Money Market Funds
Europe
Special Report

European Money Market Funds

New Definition Offers Greater Clarity

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Related Research

- *Global Money Market Fund Rating Criteria (October 2009)*
- *Global Bond Fund Rating Criteria - Short-Term Bond Fund Addendum (March 2010)*
- *Global Bond Fund Rating Criteria (February 2010)*

Summary

- On 19 May 2010, the Committee for European Securities Regulators (CESR) published guidelines for harmonised money market fund (MMF) definitions across Europe, which will take effect in July 2011. For the approximate EUR1.3trn European MMF universe, these definitions are a major step towards greater market transparency and increased clarity.
- The CESR's guidelines on MMF definitions crystallise the two-tier approach it had suggested in its initial proposal by creating two MMF categories: "short-term money market funds" and "money market funds". It also addresses, in Fitch Ratings' view, the two main issues raised by the current financial crisis for MMFs, namely maturity and liquidity, the latter being partially and indirectly tackled through restrictions on maturity.
- In general, Fitch sees global convergence of standards for short-term MMFs as regards interest rate and spread risk exposure. That said, notable differences remain when it comes to defining and setting minimum standards for portfolio liquidity and credit risk.
- The second MMF category allows for greater credit, market and liquidity risks as compared to short-term MMFs. Nonetheless, the new definition provides a relatively conservative framework for a segment of the European fund market where, to date, there has been notable divergence and some opacity in terms of fund's actual risk profile.
- As defined by CESR, many European MMFs may qualify for a rating under Fitch's Money Market Fund Rating criteria and scale, ranging from 'AAAmmf' to 'Ammf', with only those short-term MMFs that elect to maintain appropriate liquidity reserves and take on minimal credit risk potentially qualifying for a 'AAAmmf' rating.
- Under CESR's guidelines, the newly-defined European MMF universe may include funds with risk profiles that fall outside the parameters of Fitch's rating criteria for MMFs; these would be rated under Fitch's short-term bond fund rating criteria, reflecting their longer maturity profile and higher spread risk exposure.

Short-Term MMFs: Towards Global Convergence of Standards?

The CESR's definition and listed criteria for short-term MMFs confirm, in many respects, the global convergence of standards for such conservatively-oriented funds, although key regional differences remain.

This is best highlighted in *Table 1* below, which summarises CESR's guidelines in the context of the SEC's Rule 2a-7, governing MMFs in the US since 1983, and of the Institutional Money Market Fund Association's (IMMFA) code of practice, which governs European 'AAA'-rated constant net asset value (CNAV) funds. Both the SEC rule and the IMMFA code of practice have recently been revised with the shared objective of increasing the resilience of MMFs to market dislocation.

Common global standards across CESR/SEC/IMMFA definitions for short-term MMFs include:

- a maximum fund interest rate exposure at 60 days, as measured by the fund's weighted average days to reset (WAM or WAM_R);

- a maximum fund spread risk exposure at 120 days, as measured by the fund's weighted average days to final maturity (WAL or WAM_F);
- a maximum instrument maturity at 397 days - although there are differences in the treatment of sovereign floating rate notes (FRNs), as detailed below;

CESR guidelines differ from SEC/IMMFA standards in the following areas:

- Sovereign FRNs are restricted to a 397-day maturity limit by CESR. IMMFA and the SEC allow longer durations for FRNs issued by sovereigns.
- As per CESR guidelines, eligible instruments include assets of first- and second-tier credit quality; in other words, CESR sets the minimum credit quality of instruments at 'F2' or equivalent (by another recognised credit rating agency or, if not publicly rated, as per the asset management company's internal rating). While IMMFA does not have specific guidelines on the credit rating of instruments, the fact that IMMFA funds are rated 'AAAmmf' by Fitch — or have a 'AAA' MMF rating from another global rating agency — means that they only invest in securities rated 'F1+'/'F1' (or equivalent). The SEC's rule largely restricts instruments' credit quality to 'F1+'/'F1' (or equivalent), with some very limited 'F2' (or equivalent) exposure.
- No requirements are set by CESR for minimum portfolio-level liquidity. Both the SEC and IMMFA have introduced minimum requirements for a fund's overnight and one week positions as part of their amended rules. This is in recognition of the fact that insufficient liquidity buffers at a time of heightened redemption requests contributed substantially to the pressure experienced by most US and offshore CNAV MMFs during the autumn of 2008.
- Under CESR guidelines funds may be valued under a CNAV or a variable NAV (VNAV) approach. In the US and under IMMFA's code of practice, only CNAV-type MMFs are considered.

Second-Tier MMFs: A European Peculiarity

The second MMF category, as defined by CESR, comprises funds with longer exposure to interest rate and credit spread risks, while still targeting principal preservation. This category does not have an equivalent per se in other jurisdictions but provides a clear harmonised framework for funds being labelled as MMFs. Absent such a framework, there are segments of the European MMF market where,

Table 1 – Money Market Fund Definitions

	SEC 2a-7 (US)	IMMFA	CESR (Europe)	
Fund category	**MMF**	**AAA CNAV MMF**	**Short-term MMF**	**MMF**
Max fund int. rate exposure (WAM_R)	60 days	60 days	60 days	6 months
Max fund credit spread exposure (WAL/WAM_F)	120 days	120 days	120 days	12 months
Max instrument final maturity	397 days Longer for US sovereign FRN/VRN	397 days 2 yrs for sovereign FRN	397 days	397 days 2 yrs for FRN
Portfolio liquidity	Min 10% O/N Min 30% at 7 days Max 5% in illiquid assets	Min 5% O/N Min 20% at 7 days	No explicit limit	No explicit limit
Instrument quality	1st tier security ('F1+'/'F1' or equivalent) 2nd tier security ('F2' or equivalent) if security maturity <45 days and total 2nd tier exposure <3%	No explicit limit but 'F1+'/'F1' (or equivalent) given rating agencies' criteria for 'AAA'-rated MMFs	At least 'F2' or equivalent	At least 'F2' or equivalent investment grade sovereign issuance
NAV model	CNAV	CNAV	CNAV & VNAV	VNAV
Publication date	Jan 10	Dec 09	May 10	May 10
Effective date	May 10	Jan 10	Jul 11	Jul 11

Source: CESR, IMMFA, SEC, Fitch

to date, there has been notable divergence and some opacity as regards funds' actual risk profiles.

CESR's has positioned MMFs quite conservatively, relative to the views put forth by market participants, particularly as regards acceptable interest rate and spread risk exposure. For example, CESR sets the following limits:

- portfolio WAM (or WAM_R) is limited to six months;
- portfolio WAL (or WAM_F) is limited to 12 months; and
- instrument maturity shall not exceed 397 days, with the exception of FRNs that may go up to two years.

This second MMF category allows for the continued existence of a range of money market funds, while still offering a transparent, risk-constrained environment.

It should nevertheless be noted that funds within the money market fund category may cover a variety of risk profiles. For example, an MMF approaching the limits set by the CESR may be taking greater credit risk, with positions in the low investment grade space, and/or have large exposure to FRNs maturing in more than 397 days. This last point should be considered in relation to the wider price volatility and liquidity risks induced by investments in longer-dated FRNs, as illustrated by the NAV pressure experienced by some European MMFs over the last two years.

Fitch Fund Rating Criteria in the Context of the New European MMF Definition

Fitch's MMF rating criteria (summarised below), provide one measure of the ability of an MMF to achieve its combined objectives of preserving principal and providing shareholder liquidity.

Many short-term MMFs may qualify under Fitch's MMF rating criteria for a 'AAAmmf' rating, Fitch's highest MMF rating on a scale of 'AAAmmf' to 'Ammf'; others may be rated lower due to heightened spread and/or liquidity risk exposure. For example, short-term MMFs may elect to invest in Tier 2 securities or maintain less portfolio-level liquidity than is consistent with a 'AAAmmf' rating.

Table 2 – Fitch Global MMF Rating Criteria Highlights

	AAAmmf	AAmmf	Ammf
Max portfolio credit factor (PCF)[a]	1.50	2.50	5.00
Max fund int. rate exposure (WAM_R)	60 days	75 days	90 days
Max fund credit spread exposure (WAM_F)	120 days	180 days	240 days
Max instrument final maturity	397 days 2 years for 'AAA' sovereign FRN	397 days 2 years for 'AAA' sovereign FRN	397 days 3 years for 'AAA' sovereign FRN Corporate FRN >1 year on a case-by-case basis
Portfolio liquidity (baseline)	Min 10% O/N Min 25% at 7 days	No guideline	No guideline
Instrument quality	'F1+'/'F1' or equivalent	'F1+'/'F1' or equivalent Limited 'F2' or equivalent on a case-by-case basis	'F1+'/'F1' or equivalent Up to 5% in 'F2'
Counterparty credit quality	Min 'A'/'F1'	Min 'A'/'F1'	Min 'A'/'F1'
Max direct issuer exposure	10% if 'F1+' of which max 5% >7 days 5% if 'F1'	No guideline	No guideline
Max total issuer exposure (direct and indirect)	15% for a single financial group 25% for a single repo counterparty[b] 35% for a single government agency	No guideline	No guideline

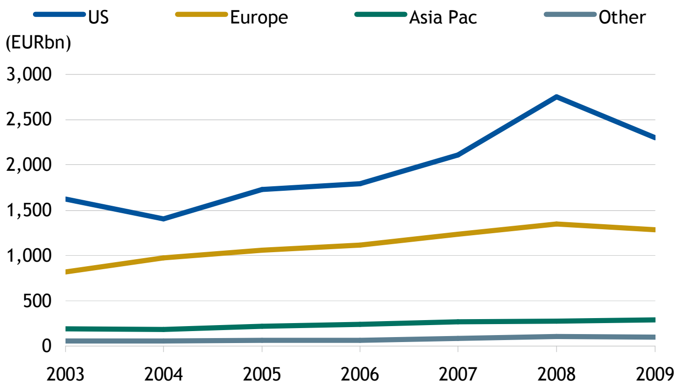
[a] The portfolio credit factor (PCF) is a matrix-based approach developed by Fitch to evaluate MMF portfolio risk along two dimensions: credit quality and asset maturity
[b] Applicable to government and/or government agency collateral with at least 102% overcollateralisation; otherwise direct exposure guidelines are applicable
Source: Fitch

Furthermore, the new CESR definition includes in the MMF universe funds with risk profiles falling outside the parameters of Fitch's rating criteria for MMFs, given their longer maturity profile and/or higher spread risk exposure. For such funds, Fitch would assign ratings under its short-term bond fund rating criteria, using a fund credit rating and a complementary volatility rating.

Such MMFs, viewed as short-term bond funds under Fitch's rating criteria, would typically be rated from 'A'/'V1' to 'AAA'/'V1' under this dual rating scale and are expected to offer limited risk to NAV stability. Still, they are not comparable to Fitch-rated MMF, where capital preservation and liquidity to shareholders are embedded within fund operating guidelines and Fitch rating criteria, due to their very short-term investment horizon and low credit and liquidity risk.

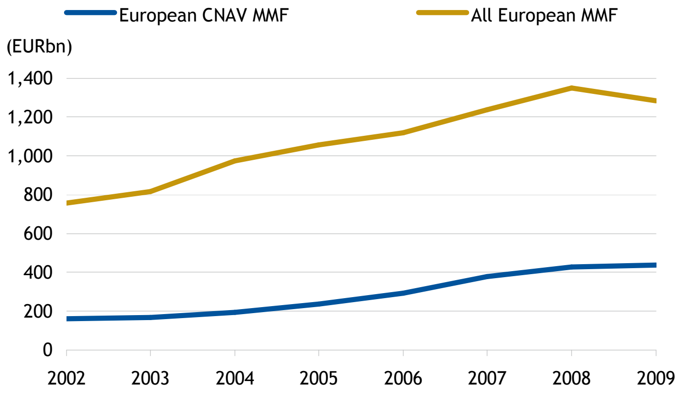
Appendix: A Look at Recent Developments in the MMF Market

Global MMF Asset Growth



Source: ICI, EFAMA, IFIA

European MMF Asset Growth



Source: EFAMA, IFIA, iMoneyNet

Recent Developments Relating to European MMF

2008-2010: A Period Rich in Initiatives – Focus on Europe

- **2008** — **AMF:** Initiated discussion work for revised French MMF regulation
- **Jan 2009** — **Fitch:** Consultation draft for changes to AAA-rated funds globally
- **Jan 2009** — **IMMFA:** Set up working party on the future structure of MMF
- **Feb 2009** — **De Larosière report:** Need for a common EU MMF definition
- **Jul 2009** — **IMMFA/EFAMA:** Joint proposal for pan-European MMF definitions
- **Sep 2009** — **AMF:** Proposed MMF definition to CESR
- **Oct 2009** — **Fitch:** Final revised global MMF rating criteria report
- **Oct 2009** — **CESR:** Consultation paper with proposal for pan-European MMF definitions
- **Dec 2009** — **IMMFA:** Revised code of practice introduced
- **May 2010** — **CESR:** Guidelines for European MMF definitions published

Source: Fitch

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