IMMFA
Institutional Money Market Funds Association

29 July 2008

By email to: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz
CH-4002 Basel
Switzerland

Dear Sirs

RE: Principles for Sound Liquidity Risk Management and Supervision

The Institutional Money Market Funds Association (IMMFA) are grateful for the opportunity to respond to the consultation paper on liquidity risk management and supervision. We are broadly supportive of the recommendations included within the consultation paper, but would also like to bring to your attention the features of the product offered by our membership which we request you consider as part of the consultation process.

IMMFA is the trade association representing the promoters of triple-A rated money market funds and covers nearly all of the major promoters of this type of fund outside the US. Money market funds are brought primarily by institutions to manage their liquidity positions and not for 'total-return' investment purposes. They are used as an alternative to wholesale money market deposits by a wide range of investor types as they offer a practical means of consolidating and outsourcing short-term investment of cash. Total assets in IMMFA members' funds as at June 2008 were in excess of €400 billion. You may obtain more information on triple-A rated money market funds from our website, www.immfa.org.

IMMFA only represents those money market funds which are triple-A rated and value assets on an amortised basis in order to provide a constant net asset value. The funds represented by IMMFA should be not confused with other fund types which may be referred to as "money market funds". These could include "enhanced" cash funds which operate with longer durations and consequently purchase longer-dated instruments in the search for higher yields.

We note the recommendations avoid providing a list of eligible assets which should be considered as liquid, but instead provide a set of qualitative criteria which should be assessed when determining the liquidity of an asset. We support this approach, but request that there should be consistency in the approach which is taken across supervisory authorities to ensure global organisations are able to manage liquidity on a consistent basis in multiple jurisdictions.

As part of the consultation process, we would like to draw your attention to the key features of the money market funds provided by our members (see Appendix). Having considered the recommendations included within the consultation paper, we believe that money market funds are liquid assets and should be capable of being included within the liquidity risk management strategies of financial institutions. As you may be aware, 'qualifying money market funds', as defined within article 18 of the MiFID implementing directive 2006/73/EC, are presently included within the UK prudential liquidity regime for building societies and liquidity mismatch regime for banks. The amendments to the Financial Services Authority (FSA) Handbook were made in October 2007, at the height of the market turmoil. Part of the requirements upon the fund in order to be eligible for inclusion within these regimes is the ability to provide same-day liquidity to investors. That such amendments were made at this time are an indication of the ability of the product to provide liquidity in all market conditions.

The money market funds represented by the IMMFA membership have performed well during the market turmoil which has been experienced since last summer. No fund has been suspended or closed to redemptions, and no fund has 'broken the buck', i.e. fallen below the point at which the constant net asset value of the fund is lost and investors lose money. Importantly, no investor has lost money in an IMMFA money market fund since the Association was established in 2000.

We consider that money market funds could provide a valuable means through which financial institutions manage their liquidity risk, and should be considered as a liquid asset. We would welcome the opportunity to meet with you and discuss the matter further.

If you require any further information, please do not hesitate to contact me.

Yours faithfully

Nathan Douglas.

Nathan Douglas
IMMFA Secretariat

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Appendix

Key features of money market funds

What are Money Market Funds?

Money market funds are mutual funds that invest in short-term debt instruments. They are actively managed within rigid and transparent guidelines and have as their primary objective the preservation of capital and provision of liquidity, along with competitive sector-related returns. These objectives are determined primarily by the requirement that funds maintain triple-A ratings.

A money market fund is an open-ended collective investment undertaking (CIU), which is a separate legal entity from the investment manager. The assets within this fund are ring-fenced and protected, so that in the event of the insolvency of the investment manager, there would be no adverse impact on the fund other than the need to transfer the investment management mandate to another manager.

As an open-ended CIU, the fund has variable capital and can increase or decrease in size as investors invest or redeem their holdings. Upon redemption, the investor sells his shareholding to the fund. As such, the amount of shares in issue is constantly changing with the addition of new shares to new investors, and the redemption of existing shares by those investors leaving the fund. The requirement for the fund to be able to operate in such a way without requiring any pre-approval from other shareholders necessitates that the fund must generally maintain sufficient liquidity at all times to be able to buy and sell assets for the fund quickly and reliably.

This fundamental necessity for liquidity within the fund is enhanced within a money market fund, as they are operated as a short-term fund to provide preservation of capital and liquidity. Other funds are generally managed to provide an investment return over a significantly longer time horizon, and therefore when compared to a money market fund, would not need the same levels of liquidity generating capability.

The nature of open-ended funds in general and money market funds in particular necessitate that investors are able to quickly liquidate their holdings and have access to cash within short periods. Provided the investor gives notice to the administrator of the money market fund before the dealing cut-off time for the day (usually by mid afternoon for European domiciled funds), the investor will have access to his cash on the same day.

Money market funds are generally used by corporate entities for treasury management purposes, particularly liquidity management, and as such, provide an essential service to industry. They are primarily vehicles for managing residual cash balances, and not used for 'total-return' investment purposes. The underlying investors within a money market fund are not concentrated in any particular sector.

Income within a money market fund is accrued daily and can, at the end of the month, either be paid out to the investor or used to purchase more units in the fund. The funds may also operate an accumulating share class. This share class uses the same valuation methods and investment guidelines, and income is accrued daily. However, unlike the distributing share class, income is not distributed but instead reflected by an increase in the daily value of the shares. Any realised gains or losses in either share class are smoothed into the yield with principal maintained at constant levels.

What is the size of the market?

The market for money market funds has grown considerably within recent years, both in Europe and in the US. In the US, the market now totals $3.5 trillion (figures from the Investment Company Institute), and represented 31% of US businesses short-term assets at the end of 2007 (source: ICI Factbook 2008).

Within Europe, the value of the Institutional Money Market Funds Association (IMMFA) members' funds has grown considerably over recent years, and at June 2008, totalled over €420 billion. This total has grown year-on-year since the creation of IMMFA in 2000, with 36% growth in the year to June 2008.

IMMFA now represents 30 providers of money market funds, and covers nearly all of the major promoters of such funds outside the US.

Regulation and self-regulation of money market funds

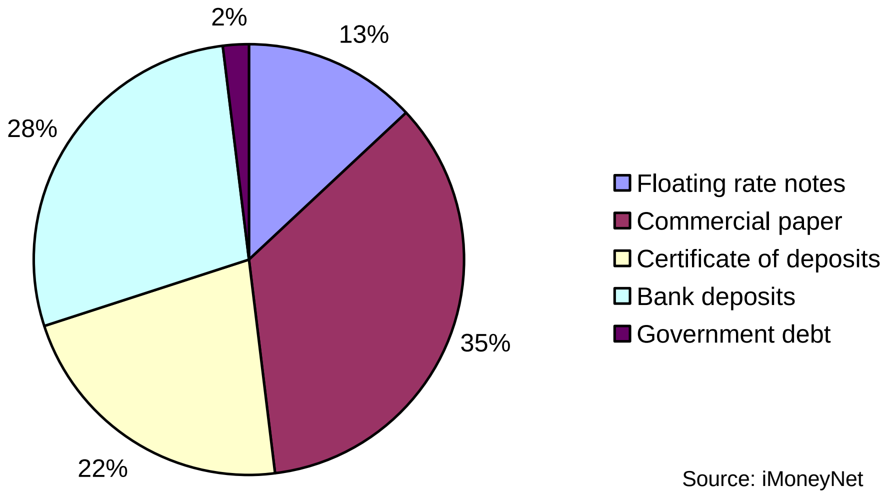
European money market funds are generally subject to regulation (issued by supervisory authorities) and to self-regulation (issued by credit ratings agencies and an industry Code of Practice) as described below:

1. Regulation

European money market funds are generally managed by investment management firms which are domiciled in the UK and authorised by the Financial Services Authority (FSA).

The money market funds themselves are generally domiciled in Ireland or Luxembourg. They are regulated in accordance with the UCITS Directive 85/611/EEC, which, amongst other things, prescribes their investment and borrowing powers (e.g. by imposing diversification requirements, investment concentration limits and by identifying eligible and ineligible assets), operational structure (e.g. by requiring the UCITS management company to maintain regulatory capital and appropriate risk management processes, and by requiring the UCITS to appoint an independent depositary) and minimum disclosure requirements (e.g. by mandating the contents of the UCITS' prospectus and simplified prospectus).

The Eligible Assets Directive 2007/16/EC (EAD) provides clarification on those assets which are eligible for investment by UCITS. Within the EAD, a money market instrument is defined as an instrument which is normally dealt in on the money market, is liquid and has a value which can be accurately determined at any time. This permits investment in, for example, certificates of deposit, government debt, repurchase agreements, commercial paper (including asset-backed), and floating rate notes. The definition of a money market instrument within the EAD would only include those instruments which would be defined as a debt instrument in the banking environment. On the basis of the EAD definition, and using the average IMMFA money market fund, a typical portfolio composition is shown below:



Source: iMoneyNet

The EAD permits the use of amortised cost as a means of valuing money market instruments. The amortisation is conducted on a straight line basis from the purchase price at a discount or premium to par to a maturity price of par. The value of the instrument at any time can quickly and easily be determined using this methodology. This valuation methodology allows the fund to maintain a constant net asset value (i.e. an unchanging face value of, for example, €1, $1 or £1).

Following the publication of the EAD, the Committee of European Securities Regulators (CESR) issued accompanying guidance. In this, CESR prescribe those funds which are permitted to utilise an amortisation valuation methodology, and confirm the circumstances in which a UCITS may follow such a methodology, i.e. where it invests

> solely in high-quality instruments with as a general rule a maturity or residual maturity of at most 397 days or regular yield adjustments in line with the maturities mentioned before and with a weighted average maturity of 60 days. The requirement that the instruments be high-

quality instruments should be adequately monitored, taking into account both the credit risk and the final maturity of the instrument.

In addition, the UCITS should operate adequate procedures to avoid the situation where discrepancies between the value using a mark-to-market valuation and the value calculated according to the amortisation method would become material, whether at individual instrument or at UCITS level.

The consequence of the introduction of this legislation, and the accompanying guidance to which the European supervisory bodies have subscribed, is that money market funds are the only funds permitted to utilise amortised cost as a valuation methodology at both instrument and portfolio level, and must invest exclusively in high-quality, short-dated debt instruments. This combination of high-quality and short-datedness are the means through which the money market fund is able to provide capital security and liquidity.

The UCITS Directive and EAD establish a regulatory framework that is broad enough to accommodate a wide variety of CIUs, from highly stable and highly liquid money market funds to relatively volatile and illiquid emerging market equity funds. Consequently, the particular features that enable money market funds to act as a substitute for bank deposits (i.e. their ability to preserve capital by maintaining a constant net asset value, and their ability to provide liquidity in order to meet client redemptions) are not found in the UCITS Directive itself, but in a unique self-regulatory regime which distinguishes money market funds from other types of CIU.

2. Self-regulation

European money market funds are subject to self-regulation, comprising an industry Code of Practice issued by IMMFA and guidelines issued and monitored by credit ratings agencies[1]. Money market funds which meet the guidelines issued by credit rating agencies are assigned a special rating. The precise notation of the rating differs between ratings agencies (AAAm from Standard & Poors, Aaa/MR1+ from Moody's and AAA/V-1+ from Fitch) but they are all intended to indicate that money market funds exhibit minimal credit (AAA/Aaa) or market (m/MR1+/V-1+) risk.

Two aspects of self-regulation are particularly important, namely those relating to portfolio restrictions (which impose stricter investment and borrowing powers on money market funds than on other types of CIU) and valuation techniques (which permit money market funds to value assets on a different basis to other types of CIU), both of which are described below.

(a) Portfolio restrictions

Money market funds are subject to portfolio restrictions issued by credit rating agencies which require them to invest in short-dated debt instruments such as

[1] In the USA, money market funds are subject to a dedicated Securities and Exchange Commission (SEC) rule (SEC rule 2a-7) which makes broadly similar requirements to the self-regulatory regime practised in Europe.

treasury and local authority bills, certificates of deposit, commercial paper, medium-term notes and banker's acceptances. Those guidelines are often more prescriptive than the corresponding articles of the UCITS Directive and EAD, and stipulate:

- the credit ratings of individual securities (>50% A1+/P1, balance A1/P1);
- the weighted average maturity of the portfolio (maximum of 60 days);
- the maximum final maturity of individual securities (13 months for fixed rate instruments and 12-24 months for floating rate notes);
- counterparty exposure (maximum of 5%);
- preclusion of derivatives; and
- duration and volatility models.

In certain respects, the portfolio guidelines issued by credit ratings agencies in the EU are even stricter than equivalent provisions in the SEC rule 2a-7 in the US. For example, credit ratings agencies' guidelines limit the weighted average maturity of a money market fund portfolio to 60 days as compared with the 2a-7 limit of 90 days.

The funds are required to undertake extensive credit research to ensure the assets held represent an acceptable level of risk for the fund, and are within the tolerances set by the rating agencies. The funds must also undertake regular stress testing at portfolio level to ensure the constituents of the fund are appropriate to meet pre-determined levels of credit, market, and interest rate risk and investor redemptions.

The effect of these portfolio restrictions is to require money market funds to invest in short-dated debt instruments which have a relatively stable market value (subject only to changes in the credit rating of the issuer or extreme interest rate movements) and therefore enable money market funds to maintain a similarly stable net asset value. Furthermore, because of the low weighted average maturity of the portfolio, instruments are constantly maturing and therefore provide liquidity which can be used to meet client redemptions.

These elements combine to ensure the funds are all short-term, with a regular maturity of assets. This regular maturity and turn-over of the assets allows the funds to rapidly alter the underlying composition of the fund to reflect the current market conditions and investor sentiment.

This ability was highlighted at the commencement of the market turmoil in 2007. Money market funds quickly altered the portfolio composition to increase the proportion of the fund which was invested in overnight deposits. This enabled the funds to cater for any investor nervousness, and provided an increased level of liquidity to cater for redemption levels above those expected through normal cashflow forecasting.

By their very nature, a money market fund offers diversification benefits. As a UCITS, the fund is permitted to not invest any more than 10% of assets in a single instrument. This concentration level is significantly higher than industry standards (which have aligned with the requirements of the rating agencies), which are traditionally set at a maximum of 5%. With larger funds, this may be lower still, and can be reduced to as little as 2% to reduce the risk of loss. As such, a money market fund will typically have a portfolio of over 100 assets at any one time.

The objective of any CIU is to pool the investment of a large number of investors, increasing the investment power of the undertaking when compared against that of an individual investor. Consequently, the fund is able to invest in a greater range and depth of investments than most individual investors could achieve. Any risk inherent within the underlying instruments is then spread across the fund rather than being held by an individual.

(b) Valuation techniques

Money market funds are allowed to value their portfolio on an amortised cost basis, in accordance with the EAD. These funds are the only type permitted to utilise such a valuation methodology at both individual instrument and portfolio level.

Money market funds are required to monitor and limit (plus or minus 50 basis points) any deviation between amortised and market value. In the USA, this monitoring must be made 'at such intervals as the board of directors [of the money market fund] determines appropriate and reasonable in the light of current market conditions'. The IMMFA Code of Practice is more prescriptive, stipulating that deviations between amortised and market value must be monitored on a weekly basis, at a minimum. Furthermore, the IMMFA Code of Practice requires money market fund providers and their fund administrator to implement an ‘escalation policy’ to act upon material discrepancies. At portfolio level, the escalation procedures require that:

- at 10 basis points variance, the administrator notifies the fund manager;
- at 20 basis points variance, the administrator notifies the senior management of the investment company; and
- at 30 basis points variance, the administrator notifies the trustees and directors.

In addition, the escalation procedures require that at individual asset level:

- at 30 basis points variance, the administrator notifies the fund manager; and
- at 50 basis points variance, the administrator notifies the directors and recommends appropriate action.

The escalation procedures required by the IMMFA Code of Practice are the basis for the guidance in the FSA Handbook and the Guidance Note of the Financial Regulator in Ireland.

The effect of valuing assets on an amortised cost basis is to insulate the fund from minor, temporary market movements (whilst the weekly monitoring ensures that any major, permanent market movements are taken into account), and reflects money market funds' investment strategy of holding short-dated debt instruments to maturity, rather than making sales at a gain or a loss before the maturity date. Furthermore, by transferring accretions and discounts to income, amortisation allows securities to be held in capital at par, and thus enables money market funds to maintain a constant net asset value.

By expressly permitting amortisation, CESR's guidance recognizes the ability of money market funds to provide a constant net asset value. CESR's guidance also represents a significant step forward in recognizing the distinctiveness of triple-A rated money market funds from other types of UCITS.

Risks within money market funds

Triple-A rated money market funds are very safe, but this does not mean that there is no risk associated with these funds.

Market risk

The funds are managed to provide a constant net asset value. If this value is maintained, there should be no risk to the investor of market movements having an adverse impact on the value of the investment.

The constant net asset value is maintained through use of the amortised cost valuation methodology. This protects the fund from minor movements in the value of the underlying assets and the overall portfolio.

In addition, the fund must conduct regular comparison with the mark-to-market value of the assets and the portfolio, and must operate escalation procedures in order to act should a material discrepancy arise between the two values. In such instances, the directors must act in accordance with their fiduciary duties and in the best interests of the investors. These procedures allow the fund to continue to provide a constant net asset value.

Credit risk

The fund could suffer from the downgrade or default of an instrument within the portfolio.

The fund is required to invest exclusively in high-quality instruments, taking both the short-term and long-term ratings into consideration. The fund must operate independent credit review processes to ensure the assets within the portfolio are appropriate both initially and on an on-going basis. These procedures should address downgrades and defaults

The diversification achieved by the fund – with no more than 5% of assets invested in a single security – spreads the impact of any credit losses, by reducing the capacity of a single instrument to have a material impact on the portfolio in its totality.

The fund will also regularly provide reports to the rating agencies who will conduct surveillance of the holdings within the portfolio. This, together with the escalation procedures for disparity in the value of holdings, ensure that at suitable junctures, the people with responsibility for managing the fund are aware of the potential for any changes in credit quality, and can determine the best course of action which is in the best interests of investors.

Realised losses

Situations may arise in which a fund realises a loss, either through selling an asset, or where an asset matures at below par. In such instances, the fund is able to smooth any losses into the yield of the fund in order to maintain the constant net asset value. Alternatively, the fund may offset any realised losses against gains which have been realised where assets mature at above par or are sold in advance of maturity at a gain.

The requirements of the IMMFA Code of Practice confirm that if a material loss arises, i.e. greater than 5 basis points of portfolio net asset value, the loss may be smoothed into the yield over no more than 60 days. However, where the fund intends to offset any proportion of this loss against realised gains, this may be conducted over a longer period of up to seven years in accordance with accepted practice in US markets (and following US Federal Tax Law). In either instance, the directors of the fund must ensure the action taken is in the best interests of the investors.

Illiquidity

In illiquid markets, an increased volume of investors may require access to cash, often with little or no notice and outside of normal cashflow forecasting. In such instances, a money market fund risks being unable to provide access to investment to all investors seeking redemptions.

Money market funds conduct detailed cashflow forecasting, with careful management of the portfolio in order to meet planned redemptions. In addition to this means of providing sufficient liquidity, the short-term nature of the funds allow the underlying portfolio to be altered quickly, thereby generating additional liquidity through the purchase of an increased volume of, for example, overnight instruments.

A buffer of overnight instruments can quickly be generated, or maintained on an on-going basis, in order to provide for unforeseen redemptions. The funds also operate with restrictions on the maximum size of investment from a single investor. This restriction also allows the fund to manage the impact on any unforeseen redemptions.

Accounting treatment

Money market funds have been confirmed as cash equivalent under IAS 7 (Cash Flow Statements). This consideration was confirmed by the four major accountancy firms (Deloitte, PricewaterhouseCoopers, KPMG and Ernst & Young), and is available on the IMMFA website at http://www.immfa.org/press/2006-023-1.pdf.

Under IAS 7, the requirements for an asset to be treated as cash or cash equivalent are defined. The Standard notes that 'Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes'. For an instrument to quality as cash equivalent it must be readily converted to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition or regular floating interest rate resets. Equity investments are excluded unless they are, in substance, cash equivalents, for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date.

Future developments

Sale and repurchase of money market fund shares

IMMFA recently commissioned a study to determine the feasibility of the development of a market mechanism for the sale and repurchase of money market fund shares. This ability is designed to provide additional liquidity for investors without the need for the shareholding to be redeemed.

The sale and repurchase of shares would remove any volatility in the money market fund which could be induced by large investment and redemptions at short notice. Whilst a fund would be able to cater for such activity, the impact would likely be a volatile yield; the facility to sell and repurchase at share level would provide investors with liquidity when required, whilst ensuring that for those investors who remained invested, there was no volatility in the yield receivable.

IMMFA intends to pursue this concept, which will involve inclusion of the fund shares on a securities settlement system, in order to facilitate the sale and repurchase between willing counterparties.

IMMFA Code of Practice

IMMFA is currently reviewing its Code of Practice in order to ensure it continues to provide the level of integrity necessary to support the continued growth of the industry. The revised Code will be based on a series of Principles with underlying guidance indicating how compliance may be achieved. Compliance with the Code will ensure the fund is robustly managed within rigid and transparent guidelines, with high quality governance arrangements to ensure the actions taken by the fund are always, and visibly, in the best interests of the investor.