Testing stress

DONALD AIKEN EXPLAINS THE ROLE OF REGULATION IN ENSURING BEST PRACTICE FOR THE VALUATION, MANAGEMENT, OPERATION AND TRANSPARENCY OF MONEY MARKET FUNDS.

Executive summary

- Outside the US, money market fund providers do not operate in a regulatory regime where capital security is of paramount importance. The Institutional Money Market Funds Association developed a code as a mechanism for funds to address these risks, and last year published its *Industry Guide to Understanding Institutional Money Market Funds*, setting out the practices a fund might adopt to meet the requirements of the code.

February saw members of the Institutional Money Market Funds Association (IMMFA) celebrate the third anniversary of the association's code of practice. The code, developed to meet industry demand for common standards, established guidance for the development and promotion of money market funds for the purpose of cash or liquidity management to the institutional market. The code, adopted by all IMMFA members, forms one of the criteria of IMMFA membership.

IMMFA's objective in issuing the code was to ensure that members offer a consistently high-quality product and service to investors, by setting best practice for the valuation, management, operation and transparency of member funds. In the US, money market funds are covered by a specific Securities and Exchange Commission (SEC) regulation, known as rule 2a-7 of the 1940 Investment Act, which addresses the key areas of a fund's operations to provide for capital security and appropriate risk management.

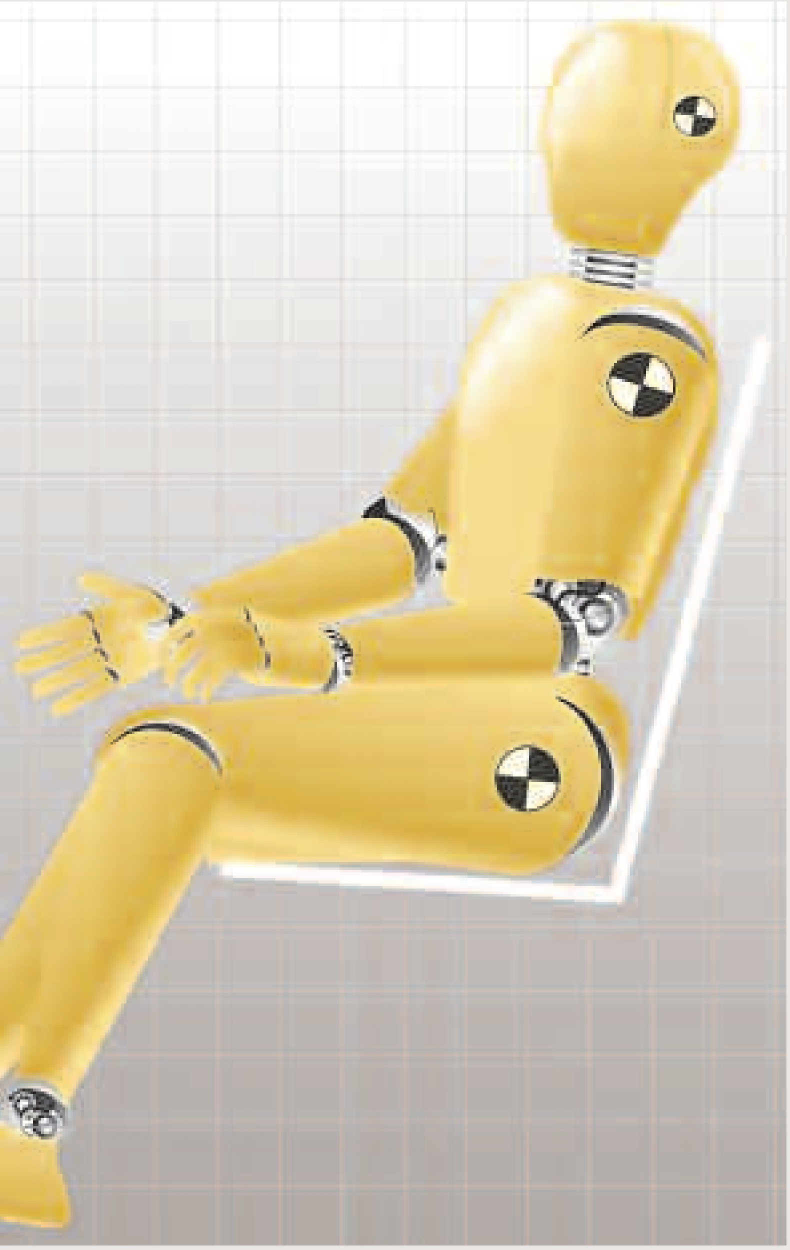
Outside the US, money market fund providers do not operate in a regulatory regime for funds where capital security is of paramount importance. There was a need for a mechanism for funds to address these risks and IMMFA rose to the challenge by developing the code. Last year, IMMFA published its *Industry Guide to Understanding Institutional Money Market Funds*, which set out in more detail the practices a fund might adopt to realise the requirements of the code.

PROACTIVE APPROACH The IMMFA code requires all members to ensure that each security held by an IMMFA fund presents appropriate risk for the period during which it is held, and members are required to take a proactive approach to managing risk to achieve this objective. Members must ensure that the weighted average maturity (WAM) of assets held in a fund portfolio does not exceed 60 days. The WAM is monitored by the manager and is a rating agency requirement to maintain the fund's AAA status. This limit ensures that funds are restricted in the types of risk that they may undertake.

Under the code, IMMFA funds are required to maintain their stable net asset value (NAV) within a prescribed tolerance of 50 basis points (bp), and funds are required to compare the amortised valuation against market valuations on at least a weekly basis to confirm that the price variation is minimal. Generally over 95% of the assets in IMMFA-type fund portfolios are held to maturity, so this comparison is intended as a risk management tool to identify any assets where action may be required.

If a fund moves beyond 50bp it is deemed to have 'broken the buck'. To avoid this scenario, funds are required to operate an escalation policy to monitor the fund when it moves beyond specified target levels of 10, 20 and 30bp. IMMFA's industry guide recommends an escalation policy that has the fund administrator notifying the fund manager at 10bp, the senior management of the investment company at 20bp, and the trustee/board of directors at 30bp. The purpose of the escalation procedure is to ensure the fund delivers on its main objective of preserving capital and keeps to its investment strategy.

Individual securities in a portfolio can counter each other to have a net effect of zero on the fund but still affect the NAV should specific



securities be sold. As a result, many funds operate escalation policies at the asset level. IMMFA is considering how this might be applied across the industry and expects to develop specific policies later in 2006. What that would mean is that each individual asset would be monitored and action taken before the asset reached 50bp, however small the effect of that movement on the fund. This would enable managers to take action and sell the holding to realise the gain, or cut their losses from an asset that could be in decline. The overriding objective is to ensure that investors' capital is kept safe at fund level.

Discussions around these issues have highlighted the importance of stress-testing within the fund, and the escalation policy is one key way of auctioning the outcome of stress testing. For example, when considering interest rate or market risk, and taking a typical IMMFA-style fund with a maximum WAM of 60 days, final maturity for fixed rate assets of 13 months, and with final maturity for floating rate notes typically between 12 and 24 months, it would take a 300bp shift in short-term interest rates to lead to a more than 50bp fall in the value of the fund.

DIVERSIFICATION REQUIREMENT Other risks are managed using other approaches. The rating agencies believe that funds that meet their requirements have a probability of default equivalent to a AAA rating. Credit risk is managed by rating agency minimum rating requirements, diversification requirements and the short maturities of the assets allowed in these funds.

The greater the diversification in a fund, the less chance there is that a single security could cause a problem, and IMMFA members are required to comply with the diversification requirements imposed by the rating agencies.

Typically, industry standards set a maximum 5% concentration level, the level of which is often lowered for larger funds. These limits are well within the requirements set by Undertakings for the Collective Investment in Transferable Securities (UCITS) regulations, which do not permit more than 10% of a fund's assets to be invested in any single security, and the portfolio to contain no more than four such holdings, with a 5% cap thereafter on single-security holdings.

Liquidity risk is typically managed by having a weighting to assets where liquidity can be raised for same-day value. The level of this liquidity will be based on a fund's client make-up in terms of number of clients, industry diversification among clients, and the characteristics of historic fund flows.

In determining the asset mix, funds seek to match the structure to the expected liquidity demands of investors. Managers consider the duration and maturity structure of the underlying assets to ensure they can meet the liquidity needs of the fund as they arise. In particular, the liquidity needs of investors in the fund must be understood so that the fund can accommodate liquidity on an ongoing basis. This in turn affects the structure of a fund's assets to obtain a specified duration – in other words, whether they use laddered or barbelled portfolios.

The operation of money market funds has come into sharper focus recently as a result of discussions about the eligibility requirements under the UCITS directive, which aims to create a level playing field for the distribution of funds across Europe. One of the criteria the directive lays down is that UCITS funds invest in a prescribed set of assets, known as eligible assets.

Recently, the Committee of European Securities Regulators (CESR) was asked by the European Commission to clarify the nature of these assets. CESR's advice to the Commission was welcomed across the industry because it resolved a number of issues regarding what could be held by UCITS. The advice was particularly good news for the money market funds industry, as CESR recognised the importance of money market funds in investment portfolios, and provided clarity on the nature of these types of funds.

The positive outcomes of the CESR work came as a result of a positive relationship between treasurers associations such as the ACT and the European Associations of Corporate Treasurers (EACT), which worked with IMMFA to highlight to CESR the importance of money market funds as a cash management service across Europe. The money market fund industry and IMMFA in particular is seeking to address the key issues facing the industry as it develops in Europe. The code of practice and associated requirements are key elements in ensuring that investors can confidently use these funds.

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IMMFA's code of practice and its *Industry Guide to Understanding Institutional Money Market Funds* can be obtained from: www.immfa.org/code.