MOODY'S
INVESTORS SERVICE

SPECIAL COMMENT

Money Market Funds: ABCP Investments Decrease

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Summary Opinion

Since 2007, the investment allocations of Moody's-rated money market funds (MMFs) to asset-backed commercial paper (ABCP) have been decreasing continuously. The reasons causing leading portfolio managers to avoid ABCP investment are: (i) investors are averse to structured finance securities after losses related to Structured Investment Vehicles (SIVs) during the financial crisis; (ii) ABCP is viewed by some managers as contrary to a fund's objectives, which is to maintain liquidity; (iii) the overall credit quality of financial institutions providing liquidity to ABCP conduits has deteriorated; and (iv) the lack of disclosure of ABCP and opacity in terms of conduit structure prevents investors from fully understanding the risks of ABCP.

Although steps have been taken to scale back the funds' risk profiles and ABCP investments – prompted by the prevailing credit conditions and euro-area sovereign debt concerns – exposure to financial institution debt remains high. A credit-negative factor is that by 2007, the average long-term bank deposit rating of the global universe had deteriorated to A1 from Aa2. However, most MMFs managed down European bank exposures, often redeploying funds away from stressed European banking systems and into stronger European banks and banks in non-European countries.

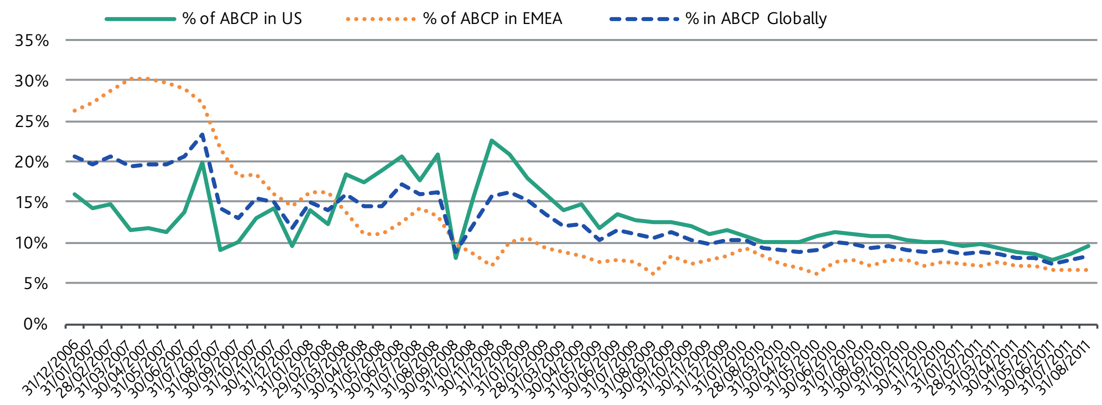
In this challenging operating environment, we expect that conservative portfolio strategies will persist and, as a consequence, ABCP investments will remain limited. Besides the lower demand for ABCP, the exposure of MMFs to this asset class has also declined due to a decrease in the number of available conduits that meet the quality criteria of MMFs. Larger conduits can issue ABCP with relative ease, whilst smaller conduits – backed by lower credit-quality financial institutions – have found ABCP issuance more challenging.

We base our analysis on the prime Moody's-rated US and European MMFs. This homogenous universe comprises 82 European and 77 US MMFs – all but one rated Aaa-mf – whose assets under management totalled US$1.2 trillion at the time of our analysis.

MMFs' investments in ABCP have decreased since 2007…

When ABCP investments peaked in 2007, they accounted for nearly 25% of prime fund assets globally. Since then, MMF exposure to this asset class has trended downwards to 8.3% on average at the end of August 2011 (see Chart 1).

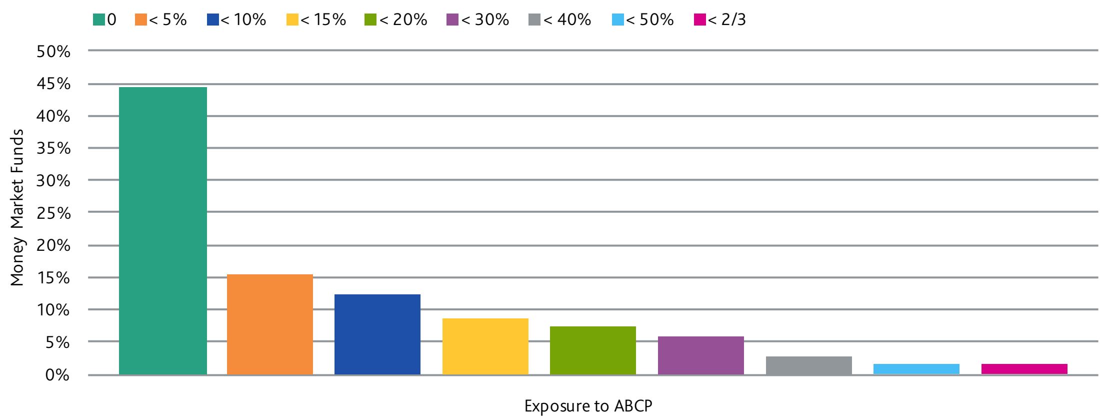
CHART 1
Evolution of Moody's-rated US and European Prime MMFs' Investments in ABCP



Source: Moody's Investors Service

Some MMF managers have entirely eliminated ABCP from their approved list, although most managers have only limited their ABCP investment allocations. Of the rated funds, 45% have no ABCP exposure, whilst 72% have an exposure of less than 10% (see Chart 2).

CHART 2
Distribution of Moody's-rated US and European Prime MMFs' Exposure to ABCP
Distribution of MMFs' exposure to ABCP



Source: Moody's Investors Service

Usually, there are three reasons that cause leading portfolio managers to avoid ABCP investment:

» Their investors have a general aversion to structured finance securities after the SIV crisis and its effects in terms of credit impairments and losses;

» ABCPs are considered by some portfolio managers as contradictory to one of the key objectives of MMFs, which is to maintain daily liquidity (i.e., investors can redeem shares at any time);

» Some market participants still view ABCPs as very complex structures, discouraging them from investing, as they do not necessarily have the resources to analyse the underlying risks.

With respect to demand-driven reasons, there is also a reduction in the number of available conduits that meet the quality criteria of the MMFs' credit teams, because the ABCP market has experienced "tiering". In other words, larger conduits have found it relatively easy to issue paper, whilst smaller conduits sponsored by lower credit quality financial institutions have found it difficult to issue.

However, some asset-management firms remain positive on the ABCP sector (19% of Moody's-rated prime MMFs have an exposure above 20%), as they believe that ABCP helps funds to reduce their risk profile. This is because they anticipate that the loss-given default would be limited due to the access to collateral. Generally, the market participants that hold this view are large, global players with significant credit resources. The biggest issue for these portfolio-management companies comes from the limited supply in terms of the number of conduits and their size, as many ABCP sponsors have sought to consolidate outstanding programs, thus limiting the number of available issuers. In fact, even the top-tier conduits have reduced their outstanding balances by selecting their assets more carefully (avoiding Collateralised Debt Obligations (CDO), for example) and by originating fewer suitable and eligible assets.

Of the funds we rate, the most popular ABCP programs globally are those that are either large and stable, typically offered by top tier banks (see Table 1), or those that benefit from a sovereign guarantee.

TABLE 1

20 Largest ABCP Holdings Held by the Moody's-rated US and European Prime MMFs

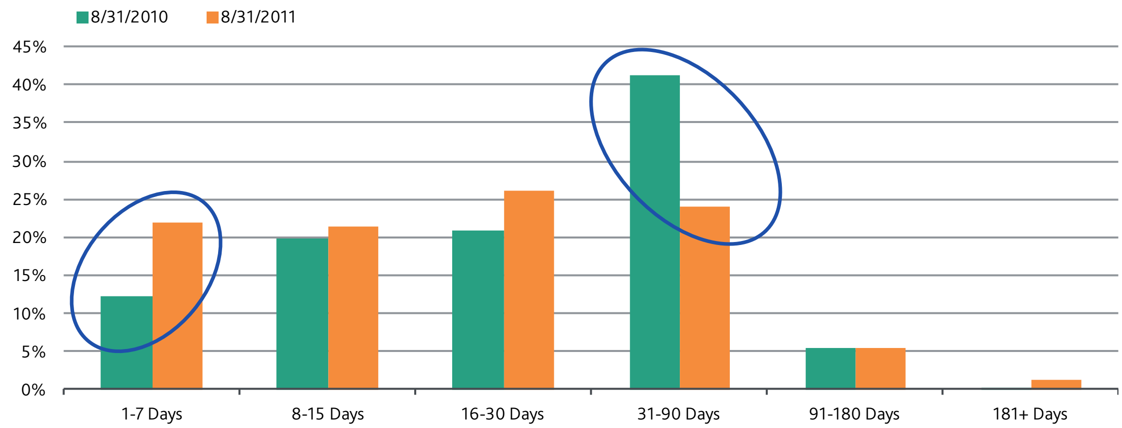
ABCP Programs	Sponsors / Support Providers	$ Par Value	%age of Global Holding	%age of ABCP Exposure
Kells Funding LLC	DEPFA Bank / FMS Wertmanagement	7,604,805,000	0.64%	7.75%
Atlantis One Funding Corporation	Rabobank	7,220,413,000	0.61%	7.36%
Grampian Funding	Bank of Scotland plc	5,530,438,434	0.46%	5.63%
Argento Variable Funding	Lloyds TSB Bank plc	4,181,963,016	0.35%	4.26%
LMA S.A.	Credit Agricole CIB	3,587,747,435	0.30%	3.65%
Thames Asset Global Securitization No. 1, Inc	Royal Bank of Scotland plc	3,028,705,781	0.25%	3.09%
Atlantic Asset Securitization LLC	Credit Agricole CIB	3,022,115,000	0.25%	3.08%
Regency Markets No. 1 LLC	HSBC	2,917,766,869	0.25%	2.97%
Barton Capital LLC	Societe Generale	2,807,334,000	0.24%	2.86%
Gemini Securitization Corp LLC	Deutsche Bank	2,806,809,000	0.24%	2.86%
Cancara Asset Securitisation	Lloyds TSB Bank plc	2,714,705,249	0.23%	2.77%
Straight-A Funding, LLC	Federal Financing Bank	2,524,078,000	0.21%	2.57%
Matchpoint	BNP Paribas	2,469,456,660	0.21%	2.52%
Northern Pines Funding LLC	Deutsche Bank	2,437,999,931	0.20%	2.48%
Sheffield Receivables Corporation	Barclays Bank Plc	2,297,708,506	0.19%	2.34%
Jupiter Securitization Company LLC	JPMorgan	1,925,101,286	0.16%	1.96%
MetLife Short Term Funding LLC	MetLife Insurance Company	1,829,088,608	0.15%	1.86%
Amsterdam Funding Corporation	Royal Bank of Scotland plc	1,747,420,438	0.15%	1.78%
Nieuw Amsterdam Receivables Corporation	Rabobank	1,617,276,941	0.14%	1.65%
Govco Incorporated	Citibank	1,586,824,536	0.13%	1.62%

MMFs favour investments in fully supported programs sponsored by highly rated financial institutions that either (i) have a strong track record; or (ii) benefit from government support, such as Kells Funding and Straight A Funding. Generally, investment is made in structures that investors believe will be supported by banks, as opposed to standalone enterprises.

Consistent with the reduction in their maturity profiles, the bulk of the prime funds' investments in ABCP are within one month, at 72% of the investments (see Chart 3).

CHART 3

Maturity Profile of the ABCP Held by the Moody's-rated US and European Prime MMFs



Source: Moody's Investors Service

...and are not expected to increase in the near future

Overall, macroeconomic conditions remain challenging for MMFs. Their operating environment is difficult, characterised by (i) historically low interest-rate levels; (ii) declining assets under management; (iii) global credit uncertainties; and (iv) a negative outlook on most financial institution sectors and/or banking systems.

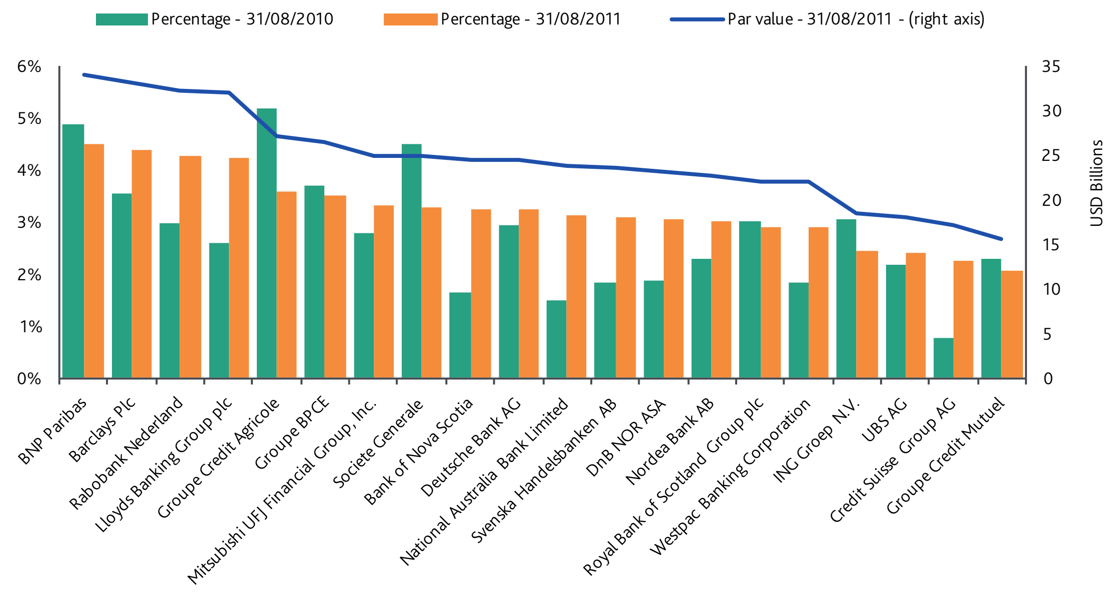
In addition, regulatory uncertainties persist. Although the SEC in the US and the CESR in Europe have tightened MMF regulations, further reform will be needed to address the systemic risk that MMFs pose. The Financial Stability Board's report on the shadow banking system released at the end of October 2011 clearly states that the role of MMFs in the financial markets will be heavily scrutinised by the International Organization of Securities Commission, which is due to report on the issue by July 2012.

In our view, the key issue is the direction in which regulators choose to move that could include: (i) requiring shifts to variable NAV vehicles; (ii) imposing capital and liquidity requirements on constant NAV MMFs; and/or (iii) whether other approaches should be taken. Therefore, in the near term, MMFs will continue to operate in a tentative market and regulatory environment and any resurgence in MMF investment in ABCP is unlikely in the short term.

Context: Funds scale back risk profiles, but financial institution concentrations rise

The prevailing global credit conditions – and in particular the euro-area sovereign debt concerns – have driven MMF managers to reduce their funds' risk profiles. Whilst MMFs remain heavily exposed to financial institutions in general, MMFs have actively managed their portfolios in recent months to exit exposures to banks in sensitive European countries and increase their exposures to banks in other countries, such as Canada, Australia and Japan.

CHART 4
20 Largest Exposures of Moody's-rated US and European Prime MMFs



Source: Moody's Investors Service

The contraction in the supply of outstanding (and eligible) highly rated and short-dated securities has exacerbated sector and issuer concentrations. To illustrate this, the top 20 issuers in rated prime MMFs are all banking institutions. Together, these 20 issuers account for 65% of all the investments held by MMFs, up from 58% in 2010. In addition, we note that this figure excludes liquidity providers, sponsors of ABCP programs and repo counterparties that would further elevate these exposure levels.

MMFs' operating environment under stress due to global bank downgrades

MMFs remain heavily exposed to financial institutions (see Chart 4). The average long-term bank deposit rating of the global universe deteriorated to A1 in October 2011 from Aa2 in November 2007 and the overall outlook for this sector remains negative (see Table 2). In Europe, during the first nine months of 2011, out of the 157 rating actions on investment-grade financial institutions taken by Moody's, 135 resulted in rating downgrades. However, most MMFs have been able to manage down European bank exposures, often redeploying funds away from stressed European banking systems and into stronger European banks and banks in countries such as Canada, Australia and Japan.

TABLE 2

Global Comparison of Banking System Outlooks and Evolution of the Average Long-Term Bank Deposit Ratings

Country	Average Long-Term Bank Deposit Ratings* November 2007	Average Long-Term Bank Deposit Ratings* October 2011	Banking System Outlook October 2011
Belgium	Aa2	A1	Negative
Finland	Aa1	Aa2	Negative
France	Aa1	Aa3	Stable
Germany	Aa2	A1	Negative
Italy	Aa3	A3	Negative
Ireland	Aa3	Ba1	Negative
Luxembourg	Aa2	A1	Negative
Netherlands	Aa1	Aa3	Negative
Portugal	Aa3	Ba2	Negative
Spain	Aa2	A1	Negative
Sweden	Aa1	Aa3	Negative
Switzerland	Aaa	Aa2	Stable
United Kingdom	Aa1	A1	Negative
United States	Aa1	A1	Negative
Global Universe	Aa2	A1	

*Weighted by assets

Source: Moody's Investors Service

Additional factors strengthen MMFs' strategies and further reduce ABCP investments

Regulations

In 2010, the SEC amended Rule 2a-7 of the Investment Company Act of 1940 governing MMFs. Taken as a whole, these amendments further strengthen several fundamental credit drivers of MMFs; these are, amongst others, credit quality, interest-rate sensitivity, liquidity, disclosure and operations. In our view, these measures reduce MMF's overall risk profiles.

Similarly, in Europe, the Committee of European Securities Regulators[1] guidelines became effective as of 1 July 2011. However, money market funds that existed before this date benefit from a grandfathering period until 31 December 2011 to comply with the new rules.

In addition, amendments have been made to the Institutional Money Market Funds Association (IMMFA)'s Code of Practice. Both these developments aim to achieve similar de-risking objectives (see Table 3).

[1] CESR changed its name to European Securities and Markets Agency (ESMA) in January 2011.

TABLE 3:
MMF Regulatory and Industry-related Amendments

Portfolio factor	SEC Requirements	CESR Requirements		IMMFA Requirements
Credit Quality	Second tier securities limited to 3%, down from 5%, and no more than 0.5% per issuer versus 1% previously, maturing within 45 days.	Investments in P-1 or P-2 rated securities		
Maturity	1. WAM ≤60 days, down from 90 days	Short-Term MMF	MMF	1. WAM ≤60 days
	2. WAL ≤120 days (new measure)	1. WAM ≤60 days	1. WAM ≤180 days	2. WAL ≤120 days
		2. WAL ≤120 days	2. WAL ≤1 year	
		3. Residual maturity of investment ≤397 days	3. Residual maturity of investment ≤2 years	
Diversification	Second tier securities limited to 0.5% per issuer	None		1. Max. family exposure (ex. ABCP) ≤10% for instruments with a maturity ≤ 5 days, and 5% otherwise
				2. Max. exposure per repo counterparty ≤25%
Liquidity	1. 10% within 1-day	None		1. 5% within 1-day
	2. 30% within 7-days			2. 20% within 5-days
	3. Illiquid securities limited to 5%			3. Illiquid securities limited to 10%
Disclosure	1. Monthly posting of holdings on website	None		1. Disclosure of cumulative %age of securities within: 1 day / 1 day to 1 week / 1 week to 1 month / to 3 months / 3 to 6 months / 6 months to 1 year / over 1 year
	2. Mark-to-market NAV with 60 day lag			2. The %age of the fund held by the top 10 shareholders supplied to shareholders on request
Operations	1. Ability to suspend redemptions in the event of a fund failure	Stress testing		Stress testing
	2. Price per share calculated at market value			
	3. Stress testing			

Outflows and Liquidity

MMFs have been experiencing net outflows for the last 2.5 years. According to the European Fund Asset Management Association (EFAMA), the net outflows from the MMF sector globally over the last 2.5 years were (i) US$640 billion in 2009; (ii) US$710 billion in 2010; and (iii) US$186 billion for H1 2011.

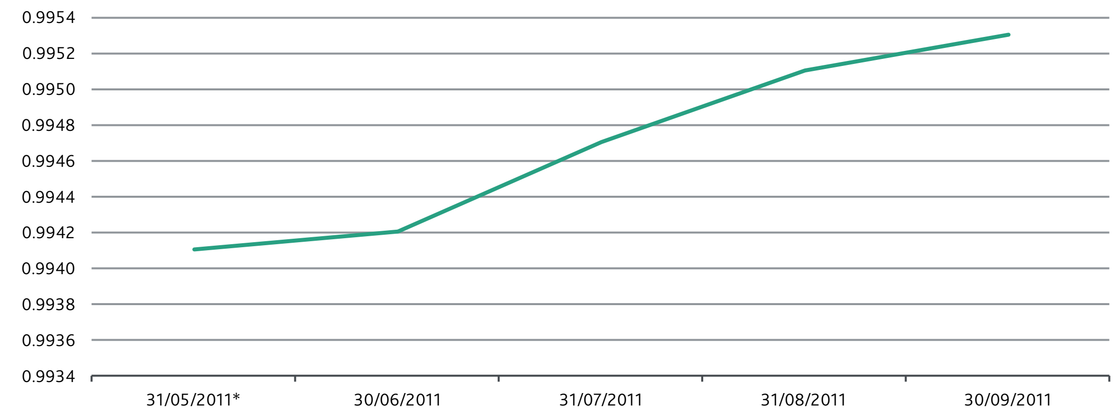
This requires MMF managers to ensure that their funds remain highly liquid, with a conservative asset-allocation profile, in order to meet investors redemptions. In other words, MMF managers have had to "de-risk" their portfolios, reflected in (i) an improved NAV stress test; (ii) a lower WAL; and (iii) increased liquidity buffers. Part of this revised strategy entails limiting their investments in ABCP.

Chart 5 shows the improvement of MMFs stressed NAV, following the steps that MMFs have taken in order to de-risk. The stressed NAV is a key measure that we use when we evaluate a fund's exposure to market risks.[2]

CHART 5

Positive Evolution of Moody's-rated US and European Prime MMFs' Stressed NAV

Stressed Net Asset Value



*This rating factor was introduced in May 2011 at the time the new methodology for MMFs was published.

Source: Moody's Investors Service

Part of the reason why this rating factor has improved is due to the shortening of the funds' weighted-average life (WAL), which is determined by the final maturity date of the underlying assets held by the funds (see Chart 6).

CHART 6

Evolution of Moody's-rated US and European Prime MMFs' WAL

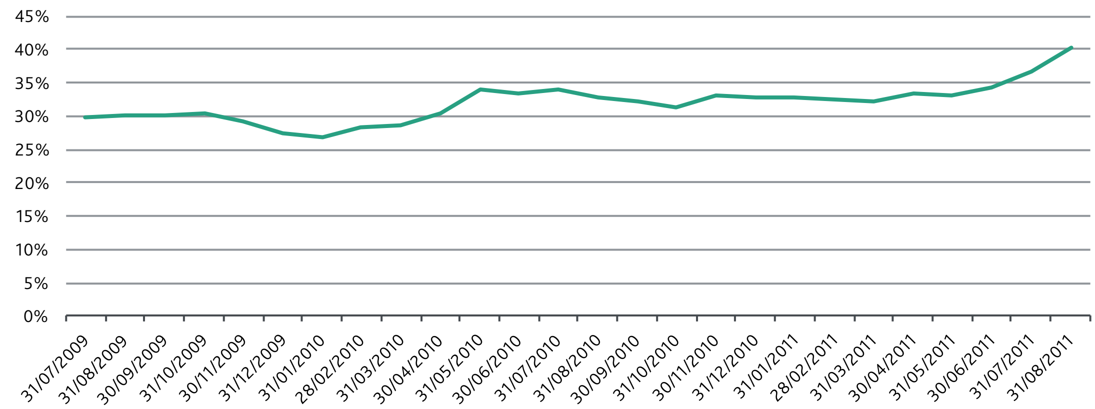
Wals in day

Source: Moody's Investors Service

[2] The objective of the NAV stress test is to measure a fund's sensitivity to a range of potential market stresses. To this end, we simulate three scenarios:
» Yield-curve shift (100 bps curve shift applied to all securities);
» Credit-spread shift (100 bps increase in the spread applied to Aa2 or lower-rated securities);
» Outflows (50% overnight redemption rate); and we then re-calculate the fund's net asset value.

Whilst both US and European regulatory requirements allow MMFs to have a WAL of up to 120 days, the Moody's-rated US and European prime funds' WAL achieved a historical low level close to 45 days at the end of August 2011. The reduction of the WAL is the result of the increase of the funds' liquidity profile. The seven-day liquidity bucket in prime MMFs – significantly above 30% of their assets since the beginning of 2011 – has exceeded the regulatory requirement in response to deteriorating market conditions and volatility in investors asset flows (see Chart 7).

CHART 7
Evolution of Moody's-rated US and European Prime MMFs' 7-Day Liquidity



Source: Moody's Investors Service

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