November 5, 2010

By Electronic Mail

Moody's Investors Service
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250 Greenwich Street
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Re: Request For Comment: Moody's Proposes New Money Market Fund Rating Methodology and Symbols (Report Number 126642)

In response to your request for comment regarding Moody's New Money Market Fund Rating Methodology and Symbols, Treasury Strategies, Inc. (TSI), the leading Treasury consulting firm working with corporations and financial institutions in the area of treasury, liquidity and payments, and Prof. John Bilson of the IIT Stuart School of Business, have prepared the following opinion.

We comment on Moody's proposed new ratings system for money market funds. In particular, we comment on the proposal to award higher ratings to money market funds (MMFs) based on subjective assumptions regarding a fund sponsor's ability and willingness to support a financially stressed fund and the likelihood of its doing so.

We believe the proposal will result in serious adverse consequences for MMF investors, sponsors (especially commercial banks), and the financial system as a whole. Some of the dangers of the proposal include:

- Inaccurate and misleading ratings
- Investor confusion
- Damaged integrity and efficiency of money market funds
- Moral hazard and systemic risk
- Increased risks for investors
- Challenges for fiduciary investors
- Regulatory and policy issues
- Adverse consequences for bank sponsors

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Only money market funds with sponsor support will be able to attain the highest rating under Moody's new rating methodology. Moody's has stated, "Only funds with highly creditworthy sponsors that are deemed likely to support their funds may achieve a rating that is higher than would be implied based solely on the fund's invested portfolio." But, as discussed below, a sponsor's creditworthiness is an illusory measure of the likelihood that it will support a distressed fund.

An assigned rating would depend not only on a fund sponsor's *ability* to provide support but also on Moody's qualitative assessment of the sponsor's *willingness* to provide support. Where a sponsor provides explicit support, such as a guarantee or letter of credit, Moody's says it will review the provisions of the agreement and take it into account in the rating. As Moody's notes, however, most money market fund sponsors have no legal obligation to support their funds, for accounting and other reasons.

In the absence of a contractual agreement, Moody's states that it will consider factors such as "the strategic importance of the sponsor's asset management franchise, in general, and its liquidity franchise, in particular." Moody's also will consider the sponsor's "track record for supporting its funds" and the "extent to which the failure of a money market fund would likely affect the sponsor's brand name or reputation, thereby creating incentive to provide support to its funds." Finally, Moody's will take into account "any limitations—legal, regulatory, or accounting—that could restrict a sponsor's ability to provide support."

These factors will result in unreliable ratings that will mislead investors, undermine the integrity of money market funds, and damage the financial system.

The Ratings System Will Generate Unreliable Ratings

A money market fund rating system that depends on sponsor support as a requirement for attaining the highest rating necessarily will result in inaccurate and unreliable ratings. The likelihood of sponsor support is a highly subjective and speculative conjecture of questionable validity. A recent Federal Reserve staff study of sponsor-supported money market funds characterizes sponsor support as "discretionary, unregulated, and opaque" and "probably most unreliable when systemic risks are most salient."[1]

Absent an express written agreement obligating a sponsor to provide support, Moody's would need to rely on verbal indications of support—hardly a credible underpinning for a rating. No bank or bank holding company sponsor could make any statement suggesting that it would guarantee an affiliated fund without significant regulatory consequences, as described below.

[1] Federal Reserve Board, Finance and Economics Discussion Series, The Cross Section of Money Market Fund Risks and Financial Crises, Patrick E. McCabe, 2010-51 (the "Report"), at 35. See excerpts of the Report attached hereto.

To our knowledge, few if any money market funds have explicit financial support or guarantee arrangements with their sponsors. Such explicit arrangements typically come into existence only when a fund has been managed such that it needs support or otherwise faces circumstances suggesting that the fund should not be rated highly.

Thus, Moody's methodology depends largely on Moody's assessment of whether an *implicit* guarantee exists. Moody's proposed methodology will result in invalid and unreliable ratings of money market funds because the ratings will be dependent on assumptions that cannot be proven and in most cases will be denied. It is reasonable to ask what purpose is served by a methodology that seeks to differentiate between funds based on such subjective and speculative factors.

The Ratings Will Create Investor Confusion

A fund that receives the highest rating from Moody's will be presumed to have an implicit guarantee from its sponsor. The fund or its sponsor likely will be asked by investors to confirm that the guarantee exists. Investors acting under a fiduciary duty to invest prudently will be obligated to inquire as to the terms of the guarantee.

It is unlikely, however, that any sponsor—particularly a sponsor of a bank-affiliated fund—would be able to acknowledge that any implicit guarantee exists. Accounting and capital consequences would prevent it from doing so, as discussed below.

Moreover, the existence of an implicit guarantee and its implied terms would need to be disclosed in public filings with the Securities and Exchange Commission. Money market funds also are subject to prospectus disclosure requirements under which they must notify fund shareholders that an investment in a money market fund is not insured or guaranteed and it is possible to lose money by investing in the fund. Any statement or suggestion that a fund is sponsor-supported would require affirmative detailed disclosure.

The Investment Company Institute has recommended that money market funds include the following statement in their disclosures to investors disavowing sponsor support:

> Shareholders should not rely on or expect a fund's affiliate to purchase distressed assets from a money fund, make capital infusions, enter into capital support agreements, or take other actions to prevent the fund from breaking a dollar.[2]

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[2] Report of the Working Group on Money Market Funds, Investment Company Institute, March 2009. This recommendation recognizes the significant regulatory and other impediments to the provision of financial support by a money fund adviser to its advised funds.

Under the Dodd-Frank Act, moreover, Moody's will be required to disclose the assumptions underlying its ratings and the data relied on in determining each rating, including information on the reliability, accuracy, and quality of the data relied on in determining the credit rating.[3] Moody's will need to describe how it was able to conclude that a fund sponsor is likely to support an affiliated fund in the face of public disavowals by the sponsor.

Moody's ratings will undermine fund disclosures and create confusion among investors as to whether money market funds in fact are guaranteed by their sponsors or not.

If a money market fund or its sponsor disavows or fails to confirm an implicit guarantee, Moody's then will be faced with the dilemma of whether to downgrade the fund. If Moody's does not downgrade the fund, the integrity of its MMF rating methodology will be completely undermined. Again, it is reasonable to ask what purpose is served by such a rating system that will produce such illusory and confusing ratings.

The Ratings Will Undermine MMF Integrity and Market Efficiency

Money market funds are widely used by a wide range of investors who rely on credit ratings in making their fund selections. If the ratings are inaccurate and unreliable, the integrity of money market funds themselves will be called into question and their important role in the financial markets will be undermined.

Money market funds are used by individual investors, retirement plans, pension funds, corporations, bank trust departments, brokerage firms, state and local governments, charitable foundations, and other investors for cash management and investment purposes. Approximately 80 percent of U.S. companies use money market funds to manage at least a portion of their cash balances. At year-end 2008, U.S. non-financial businesses held approximately 32 percent of their cash balances in money market funds.[4]

If the ratings system for money market funds is perceived as unreliable and confusing, the investors who rely on these funds may be forced to seek other, less efficient, alternatives for their cash management and short-term investment needs. Money market funds were developed specifically to serve these needs and have done so successfully and efficiently for decades. A flawed ratings system will undermine the efficacy of money market funds in the financial markets and thereby reduce the overall efficiency of the markets.

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 111th Cong. 2d Sess. (2010) § 932.

[4] 74 Fed. Reg. 32,688, 32,689 (July 8, 2009) (SEC proposed amendment to Rule 2a-7).

The Ratings Will Create Moral Hazard and Systemic Risk

A. Moral Hazard

The proposed rating system effectively endorses sponsor support arrangements and thereby creates moral hazard. The expectation of sponsor support encourages fund managers to take on additional risk for the sake of improving yield and gathering higher levels of assets under management.

Rather than relying on prudent credit analysis as the primary measure of a fund's risk and downgrading funds that rely on sponsor support, Moody's ratings will reward funds that take on additional risk with the backing of a strong sponsor. If given Moody's highest rating, such funds will be able to generate still greater yields and create competitive pressure on other funds to go further out on the risk curve to earn similar yields. The resulting moral hazard will quickly develop into a real systemic risk creating vulnerability for the financial system as a whole.

This concern was raised in the recent Federal Reserve Board study, which found that sponsor support contributed to the transmission of moral hazard risks to the financial system.[5]

B. Incentives for Imprudent Fund Management

The use of sponsor support as a rating criterion will create misguided incentives for fund managers. By rewarding poorly managed funds that have a history of sponsor support, the methodology will encourage behavior that results in the need for sponsor support. Under the new system, it appears that Moody's intends to rate sponsor-supported funds more favorably than well-managed funds that have no history of sponsor support. The logic of a rating system based on such contradictions is perverse. Such a system is not only self-contradictory but a liability to the financial system.

The recent Federal Reserve study of sponsor support for money market funds during the financial crisis concluded that "the sponsor-support option may distort incentives for portfolio managers" and "the possibility of sponsor support may undermine incentives for prudent asset management."[6]

C. The Ratings Will Result in "Too-Big-To-Fail" Funds and Fewer Fund Options

Moody's proposed rating system likely will result in a shift in investor assets to those funds with the highest rating. Because only a few funds will be willing to acknowledge implicit sponsor support arrangements (and thus will qualify for the highest rating), fund assets will gravitate to these funds, which will become increasingly large. In the end, investor assets will be concentrated in only a few funds. Only the largest funds will survive and investors will have fewer fund options.

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[5] Report at 3 and 35.

[6] Report at 3.

> The largest funds likely will be bank-affiliated funds because of Moody's emphasis on the "deep pockets" of fund sponsors. These funds will become "too-big-to-fail" and will require federal government support in the event they become destabilized in a future crisis. In a severe financial crisis, sponsor support will be unavailing. Indeed, the Federal Reserve report noted that sponsor support for money market funds is "most unreliable when systemic risks are most salient."[7]

The Ratings Will Increase Risks To Investors

The proposed rating methodology will increase risks to investors to the extent it encourages sponsor support and less prudent investments by portfolio managers who know their fund will be bailed out if they make investment mistakes or extend the fund's risk profile to improve yields.

The Federal Reserve Report found that "sponsor support has likely increased investor risk for money market funds."[8] Moreover, the report found that "sponsor-supported funds exhibited greater investor risk than the rest of the prime fund industry by several measures: They had lower expense ratios, more rapid growth in the previous year, and greater flow volatility and sensitivity to yield."

Should a money market fund require sponsor support, it is likely that the need would arise during a period of acute financial distress when the sponsor itself is under duress and unable to provide support. In the case of a bank-affiliated fund, regulatory obstacles would impede the availability of sponsor support. It is unlikely that banking regulators would permit a distressed bank or bank holding company to transfer capital to an entity outside the federal safety net when the banking organization itself is at risk. Investors who have placed their assets in such a fund in reliance on sponsor support-based Moody's ratings would find that they have incurred unanticipated risks.

The Ratings Will Create Problems For Fiduciary Investors

It would be an imprudent practice for a trustee or other fiduciary to invest fiduciary assets in a money market fund based on the assumption that the fund will have access to sponsor support absent written assurance of such support. Trustees and other fiduciaries have a heightened duty of prudence when investing fiduciary assets in a money market fund with a record of external financial support.

[7] Report at 35.
[8] Report at 35.

The provision of financial support to a money fund by its sponsor is an extraordinary event raising questions concerning the quality of the fund's portfolio and its management. The credit review competency of the fund's adviser particularly is called into question. A fiduciary investor would be required to ask why impaired securities were included in the fund's portfolio, why the adviser did not anticipate a default or credit event, and why the adviser did not act to divest the impaired assets or otherwise avoid harm to the fund before the need for external support arose. The fiduciary would need to review the fund's other portfolio holdings and form a judgment as to their soundness, and review the adviser's credit review processes and the rigor and quality of its credit analysis. The fiduciary would need to form a judgment as to the adviser's ability to manage the fund's portfolio to avoid the need for external support in the future.

The mere assumption that a money market fund will have access to financial support from its adviser in the future is not a proper consideration for fiduciary investors.

The Ratings Raise Significant Regulatory and Policy Issues

An obligation of a fund sponsor to support an affiliated money market fund gives rise to significant accounting and regulatory issues, particularly when the sponsor is a banking organization. Moody's proposed rating methodology fails to adequately consider these issues.

The Financial Accounting Standards Board, in conjunction with the International Accounting Standards Board, is conducting proceedings on the appropriate accounting treatment for such arrangements.[9] The federal banking agencies similarly are expected to clarify the regulatory capital implications when the sponsor is a banking organization. Currently, such a sponsor that acknowledges the existence of a guarantee would be required to consolidate the fund on its balance sheet for accounting purposes. The institution also may be required to post additional capital to cover an implied *future* guarantee of affiliated money market funds.

Concern exists that such support will create an unwarranted expectation that money funds will always be guaranteed by their bank or bank holding company advisers. Such an expectation raises questions concerning the scope of the federal safety net and whether it is appropriate to extend that protection on a routine basis to money market funds that historically have operated outside of the safety net.

[9] Earlier this year, FASB deferred the requirements of Statement 167 for money market funds that comply with Rule 2a-7 pursuant to the Investment Company Act of 1940, pending further joint proceedings with the International Accounting Standards Board.

Congress and the regulators would need to consider whether FDIC insurance premiums should be increased to cover the substantial additional liability to the FDIC insurance fund if banks implicitly guaranteed their affiliated money funds. Federal policy requires bank holding companies to serve as a source of strength to their subsidiary banks, and their ability to do so while guaranteeing affiliated money funds would come into question. A policy issue also would be raised as to whether banking regulators should have supervisory and regulatory authority over money funds that are guaranteed by banks or bank holding companies.

Current supervisory guidance strongly discourages banks from supporting their affiliated money market funds and any instance of such support would trigger heightened supervisory scrutiny. Additionally, banks are subject to limitations on the amount of any affiliate guarantees under section 23A of the Federal Reserve Act and banks may not purchase any low-quality assets from an affiliated money market fund.

It is our understanding that it is not the present intention of federal banking regulators to allow banking organizations to provide explicit or implicit financial support to affiliated money funds on a permanent basis going forward.[10]

The Ratings Will Create Adverse Consequences For Bank Sponsors

Only funds with highly creditworthy sponsors that are deemed likely to support their funds will be able to achieve the highest rating under the proposed methodology. Bank-affiliated funds cannot be included in this group because Moody's never will be able to make a credible assessment that a bank or bank holding company sponsor is likely to support an affiliated fund. Too many regulatory and capital impediments make that assessment impossible, as noted above.

In making a determination about the "likelihood" of sponsor support, Moody's has said it will rely on the "strategic importance" of the sponsor's asset management franchise and the "extent to which the failure of a money market fund would likely affect the sponsor's brand name or reputation, thereby creating incentive to provide support to its funds."

Every money market fund sponsor has a substantial interest in preserving its franchise and reputation. Non-bank companies that specialize in fund management arguably have a higher franchise and reputation stake than bank-affiliated fund sponsors for which money market funds are not their core business. The former are more likely to manage their funds in such a way as to avoid the need for sponsor support. Experience during the recent financial crisis bears this out. The number of bank-affiliated money market funds that required sponsor support far exceeded those that were not bank-affiliated.

[10] We also note that the Task Force on Regulatory Reform of the American Bar Association's Banking Law Committee has raised concerns about sponsor support for bank-affiliated money market funds and recommended measures to further discourage sponsor support for such funds. See http://www.abanet.org/dch/committee.cfm?com=CL130055.

Moody's says it will consider a sponsor's "track record for supporting its funds" and suggests that this is a positive factor. But recent experience indicates that a record of sponsor support should be a negative factor. The Federal Reserve Report found that funds that received support during the recent financial crisis on the whole were less prudently managed than those did not:

> [O]ne proxy for sponsor risk—whether an MMF was affiliated with a bank—was a significant predictor of poor outcomes during this episode. Bank-affiliated money funds were more likely to receive sponsor support and to hold distressed ABCP in their portfolios.[11]

Conclusion

Moody's proposal to adopt sponsor support as a factor in its ratings of money market funds is misguided and harmful to investors and the financial system.

- It creates moral hazard and systemic risk.
- It creates confusion for investors and issues for fiduciaries.
- It will result in fewer fund options available to the public.

We urge Moody's to withdraw its proposal.

Sincerely,

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[11] Report at 34.

APPENDIX I — Excerpts from a Federal Reserve Staff Report[12]

The following findings and conclusions from a recent Federal Reserve staff report indicate that assigning credit ratings to money market funds based on the likelihood of sponsor support is a misleading measure of risk and could create perverse incentives for portfolio managers resulting in moral hazard and systemic risk. Among other things, the report found that bank-affiliated sponsors were more likely to have needed sponsor support during the recent crisis.

> The link between sponsor risk and holdings of distressed paper during the ABCP crisis indicates that the **sponsor-support option may distort incentives for portfolio managers**, and the role of sponsor risk in channeling concerns about financial institutions to their off-balance-sheet MMFs during the 2008 run suggests that **expectations for such support may contribute to transmission of financial shocks**. These concerns at least warrant greater attention to the **systemic risks posed by the MMF industry's reliance on sponsor support**.[13]
>
> **Supported funds also were more likely than other prime funds to have had a triple-A rating**: one-third of all MMFs had such a rating, but triple-A funds accounted for almost half the funds that received support.[14]
>
> **Sponsor-supported funds exhibited greater investor risk** than the rest of the prime fund industry by several measures: they had lower expense ratios, more rapid growth in the previous year, and greater flow volatility and sensitivity to yield. Supported funds were more likely than average to be bank-affiliated and to have sponsors with CDS spreads in the Markit database.[15]
>
> Riskier portfolios were more likely to experience losses that sponsors ultimately absorbed. In contrast, **a triple-A rating had no significant predictive power** in the full sample and had the "wrong" sign in the CDS sample: controlling for CDS spreads, funds with triple-A ratings were more likely to have been the recipients of sponsor support.[16]

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[12] Federal Reserve Board, Finance and Economics Discussion Series, The Cross Section of Money Market Fund Risks and Financial Crises, Patrick E. McCabe, 2010-51 (the "Report").
[13] Report at 3.
[14] Report at 29.
[15] Report at 29 (references omitted).
[16] Report at 30.

Sponsor risk had a significant but somewhat ambiguous role in predicting sponsor support. **Bank-affiliated MMFs were more likely to receive support…**bank-affiliated fund managers "were over-represented among support providers." As noted above, the link between banks and MMF support may reflect a greater propensity for deep pocketed sponsors to bail out troubled funds, conditional on similar exposures to distressed securities, or it may reveal a **moral hazard problem** for bank-affiliated portfolio managers. An additional consideration is that the banks may have been more likely to disclose financial support for affiliated MMFs because banks face more rigorous regulatory oversight and disclosure requirements than some other financial services firms.[17]

Apparently, aside from a sponsor's bank affiliation, riskier sponsors were more likely to intervene later to support their funds.[18]

A finding that **bank-affiliated advisers were more likely to have invested in problematic ABCP** would be evidence in favor of a **moral-hazard** explanation for the link between bank affiliation and sponsor support.[19]

MMFs with bank-affiliated sponsors were significantly more likely to hold distressed ABCP than other funds. Depending on specification and sample, bank affiliation increased the probability that a fund held distressed paper by between 26 and 41 percentage points. The strength of this result aids in interpreting the link between bank affiliation and sponsor support—bank-affiliated funds evidently were more likely to receive support because they were more likely to hold problematic ABCP—and points to a potential **moral hazard problem** for bank-affiliated MMF managers. Moral hazard is not the only possible explanation, but some others are no more charitable. For example, it is possible that bank-affiliated managers were more likely to purchase risky ABCP for their funds because they had more institutional familiarity than other managers with complex instruments like paper issued by structured investment vehicles (SIVs).[20]

I find that **another possible indicator of portfolio risk—whether a fund had a triple-A rating—was of little use** in predicting crisis outcomes, including outflows during the run in 2008 or exposure to distressed paper during the ABCP crisis. This is perhaps surprising, as ratings organizations' publications suggest that a top rating should be useful as an indicator of an MMF's (low) risk, particularly as reflected in its portfolio quality.

[17] Report at 30-31.
[18] Report at 31.
[19] Report at 31.
[20] Report at 32.

Although sponsor risk was not a significant factor in the cross-section of net flows during the ABCP crisis, one proxy for sponsor risk—**whether an MMF was affiliated with a bank—was a significant predictor of poor outcomes during this episode**. Bank-affiliated money funds were more likely to receive sponsor support and to hold distressed ABCP in their portfolios.[21]

Hence, **sponsor support has likely increased investor risk for MMFs**. The fact that funds with bank sponsors were more likely to have held distressed ABCP and to have received sponsor bailouts in the wake of the ABCP crisis also suggests that the possibility of **sponsor support may undermine incentives for prudent asset management**.[22]

Furthermore, during the run in 2008, concerns about the ability of sponsors to support their MMFs evidently prompted heavier redemptions from money funds with weaker sponsors, and thus transmitted the sponsors' strains to off-balance-sheet MMFs and into short-term funding markets. Thus, **by fostering expectations of implicit recourse to sponsors, past support actions had created a channel for the transmission during crises of strains** between entities that should not have been related. **Whether or not such support was actually delivered, it may have contributed to financial strains.** Bailouts of MMFs during the run required scarce capital from sponsors at a time when liquidity was in short supply and worsened some sponsors' financial condition (Standard & Poor's, 2008a). But Reserve's failure to provide support that investors had come to expect was catastrophic for the Reserve franchise and destabilizing for the financial system. Moreover, despite the apparent importance of sponsor support for MMFs, **the practice is discretionary, unregulated, and opaque, and it is probably most unreliable when systemic risks are most salient**.[23]

These findings strongly suggest that it would be inaccurate, misleading and potentially harmful to the financial system for Moody's to adopt rating criteria that emphasize the likelihood of sponsor support for money market funds.

[21] Report at 34.
[22] Report at 35.
[23] Report at 35.

APPENDIX II — Background of Authors

Treasury Strategies, Inc. is the leading Treasury consulting firm working with corporations and financial institutions. Our experience and thought leadership in treasury management, working capital management, liquidity and payments, combined with our comprehensive view of the market, provides us a unique perspective and unparalleled insights into both the corporate and financial sectors. The fact that our clients include corporate investors, financial institutions, regulators, and fund companies is further evidence of our involvement within the money market fund industry. Anthony J. Carfang is a Partner of Treasury Strategies. Jacob Nygren is a Manager in the firm's Financial Services Practice.

John Bilson is a Professor of Finance at the IIT Stuart School of Business. He is the director of IIT's graduate program in Finance and Associate Director of the doctoral program in Management Science. Dr. Bilson received his PhD in International Economics from the University of Chicago in 1973. He subsequently taught in the economics department at Northwestern University and became a member of the research department of the International Monetary Fund. In 1976, Dr. Bilson returned to the University of Chicago as an associate professor and subsequently, as a senior lecturer in International Economics and Finance in the Graduate School of Business. At this time, he was a research associate of the National Bureau of Economic Research. He has held visiting appointments at the Board of Governors of the Federal Reserve System, the Graduate School of Business at Stanford University, and the Hoover Institution on War, Revolution and Peace.

Dr. Bilson is the editor (with Richard C. Marston) *of Exchange Rate Theory and Practice* (1984, University of Chicago Press) and has published over thirty articles in the areas of international finance, international economics, and risk management. In addition to his PhD, he holds Master of Economics and Bachelor of Economics (Hons.) degrees from Monash University, Melbourne, Australia.