

# Feeling the quality

THE SAFE HAVEN IMAGE ENJOYED BY MONEY MARKET FUNDS HAS TAKEN SOME NASTY JOLTS OVER THE PAST COUPLE OF YEARS. **GRAHAM BUCK** EXAMINES THE BACKGROUND TO THE NEW MMF GUIDELINES.

What are the virtues of money market funds? Promoted as low-risk, low-return funds for short-term investments, MMFs vary greatly in size, from the relatively small to as much as £20bn, and have traditionally been seen by investors as a safe haven. Most recently their appeal appears to have grown for local authorities, many of which had their fingers burned chasing the generous returns offered by Icelandic banks. Recent figures show that councils put a total of £2.4bn of their cash into MMFs in September 2009 – more than double the figure for the same month a year earlier.

According to the Institutional Money Market Funds Association (IMMFA, the trade body representing Europe's triple-A rated MMF industry), the funds represent "a vital cash management tool for institutional investors across Europe". Their attractions include diversification, same-day liquidity and segregation of assets. Focusing their investments on high-quality, short-term money market securities, MMFs also "provide businesses with access to lower-cost financing and contribute liquidity to the European money markets".

The drawback to this kind of security is that the returns from MMFs are less than stellar. However, the rates offered by banks and building societies have also been meagre since the onset of the credit crunch and the Bank of England cut base rate to 0.5% a year ago. Add the ratings downgrades suffered by many building societies last April and May, and MMFs would appear to have great appeal to the risk-averse.

Yet this image has been undermined by the record £2.45m fine meted out to Standard Life in January by the Financial Services Authority. The company marketed one of its MMFs, the Pension Sterling Fund, as a cash fund, although by 2008 no more than 12% of it was allocated to cash while 44% was in mortgage-backed securities, including 13% in sub-prime. In early 2009, Standard Life admitted the fund had declined 4.8% in value and had lost around £100m.

The company's parent, Standard Life Assurance, repaired some of the damage by injecting £102.7m into the fund and alerting the FSA, which spared it an even heavier fine of up to £3.5m. However, the watchdog still ruled that Standard Life's customers had been exposed to "a risk of unexpected capital losses" and was negligent in not updating its marketing material to reflect the change in investment strategy. It has since been reported the FSA had misgivings about MMFs in 2008 and carried out a review that included the marketing methods used.

**ATTRACTIONS WANE** This tarnished image has emerged as reports suggest that MMFs have found it more difficult to attract investors in recent times and their appeal to corporate treasurers on this side of the Atlantic has waned considerably. According to JP Morgan's latest annual Global Cash Management Survey, published in January, corporate reliance on bank deposits rose during 2008 and 2009 despite the poor publicity that surrounded the banking sector.

The survey found that while 97% of the participating treasurers said they were permitted to use their surplus cash in bank deposits, the number allowed to invest it in MMFs had declined since the previous survey, from 69% to 51%.

The report's authors noted: "This is surprising as demand for triple-A rated money market funds has been strong through the financial crisis, but perhaps reflects to some degree the concerns of continental European treasurers about the quality of riskier European cash funds that do not maintain a stable net asset value."

Respondents also said that daily liquidity had overtaken yield as the most important factor when they were selecting an MMF, while the proportion seeking a return in excess of LIBOR from their cash holdings had fallen from 40% to 27%.

But the industry is fighting back. Marc Doman is managing director of Invesco Aim Cash Management, a specialist provider

of MMFs. He says: "The reduction in the approval to use MMFs over the past year is a knee-jerk reaction by many new users of the funds that had yet to see them stand up to a crisis, together with some concerns about enhanced cash funds.

"In actual fact, MMFs overall performed well during the crisis and most continued to operate as usual. The high-quality, diversification and intrinsic liquidity of the funds provided additional comfort to investors, and once this is appreciated, these funds will be back on approved lists."

The findings from the survey in both Europe and Asia contrasts with the situation in the US, where treasurers who responded continue to make significantly higher allocations to MMFs, and lower allocations to bank deposits. This is unsurprising "given that US cash investors have traditionally used MMFs rather than bank deposits for their excess cash requirements". However, the report also noted that MMFs in the US are covered by regulations "designed to reduce risk and provide certainty to investors (specifically rule 2a-7)".

**EUROPEAN FUNDS RUN INTO TROUBLE** MMFs in Europe and elsewhere in the world have a much broader definition and a number of riskier European cash funds – although not the stable net asset value (NAV) MMFs – got into trouble towards the end of 2008 and early in 2009. As a result, European treasurers may have tightened their investment guidelines to exclude such funds and focus instead on the more conservatively managed cash funds.

This suggests that those treasurers permitted to use pooled funds are only using the highest quality ones, such as the stable NAV triple-A rated MMFs covered by the IMMFA's code of practice in Europe and by the Securities and Exchange Commission's rule 2a-7 in the US.

While the European funds that ran into trouble did not include the triple-A rated ones – the culprits were "enhanced" MMFs in France and non-stable value funds in Germany – the IMMFA has pushed ahead with the introduction of tighter guidelines for MMFs to help reassure potential investors. The changes are effective from 1 January 2010, although IMMFA members have a 12-month transitional period in which to adopt them.

As the association explained: "In light of the events of the past two years, the IMMFA code has been revised to provide additional protection to investors in MMFs, through improved standards for maturity, credit quality, liquidity and disclosure."

IMMFA chief executive Gail Le Coz added that the code was steadily establishing itself as the benchmark by which MMFs are measured. She described the more rigorous guidelines as "a proactive step by the industry to enhance the existing MMF framework".

The new code reinforces credit quality. The weighted average final maturity (WAFM) is now set at a maximum of 120 days. Interest rate risk guidelines have also been tightened, with the weighted average maturity (WAM) now a maximum of 60 days. Holdings are no longer permitted in government debt securities with a maturity beyond 762 days or corporate debt with a maturity exceeding 397 days.

Funds must manage liquidity by ensuring that at least 5% of assets are held in overnight securities and 20% in securities

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maturing within one week. Adhering to these rules will enable MMFs to meet redemption requests even if liquidity suddenly dries up in the secondary market at any time. New disclosure rules mean that investors must be provided with details of the fund's WAM, WAFM, liquidity ladder and performance data on a monthly basis. Also, if requested, the fund must also reveal the percentage held by its top 10 shareholders.

Across the pond, the Securities and Exchange Commission made similar moves to tighten US guidelines after some MMFs took on higher risks for only marginally better returns. They invested in structured products and subordinated or long-term debt, which lowered credit quality and created funding maturity mismatches. A further round of restrictions was imposed on MMFs by the SEC in late January.

The higher risk strategy resulted in a major MMF "breaking the buck" at the height of the financial crisis in September 2008. Investors rushed to withdraw cash from Reserve Primary Fund, which had to write off a $785m investment in commercial paper issued by Lehman Brothers. The mass withdrawal pushed the fund's NAV lower than the $1-per-share level previously regarded as the absolute minimum. To prevent panic, the US Treasury established a short-term insurance programme to back MMFs for a 12 month period while the SEC set about strengthening the rules.

**SYSTEMIC THREAT** MMFs' short-term, high-quality securities have traditionally offered a haven for the risk-averse. However, a report issued in January 2009 by the G30 international body of financiers, called Financial Reform: A Framework for Financial Stability, suggested that MMFs posed a systemic threat. It criticised their lack of minimum liquidity and risk management standards and for having "no capital, no supervision and no safety net".

So should treasurers be using MMFs, and if so how? Perhaps they would be best advised to stick to triple-A rated funds, also known as qualifying money market funds (QMMFs), CNAV (constant net asset value) funds and liquidity funds. QMMFs adhere to a tighter set of investment guidelines, providing the reassurance of investment focused on highly rated, short-term money market securities, of which at least 50% must have a short-term rating of A1+, with the balance rated A1. They must show diversity in the pool of assets held, typically with no exposure to an individual counterparty greater than 5% other than for short-term deposits. As ever, quality is key.

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