



ABI MONEY MARKET SECTOR REVIEW

Feedback to the consultation paper proposing the introduction of a new ABI money market sector

SUMMARY

1. This feedback statement attempts to summarise the views received from consumer groups, advisers, firms and other interested parties about our proposal to create a new money market sector in addition to the existing money market sector. This statement details the final decisions as taken by the Investment Classification Committee on this issue.
2. We received twenty-seven responses to the consultation paper; of which five were received directly from consumers, fifteen from member firms and six from associations. We also received a formal response from the Financial Services Authority and discussed our proposals with the Bank of England. Further discussions were held with many other companies and organisations. The ICC would like to thank all those that gave up their time to contribute to this process.
3. After careful consideration the ICC has decided to introduce a new sector for money market funds that have stricter limits on the instruments that they may invest in and a limit on the length of maturity of those instruments. Funds in this new sector must also have stability of capital as the principal and overriding objective.
4. The new sector will be called the Deposit & Treasury sector and the full definition is below:
 - Funds in this sector are not 'no risk' funds but to satisfy the sector parameters they must have stability of capital as the principal and overriding objective.
 - Funds must invest 100% of their assets in sterling denominated permitted instruments.
 - Permitted instruments must not have a final maturity greater than 12 months.
 - The investment quality of each of the permitted instruments must be closely matched with the fund's objective of stability of capital.
 - The permitted instruments for this sector are:
 - a. Current Account Cash
 - b. Time Deposits (including call accounts)

- c. Certificates of Deposit
 - d. UK Treasury Bills
 - e. UK Short Gilts
- Insured funds that track a recognised cash index, such as the Bank of England base interest rate, can be included.
5. The new sector will be launched on 1st November and all funds that wish to reside in the new sector must not hold any ineligible assets for the sector from this point on. A further eight months, to July 2010, will be provided to enable firms, if required, to alter their fund objectives and communicate any fund changes to policyholders.
 6. Track record will be retained for those funds that have continually met the sector requirements in the past five years. The Investment Classification Committee will consider those that have not historically met the new sector's requirements on a case-by-case basis.

THE ABI SECTORS

7. The ABI Sectors are a system for the classification of life and pension funds. Every sector sets out clear criteria that must be followed by funds wishing to belong to that sector. The ABI Life and Pensions Fund Sectors currently consists of 34 different sectors, and there are over 7000 funds classified into the sectors. The Sectors aim to help consumers, and advisers, find investment funds with similar investment strategies so they can choose the best fund for their needs.
8. The ABI's Investment Classification Committee (ICC) acts as the impartial governance mechanism for the ABI Sectors and is made up of experts from ABI member companies and fund data providers. The ICC is responsible for developing the criteria for the Sectors. It also monitors whether investment funds comply with these criteria. This monitoring process involves a detailed analysis of the assets held by each fund to ensure that they continue to meet the criteria for the sector they are in.

BACKGROUND TO THE REVIEW

9. The money markets are the global financial markets for short-term borrowing and lending. They provide short-term funding for the global financial system through the provision of a variety of financial instruments, including asset-backed securities. The ABI Life and Pensions Sectors have included a money market sector since 2001 for funds that hold these instruments. The definition of this has been largely unchanged in this time and it allows the inclusion of certain asset backed securities.
10. The closing of the market for some asset-backed securities has placed constraints on the liquidity of some of the money market funds that had holdings of these

instruments. This, together with falling market values for these instruments, has led to some funds in the money market sector delivering negative returns. Investors in these funds were often unaware that such incidences could occur.

11. The ABI therefore commissioned an urgent review of the money market sector on 18 February 2009. The purpose of the review was to look at the changing and volatile market conditions facing the money market sector, analyse what could be done to help consumers better understand what these funds invest in, and explore whether we could assist consumers to more easily identify funds that meet their risk preferences.
12. A consultation paper detailing the ABI's proposal to launch a new sector for money market funds with stricter limits on the type of instrument that they may hold was published on 8th May. The consultation received twenty-seven responses, of which five were received directly from consumers, fifteen from member firms and six from associations. We also received a formal response from the Financial Services Authority and discussed our proposals with the Bank of England. Further discussions were held with many other companies and organisations. The ICC discussed the content of these responses in a number of meetings before making the final decisions on the proposals.
13. This paper attempts to summarise the responses the ICC received to the consultation and set out how the ICC intends to proceed.

THE PROPOSAL

Question 1: Do you agree with the decision to create a new money market sector to help consumers find greater security?

14. The consultation proposed the creation of a new sector for money market funds that have the principal objective of the stability of capital in addition to the existing money market sector. Funds in this sector may not be 'no risk,' as funds will still be exposed to credit risk and a degree of liquidity risk, also in a very low interest rate environment it is possible that the returns may not exceed the charges levied for some funds within the sector. But funds in this sector will be lower risk than those funds that invest in other money market instruments with higher yields.
15. We asked respondents whether they agreed in principle with our proposals. Respondents were very much in favour with our proposals and only 12% of respondents disagreed with the generality of what we were proposing. Those that were against the proposal favoured either awaiting the work that is being conducted at the European level or simply tightening the existing sector definition. The consumers that responded to the consultation were unanimously in favour of the proposal.
16. Considering the positive response, the ICC have decided to launch a new money market sector for funds that have the principal objective of the stability of capital.

Funds in this new sector will only be allowed to invest in a limited number of instruments and will face stricter requirements on the duration of those instruments.

THE WIDER ABI MONEY MARKET SECTOR

Question 2: Do you believe that leaving the current money market sector definition as it is, pending developments in Europe, is the right approach?

17. The consultation document made it clear that it was the ICC's preference to leave the existing money market sector as it was for the time being. The group would await the publication of the review of European Money Market Funds being conducted by the European Fund and Asset Management Association (EFAMA) and the Institutional Money Market Fund Association (IMMFA). The vast majority of respondents welcomed this approach.
18. EFAMA and IMMFA have published their recommendation for a European classification and definition of Money Market Funds. They recommend the creation of two broad definitions of money market funds – “short-term” money market funds and “regular” money market funds. These definitions will allow funds to continue to use all the instruments traded on the money markets, including asset-backed securities, but they will impose restrictions on the average duration of all the instruments held within the fund's portfolio and restrictions on the durations of individual instruments.
19. EFAMA and IMMFA have committed to promoting the use of these definitions across Europe, and the Investment Management Association (IMA) – the UK member of EFAMA – is consulting on the recommendations. The ICC intends to cooperate with this consultation and consider whether it too should revise its definition of the wider money market sector. The ICC also intends to consider whether it should rename the wider money sector in order to minimise the possibility of misunderstanding amongst consumers. The ICC aims to conclude this work by the end of 2009.

THE NEW SECTOR

Question 3: Do you agree with the proposed definition of the new sector, if you do not, what changes do you think should be made and why?

20. The revised definition of the new money market sector is shown below:
 - Funds in this sector are not ‘no risk’ funds but to satisfy the sector parameters they must have stability of capital as the principal and overriding objective.
 - Funds must invest 100% of their assets in sterling denominated permitted instruments.
 - Permitted instruments must not have a final maturity greater than 12 months.

- The investment quality of each of the permitted instruments must be closely matched with the fund's objective of stability of capital.
 - The permitted instruments for this sector are:
 - a. Current Account Cash
 - b. Time Deposits (including call accounts)
 - c. Certificates of Deposit
 - d. UK Treasury Bills
 - e. UK Short Gilts
 - Insured funds that track a recognised cash index, such as the Bank of England base interest rate, can be included.
21. The new definition, whilst similar to the one that was consulted on, has changed in a number of ways. This new definition requires capital stability as the principal and overriding objective, rather than simply the principal objective. We have extended the definition to include current account cash held by funds and confirmed that time deposits includes call accounts. A call account is a deposit with a financial institution without a fixed maturity date that can be withdrawn at any time.
 22. In response to points made by consumers, other organisations and comments made by the regulator we have decided to exclude commercial paper from the definition. The ICC took this decision after careful consideration of the appropriate balance between consumer demand for a sector comprised of relatively simple funds, and retaining the ability of the managers to diversify. After conducting analysis of the funds that would reside in the new sector and weighing up the clear consumer demand for a simpler sector, we decided to exclude commercial paper.
 23. The final change to the definition was the addition to the sector definition of the parameter regarding insured funds that track a recognised cash index. These are funds, also known as non-property funds, that do not have any direct holdings but track a recognised cash index and are on the insurance company's balance sheet.
 24. Analysis of the life and pension money market funds, conducted on behalf of the ABI by Lipper, suggested that at least 70 funds of the 224 primary money market funds would qualify to reside in the new sector once it is launched.
 25. The new sector will be in launched on 1st November and all funds that wish to reside in the new sector must only hold the eligible assets for the sector from this point on. A further eight months, to July 2010, will be provided to enable firms, if required, to alter their fund objectives and communicate any fund changes with policyholders.

26. Track record will be retained for those funds that have continually met the sector requirements in the past five years. Those that have not will be considered on a case-by-case basis.

Question 4: What should the new sector be called; the Capital Stability Fund Sector or the Treasury and Deposit Fund Sector? If you think neither of those names is appropriate, what should the sector be called?

27. The consideration of the name of the new sector was one of the more contentious issues under consideration. Of the two names suggested by the consultation paper, respondents marginally favoured the name 'Treasury and Deposit Fund Sector.' However, the majority of respondents did not like either of the names. The alternative suggestions from respondents highlighted the less complex nature of the eligible investments in the new sector, including; 'cautious money market,' 'simple money market' and 'cash funds sector.'
28. Given this impasse, the ICC took the opportunity to seek insight from member company's internal resources and to further discuss the issue with the FSA. Some felt that consumers would favour the term 'cash.' However, although a number of the eligible instruments in the new sector behave like 'cash' and are not volatile, they are not 'cash' in the way that a consumer understands the term. Using the term cash therefore creates a substantial risk of consumers misunderstanding the full nature of the fund. We therefore decided not to include the term cash at all.
29. The ICC decided to call the new sector 'Deposit & Treasury.' This name, whilst not as simple as a name such as 'cash funds sector,' does benefit from the fact that consumers are unlikely to be misled by the name. The eligible instruments for the sector are deposit type instruments and UK Government Treasuries and the sector name reflects this state of affairs.

ADDITIONAL COMMENTS AND QUESTIONS

Other Instruments

Question 5: Should Asset Backed Commercial Paper be included as a permitted instrument in the new sector and, if so, why?

30. The consultation paper proposed that asset-backed commercial paper would not be an eligible instrument in the new sector for a number of reasons. Firstly, the value of Asset-Backed Commercial Paper is tied to the value of the underlying assets. In the event of disruptions in the underlying market the perceived quality and risk of the paper is affected. Since funds in the new sector are seeking capital stability, we did not believe that it would be appropriate to include an instrument with that additional risk.
31. Secondly, consumers and advisers are conscious that asset-backed instruments have been at the epicentre of the current market disruptions. The ICC did not,

therefore, feel it would be appropriate to include an instrument with such connotations when consumers are seeking greater security.

32. The majority of respondents favoured our approach and backed our position on these types of instrument. A number of respondents also noted that whilst there are numerous examples of very high quality asset-backed commercial paper, retail customers are implacably opposed to the inclusion of such instruments.
33. Those that opposed the exclusion felt that it would limit fund managers' access to assets with appropriate risk profiles. The ICC were sympathetic to this view, but felt that inclusion of such an instrument was at odds with our aim to create a sector that only allows funds to hold simpler instruments. Indeed, the ICC has gone further and excluded commercial paper entirely.

Question 6: Should repurchase agreements collateralised against Government securities be included as a permitted instrument in the new sector, and if so why?

34. The consultation proposed excluding repurchase agreements collateralised against Government securities due to the relative complexity of these instruments, and because they are not widely understood by consumers or advisers. The purpose of the new sector is to provide a sector that can be easily understood by consumers. The ICC did not feel that repurchase agreements would meet this requirement.
35. The majority of industry respondents favoured the inclusion of such instruments in the new sector. They felt that repurchase agreements collateralised against Government securities enable efficient portfolio management and provide liquidity. All responses we received from consumers backed our decision to exclude these instruments from the new sector. A number of industry practitioners were also sceptical about the inclusion of such an instrument in a sector for retail customers seeking simplicity. They also pointed out that the Government collateral might be of any duration, and in the unlikely event of a default the fund may be left holding assets that do not comply with the sector definition and may face an unexpected price risk.
36. The ICC carefully weighed up these conflicting views and ultimately decided to maintain the simplicity of the sector and retain the exclusion of repurchase agreements.

Question 7: Are there any other money market instruments that should be included as a permitted instrument in the new sector, and if so why?

37. We asked respondents to the consultation to suggest any other instruments that should be added to the definition. The two suggestions that we have decided to include in the new sector definition are current account cash and a clarification that time deposit includes call accounts. Current account cash is simply the cash held by funds before purchasing other instruments. A call account is a deposit with a financial institution without a fixed maturity date that can be withdrawn at any time.

38. Other suggestions that were made included short dated Floating Rate Notes (excluding asset-backed FRNs), investment into AAAM rated money market funds and short dated bonds. The ICC felt that inclusion of FRNs and short-dated bonds was at odds with our aim to create a sector that only includes funds that hold relatively simple instruments.
39. The discussion regarding AAAM rated money market funds was much more contentious. These funds can use a wide range of very short dated instruments to maintain a stable value whilst delivering 'cash like' returns. Proponents of their inclusion argued they should be included because they are managed to minimise risk and deliver stable values. However, opponents argued that these funds hold many of the instruments we have deemed as not compatible with our aim of a simple sector. The ICC therefore decided that such investments should not be included in the new sector.

Quality, liquidity and duration

Question 8: Do you agree with the credit quality statement within the current proposed definition?

40. The consultation paper proposed that the new sector would not include a rating qualification for the instruments held by funds in the sector. We did, however, make it clear in the sector parameters that instruments should be of sufficient quality to be commensurate with the objective of maintaining capital stability. We asked respondents whether they agreed with the statement on credit quality in the proposed definition. The vast majority of respondents agreed with the statement contained within the new sector's proposed definition. The ICC therefore decided to include the statement as proposed.

Question 9: Do you think that a specific liquidity statement or requirement should be added to the proposed sector definition? If so what should it be?

41. The proposed definition included in the consultation did not include a specific statement on liquidity, as we believe that fund managers should manage their liquidity according to their likely needs.
42. A majority of respondents did not favour including a specific liquidity statement. This was largely due to the feeling that the existing Conduct of Business (COBS) regulations render such a statement unnecessary. COBS rule 21.2.2R require funds to have the necessary resources to be available to claims as they fall due. Those respondents that favoured the inclusion of a specific statement felt that this would be a sensible mechanism to ensure that capital stability is maintained. The ICC concluded that an additional statement on liquidity is not necessary.

Question 10: Do you think the 12-month maturity limit requirement for instruments held by funds in the new sector is appropriate? If not, how would you like to change it?

43. The consultation proposed a final maturity limit of 12 months for instruments held by funds in the new sector. The vast majority of respondents were broadly in favour of this proposed duration. Those that opposed the definition argued that the inclusion of a weighted average maturity (WAM) would be sufficient. The ICC felt that a WAM requirement, whilst effective, is not simple for consumers to understand and would allow funds to potentially hold instruments of a longer duration than the ICC felt appropriate. It did not, therefore, favour adopting a WAM requirement.
44. Those respondents broadly in favour of the 12-month duration suggested a slight increase to ensure that anomalies, such as bank holidays, leap years, and clearing delays can be taken into account. The ICC, whilst sympathetic to these suggestions, felt that a 12-month duration would be clearer for consumers to understand than 13-months, 375 days or any other similar duration.

Diversification

Question 11: Should the definition include a statement on, or a stipulated level of, counterparty exposure?

45. The definition included in the consultation did not include a comment about the diversification of fund holdings amongst counterparties. This is because funds must be managed with the objective of stability of capital. Funds with this objective must therefore be managed with the appropriate level of counterparty exposure.
46. The majority of respondents did not favour such an inclusion because many expected these risks to be managed at both fund and group levels and monitored accordingly. Additionally, regulations exist on counterparty risk for investment funds that follow the rules set out in the collective investment sourcebook. Those that did favour a statement on counterparty exposure felt that such a statement would add clarity for consumers. The ICC concluded that no such statement was necessary, as funds must have the overriding objective of capital stability and this implies a diversification of counterparties.

Non-property linked funds and guaranteed funds

Question 12: Should non-property linked funds that meet the proposed sector's objective of stability of capital be included in the sector, at the discretion of the Investment Classification Committee?

47. Non-property linked funds are insurance-based investment funds that do not directly hold any underlying assets. They can be constructed like a money market fund and aim to track a published index, such as the Bank of England base rate or the average building society rate. The original consultation proposed including these funds if they tracked a recognised cash index, but at the discretion of the ICC.
48. The majority of respondents were sceptical about the inclusion of such funds within the new sector. However, those consumers that did respond to this question

favoured accessing such a fund. Indeed, one consumer stated that this was “*exactly the sort of fund that I would want to invest in.*” Discussions with the regulator also suggested that such funds would be an appropriate inclusion in the new sector.

49. The ICC therefore decided that these funds could be included in the new sector at the discretion of the ICC. Firstly, these funds are on the balance sheet of Life Insurance companies and they have promised to meet any obligations. Secondly, the FSA’s rules require companies to cover their index-linked liabilities for funds of this sort with assets that represent that index (FSA Rule INSPRU 3.1.58 R). Thirdly, these funds track recognised cash indices, such as the Bank of England base rate, which makes them simple for consumers to understand.
50. The ICC has therefore proposed adding the below additional parameter to the new sector’s definition:
 - Insured funds that track a recognised cash index, such as the Bank of England base interest rate, can be included.

Inclusion of such funds will be conducted on a case-by-case basis and the ICC will make the final decision.

Question 13: Should money market funds with an explicit guarantee that the daily unit price of the fund will not fall be included in the sector even if they do not strictly meet the sector criteria? If yes, how should the quality of guarantee be evaluated?

51. The vast majority of respondents opposed this proposal. Respondents felt that the guarantee is only as good as the guarantor and it would not be appropriate for funds in this sector to require such a judgement to be made.

TIMETABLE

Question 14: What would be the ideal transition timetable for the introduction of a new sector, and what could be done to speed up this transition without imposing disproportionate costs?

52. The new sector will be in launched on 1st November and all funds that wish to reside in the new sector must only hold the eligible assets for the sector from this point on. A further eight months, to July 2010, will be provided to enable firms to, if required, alter their fund objectives and communicate any fund changes with policyholders.
53. Fund managers will be contacted between now and 1st November to confirm whether they wish to nominate their funds for inclusion in the new sector. Track records will be retained for those funds that have continually met the sector requirements in the past five years. Those that have not will be considered on a case-by-case basis.