Extra Credit: An Insider's Look at the New Money Market Landscape

The extreme pain brought about by the financial crisis awakened a greater appreciation for credit quality, which is the guiding light toward liquidity and safety of principal–the long-standing objectives of money market funds. In a historically low interest rate environment, achieving these objectives has tested the mettle of fund managers. Adding to the mix, a combination of stronger regulations and a still-tepid issuer market has created a situation where demand for high-quality issuance can outpace available supply, especially in sectors hardest hit by the credit crunch. It's a delicate balance, requiring managers to adapt to a new investment landscape.

As with the economy in general, improvement in the credit environment continues, even as economic indicators remain mixed. "We've never taken credit quality for granted," says Deborah Cunningham, chief investment officer for Federated taxable money market funds, "and now the stringent quality and maturity standards of Rule 2a-7 only strengthen the ability of funds to withstand market stresses."

Given the interdependence of the economy, the investment community and the money markets, it's widely anticipated that new securities in which fund managers can invest will support them in navigating the new regulatory landscape. But how do things stand today? This report provides an overview of the current environment among money market issuers and their overall credit quality from the perspective of Federated money market analysts who have been keeping close watch on their sectors throughout these eventful times.

Domestic Banks

Having gone through an extensive reparation process, domestic banks are largely better capitalized and have better liquidity profiles than they have had in years. According to Mark Weiss, senior investment analyst in Federated's taxable money market group, this doesn't mean it's clear sailing ahead, however. "Domestic banks are continuing to stabilize and asset quality is improving, at least in terms of the larger banks," Weiss says. "This has allowed these banks to return to bottom-line profitability through the release of loan loss reserves." However, banks still face a number of revenue headwinds, including an extended low interest rate environment, a lack of loan demand from borrowers, and regulatory changes. As a result, despite the return to bottom-line profitability, banks' core earnings growth remains challenged. In response, they are focusing on cutting expenses and finding new ways to make up for lost fee revenue.

At the same time, a slow economy and political uncertainty are having an impact on the issuance of bank paper. "From a supply side, banks have been loosening lending standards, but at a relatively slow pace," says Weiss. "And while companies are showing signs of increasing demand for loans, they remain hesitant to take on additional debt as they are unsure about future growth prospects in light of a sluggish economy and the ongoing

Executive Summary

- The credit crunch has affected the universe of money market fund issuance sectors, with the current state of credit quality ranging from cautious to stabilizing.
- Financial regulation continues to evolve. Managing in still-tenuous financial conditions, funds are simultaneously navigating Rule 2a-7 and Reg. AB impacts as they anticipate upcoming Basel III Accord standards.
- When it comes to determining credit quality—whether domestic or international—there are no shortcuts. Regardless of the issuing sector, intensive credit work is critical to uncovering unacceptable risks as well as potential investment opportunities.

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mandate for U.S. national fiscal discipline," Weiss explains. As a result, although loans are growing again, the pace has been gradual. This has allowed many banks to continue to rely on core deposits for funding versus wholesale investments from money market funds.

Uncertainty regarding regulatory changes is another challenge. Basel III aims to establish international standards for bank capitalization and liquidity. With respect to capital, banks now have a better estimation of the new requirements. As a result, banks are making efforts to align themselves with the proposed capital rules for which the phase-in period is scheduled to begin in January 2013. Most of the larger banks are already in line with the higher capital standards. However, others continue to build capital and to divest non-core assets in order to bring ratios in line. As for the new liquidity standards, a greater degree of uncertainty exists as regulators intend to monitor the potential impact of new proposals on the financial system and overall economy. "Of course for money funds, the 2a-7 requirements (which restrict money funds' investments by quality, maturity and diversity) are somewhat at odds with what the new regulations are asking of banks," explains Weiss. "On one hand, anything that ensures that the banks have better liquidity profiles makes the issuance more safe and secure." But there's a downside. Basel III's proposed liquidity ratios are weighted in a way that requires a bank's funding to be longer-dated while the new 2a-7 rules call for money market funds to allocate a larger percentage of their holdings at the shorter end of the money market yield curve.

As the regulatory rules become clear, Weiss believes banks and money market funds will work together to develop capital market instruments that comply with 2a-7 rules, while enabling banks to meet their liquidity requirements. "For now," he notes, "it's still a work in progress."

European Banks

For many money fund managers, certain international banks remain a viable investment option because—unlike many of their domestic counterparts—they have been consistently active in their issuance while maintaining a sound credit profile. This is the case even as regulatory oversight has increased and the sovereign debt crisis has created a major disruption in the market. According to Bill Jamison, senior investment analyst in Federated's taxable money market group, the key is to both know what you own and balance that understanding against the current unsettled environment. "In addition to being extremely selective in terms of countries and issuers, we are taking an additional conservative stance by shortening the maturities of the foreign banks that we purchase. For example, instead of six-month securities, we may be buying one- or three-month securities," he explains.

From a credit quality standpoint, there is still pressure around foreign banks. "The outlook remains one of caution, as banks are maintained as a key functional area of the flowing economy. This will result in fund managers remaining diligent," says Jamison. "Many fund managers will say that approving issuers is the easy part of the process. The real challenge begins once the issuer is approved and involves the constant, daily monitoring of an issuer's quality. Eventually, Basel III will bring about new liquidity requirements and raise overall capital standards, and this looks to be a positive development for the credit profile of the banks globally."

With overseas banks, disclosure has always been a consideration for fund managers given that European banks don't have the same requirements, such as SEC filings, that have been mandated in the United States for years. This issue has become even more of a concern in the current environment.

Basel III Eases in Bank Liquidity Rules — *Shading indicates transition periods (All dates are as of 1 January)*

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1/1/2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015				–	Migration to Pillar 1 Minimum Capital Standards	–
Minimum Common Equity Capital Ratio	–	–	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer (to ensure a buffer of capital during periods of financial/economic distress)	–	–	–	–	–	0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer	–	–	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Minimum Tier 1 Capital	–	–	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital	–	–	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer	–	–	8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital	–	–	Phased out over 10 year horizon beginning 2013						

For illustrative purposes only and not representative of performance for any specific investment.

Source: Bank for International Settlements

According to Jamison, the situation has improved somewhat over time and by thoroughly analyzing the information that is available, it is possible to make reasonable credit risk determinations.

The primary consideration when investing overseas is the sovereign's quality. For this reason, funds have largely been avoiding banks from Italy and Spain as the sovereign debt crisis has migrated their way. Portuguese and Irish banks have long since been removed from this space.

"Even when the overall quality of a sovereign is established, as it has been for Australia, Germany and Sweden," Jamison notes, "determining the credit quality of that country's leading banks is an essential next step. These top echelon banks are typically global in nature with a range of operations well beyond their home countries. "Although this global scope requires an additional layer of risk management on the part of the banks, it offers the benefit of additional diversification of funding and earnings for these institutions and enhanced potential for issuance of investable securities," says Jamison.

Asset Backed Commercial Paper

One of the largest sources of money market fund issuance pre-financial crisis, the asset-backed commercial paper (ABCP) market has experienced substantial contraction over recent years. According to Mary Ellen Tesla, senior investment analyst in the taxable money market group at Federated, the market's pre-crisis level of some $1.2 trillion in outstandings has diminished to approximately $360 billion. "Where money funds had invested 35% to 45% in ABCP, the average now is probably closer to 10%," Tesla explains, a function of both decreased supply and pricing.

Unlike single-issuer term asset-backed securities, most ABCP programs are administered by large financial institutions. An ABCP program can finance the assets of hundreds of sellers, including auto finance companies (auto loans and leases), manufacturers (trade receivables and equipment loans), and financial intermediaries (credit card receivables and student loans) through a conduit structure. The majority of ABCP programs are structured with 100% liquidity support as well as transaction-level and program-wide-level credit enhancement.

"The creation ABCP is largely aligned to the state of the economy," says Tesla. "With little evidence of a sharp upturn in the near future, the amount of ABCP is likely to remain at a lower level until the economy picks up and, along with that, demand for credit."

> ***"The market is again dominated by back-to-basics, multi-seller, bank-administered asset-backed commercial paper programs."***

Additional factors affecting the ABCP market—outside of the economy and interest rates—are consolidation and/or termination of conduits by program administrators, limited new product availability and finding good value among ABCP names versus other short-term product offerings. Regulatory uncertainty is also a factor impacting both asset-backed commercial paper and the term market. Tesla notes that despite the decrease in ABCP issuance, there is a silver lining. "The market is again dominated by the back-to-basics, multi-seller, bank-administered ABCP programs."

Term Asset-Backed Securities

Because the primary types of term asset-backed securities (ABS) in which money market funds invest are auto and equipment loans, it's not surprising that supply over the past few years has decreased in step with continuing economic stress. Term ABS consists of loans issued by finance companies or the finance company arm of a manufacturer—for example Ford Credit for Ford Motor Company—and have long been considered a creditworthy investment for money market funds because, in most cases, the funds buy the most senior tranche of a term ABS deal and therefore are first in line for repayment of principal and interest.

"The advantage of term ABS is that even if the issuing company is undergoing stress, consumers will continue to make their loan payments," says Tesla. "Because the loans involved in term ABS are isolated from the corporation in a Special Purpose Entity, when consumers make payments, the cash is directed to paying off the term ABS investor rather than flowing into the corporation's general account."

At the highpoint in 2005, auto and equipment term ABS issuance was at $125.7 billion and as of July 2011, year-to-date issuance was at $40 billion. Currently, money market funds are faced with more investors with more money competing for the reduced issuance in the market. Additionally, the amount of credit available to consumers and stalled auto sales continues to affect issuance.

Industrial/Retail Sectors

Securities from these sectors (representing pharmaceutical, chemical, healthcare, technology and retail companies, among others) typically make up a relatively small percentage of money market fund holdings. Nonetheless, they offer valuable portfolio diversification. Issuance seems to have picked up, possibly reflecting companies' views that they are more firmly positioned even in an expected slower growth economy.

According to Jason DeVito, analyst in Federated's taxable money market group, Tier I[1] commercial paper issuance is by no means robust, but conditions are improving. "We are seeing some positive developments as a growing number of companies have recalibrated and adjusted to evolving economic conditions," he explains. "It's still true that, by and

large, many firms see no reason to expand or invest in their businesses when they aren't selling enough product to use the capacity they have," he says. "Like many consumers, these companies are holding onto their cash and remaining cautious about large expenditures—and debt. But while in 2010, most of these companies would only consider big expenditures or stock buybacks if they could finance them with stockpiled cash, more seem to be confident enough about their cost structures and profits that they are willing to take on some measure of additional debt. They are in a better position to prepare for the future and reward shareholders," DeVito says. "The extended low interest rate environment has also made it an advantageous time to issue debt." He notes that there has always been a select group of Tier I companies large and diversified enough to continue issuing substantial amounts of commercial paper, even through extended downturns. "If the pricing is right, they have remained a reliable source of high quality securities," DeVito says.

"It appears that with balance sheets being slowly restored, the most important missing ingredient is confidence and clearer evidence of a rebounding economy."

A growing number of Tier II[1] issuers are also entering the market to fund acquisition and expansion needs. "It's a positive development," says DeVito, "and much of it can be attributed to rapidly increasing demand by emerging market economies for products, services and commodities. Although they are classified as Tier II issuers, many of these companies are successful, well-known names with global reach." According to DeVito, the agricultural space has seen a tremendous growth due to emerging market need for increased and higher quality food production. "From our standpoint, we're looking for established companies that more or less have a lock on the market when it comes to supplying a particular commodity or product. A strong market position underscores a company's strength and supports its ability to bring high quality issues to the market."

Another factor benefiting money market issuance is pent up demand from corporations that had severely curtailed spending—and borrowing—throughout the financial downturn. "Companies that do business with other companies are benefiting from that pent up demand—we're seeing somewhat more spending on the business side," says DeVito. "By contrast, companies that rely on the consumer are still subject to a retail sector that remains largely contracted."

"Of course, because of 2a-7 rules, the percentage of Tier II securities has dropped to 3% from 5% per fund, and we can only hold 0.5% of any single issuer," DeVito explains. "Money market funds will need to continue expanding their universe of Tier II names so that they can use that 3% bucket across more issuers." As for the future, it appears that with balance sheets being slowly restored, the most important missing ingredient is confidence and clearer evidence of a rebounding economy.

Municipals

The current state of municipal issuance is one of continuing light supply, a reflection of fiscal uncertainty despite low borrowing costs. Municipal money market funds typically invest 60% to 80% of their total assets in variable rate demand notes (VRDNs), favored because they are highly liquid and backed by guarantees from insurers with bank liquidity or bank letters of credit. Many of these bank facilities were set to expire during the second quarter of 2011, but the vast majority of bank-supported transactions had their expiration dates extended by the existing bank. In other cases, a substitute facility was arranged by another bank. The remaining transactions were refunded through the issuance of bonds. According to reports issued about this topic, banks offered longer terms during the second quarter of 2011 especially to higher rated, larger transactions. Most bank facilities were provided by a small number of U.S. banks. However, direct loans from banks gained market share which negatively affected supply of VRDNs.

According to The Bond Buyer 2011 Yearbook, VRDN issuance declined from over $50.3 billion in 2007 to $24.8 billion in 2010. Even as VDRN issuance declined, municipal entities compensated through the issuance of other forms of debt, and short-term issuance was healthy through 2010 and continuing into 2011. Short-term issuance in 2010 was $65 billion, slightly higher than that of 2009 and significantly higher than 2008 and earlier years. Short-term issuance through August 2011 compared favorably to the same period in 2010 as well.

Hanan Callas, senior investment analyst in Federator's tax-exempt money market group, sees signs of stabilization in the credit quality of states. "Tax revenues have exhibited signs of recovery," she says. "States have balanced their budgets and demonstrated fiscal discipline, especially as federal stimulus funds have run out. In addition, many have enacted pension reforms that will have positive long-term impact on budgets and reserves."

Future headwinds may be facing states and local governments as a result of the Budget Control Act of 2011 that cuts spending by $900 billion in discretionary spending over the next decade and will affect many state programs such as education, transportation and environment programs. "States will need to have careful budget planning in 2013 and beyond," says Callas. "We remain cautious about local governments as they have struggled with declining property values, tax appeals and reduced state aid; in addition some states have imposed limits on tax rate increases." The slow economic recovery, especially in the housing market, calls for continuing careful analysis of these entities. Callas says,

"For many reasons, the money market fund industry is taking on a more conservative approach. In this environment, extensive credit research and municipal sector specialization is going to be as essential as the ability to source and access sufficient allocations of issuance."

Government-Sponsored Enterprises

Although the Farm Credit System and Tennessee Valley Authority are also government-sponsored enterprises (GSEs), it's Fannie Mae, Freddie Mac and the Federal Home Loan Bank System that have taken the spotlight over the past few years. Although these GSEs have lost billions of dollars since the subprime meltdown, government support has enabled them to continue issuing debt and remain highly rated. In August 2011, in conjunction with their downgrade of the U.S. credit rating, Standard & Poor's also downgraded the long-term rating on all GSEs from AAA to AA+. Moody's and Fitch, however, affirmed the AAA rating on the United States and all GSEs. For government money market funds, Fannie Mae, Freddie Mac and the Federal Home Loan Bank System debt are their primary investment alternatives. "But it's not just the mutual fund industry that purchases GSE debt," explains Joe Natoli, senior investment analyst in Federator's taxable money market group. "It's also the Federal Reserve and central banks around the globe. Fannie, Freddie and the Home Loan Bank System are so critical to a tenuous housing market and economic stability that if something would prevent them from servicing and repaying debt, the ripple effect would be devastating. "

Over two years ago, Fannie Mae and Freddie Mac went into conservatorship, have yet to be restructured and are still losing money. "They are being used as a support mechanism for the economy, in general, and the housing market, in particular, and that has contributed to their losses," says Natoli.

Nevertheless, the GSEs are considered to be among the safest and most liquid investments in the world. "The GSEs had unlimited support until this year and will continue to have substantial support," Natoli says, "Legislative and regulatory changes appear to be well off in the future, as well."

The Road Ahead

As credit quality gradually improves across the investment spectrum, is finding supply of investable securities likely to remain a challenge? "Potentially in some sectors and for the immediate future," Cunningham says. "In general, however, firms for which cash management is a core business and that have the resources to both access supply and scrutinize credit quality are in a strong position to navigate the challenges." With that says, Cunningham is confident that given the essential role of the money markets in this country and around the world, issuance supply will gradually return to more abundant levels as new structures are developed to accommodate the 2a-7 liquidity and credit quality requirements.

[1] *Tier I and Tier II securities represent the highest and second highest ratings, respectively, from at least two nationally recognized statistical rating agencies for eligible short-term obligations.*

Diversification does not assure a profit nor protect against loss.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.Securities are considered to be "first tier" as follows: Standard & Poor's: A-1+ and A-1, based on the obligor's capacity to meet its financial commitment on the obligation; Moody's: P-1, based on the issuer's ability to repay short-term obligations; Fitch: F-1+ and F-1, based on the issuer's liquidity necessary to meet financial commitments in a timely manner.

Variable rate demand notes are tax-exempt securities that require the issuer or a third party, such as a dealer or bank, to repurchase the security for its face value upon demand. The securities also pay interest at a variable rate intended to cause the securities to trade at their face value.

Rule 2a-7 is a rule under the Investment Company Act of 1940 which permits a money market fund to use amortized cost to stabilize the value of its shares at $1.00. Rule 2a-7 imposes various restrictions on the money market fund's portfolio, including restrictions related to diversification, and credit quality and maturity of portfolio securities.

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards.

Credit ratings of A or better are considered to be high credit quality; credit ratings of BBB are good credit quality and the lowest category of investment grade; credit ratings BB and below are lower-rated securities ("junk bonds"); and credit ratings of CCC or below have high default risk.

An investment in a money market fund is neither insured nor guaranteed by the Federal Deposit Insurance Corporation (FDIC) or any other government agency. Although money market funds seek to preserve the value of an investment at $1.00 per share, it is possible to lose money by investing in the fund.

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