Money market funds (MMFs) developed in the early 1970s in the US. They evolved from 1971 onwards in response to the restrictions of Regulation Q that limited interest rates on bank deposits. Indeed the imposed zero rates on demand deposits encouraged the emergence of such funds that took advantage of the fact that open market rates were above Regulation Q ceilings. Although MMFs remain more popular in the US than Europe, European money market funds have been growing at a rapid rate.

Typically money market funds offer daily liquidity and so can be (and are) used by institutional investors for daily cash management purposes. When there is uncertainty in the financial markets, money market funds invest an increasing proportion of the fund in highly liquid instruments to ensure same day liquidity can be maintained at all times. Money market funds typically invest in certificate of deposits, commercial paper and government securities. These finds typically avoid default risk and prefer securities issued by low-risk debtors, such as the government.
Despite the announced objectives of preservation of capital and daily liquidity, investors have started to voice concerns, since the events of the summer 2007, about what markets their underlying investments are in - including MMFs - and whether their investments are in fact safe and perform in terms of price.

**DEFINITION**

The most generic definition of a money market fund states that it is a mutual fund investing in short-term debt instruments. Indeed from a legal point of view MMFs can be classified in the same category as other mutual funds. However, from an economic point of view, these funds have little in common with, for instance, equity funds characterised by high volatility and high potential returns. In fact MMFs are a very close substitute for transaction accounts. Both types of assets are characterised by low risk, high liquidity and low rate of return. Moreover MMFs are almost as liquid as M1 deposits. Basically, MMFs serve all purposes of transaction accounts with the exception of serving immediate transaction needs.

However the definition of MMFs should also consider different types of MMFs which go beyond the simplistic comparison to transaction accounts.

- **liquidity funds (or short-term MMFs)**

  Money market funds invest in high quality, short-term securities that present minimal credit risk. These funds pay therefore dividends that generally reflect short-term interest rates. Although the net asset value per share of a traditional mutual fund changes daily in response to market factors, money market funds are structured to avoid these changes by seeking to maintain a stable NAV of 1.00/share. These funds provide daily liquidity as well as stable NAV. The prime objective of the liquidity funds is to provide a yield that is equal to or slightly higher than a bank deposit. Typically these funds are rated AAAm.

- **cash plus funds**

  These funds may invest in more illiquid instruments of slightly lesser credit quality, extend portfolio maturity further out onto the yield curve, or sacrifice same-day liquidity to aim to produce higher returns. As a consequence, the value of investments in these funds may be more volatile than in a liquidity fund, making cash plus funds suited to capital that can be locked away for a longer period of time, say six to 12 months.
- Enhanced money market funds

Enhanced money market products typically seek higher yields than the more traditional and conservative liquidity funds. This is achieved through investment in longer-dated and more volatile instruments such as asset and mortgage-backed securities and structured notes and derivatives. As such, these funds are not able to alter the underlying portfolio as quickly as traditional money market funds to reflect changing market conditions and investor sentiment. Prices can also be more volatile.

**IMPACT OF RECENT EUROPEAN REGULATORY DEVELOPMENTS**

One of the major reasons for the US money market funds has been the existence of a regulated environment specific to these funds (known as SEC Rule 2a-7\(^1\)). It has enhanced awareness of the funds among treasurers and other potential clients. Moreover the SEC Rule 2a7 defines exactly what an investor is investing in with a MMF.

Outside the US, there is no equivalent regulation and while the Undertaking for Collective Investments in Transferable Securities III (UCITS III) \(^2\) offers some diversification guidelines in Europe, they are in the broader context of mutual funds and do not specifically apply to MMFs or any other asset class. The UCITS Directive definition for money market instruments is,

*For the purposes of this Directive ‘money market instruments’ shall mean instruments normally dealt in money market which are liquid, and have a value which can be accurately determined at any time*.

In addition, credit rating agencies set independent ratings guidelines and corporate treasurers should be aware that each agency has different guidelines. For instance, a fund might be triple-A rated but it could be an AAA-rated enhanced cash fund rather than an AAm-rated MMF where the 'm' is assigned to denote a stable (NAV). With this uncertainty, it is difficult for some investors to know exactly what they are buying and understand the differences between triple-A rated funds rated by different agencies.

The European changes in the regulatory environment has, however, become more favourable to such funds and made them more accessible to potential

\(^1\) [http://www.law.uc.edu/CCL/InvCoRls/rule2a-7.html](http://www.law.uc.edu/CCL/InvCoRls/rule2a-7.html)

clients. Indeed there has recently been a significant 'status upgrade' for some MMFs. In particular, the regulatory environment has become more favourable to such funds and made them more accessible to potential clients. As a consequence of the European Union's Capital Requirements Directive (CRD), many MMFs with an AAA rating are being put in line with bank deposits in terms of regulatory treatment. Furthermore, from November this year, custodians holding client money will be able to place it in certain MMFs under the Markets in Financial Instruments Directive (MiFID), rather than being restricted to bank deposits.

The IMMFA Code of Practice

The European MMFs industry has not had the equivalent benefits that the US industry has enjoyed. In the US, Rule 2a-7 of the Investment Company Act of 1940 has been the clear guiding regulatory framework. There is no equivalent in Europe and this lack of clarity has forced the industry to develop its own Code of Practice using the IMMFA, as well as looking to the rating agencies to fill the void. Yet the IMMFA Code of Practice only applies to AAA-rated money market funds.

EFAMA European Fund Categorisation Forum (EFCF)

The EFCF is the body charged by EFAMA with introducing new standards in the EU fund industry. The classification splits EU funds into four broad categories – equity, bonds, money market and mixed – and sets clear parameters for each section. The new classification is intended to increase transparency by facilitating comparisons between the broadening range of financial instruments. EFAMA is committed to encouraging the adoption of the classification as the industry standard.

FUTURE MARKET DEVELOPMENTS

There are currently over 400 MMFs outside the US and there are still new entrants, but the entry cost is ever increasing, initial fund launch size is now significantly larger today than five years ago. The winners in the MMFs business are the providers that have achieved critical mass and economies of scale. The bigger will get bigger as smaller players are forced to 'white label' their funds or ultimately merge.

MMF portals have become an important part of the European MMF industry as they clearly offer the right service for some clients. Portals will continue in importance as institutional investors are likely to be more performance driven than retail investors and they will utilise portals as they demand speed of

3 [http://www.immfa.org/About/Codefinal.pdf](http://www.immfa.org/About/Codefinal.pdf)
execution, transparency, larger size tickets, lower transaction costs, later cut-off times, and straight through processing.

MONEY MARKET FUNDS AND THE CREDIT SQUEEZE

Money market funds have been affected by the credit squeeze. On the one hand business corporations have increased their allocation to money market funds, this is in addition to the normal surge in securities lending, safe harbour and arbitrage-related money that accompanies falling interest rates. Yet market conditions have also had a major adverse impact on a number of products that have used ‘money market’ or ‘enhanced cash’ in their naming conventions. Consequently concerns were expressed as regards the types of underlying investments made. There have also been questions surrounding direct exposures or how asset-backed commercial paper works.

The credit crunch, an opportunity for money market funds?

The definition of money market funds is critical. Indeed the announcement made by the Reserve Management Corporate\(^4\) that a US domiciled fund managed out of New York was unable to maintain a USD 1.00 net asset value and therefore was ‘breaking the buck’, has added a risk factor in considering investing in money market funds. Although the event remained an isolated one, parent companies have also fled to the rescue of their money market funds.

Managers of money market funds investing in sovereign bonds have seen a growth in funds under management since the onset of the credit crunch, save for September. Money market funds should be clearly defined to investors according to risk considerations.

As safe as bank deposits but without the same governmental guarantees

Money market funds are usually seen as an alternative to bank savings accounts. However they did not benefit from the governmental safe protection in the European Union. Indeed governments, on a global level, have keen to guarantee deposits as a pre-emptive measure. On the other hand, no measure has been taken to guarantee – formally – money market funds’ assets in Europe. On the other hand the US Treasury announced an optional program to “insure the holdings of any publicly offered eligible money market mutual fund — both retail and institutional — that pays a fee to participate in the

\(^4\) On September 16, 2008, Reserve Primary Fund ‘broke the buck’ when its share fell to 97 cents after writing off debt issued by Lehman Brothers.
program." The insurance will guarantee that if a covered fund breaks the buck, it will be restored to $1 NAV.\(^5\)

**CURRENT DISCUSSIONS**

As European regulation continues to gather pace, consultation and the resulting lobbying is critical. IMMFA, for instance, attempts to ensure that a European regulatory framework fully accommodates money market funds. The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive now accommodates money market funds and legitimises the use of amortised accounting. This has been a step towards the goal of an integrated market, and if European regulators can remove the administrative and regulatory frictions that slow down cross-border market access a functioning pan-European integrated market may yet be achievable.

Some MMFs are in favour of a regulation across Europe. Regulatory developments would introduce standardisation and, more importantly, clarify the definition of MMFs. Recent events have highlighted that investors should be made aware of the quality of their investments and should not worry about differences between rating agencies. The current debate is to promote a US-style 2a-7 regulation that would improve transparency, provide better information and may help to make the products more widely utilised. However, the European scope of the regulation may have to include harmonised application across countries, consistency with existing European regulations and a thorough impact assessment. Discussions have also focused on risk management processes and diversification of MMFs products.

The differences in definitions and regulatory treatments need to be addressed. These points need careful consideration by the Asset Management and Investors Council. Standardising definitions of money market funds and clearer identification of different types of money market funds should be looked at. Moreover a pan-European regulatory framework, specific to money market funds, which would have measured the United States approach, should be considered to ensure a high degree of transparency and consistency.

\(^5\) [http://www.treasury.gov/press/releases/hp1147.htm](http://www.treasury.gov/press/releases/hp1147.htm)