



## Fitch: Market Challenges Offer 'Lessons' for Rated Money Market Funds

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Fitch Ratings-New York/London-01 October 2008: While money market funds have weathered rapidly escalating redemption increases fairly well, these events raise questions as to whether long-term changes are coming for money market funds, and more specifically, the way money fund portfolios are managed to ensure same-day liquidity and stable NAV, according to Fitch Ratings.

Money market funds - primarily 'prime' funds - have faced unprecedented redemption activity over the last two weeks primarily due to the default of Lehman Brothers Holdings, Inc. (Lehman), the net asset value (NAV) impairment of the Reserve Primary Fund (which had significant Lehman exposure) and the temporary closure of Putnam Prime Money Market Fund (Institutional).

Fitch has been in close contact with Fitch-rated fund sponsors during this market upheaval, requesting daily updates of portfolio composition and redemption activity, with particular focus on prime and off-shore U.S. dollar funds.

### Market Update:

Redemption activity among Fitch-rated funds has been driven largely by reduced investor confidence, as opposed to observable credit deterioration, with 'AAA/V1+' rated funds maintaining high credit quality. However, market-based liquidity for many fund assets proved to be unreliable in the current stress. While redemption activity has stabilized following recent actions by the Federal Reserve and U.S. Treasury, certain prime funds experienced exceptionally high cash outflows during the last two weeks reflecting fund-specific concerns or the effects of the approaching quarter-end. Redemption activity was high for a number of prime and U.S. dollar off-shore funds, while other rated funds, particularly government funds experienced positive net cash flow, evidencing a pronounced flight to quality.

To date, most prime money market funds have been able to meet redemptions through holdings of cash and short-term assets. In a few instances, support from a well-capitalized parent/sponsor has been an additional source of support. That said, the unusually high redemption activity has put pressure on the remaining liquidity resources of some funds and led to an extension of the funds weighted average maturity (WAM) - one measure of liquidity. A limited number of funds saw WAM extend to beyond 60 days, which typically is the outer WAM band for AAA/V1+ rated funds. However, in these instances the combination of supportive actions from fund sponsors and the U.S. Treasury mitigated liquidity concerns.

Fitch views the actions taken by fund sponsors to preserve liquidity and support fund NAV as reasonable in response to unprecedented challenges. In the case of Putnam Prime Money Market Fund (Institutional) and other funds not rated by Fitch, these actions included closure of the fund given the magnitude of redemption requests. While not consistent with money funds' stated redemption policy of same day liquidity, Fitch recognizes that such suspensions allow for a more orderly liquidation of fund assets, and ensure equitable distribution of proceeds.

### U.S. Actions Provide Support:

The Federal Reserve's Asset-backed Commercial Paper (ABCP) Money Market Mutual Fund Liquidity Facility and the U.S. Treasury sponsored Temporary Guarantee Program for Money Market Funds have both provided important sources of liquidity and confidence for money market funds.

The ability of money market funds to put ABCP (on an amortized cost basis) to the Federal Reserve via the MMMF Liquidity Facility has provided immediate and material liquidity relief. As a result, money market funds holding recently illiquid ABCP have access to a reliable liquidity source, greatly reducing pressure on the industry. While the ABCP MMMF Liquidity Facility primarily is designed for money market funds governed under rule 2a-7 of the Investment Company Act of 1940, Fitch understands that fund complexes have also been able to utilize this facility for offshore money market funds in some instances.

On Sept. 29, the U.S. Treasury opened its Temporary Guarantee Program for Money Market Funds, which guarantees the share price of any eligible, 2a-7 registered money market fund that pays a fee to participate. Not surprisingly, given the modest cost to participate, a significant number of leading fund complexes have announced their intention to sign up for the program.

#### Implications for Money Fund Industry:

While it may be too early to draw firm conclusions, Fitch sees potential implications for the industry, for how portfolios are managed and for how Fitch rates money market funds.

One clear observation is the importance of institutional support in times of severe credit and/or liquidity stress. With respect to credit risk, fund sponsors with the financial wherewithal have shown a willingness to provide financial support to maintain a fund's liquidity and NAV. For example, a significant number of fund sponsors acquired or indemnified SIV exposures over the last year, as was the case more recently with respect to Lehman exposures.

The last year has re-emphasized the importance of portfolio diversification in combination with robust, proactive portfolio management. Most funds were able to eliminate or minimize exposure to SIVs and Lehman, by limiting their absolute exposures and/or taking measures to scale back their risk as the credit picture deteriorated. Heightened redemption activity has also emphasized the importance of a diversified, stable investor base. In certain instances, redemption activity was driven by one or several large institutional investors electing to withdraw invested money. Going forward, the industry likely will reflect on 'lessons learned' and modify portfolio management and investor composition practices commensurately.

Fitch's ratings criteria for money market funds - both 2a7 registered and off-shore funds - primarily emphasizes the importance of credit quality, liquidity and interest rate risk management and the fund sponsor's overall portfolio management capabilities. At the same time, financial wherewithal and sponsor support have not been explicit ratings considerations. In light of continuing events, Fitch will consider whether some elements of its criteria, including the importance of sponsor support, will need to be revised.

Additional money market fund commentary (highlighted below) is also available at '[www.fitchratings.com](http://www.fitchratings.com)':

--'Money Market Funds Rated 'AAA/V1+' Well-Insulated from Exposure to Lehman' (Sept. 17, 2008);

--'Fitch Downgrades & Places on Watch Negative Putnam Prime Money Market Fund (Institutional)' (Sept. 18, 2008);

--'Fitch Affirms Federated Prime Obligations Fund: Withdraws Putnam Prime Money Market Fund Ratings' (Sept. 25, 2008).

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