IMMFA
Institutional Money Market Funds Association

The Committee of European Banking Supervisors
Floor 18, Tower 42
25 Old Broad Street
London EC2N 1HQ

6th October 2005

Dear Sir or Madam

IMMFA response to CP07 on the recognition of External Credit Assessment Institutions (ECAIs)

I am writing in response to the CEBS consultation on its proposals for a common approach to the recognition of eligible ECAIs, as set out in CP07. Although the paper covers several topics, IMMFA's focus is on one area of interest, i.e. the criteria for the mapping of external credit assessments to the credit risk weights of collective investment undertakings (CIUs).

IMMFA is the trade body representing providers of triple-A rated money market funds. IMMFA members cover nearly all of the major providers of this type of fund in Europe. The institutional money market funds sector is large and rapidly growing: funds under management for IMMFA members alone stood at over €210 billion[1] as of June 2005.

In the section of the consultation which deals with CIUs, CEBS suggests that further work is needed to assess whether the credit assessments of CIUs might be subject to a different mapping process, since credit assessments of CIUs often use different rating scales and in many cases appear to be more a measure of expected loss than probability of default. CEBS is seeking input from market participants to inform its work on this issue. To this end it asks:

> *Question 6: Do you think that the concept of loss, rather than default probability alone, is the appropriate key parameter for mapping securitisation credit assessments? If not, what should be the appropriate parameter? How should it be measured statistically? To what extent do the same considerations apply for CIU credit assessments?*

We are only able to respond to this question in relation to the credit assessment of triple-A rated money market funds. We understand that these funds comprise approximately 80% of total CIU ratings. Different considerations may apply to the credit assessment of other types of CIU.

[1] Source: iMoneyNet.

European money market funds are subject to investment and operational guidelines issued and monitored by credit ratings agencies. Money market funds which meet those guidelines 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 invest their assets and are operated in such a way as to minimise credit risk (AAA/Aaa) and market risk (m/MR1+/V-1+).

As described on IMMFA's website (www.immfa.org) the rating criteria comprise four main areas of analysis: credit quality, portfolio construction, fund management and regular post-rating inspection.

- *Credit quality*. Credit quality is evaluated on three levels: what the fund can buy, who it can do business with (including the exact nature of business) and who it can appoint to keep its assets safe. The rating criteria therefore stipulate the fund's asset range and restrictions (such as quality, type and currency), acceptable counterparty risk (for all transaction based investments) and acceptable choice of custodian[2].

- *Portfolio construction*. The most complex part of analysing a money market fund is judging a fund's sensitivity to changing market conditions and, therefore, gauging a measure of its ability to shield investors from adverse market swings. All money market securities (rated or otherwise) are subject to price fluctuations – based on interest rate movements, maturity, liquidity and the supply and demand for each type of security. Quantifying the cumulative effect of these is crucial to assessing overall portfolio performance. Capital preservation is expressed in terms of the stability or constant accumulation of the fund's net asset value per share. As such, both formats are scrutinised for potential deviation in the fund's market value. Determination of market value, or portfolio price exposure, starts with the examination of susceptibility to rising interest rates. A critical component of this is the fund's weighted average portfolio maturity (or WAM), which is specifically restricted by rating category. IMMFA members' funds, which are triple-A rated, must stay within a 60-day limit, an optimal level derived from portfolio stress testing analysis. Other variables evaluated include instrument liquidity, index and spread risk, portfolio diversification, potential dilution of investor holdings and portfolio valuation.

- *Fund management*. The rating process requires an assessment of a fund manager's operations – in common parlance, the front, middle and back offices. Key areas of interest are the fund manager's level of experience, the stated investment objectives, portfolio management techniques, risk aversion strategies, operating procedures and internal controls, including disaster recovery. Owing to the precision necessary in running a money market fund successfully, every aspect of the fund's management must be able to withstand close scrutiny and demonstrate effective, ongoing integrity of operation.

- *Portfolio inspection*. Owing to the constraints of the rating criteria and the extremely low margin of error permitted at the level of fund valuation, rated money market funds are contractually obliged to supply all portfolios for periodic rating agency

[2] The portfolio of a triple-A rated money market fund is entrusted to a third-party custodian, independent of the fund manager. Therefore, even in the event that the fund manager were to become insolvent (say, because of an operational failure), the portfolio would remain intact and secure.

inspection: fund surveillance, as it is called. Any infringement or potential concern is communicated to the fund and timely rectification is required.

From the above, we believe that the fund rating incorporates the concepts of default probability (i.e. credit risk) and loss (i.e. portfolio construction).

Furthermore, we would like to highlight two other features of triple-A rated money market funds which are relevant to their credit risk. First, units in a triple-A rated money market fund represents an interest in its long-only, unleveraged portfolio. Therefore, any credit risk borne by investors solely relate to the credit risk of the money market instruments comprising the portfolio. Second, all units in a triple-A rated money market fund carry the same credit risk exposure to its portfolio, in contrast to securities issued by corporates (and most other issuers, for that matter) which often carry differing rights and entitlements in the event of a default. Consequently, whereas all investors in a triple-A rated money market fund are exposed to the same credit risk, investors in securities issued by a corporate are subject to different levels of credit risk depending on the rights and entitlement of the security in question.

We would welcome the opportunity to explain the operation of money market funds in more detail and answer any questions that may arise from our response, should further clarification be required.

Yours faithfully

Gerard Fitzpatrick