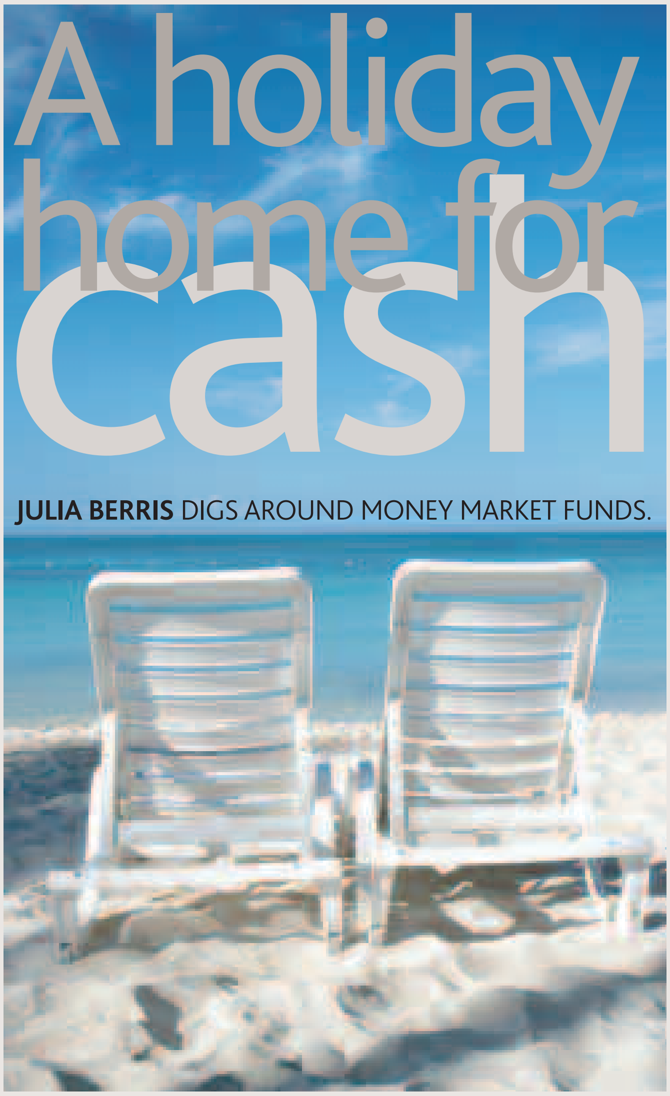
A holiday home for cash



JULIA BERRIS DIGS AROUND MONEY MARKET FUNDS.

Executive summary

- Happy in the US and the UK, money market funds have yet to find their place in the sun in Europe. Will Basel II be the answer?

Money market funds have gone from strength to strength since they began 25 years ago. As they continue to gather momentum in their US birthplace and over here in the UK, there is growing support in the banking community for increased regulation and guidance that will assist the success elsewhere around the globe.

These mutual funds have become the popular option for many investors because they are a highly liquid holiday home for cash that will be moved on quickly.

Originating in the US, money market funds (MMFs) are regulated by the Securities and Exchange Commission (SEC) but are not insured or guaranteed by the US government.

Although very successful in the UK, money market funds have not been subjected to the rigorous regulatory restraints that many other financial instruments generally are. While this lack of regulation has had many positive outcomes for money market funds, as time moves on it is becoming a negative aspect of the industry, and starting to constrain their progression.

"From within the fund industry there is starting to be a push to get MMFs regulated," says Richard Norval, Head of Liquidity Fund Sales at Royal Bank of Scotland. "It makes it far easier to register them overseas where regulators understand UK regulation."

While the US and the UK are familiar with money market funds, the same is not true for continental Europe. Norval describes Europe as one of the holy grails for MMFs. Regulation would allow money market funds to differentiate themselves from other existing European funds that do not have the same features.

"Fund managers have been talking about what they expect to happen in Europe over the coming years," says Norval. "MMFs are becoming commonplace in the UK and have become much more popular with treasurers. There is a general acceptance by financial institutions that they are a good thing in the UK. In Europe there has been a much slower take-up."

This cash management tool has drummed up support in the US and in the UK because it carries less risk than other instruments, you can get your money back on the same day and the yield is competitive.

"The advantages that we discuss and which seem to be hitting home with UK treasurers are not cutting much ice in Europe," says Norval. "This is particularly true of Germany and France. We need to market more actively; to do that, we need to be registered locally and differentiate ourselves. Being regulated in the UK should help to do that."

While money market funds continue to try and penetrate the European market it is argued that the introduction of Basel II will help improve and build upon their usage and success.

"A big issue is the relaxation of the banks' criteria for investing in MMFs," says Norval. "After Basel II has been implemented, it looks as if it will be easier for banks to invest in money funds. However, I see more MMF people getting excited about that than banks. From the supply side, people are certainly seeing this as a positive thing but it is not so obvious on the demand side."

While many money market funds look forward to the introduction of Basel II in January 2007 as a new opportunity, Norval does not feel quite so confident.

"If people are expecting a huge in-flow into MMFs on January 1 2007, I think they may be disappointed," he warns. "It may take time for this to have a meaningful impact."

MMFs attempt to maintain a stable dollar per share net asset value (NAV), and the risk exposure is negligible compared with stock and bond funds.

"They are really safe, but conservative in terms of return," says Norval. "However, they aren't used to earn the maximum possible return: they are a convenient place to park your money temporarily. They are going to give you the best return available considering the constraints of the AAA rating and the liquidity."

There is only one example of a money market fund ever breaking the buck (dropping below the $1 share price). In 1994 an institutional money fund, Community Bankers US Government MMF, liquidated at 94 cents a share due to derivatives-related holdings.

Return does equal risk but for MMFs the risk is so minimal that investors will continue to use them to hold cash while they are waiting to move it on.

Julia Berris is a Reporter on *The Treasurer*.
editor@treasurers.org