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RESEARCH NOTE: Proposed Moody's Rating Changes for Money Market Funds

Moody's Investors Service, Inc. is proposing changes to the method they use to rate money market funds. Their proposal, which was released on September 7, 2010, was sent to market participants for a 60-day review and comment period, with an expected final review and implementation in early 2011.

This proposal is in response to the issues and resulting government intervention that impacted money market funds in late 2008. Moody's noted the new methodology is designed to provide data that serves as a gauge of a fund's ability to protect investor's assets, provide liquidity and better distinguish between the ratings for money market funds versus long term debt ratings. Their proposal has highlighted and refined the following key elements that are critical to rating a money market fund and understanding its associated risk:

- A fund's underlying asset quality and concentration.
- The level of fund liquidity and related redemption risks.
- The impact of market risk; including a stress-test analysis on the impact of interest rate and yield curve shifts to the portfolio.
- The underlying support offered from a fund sponsor; included in this assessment will be an evaluation of the concentration of sponsor obligations, and the ability to support a fund in the event of significant withdrawals.

Moody's has proposed revising the current money market fund rating scale (i.e. Aaa, Aa, etc.) to a five-level rating system for these "Managed Funds" ranging from MF1+ (strongest) to MF4 (weakest). The terminology change was predicated on adding the layer of portfolio stability analysis, based on the above listed factors, to the current credit analysis. Also, the terminology change was based on language in the Dodd-Frank financial reform act, passed earlier this year, which prevents rating agencies from using the same terminology for different definitions (i.e. the same ratings terminology for both long and short-term obligations).

The proposals do address a number of risk-related issues that PEI has been highlighting in our assessment of money market funds for the last two years; credit, liquidity and market risk. While PEI does not assess credit quality directly, we have evaluated many of the parameters that are related to the quality of the underlying assets in a portfolio. Some examples of data we evaluate are the distribution of portfolio liquidity in order for the fund to be able to accommodate market disruptions, and the need to evaluate the type, quality, and concentration of the underlying holdings along with the associated sponsorship and credit quality.

There has been some published, strongly worded criticism to this proposal, including the concern that if a fund is downgraded from the highest level, the fund company will choose to opt-out of the ratings process. Investors would not have a choice but to concentrate all of their money market holdings in a few funds, leaving the remaining rated funds vulnerable to crisis-driven withdrawals. A second concern that has been expressed by market participants is that institutional investors would need an equivalency table to compare old to new ratings. Alternatively, they will have to revise language in their investment policy statements to accommodate the nomenclature and definitional changes, or exit the holdings in the interim. Moody's has commented that a direct-equivalency

table would not be appropriate because the basis of the proposed ratings will be different than that of the current ratings. Moody's has suggested that a fund currently rated Aaa may be rated MF1 or MF1+, as they anticipate the risk profile of the entire fund to be broadly consistent with portfolios that are predominantly populated with P1 rated instruments. The last and most significant criticism is that the subjective evaluation surrounding a sponsor's support of the fund could be interpreted by investors as an obligation to pay, which is contrary to the lack of a contractual guaranty that exists for money market funds.

Moody's is hopeful that their new ratings system will provide investors with more information to evaluate a fund and its liquidity under potential market-stressed conditions, and address issues specific to short term issuance that are separate and distinct from long term debt borrowings. However, they will have to review comments in light of objections raised as they finalize their proposals moving forward. Conceptually, PEI agrees with the logic behind the proposal, especially third party stress-testing, and the confusing nature of the current ratings scale applied to a portfolio of short term investments. However, we share many of the concerns raised with regards to the impact on institutional investors. We also note that SEC regulatory changes in 2010 specifically addressed some of these issues for money market funds, and can serve as a backstop to some of the factors that concern Moody's. Regardless of the proposed changes in the ratings methodology, investors should still perform due diligence on money market funds by assessing many of these characteristics, and not rely solely on the recommendations of the rating agencies.

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