a MMF credit rating is an evaluation of the ability of a fund to guard that principal value and limit exposure to loss, and for some rating agencies the volatility associated with that. It is a very different animal to a traditional bond rating. Because of the short-term nature of the portfolio, the ratings process is much more active and funds are continuously monitored on their credit quality, the average maturity of underlying money market instruments, the level of liquidity, new investments being added, and on their management. Funds are also evaluated on their historical and prospective financial condition, general investment policy and company philosophy, ownership structure, operations and internal controls (see article on pIX for more on credit ratings).

The main risks of MMFs lie in the credit risk of securities and counterparty risk of transaction-based investments, liquidity, and market price exposure – or the potential for a decline in market value of group assets. The last point is important, as it is possible, although almost unknown for AAA-rated funds, for the capital value of shares to decrease, mainly because of the short-term nature of the underlying instruments. If the fund's principal value falls below the prescribed level per share, it is known as 'breaking the buck'. Market price exposure is measured through a portfolio's sensitivity to changes in liquidity, spreads, market conditions and interest rates, among other things.

As previously mentioned, there are very strict guidelines placed on MMFs for each rating category, and factors such as maturity-distribution, type and liquidity of underlying instruments, issuer concentrations and so on, are all controlled and monitored. Sensitivity to interest rate fluctuations is primarily measured through the weighted average maturity (WAM) of a portfolio. It is an important part of the analysis of any MMF and it is restricted within each rating category. For example, the maximum WAM of a fund rated AAAm by Standard & Poor's is 60 days.

In addition to maturity-distribution, the type and liquidity of underlying instruments in the portfolio are constantly evaluated. For example, to receive an AAAm rating from Standard & Poor's, a fund must have a minimum of 50% of investments in instruments rated A-1+ and a maximum of 50% of investments housed in A-1 rated securities. No instruments rated less than A-1 can be included in the portfolio.

Aside from portfolio characteristics and market conditions, the stability of a fund is also affected by the fund management and by the characteristics of shareholders. Rating agencies analyse the impact of a large redemption and the likelihood that a fund's main shareholders would effect such a redemption. This could have a significant influence on a fund's NAV, and therefore its market price exposure.

The managers of a fund have the most direct influence on whether a fund will reach its stated goals and stay within guidelines set out for its particular rating. Therefore, the effectiveness and experience of management is also a key criteria in a fund's rating.

Code of practice

While much reliance for evaluating MMFs is placed on the rating agencies, the majority of AAA funds in Europe are also self-governing, through their trade body, IMMFA (www.immfa.org). The IMMFA was set up in 2000 to provide information and performance data to investors, to act as a lobbyist for MMFs in Europe and to set standards of best practice for AAA-rated funds in Europe.

IMMFA launched its Code of Practice in February 2003, with which it plans to set common standards for members and promote the use of MMFs across the region. The standards laid out in the code outline practices for managing MMFs and practices to be used in valuing funds. It also attempts to ensure transparency across funds.

With best practices and stringent standards being set across Europe – through the traditional channel of rating agencies, through its trade organisation, and through increased EU legislation – the MMF market in Europe is maturing. Although it will be some time before it catches up with its US counterpart, which was valued in 2002 at more than $2 trillion, the European market is growing fast and, with the addition of local authorities to the investor base, the pace of that growth looks set to continue.

If the fund's principal value falls below the prescribed level per share, it is known as 'breaking the buck'