When the dust settles

Executive summary

- There is a growing demand in Europe for money market funds (MMFs). One factor is the implementation of Basel II, when the risk weighting for MMFs will be lowered, making them equal to interbank deposits and so more attractive for short-term placements of cash for corporates.

While banks are busy preparing themselves for implementation of Basel II, corporates have started to turn their attention to the way the new Capital Adequacy Accord will affect their current and future loan and deposit requirements.

The three risk models under Basel II, which will be used by banks to calculate capital adequacy, will make a difference to how treasurers structure loan deals and what instruments are used to fund them.

Treasurers should see an influx of new instruments developed to take advantage of the benefits that Basel II presents. The precise details will depend on which banks corporates work with and the risk weighting models they adopt.

As well as snazzy new loan instruments, already established deposit vehicles may see developments and positive outcomes after the implementation process begins in January 2007. Money market funds (MMFs) have experienced success in the US and over the last decade have made impressive headway in European markets.

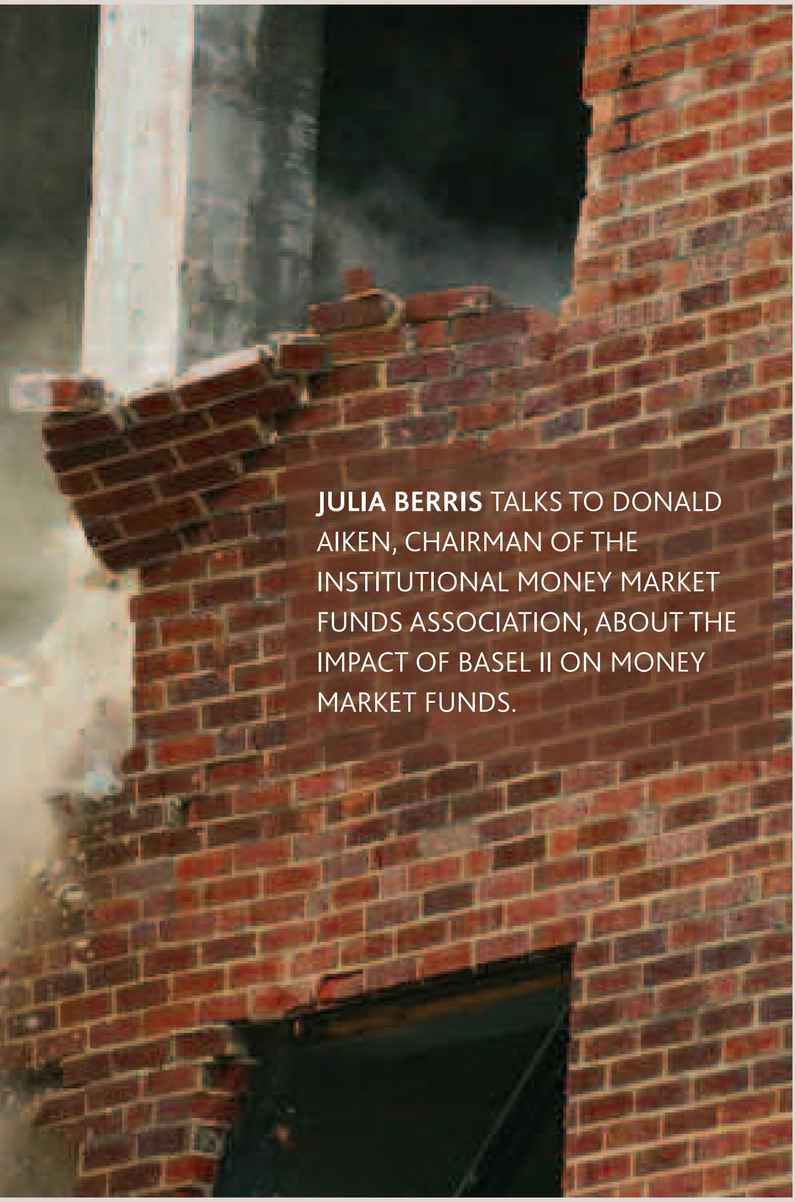
FURTHER PROGRESS The MMF industry is convinced that Basel II will help advance the progress and success of these low-risk, highly liquid AAA-rated vehicles. Some are even arguing that a transformation on a huge scale is set to hit the MMF scene at the beginning of next year.

Chairman of the Institutional Money Market Funds Association (IMMFA) and Head of Cash Services at Scottish Widows Investment Partnership, Donald Aiken, says: “Basel II is probably the biggest shake-up that we have witnessed in liquidity management in years. The artificial barriers between investment and treasury products that were in place with Basel I will not be there any more and vehicles will no longer be pigeonholed by product type.”

Aiken sees a healthy future for MMFs and thinks Basel II will have a beneficial impact. The original Accord had been criticised for being risk-insensitive and in need of updating. By contrast Basel II takes note of credit risk, market risk and operational risk.

At the moment, every loan to a corporate or investment in an MMF is treated the same for bank capital adequacy calculation purposes, regardless of credit ratings. The risk weighting is 100% of capital compared with a fifth of this amount – 20% – if a bank lends to another bank.

The new risk models, the Standardised, IRB and Advanced IRB



JULIA BERRIS TALKS TO DONALD AIKEN, CHAIRMAN OF THE INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION, ABOUT THE IMPACT OF BASEL II ON MONEY MARKET FUNDS.

approaches, will analyse each company and calculate the risk based on the rating outcome generated by the model.

Aiken says: "Although an MMF has in the main the characteristics of a treasury deposit, as a collective investment scheme it is considered to be like an equity fund under the one-size-fits-all approach of Basel I and as a result is 100% risk-weighted. This means that banks generally don't use these funds because putting money into them would have five times the capital implication for its balance sheet."

After implementation of Basel II, MMFs will receive more favourable treatment, with their risk weighting being reduced. This should result in banks and corporates taking advantage of the liquidity, enhanced yield and stability that these vehicles provide and boosting their attractiveness as a destination for short-term cash placements.

MMFs have been operating in Europe since the mid-1990s and while they have experienced success, the restrictions imposed by Basel II and the lack of regulation has held back their progress.

Aiken says: "The European MMF market is very different to that of the US, which is domestic and has no need or intention to become international. In Europe we are still in the education stage in which we are explaining to people what a money fund is and what the benefits are.

"However, we are seeing a growing demand in Europe from banks which have an investment house. They are starting to enquire about what a money market looks like and what it involves."

After Basel II is implemented, the lower risk weighting for MMFs will make them equal to interbank deposits. Aiken argues that banks will then have a choice between investing with banks or with MMFs.

He says: "Basel II means that MMFs and other collective schemes will have better treatment because the capital cost is based on external ratings. MMFs have gone from being disadvantaged under Basel I to being advantaged under Basel II owing to their being AAA-rated with low capital cost implications for banks."

With MMFs becoming a more viable option for banks to use, it would be logical to assume that banks would see developing their own funds as the next step.

MARKET MOVES While many large banks in Europe already have their own MMFs they could be joined by smaller banks after the new Accord is implemented. Aiken believes that many of the existing MMFs may come together to form larger units rather than many smaller vehicles.

He says: "This is where the subject moves nicely into the corporate space. It becomes cost-effective and capital-effective to use off-balance sheet vehicles. My vision is that you will ultimately see banks creating off-balance sheet collective schemes. For example, you could package all your gilts into a fund so that it is easier to look after them in one pod using a specialist to look after it."

Could this be the start of something significant for MMFs as off-balance sheet, liquidity capital, standalone vehicles?

MMFs have been sidelined in Europe because of risk weighting restrictions. With the new set of rules, development and innovation in this area seems certain.

While large banks may decide to develop their own MMFs and other types of collective schemes, the smaller financial institutions may opt for a different approach and method of working with MMFs. Banks currently active in the corporate deposit market but which do not have the advantage of scale of the other larger banks could work with established MMFs. They would then be able to benefit from the mutual funds and apply their name and brand to the fund.

A key element of MMFs is their suitability as off-balance sheet assets. The attraction to money funds will mean that the deposit industry shrinks and banks may choose to focus on liquidity provided by money funds and similar vehicles.

Aiken says: "The impact of MMFs buying off-balance sheet assets is important. I can't say how quickly this development will start to move and take shape. At the moment it is still seen as radical for banks to be considering this kind of approach, but it has started. Some of the mortgage books and credit card portfolios have come off the balance sheet."

Aiken argues that corporates and treasurers, as well as banks, will perceive benefits in using MMFs. He says: "All of this means you will find that treasurers will be putting more money into these kind of funds because of the low risk profile, as evidenced by their AAA rating. It makes a lot of sense for treasurers to buy these assets.

"The advantages for corporates will be very similar to the advantages for banks: increased liquidity, enhanced yield, diversification and cost reduction."

At present it is not easy for banks to assess the impact of Basel II and form conclusions about what, when and how certain vehicles will become popular and appealing.

“BASEL II IS PROBABLY THE BIGGEST SHAKE-UP WE HAVE WITNESSED IN LIQUIDITY MANAGEMENT IN YEARS. THE ARTIFICIAL BARRIERS BETWEEN INVESTMENT AND TREASURY PRODUCTS THAT WERE IN PLACE WITH BASEL I WILL NOT BE THERE ANY MORE AND VEHICLES WILL NO LONGER BE PIGEONHOLED BY PRODUCT TYPE.”

Aiken says: “The reason this has not been discussed too much is that banks are really very short of time. They are very busy working on how to put the systems in place. This is where they need to be concentrating their efforts at the moment.”

Talks began on how to update the original Accord in 1998. The strategy and logistics of how Basel II was going to be shaped and applied was not agreed by the Basel Committee until 2004 after many studies and two consultative papers.

Since then it has been an uphill struggle for the banks worldwide to work towards putting in place the structure and approach that they will use.

Aiken says: “What we have been discussing and focusing on recently is actually quite far ahead of the banks. They are quite rightly busy with preparing for implementation. Also, many banks would not necessarily have noticed the impact of Basel II on money funds because they are not so familiar with collective schemes simply because they don’t use them.”

CHANGE OF EMPHASIS Even though banks are focusing their attention on making sure they are ready for implementation, a lot of others are thinking about what will need to be done to ensure they can cope with the change of emphasis from the deposit base to off-balance sheet collective schemes. Technology systems will need to be enhanced and procedures amended so they can cope with the increased usage of money funds.

MMFs have a very different profile in the US compared to Europe and as a result the impact of Basel II there will not be as dramatic or noticeable.

The MMF sector in the US is more than 25 years old and at the end of May this year was worth $2,063bn. The European market, established in the 1990s, was worth $273bn at the end of June.

Although dealing with variants of the same vehicle, the two markets are different because of the Securities & Exchange Commission’s regulation of the US market and the different ways funds are used.

Aiken says: “The US is very large in asset-backed security, and money funds have been extremely successful in the domestic market. It is a big enough market as it is, so they don’t have the same drivers as European funds have to come out of the domestic market.”

For Europe, however, many see MMFs as an important opportunity to develop a relatively new sector of the market, which, once Basel II has been implemented, could make a difference to banks and corporates.

Aiken says: “Business has changed and developed a lot over the years and a great deal of commercial activity has gone to India and China. This will obviously continue for some time yet. If MMFs become more popular as a viable option we could suddenly have a new financial powerhouse emerging.

One problem that money funds in Europe have encountered is the disadvantage of a lack of regulation. Despite a well-respected code of practice drawn up by IMMFA, Aiken argues that a stronger regulatory framework is necessary under Basel II.

Aiken says that working with local regulators to ensure the sector is structured well is something that should be addressed sooner rather than later.

He says: “There is a gap when it comes to controls. How do people make sure providers are keeping within known parameters? The code of practice works very well for investors but when we are fast approaching the new world of the Capital Requirements Directive the code is flawed due to a lack of a recognised definition.

“It is also very hard for a fund just to ask regulators to trust them without any kind of regulation backing them.”

The new Accord should raise the profile of MMFs and so promote understanding of what they are and how they work. Increased regulation including a set definition of funds should further benefit and enhance the use of funds.

Aiken says: “I believe we need to step up to the plate and enhance standards along regulatory lines. I don’t think it is a wise move for us to try to fit ourselves into new directives if we don’t enhance our standards to justify the faith that people are putting in us.”

It seems MMFs have an exciting few years ahead. In 2007 the sector is set to embark on a new era of being used as off-balance sheet vehicles by banks and corporates.

Aiken says: “Like banks, we need to raise our game in the area of risk management. We need to look at stress testing and work out what the impact of various scenarios will be. If we do this and don’t wait for problems to happen before we deal with them, I think we could have a world-class industry.”

Some years down the line, after the dust has settled from Basel II implementation, Aiken believes treasurers and MMF specialists will be working together to create further innovations in collective schemes.

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See Into The Unknown, The Treasurer, *June 2006, page 22.* The Treasurer *is planning a series of articles on the implications of Basel II. If you have any comments or contributions, please email us*