

European Money Market Funds Quarterly

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Summary

- ▶ This is the first issue of Fitch Ratings' European Money Market Funds Quarterly report, commenting on trends, developments and pertinent issues in the money market funds (MMF) industry in Europe. For the purposes of this first report, Fitch will include a review of the industry prior to the last quarter of 2009, and take a view on the changes in MMFs since the start of the financial crisis.
- ▶ In 2009, assets under management (AuM) in European MMF remained flat overall (c. EUR1.3trn as at end-2009), with growth in the first half of the year offset by some outflows during the last quarter of 2009. AuM in 'AAA' rated MMFs increased by only 2.7% to EUR438.61bn (as at end-2009), the smallest annual growth rate in the past nine years. The bulk of the industry assets remained stable in a cash rich but still uncertain environment. However, some money left low-yielding MMFs in search of returns while riskier asset classes exhibited record performances from Q209 onwards.
- ▶ From mid 2008 to mid 2009, MMFs benefited on average from higher returns versus the cash markets, as a result of the collapse in policy rates. The introduction of treasury MMFs assisted in the flow of funds to the MMF industry and masked the relatively large outflows immediately following Lehman Brothers' collapse. Since 2009, all short-term yields have normalised and MMFs are evolving in a low interest-rate environment. Furthermore, curves have flattened and being long on the curves is now paying less and less.
- ▶ There has been significant variance between the highest and lowest yielding funds in 2009. This is partly due to more conservative investment practices, and in part due to the wider spreads in different asset classes, including securities within the same rating levels. Funds with a stable investor base attempted to capture a better yield by investing further along the curve and by investing in relatively less liquid assets.

Related Research

- "Global Money Market Fund Rating Criteria" (Oct 2009)
- "ABCP in European Money Market Funds – What Investors Need to Know" (Jul 2009)
- "European ABCP Conduits: An In-depth Look" (Jan 2010)

- › On average, funds are now maintaining a relatively higher weighted-average maturity (WAM) than a year ago that reflects more of a “carry strategy” and managers’ expectations that an interest rate rise is not expected until the second half of 2010 at the earliest.
- › With the market expectation that interest rates may rise in H210, the timing will be critical for managers switching from the carry component they have on at the moment (which has pushed them towards higher WAMs), towards the interest rate move component (which would mean a reduction of WAM).
- › Effective liquidity management in MMFs was a key consideration in 2008 and 2009. Funds have built up significant liquidity positions compared to pre-crisis levels, with the average overnight investment in Fitch-rated MMFs at 24% as of the end of Q409. Fitch’s new MMF criteria sets minimum liquidity benchmarks of 10% and 25% overnight and one week liquidity, respectively.
- › The MMF portfolio composition has changed significantly from the pre-crisis level, reflecting efforts to improve liquidity by increasing investments in deposits, treasuries and overnight repurchase agreements. MMFs are investing less in floating-rate notes and asset-backed securities,

due to more conservative risk positioning and reduced availability of such instruments.

- › European MMFs are increasingly focused on addressing sovereign risk issues. As concerns around sovereign indebtedness continue to mount, MMFs review both direct government or government-related entity exposures and indirect exposures via financial institutions in countries such as Portugal, Ireland, Italy, Spain and the UK.
- › Fitch also discusses in this report regulatory and industry changes, the agency’s revised global MMF criteria and the launch of its MMF surveillance online tool – Funds SMART.

European Money Market Funds Commentary

The events of the past two years have led to significant changes in the way MMFs operate, the way they are regulated and the way they are perceived and assessed by investors. Given that this is the first Money Market Funds Quarterly report to be published, Fitch has gone beyond just looking at the changes and considerations for the quarter to assess the changes that have taken place since the beginning of the financial crisis in 2008. These changes, both proposed and adopted, have aimed to improve the standards for credit quality, market risk and liquidity management in MMFs.

Assets under Management in European Money Market Funds

The Broad View

At the end of 2009, European MMFs stood at approximately EUR1.3trn. The chart below shows the growth in AuM of both EFAMA¹ and French MMFs. As can be seen, French MMFs accounted for approximately 50% of the EFAMA universe. Irish-domiciled MMFs, which at the end of December 2009 accounted for EUR307bn, have been added to the EFAMA AuM figures to estimate the total European AuM.

IMMFA is the trade association that represents the European ‘AAA’ rated MMF industry. All IMMFA members must abide by the IMMFA Code of Practice and obtain a ‘AAA’ rating for their funds, which can be denominated in euros, sterling or US dollars. IMMFA funds are generally registered in Luxembourg or Ireland.

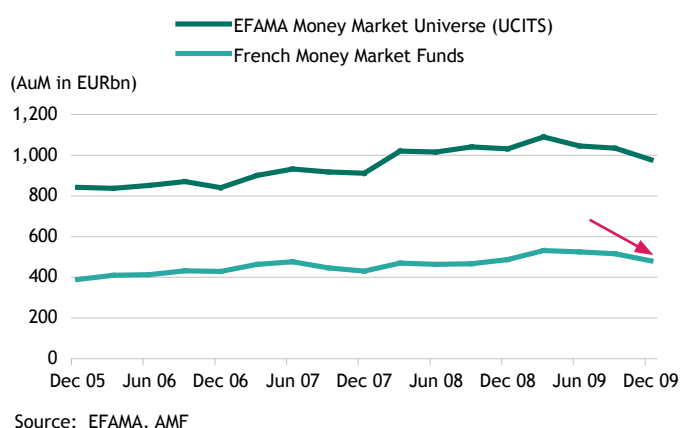
Scope of the Report

For the purpose of this report, Fitch is focusing on European MMFs with the primary objective of security of principal and daily liquidity. As per Fitch’s global MMF rating criteria published on 5 October 2009, the agency has recently updated its MMF rating scale with an ‘mmf’ subscript. Such ratings are dedicated specifically to this type of funds.

Except where stated, the information in the tables and the charts refers to ‘AAA’ rated MMFs included in iMoneyNet’s offshore MMF universe. This universe comprises MMFs with the primary objective of capital preservation and daily liquidity, domiciled outside of the US, predominantly in Ireland and Luxembourg. By ‘AAA’ ratings, Fitch refers to ‘AAA’ ratings that are assigned to MMFs by Nationally Recognised Statistical Rating Organisations (NRSRO). Most observations and conclusions may also be applicable to a broader universe comprising conservative European MMFs, even if unrated.

¹ European Fund and Asset Management Association. Each quarter, EFAMA compiles the total assets in “money market funds” as defined locally.

European Money Market Funds

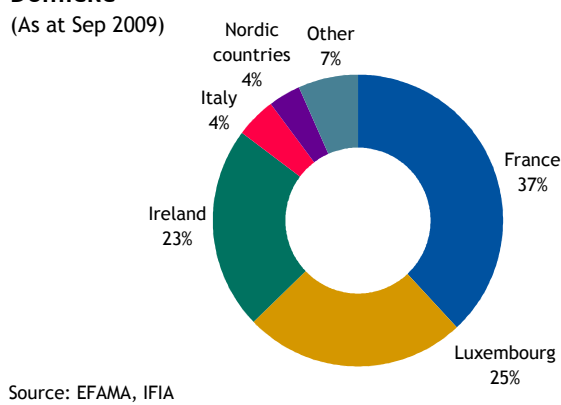


Total AuM for IMMFA members at the end of 2009 was EUR420bn. This figure represents growth of 3% for the year. Within the individual currencies, total euro funds increased by 26% and sterling funds increased by 5%, whereas US dollar funds declined by 8%.

A pronounced and prolonged redemption period for French-domiciled funds occurred in the autumn of 2007 with the rising credit, and subsequent liquidity, concerns across asset-backed securities and structured investment vehicles. Outflows however affected mostly dynamic or enhanced MMFs and several managers of such fund types in Europe were either forced to suspend redemptions or had to take the decision to liquidate their funds.

During the generalised risk aversion period in the second half of 2008, the priority for investors was liquidity and security of capital. Thus, at an industry level, European MMFs benefited from inflows in the third quarter of 2008 and first quarter of 2009. This was despite an elevated level of cash flow volatility resulting from asset reallocation in wake of Lehman Brothers Holdings, Inc.'s bankruptcy filing. Overall, between end-2007 and end-September

European MMFs by Country of Domicile



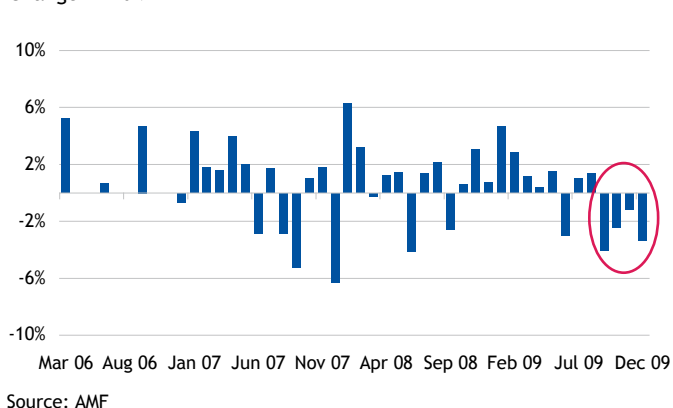
2009, EFAMA and France-domiciled funds' AuM increased by 14% and 20%, respectively.

During 2009, as a consequence of the short-term interest rate environment, decreasing MMF returns led to stalling inflows and even outflows later in the year, reflecting reallocation to riskier asset classes and also a switch into longer duration asset types. On this latter point and as an illustration, according to fund data provider Europerformance, the AuM of enhanced cash funds in France moved up 9% from April to December 2009, after three years of outflows. More generally, Fitch has also observed the launch or active marketing of extended duration funds that could siphon assets away from MMFs in search of better returns.

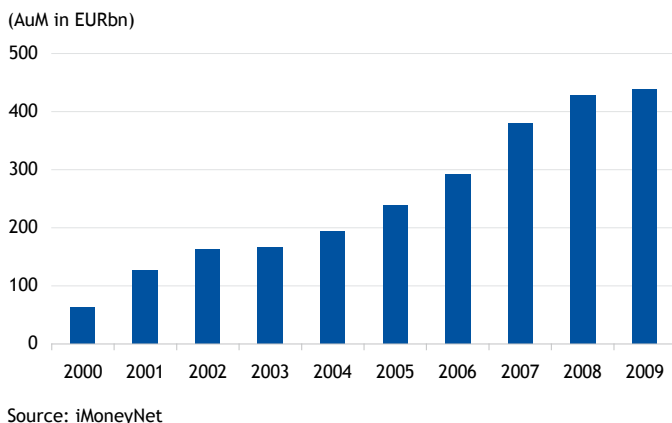
Year-on-Year Assets under Management for 'AAA' Rated Offshore Money Market Funds

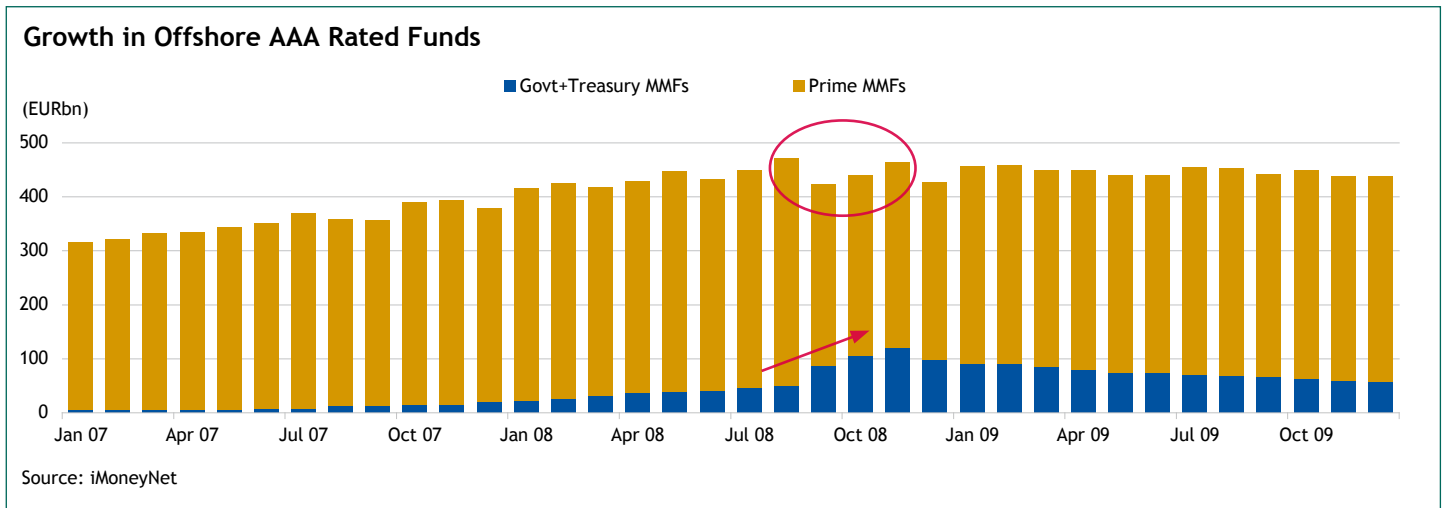
AuM of 'AAA' rated offshore MMFs have been growing steadily on an annual basis over the years, reaching EUR438bn at the end of 2009.

French Money Market Funds Monthly Movements



Offshore Universe of Rated Money Market Funds





Cash Flow Volatility During the Crisis

The chart above illustrates monthly changes in the AuM of 'AAA' rated offshore MMFs during the financial crisis. The first dip in AuM occurred at the start of the financial turmoil in August 2007. AuM decreased again in December 2007 when leading central banks offered billions in loans to banks so as to lower interest rates and ease the availability of credit. Through the first half of 2008, 'AAA' rated offshore MMFs however benefitted from the "flight to quality" and their AuM increased and peaked in August 2008 at EUR470bn.

Treasuries Maintain Growth in the European Money Market Fund Industry

The continued growth in MMFs, particularly post Lehman and the failure of a US MMF (see above), was largely helped by the launch and growth of treasury MMFs (blue bars in the chart). The AuM of these funds peaked at EUR120bn in November 2008, as they benefited significantly from the flight to quality.

MMFs that invest solely in government and government agency securities, or repos backed by these securities, are not a new concept in the US. In the European space, however, prior to 2008 there were only a limited number of such MMFs denominated in

US dollars. Their euro and sterling equivalents were not available at all. The launch and growth of such funds in Europe served to maintain a relatively stable level of AuM in offshore MMFs and masked the outflows of the conventional MMFs.

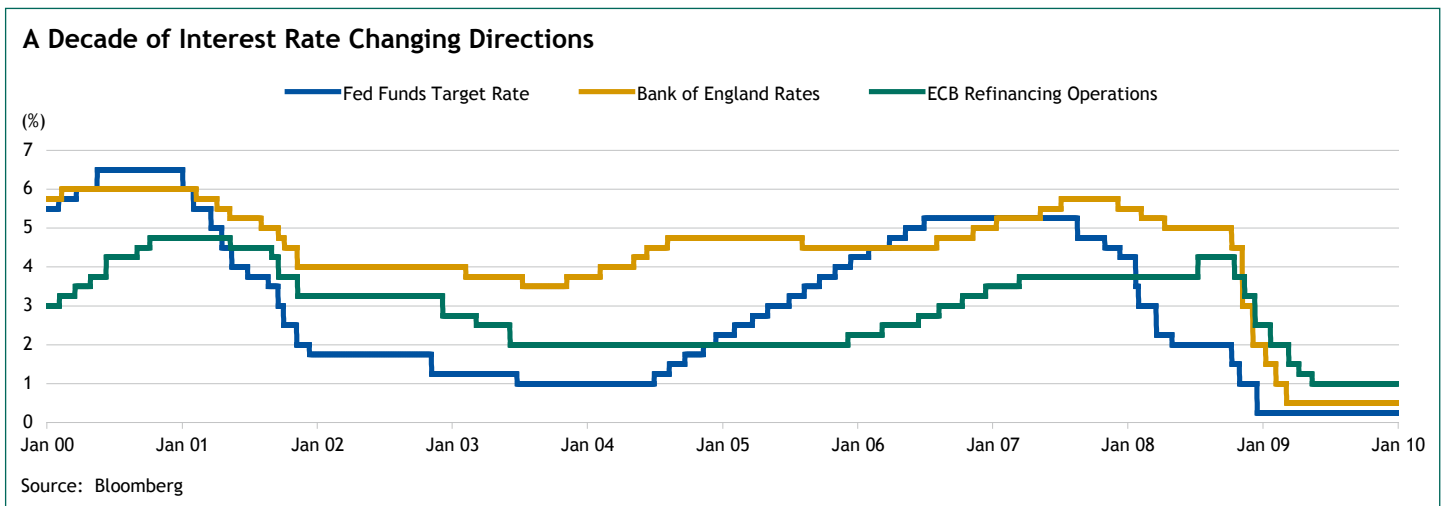
In September 2008, when Reserve Primary Fund's net asset value (NAV) went below USD1², AuM of offshore traditional (non-government) "MMF" total assets dropped by 20% to EUR336.55bn, from EUR421.12bn. As the market regained stability and MMFs restored the confidence of investors, investments in treasury MMFs gradually started to shift back to the more traditional MMFs.

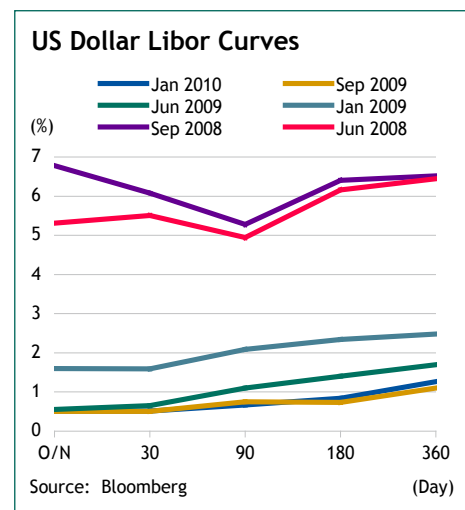
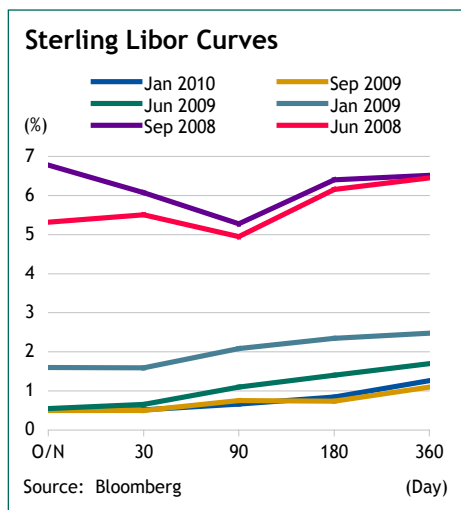
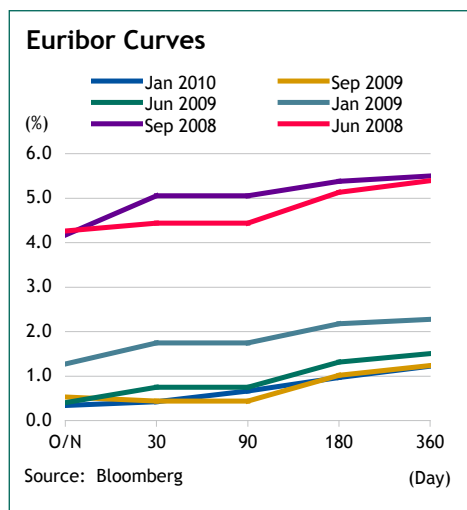
The Interest Rate and Market Environment

Interest Rate Levels Remain at Historical Lows

As shown in the chart below, the current period of stable interest rates follows a sharp downward trend that began in the second half of 2008 (2007 in the US) in response to the global recession.

² Reserve Primary Fund, the oldest US MMF, became the first money-market fund in 14 years to expose investors to losses after writing off USD784m of debt issued by Lehman Brothers. The fund's NAV fell to 97 cents and redemptions were suspended for as long as seven days.





By March 2009, policy rates were cut to their lowest historical levels in dollars, sterling and the euro. For a year now, MMFs have operated in an historically low interest rate environment.

The general view taken by the market, as reflected by the very flat yield curves seen in the charts above, and expressed by managers that Fitch talked to, is that interest rates are not expected to change over the next three to six months. Inflation is not perceived to be a risk at the moment and the extent of any recovery is still considered to be unclear.

Curves Offering Less and Less Carry

Throughout 2009, yield curves flattened thanks to a return of liquidity and increasing market expectation that rates would be kept low for an extended time. While in the first half of 2009 it paid to be positioned at the three-month maturity point on the curve, fund managers have more recently had to go up to six months maturity to find equivalent carry, which is generally done cautiously given heightened liquidity and market volatility

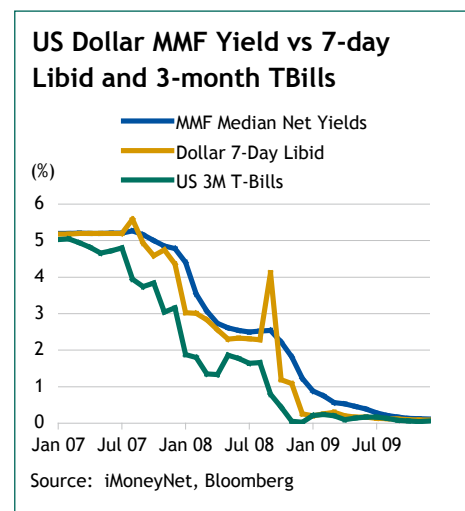
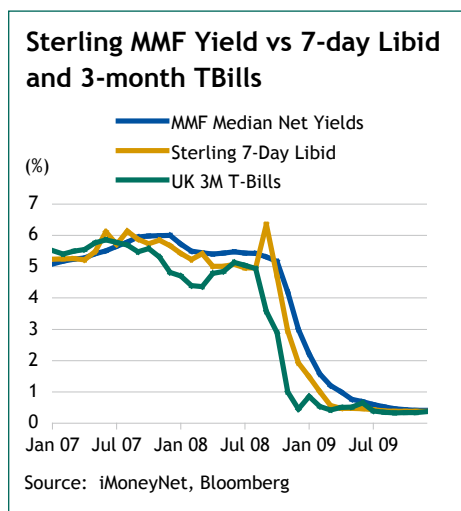
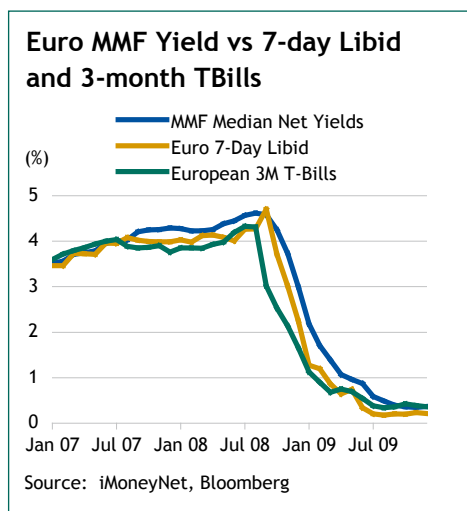
risks. The differences between the interest rate on overnight, one-month and three-month rates are now almost zero.

Offshore Money Market Fund Yields

Comparison with Cash Markets

The three charts below illustrate 'AAA' rated offshore MMFs' average seven-day (simple) net yields and compare these yields to the seven-day Libid rate and the three-month US Treasury bill rate.

MMF yields have fallen dramatically, not only as a result of declining interest rates, but also due to changes in portfolio structure. Higher yielding asset classes such as ABCP and floating-rate notes and/or longer-dated investments have been replaced with more liquid investments such as Treasury securities, bank deposits and/or overnight call accounts (please see Portfolio Allocation section).



The peak in September 2008 corresponds to a temporary shock that MMFs could not capitalise on, at least not for their whole portfolios.

Offshore ‘AAA’ rated non-government MMFs in all three currencies were, for the most part, able to maintain the seven-day average yields (after fees) above the seven-day Libid levels that many MMFs set as their benchmark. In the declining interest rate environment, MMFs were able to offer yields higher than the general level of short-term interest rates, by investing in longer-dated money market instruments and locking into higher rates. As these securities matured, however, and the cash was reinvested at the market rates, the yield differential decreased back to the levels of the seven-day Libid and three-month T-bills.

Variance Among ‘AAA’ Rated Offshore MMFs

The charts below show the impact of the market volatility on the yields offered by ‘AAA’ rated offshore MMFs. To make the data comparable, offshore MMFs investing exclusively in sovereign securities were excluded.

As reflected by the charts below, MMFs have exhibited similar trends in the variance in yields between the top and bottom yielding MMFs throughout the period, regardless of the currency class. It is interesting to note the extent to which these figures have changed over the period.

At the start of 2007, the yield differential between the median, the lowest and the highest yielding MMFs was extremely small, indicating that the majority of the funds were achieving yields very close to each other. In 2008, this spread significantly widened and within three months of Lehman Brothers’ collapse peaked at 2.83%, 2.75% and 2.94% for euro, sterling and dollar funds, respectively, from a 43bps, 26bps and 27bps right at the beginning of 2007. The historically large yield differences seen at the end of 2008 and the start of 2009 give an indication of the significant differences in the risk appetite that emerged as result of the crisis.

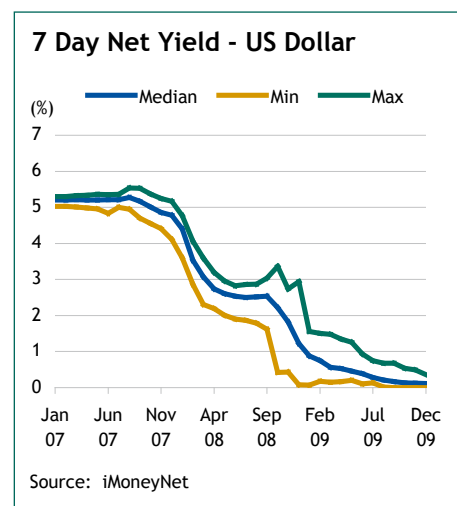
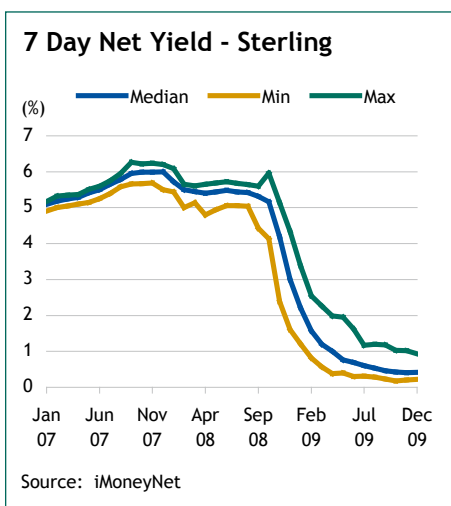
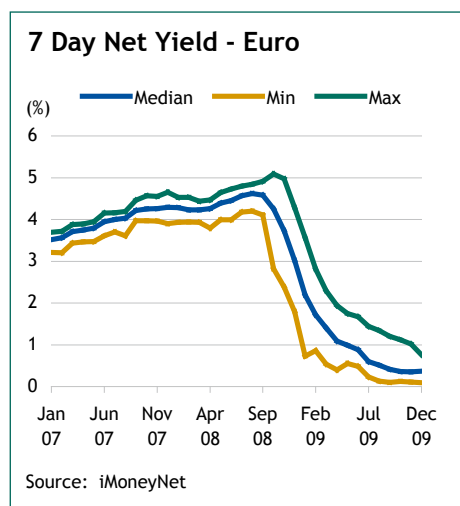
What had previously been thought of as a commoditised product, with very few differentiating factors, had suddenly turned into a differentiated product. Investors therefore started questioning the variances in MMF yields given the similarities of funds’ objectives and investment guidelines.

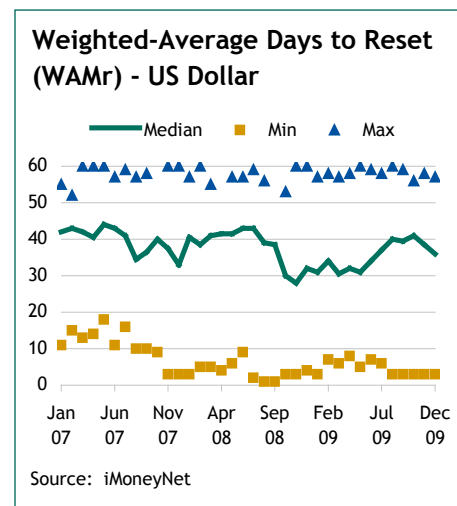
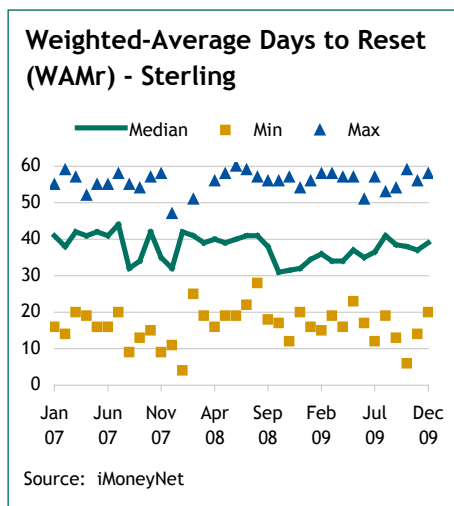
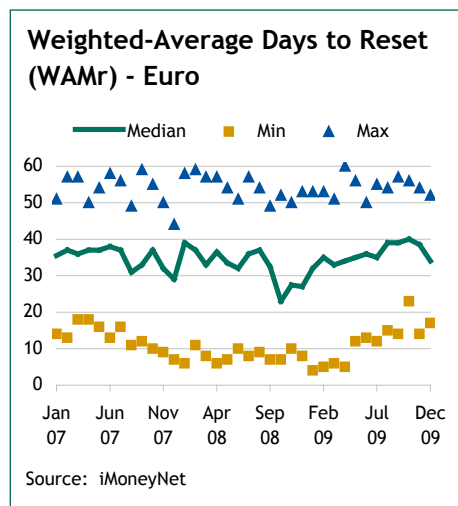
The dispersion in yields can be attributed to a number of factors. Some of the lowest yielding funds are those that changed their investment practices significantly – increasing exposures to overnight and very short-dated assets, as well as increasing exposures to Treasury securities. Another reason for the wider differences in yields is the increased existence of market opportunities, which some funds have been able to capitalise on thanks to a stable investor base or modest size. Within the same rating category for a given investible asset type, there emerged greater yield differentials. Prior to 2008, securities in the same rating categories and maturities traded narrowly. More recently, spread differences have been significantly higher. However, as market conditions normalise, these types of opportunities are fading away and yields between MMFs have started converging as spreads are compressing and curves have flattened.

Liquidity and Maturity Profile

Weighted-Average Maturity to Reset

The weighted-average maturity to reset (WAMr) is the traditional measure of an MMFs exposure to interest rate risk. Factors affecting the fund’s WAMr include the fund manager’s view on future interest rates, and the need for portfolio liquidity (as internal policy, for future expected redemptions and/or post sudden unexpected redemptions), to mention just a few.





The above charts illustrate the wide variance in 'AAA' rated offshore MMFs' WAMr. MMFs investing exclusively in sovereign securities are excluded.

During 2009, the median WAMr across euro, sterling and dollar MMFs increased by about 10 days to 40 days as funds searched for higher yields further along the curve. Longer-dated MMFs managed their WAMr to 40 to 60 days.

While an extended WAMr may increase liquidity risk to the fund in the event of heightened redemptions, this risk may be mitigated in circumstances where the underlying shareholder base is highly stable and/or predictable in terms of cash flow needs. Some fund managers have been comfortable with higher WAMr levels given the overall market liquidity thanks to central bank action, and because it has paid to be invested out longer. However, as explained in the Industry Issues section, investors need increasingly to pay attention to the interest rate risk component of their funds and make sure managers are equipped to deal with potentially greater interest rate volatility.

Weighted-Average Maturity to Final

The weighted-average maturity to final (WAMf, a measure of spread risk and liquidity) across all Fitch 'AAAmmf' rated funds shortened significantly in 2008 as a result of changing portfolio management strategies, aimed at strengthening liquidity and credit profiles. The WAMf average figures now approach WAMr levels, given the limited investments in floating-rate notes as a percentage of portfolios (please see Portfolio Allocation section).

Liquidity Management

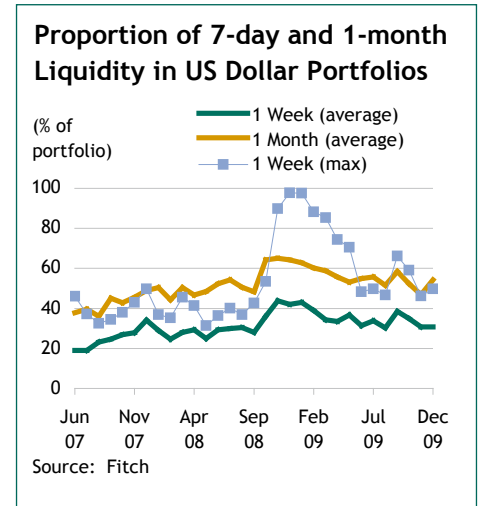
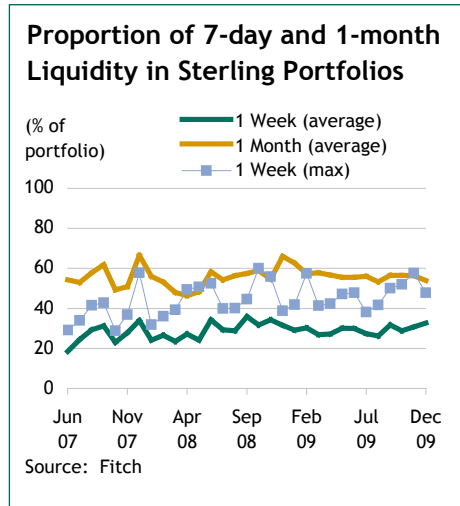
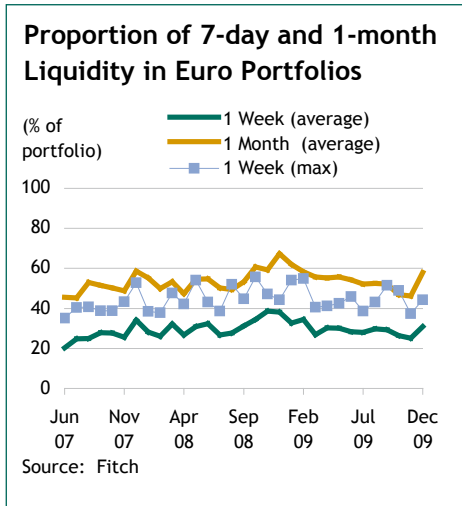
One of the most important aspects of a portfolio manager's role is to manage the fund's portfolio of investments

consistent with the expected liquidity requirements of the fund's investors. Liquidity management has also become a primary focus of market participants and fund providers. The following highlights the sources of liquidity risk in MMFs:

- › unexpected redemption activity in excess of a fund's available liquidity in overnight or readily marketable assets;
- › large investments from a single shareholder;
- › large investments from shareholders exposed to the same market sectors, particularly those typically demonstrating higher volatility;
- › exposure to asset classes that can experience unexpected lack of liquidity; or
- › large withdrawals related to negative announcements related to the fund's parent company.

Also, the investor type, whether institutional or retail, may imply a different liquidity management strategy as retail-oriented funds with a diversified shareholder base may exhibit lower volatility of flows and operate with lower levels of available liquidity.

Fitch's updated global MMF rating criteria contains a discussion of shareholder redemption risk and provides guidance on the portfolio level liquidity deemed to be consistent with an 'AAAmmf' rating. In evaluating the liquidity of MMFs, the agency considers the nature and concentration of fund shareholders, the ability of portfolios to meet redemptions via asset maturities, the liquidity of underlying assets in the secondary market, and alternative sources of liquidity to avoid forced selling of assets.

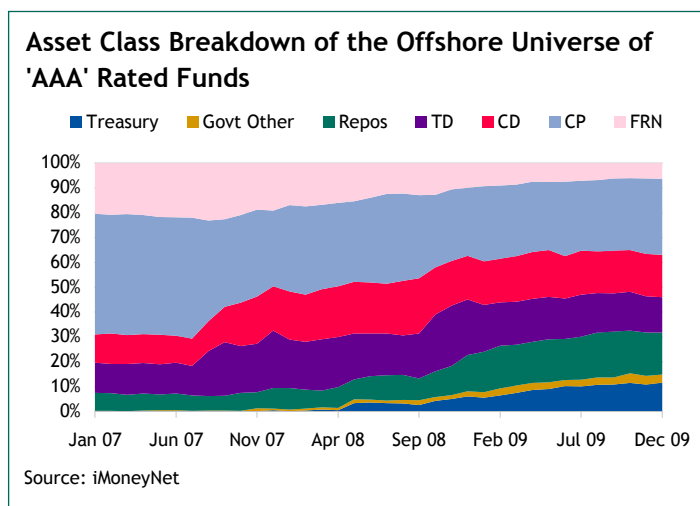


The above charts show the one-week and one-month average liquidity for Fitch ‘AAAmf’ rated MMFs. Funds that may have previously viewed 10% to 20% of overnight liquidity to be sufficient, took overnight exposure to double that amount. A few funds even took their overnight liquidity to as high as 50% following significant outflows. Many funds are still running with significantly higher levels of liquidity. As market conditions have stabilised, these figures have been brought down somewhat, but given the experience of the complications faced and new regulatory restrictions in place, Fitch expect that funds will remain flexible to change their liquidity positions as markets change.

With respect to capital stability, fund managers that Fitch has spoken to have taken active steps to diversify their client base across different sectors, monitor their investor “types” more rigorously, and communicate more actively with their investors, to get a better feel for their clients’ needs.

Portfolio Allocation

MMFs traditionally invest in highly rated money market instruments or short-term debt denominated in the funds’



base currencies. Among available asset types are commercial paper (CP), including asset-backed commercial paper (ABCP), certificates of deposit (CD), time deposits (TD), repurchase agreements and fixed- and floating-rate notes issued by corporates, governments or government agencies.

During the period from January 2007 to December 2009, there was a dramatic shift in MMFs’ portfolio allocation as shown in the chart below. The chart depicts the total exposure to all asset classes for all ‘AAA’ rated offshore MMFs, including sovereign MMFs. As can be seen, funds made a significant move into more liquid asset classes as early as August 2007 when the scale of the crisis emerged. Investments in overnight time deposits increased, almost doubling, and exposure to CP reduced. It should be noted that in the chart CP also includes ABCP.

No material change in funds’ allocation to asset classes can be observed since the beginning of 2009.

Treasuries – New Asset Class and New Money Market Funds

Not only has there been an emergence of offshore MMFs investing exclusively in government securities, but also allocations to government securities were made by a number of offshore MMFs for the first time during the market crisis. By December 2007, both euro and US dollar MMFs introduced sovereign exposure to their portfolios, albeit at very low levels at that stage. Sterling MMFs were slower to add sovereign exposure, only joining in October 2008.

Some funds considered purchasing sovereign securities due to decreased availability of other eligible investments. For example, many credits were driven off eligible investment lists or taken to such low tenors that fund managers had to seek “alternatives”. Starting in October 2008, after the ECB cut rates in coordination with other central banks, MMFs considerably reduced the WAMr across all three currency

classes. As markets were expecting further rate cuts in the future, MMFs sought to increase the WAMr to lock in to higher yields through exposure to securities with low credit risk. As a result, exposure to government debt out to one-year tenor increased. Euro MMFs increased their exposure to government securities to the highest, going up to 20% of total assets, on average, by December 2009.

Growing Investments in Repos: When Liquidity Needs Meet Changing Bank Funding

Allocation to repurchase agreements (repos) increased in sterling, euro and dollar-denominated MMFs. Dollar MMFs have traditionally been investing about 15% of their portfolios in repos, unlike sterling and euro funds, for which investment in repos only started to pick up in December 2008, moving up to 15% of total assets by December 2009.

The supply of repos has increased significantly in the past two years and, given the need for greater liquidity in portfolios, managers have increased their exposure to these transactions. Funds have actually, on occasion, been getting a better rate on repos than for deposits, which is counter-intuitive, as through repo trades, funds get collateral for placing their cash with the banks. This was the result of the demand dynamics resulting from the changing activities and funding needs of banks. Notably, increased exposure to government debt led more banks to start trading repos to fund their government debt exposure.

Liquidity Concerns Reduced Exposure to Floating-Rate Notes

Prior to the crisis, offshore MMFs, on average, invested about 20% of their total assets in floating-rate notes (FRNs) consistently across all currency classes. Some funds would even be comfortable to take exposures up to 30% of total assets, or even higher. By the end of 2009, exposure to FRNs was significantly down. The reduction in FRN allocations was caused by the general pessimistic views on the credit environment, a less liquid secondary market and changes to MMFs' approved lists in respect to the tenors of approved credits.

In its latest global MMF rating criteria, Fitch has limited the maximum maturity to corporate FRNs for 'AAAmf' rated funds to 397 days. For European 'AAAmf' rated funds this has meant a reduction from the previous limit of two years. Also, the introduction of its weighted-average maturity to final (WAMf) metric, which primarily measures spread risk and overall portfolio maturity, will give investors more insight into the risk component of FRN exposure. Fitch expects the fund's portfolio WAMf, for 'AAAmf' rated funds not to exceed 120 days. The measurement of the spread risk

in portfolios has also become a part of the US SEC's and the Institutional Money Market Fund Association's (IMMFA) updated guidelines for MMFs. It should be noted that a high exposure to FRNs does not necessarily mean a high WAMf figure as investments can be made in very short maturity FRNs (under three months and therefore past the final reset date), though of small ticket size.

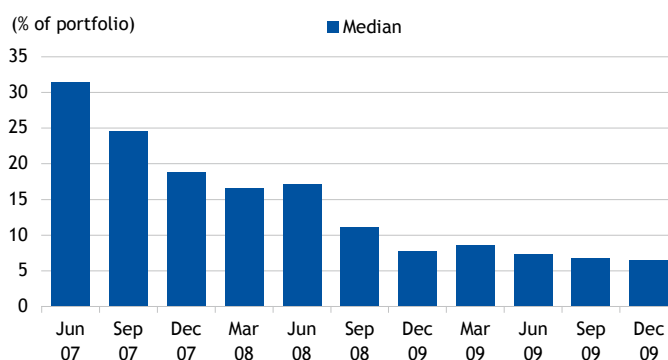
MMFs are now somewhat restricted in purchasing FRNs as there is currently limited new issuance. At the moment, it seems that issuers may not consider offering FRNs with one-year tenor as they seek to reduce their reliance on short-term funding. In Europe, FRN issuance has been reserved for maturities of one year and above but, in the future, issuance in the one-year space is a possibility, as in the US where specific tranches for MMFs have been available.

Asset-Backed Commercial Paper

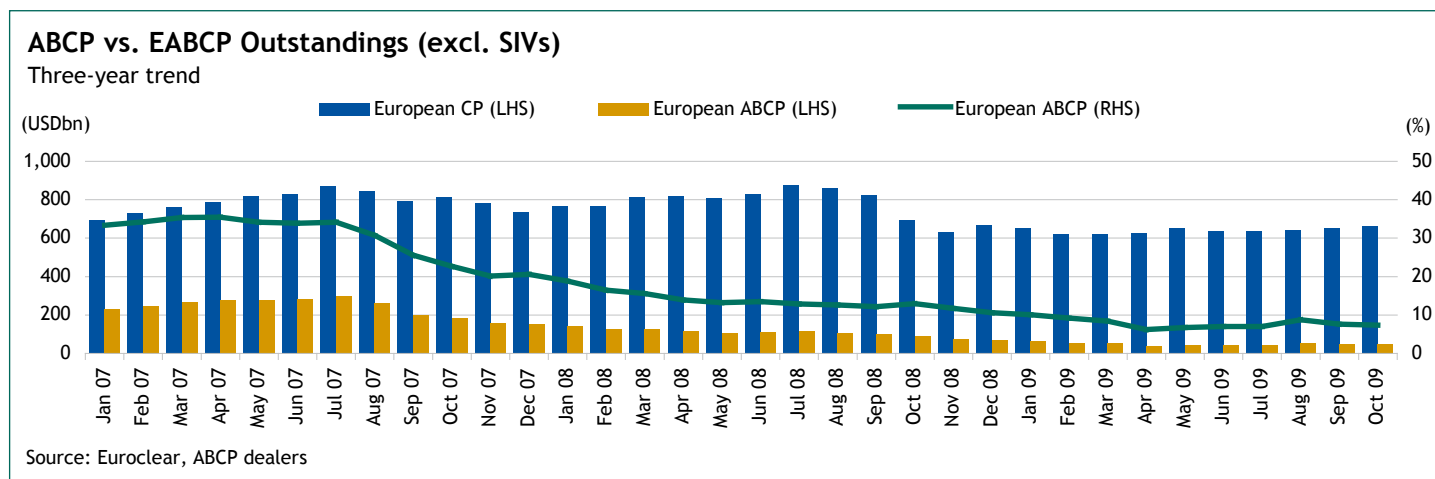
ABCPs have been a traditional part of some European MMF portfolios, and absent in others. There has been a large difference of opinion in the industry with regard to this asset type because of the perception of their complex structure, less transparent nature (in sterling and European ABCPs) and, more recently, their lower liquidity levels. These complexities have set ABCPs aside for managers who have the experience and ability to appropriately analyse the structure of each programme/transaction and its sponsor, and the underlying collateral. Investment by MMFs in ABCP conduits sponsored by highly rated institutions is consistent with Fitch's MMF criteria. In the Asset Class Breakdown chart on page 8, one can see that 'AAA' rated offshore MMF exposure to CP decreased significantly in the second part of 2007. This was mostly a shift out of ABCP rather than a decline in non-secured CP. The chart below shows more detail of exposure to CP across Fitch 'AAAmf' rated funds.

Evolution of ABCP (excl.SIVs) Holdings of Fitch 'AAAmf' Rated Funds

(all currencies)



Source: Fitch



Between June 2007 and December 2008, there was a significant cut in ABCP exposure, with almost two-thirds of the funds holding above 20% of ABCP at the start of the period compared to less than 10% currently. Few funds, however, stopped investments in ABCP altogether. The decline has in part been a function of reviews of MMFs' approved lists, headline concerns and low secondary market liquidity of the ABCP market during the crisis. During 2009, the level of ABCP investments in the fund portfolios remained relatively stable, but some funds started increasing their exposure slightly.

There has been a substantial reduction in supply of ABCP and, in particular, of European ABCP, which witnessed a drop of 83% from its peak of outstandings in July 2007 (USD296.9bn) to September 2009. Since January 2009, ABCP outstandings have hovered around the USD50bn mark, which is in line with the volumes seen in 2003. As can be seen in the chart above, the asset class now represents 10% of the ECP market compared to 35% two years ago.

Various dynamics drove down the supply in the European ABCP markets. Some of the fall in issuance has been a result of conduits going over to the US domestic market to get funded. The dynamics made it more economical for the conduits to shift out of euros and sterling, and into dollars and fund themselves at cheaper levels out of the bigger and deeper US market. Additionally, when the Fed bolstered liquidity support for MMFs by establishing the ABCP Money Market Fund Liquidity Facility (the AMLF), it helped restore liquidity in the US ABCP market. This feature is also reflected in the composition of euro and sterling portfolios, where the average ABCP holdings decreased more significantly.

Industry Issues

Fitch's New Criteria and Reporting Tool

SMARTer Investors

To address the demand from investors for enhanced transparency, Fitch launched its new MMF analytical tool, Funds Surveillance Metrics Analytics Research Tool (Funds SMART), in January 2010, accessible through the agency's website (www.fitchratings.com; Financial Institutions/Fund and Asset Manager Ratings/Surveillance section). Funds SMART provides a valuable one-stop platform for MMF investors. This web-based tool is intended to provide investors in Fitch-rated MMFs with updated fund-level summaries and analytics for those credit, market and liquidity risk metrics most relevant to an MMF's safety of principal and liquidity levels. Some of the analytical metrics captured by Funds SMART include:

- portfolio composition by asset type, credit quality and maturity;
- portfolio liquidity as measured by maturity distribution and weighted-average maturity;
- time series data with respect to portfolio AuM; and
- time series data with respect to portfolio AuM.

SMART metrics are based on monitoring data provided by fund administrators and checked/enriched by Fitch's surveillance analysts.

New Criteria and Rating Scale for Money Market Funds

In 2009, Fitch considered changes to its MMF criteria, in light of the changing market events. After issuing an exposure draft early in 2009, and spending considerable time getting feedback from fund providers and market participants, Fitch published its global MMF ratings criteria on 5 October 2009. The key elements of Fitch's new criteria include:

- ▶ a new rating scale ('AAAmmf') and definitions that are intended to provide improved transparency and differentiation;
- ▶ the measurement of overall portfolio risk along two dimensions – credit quality and maturity (termed the portfolio credit factor or PCF matrix);
- ▶ an analysis of fund diversification that considers direct and indirect credit risk exposures;
- ▶ overnight and weekly portfolio liquidity analysis to determine a fund's shareholder profile and concentrations in addition to fixed percentages;
- ▶ a review of guidelines designed to reduce the risk from securities lending, reverse repurchase agreements and other leveraged activities; and
- ▶ an evaluation of the fund sponsor's multi-faceted role, and its operational and financial standing.

Sovereign Risk

During the crisis, sovereign governments actively intervened by providing support to the financial sector or fiscal stimulus packages, which, combined with poor economic figures, resulted in pressure on sovereign ratings. This was true specifically for states with weaker credit profiles or less financial flexibility. Ireland and Greece were downgraded by Fitch twice in 2009 while other highly rated countries were placed on Negative Outlook.

Market perception of the quality of debt, as measured by credit default swap (CDS) implied ratings, is currently one to two notches below current ratings for several highly rated countries (typically rated above 'AA-'). In the 'AAA' peer group, according to the credit spreads and implied ratings, there is a perception of heightened credit risk with respect to the UK, Spain and Portugal although the ratings of the UK and Spain were affirmed by Fitch in 2009 with a Stable Outlook.

In the context of European MMFs, it is now important to consider direct exposure with investment in securities issued by sovereign governments and government-related entities as well as indirect exposure via banks, particularly as most of the funds are focused on banks with the highest support ratings. Besides, some banks are currently at their rating floor (see "Global Financial Institutions Rating Criteria", dated 29 December 2009) and therefore their ratings are very sensitive to a rating action on the sovereign. Any further pressure on a country's rating may also potentially affect the flexibility of support. As a result, many European MMF managers stopped investing or reduced the tenor of investments in securities from affected countries such as Ireland or Greece.

Country IDR versus CDS Implied Rating and Spread

| Country | Fitch Rating | Outlook | CDS Implied Rating ^a | Five-Year CDS Spreads (bps) |
|----------------|--------------|----------|---------------------------------|-----------------------------|
| Spain | AAA | Stable | AA- | 95.09 |
| United Kingdom | AAA | Stable | AA- | 70.44 |
| New Zealand | AA+ | Negative | AA+ | 49.37 |
| Ireland | AA- | Stable | A | 112.89 |
| Italy | AA- | Stable | AA- | 90.04 |
| Portugal | AA | Negative | A | 111.35 |
| Austria | AAA | Stable | AA+ | 48.83 |
| Denmark | AAA | Stable | AAA | 29.24 |
| Finland | AAA | Stable | AAA | 22.05 |
| France | AAA | Stable | AA+ | 36.77 |
| Germany | AAA | Stable | AAA | 26.16 |
| Netherlands | AAA | Stable | AAA | 29.73 |
| Norway | AAA | Stable | AAA | 15.46 |
| Sweden | AAA | Stable | AAA | 32.09 |
| United States | AAA | Stable | AA+ | 41.97 |
| Japan | AA | Stable | AA | 58.45 |
| Australia | AA+ | Stable | AA+ | 35.76 |
| Belgium | AA+ | Stable | AA+ | 46.73 |

^a CDS implied rating based on five-year CDS spreads and assuming a 40% recovery rate
Source: Fitch, Bloomberg, Data as of 15 March 2010

Historically, European MMFs have concentrated, either through direct or indirect investments, in the largest and most liquid markets such as France, the UK, the Netherlands, Spain, the US and, to a lesser extent, Sweden and Germany. Although significant, exposure to Spain is essentially composed of international banks rather than local ones.

In total, exposure to sovereigns rated lower than ‘AAA’ remains modest and short term, typically from overnight to seven days. In 2009, a number of funds brought Ireland (‘AA-’/‘F1’) back onto their eligible investments list. Currently, a third of funds now have Ireland in their portfolios, most often for a seven-day period and exclusively with supported banks.

With respect to direct T-bill exposure, with the exception of France, the UK, the US, the Netherlands and Germany, the majority of the funds treat government holdings as a single corporate issuer and allocate no more than 5% per country. With the exception of these countries, the maturity of government instruments is within three months.

Regulatory Proposals and Changes in Europe: Towards Pan-European and Even Global Standards

In Europe, MMF-specific regulations and definitions have to date been based on individual countries’ regulatory regimes. This has created the potential for different MMF practices between the US and Europe as well as within Europe itself. In this context, the Institutional Money Market Fund Association (IMMFA), a trade body association representing European ‘AAA’ rated MMFs set up in 2000, introduced a set of standards through its “code of practice”.

In 2009, regulators and the trade body association launched a number of initiatives globally, both to, clearly define MMFs and to revise the frameworks governing these funds, which are summarised in the table below. The common objective was to

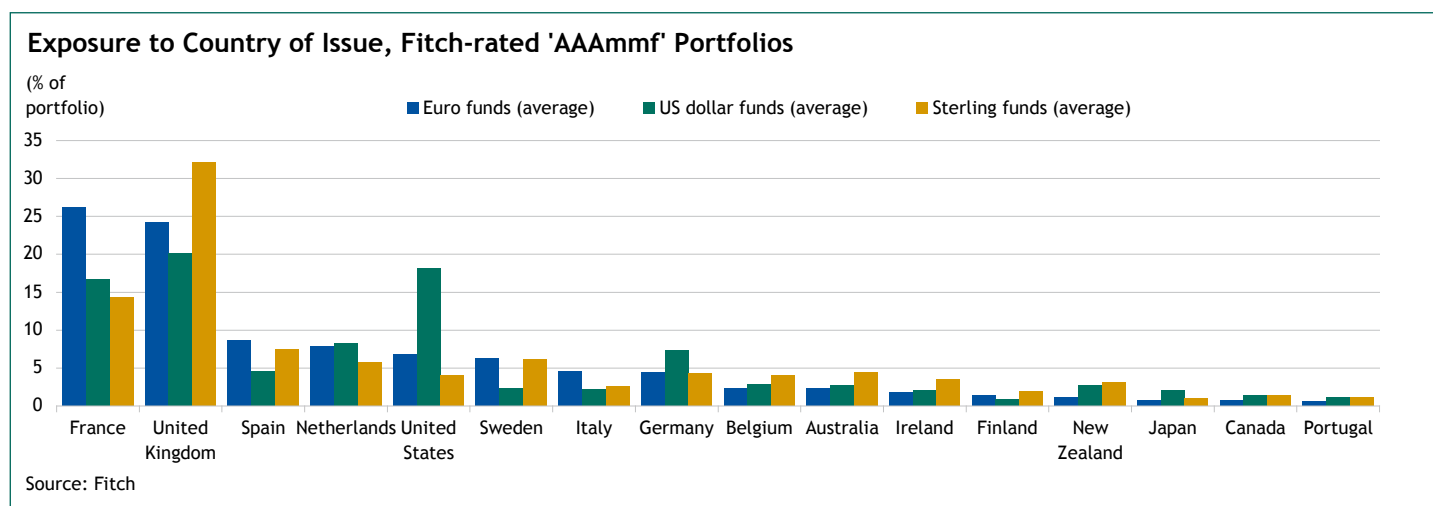
provide greater market stability and transparency following the recent credit market dislocation and liquidity crisis.

In Europe, the Committee for European Securities Regulators (CESR) submitted to the market in October 2009 consultation proposals for pan-European definitions. This follows recommendations to the European Commission from the de La Rosière report in February 2009, which highlighted the need for a common European definition of MMFs. In parallel to this, the European Fund and Asset Management Association (EFAMA), jointly with IMMFA, submitted a proposal for a pan-European MMF definition in July 2009. IMMFA also separately initiated an update of its code of practice governing European ‘AAA’ rated constant net asset value (CNAV) MMFs, which was finalised in December 2009 and has been effective since January 2010. In France, the AMF (Autorité des Marchés Financiers) published in September 2009 the definitions it had proposed to the CESR following several months of discussions with French asset managers and investors.

The proposals put forth by European market participants, including the CESR, all share a common position on the following two points:

- The MMF designation should be confined to those funds whose primary objective is to preserve capital while providing liquidity to investors with yield generation being a secondary objective at most.
- There is a need for classification that recognises the diversity of the European MMF universe and allows some differentiation within this universe between the very short-term oriented funds and those seeking slightly longer-term exposure but still following conservative investment guidelines and targeting capital preservation.

US MMFs, which are part of a USD3.4trn industry, have been operating under the SEC’s Rule 2a-7 since 1983. The



recent crisis led the SEC to tighten its guidelines with a view to increase the resilience of MMFs to market disruptions. The proposed amendments to Rule 2-a7 were approved by the Securities & Exchange Commission on 27 January 2010. In addition to the changes in quantitative limits detailed in the table below, key amendments include the introduction of “know your investor” procedures for effective redemption management as well as monthly disclosure of portfolio holdings and periodic stress testing. The SEC also re-emphasised its intention to pursue more fundamental changes to the structure of MMFs. It is notably actively evaluating other possible reforms with a particular focus on assessing the merits of:

- › floating NAV, while the stable USD1.00 NAV prevails today;
- › mandatory redemptions-in-kind for large redemptions (such as by institutional investors);
- › “real time” disclosure of shadow NAV; and
- › a possible “two-tiered” system of MMFs, with a stable NAV only for MMFs subject to greater risk-limiting conditions and possible liquidity facility requirements.

The following table highlights the main initiatives and summarises current definitions and regulatory changes that are currently under way in the US and Europe:

MMF: Current Definitions and Proposed Evolutions

| | AuM (EURbn) at end-2008 | Status | Max fund int. rate exposure (WAMr) | Max fund credit spread exposure (WAL/WAMf) | Max instrument final maturity | Liquidity | NAV |
|-----------------------|-------------------------|-------------------------------|------------------------------------|--------------------------------------------|------------------------------------------------------|----------------------------------------------------------|-------------------------|
| SEC 2a7 (US) | 2,754 | Previous | 90 days | No explicit limit | 397 days & longer for US sov. FRN/VRN | Max 10% in illiquid assets | CNAV |
| | | Current since Jan 10 | 60 days | 120 days | 397 days & longer for US sov. FRN/VRN | Min 10% O/N & 30% at 7 days Max 5% in illiquid assets | CNAV VNAV considered |
| CESR (Europe) | 1,350 | Proposal – Short-Term Oct 09 | 60 days | 90 days or 120 days | 397 days or 397 days & 2 yrs for FRN, max 10% > 1 yr | No explicit limit | VNAV & CNAV |
| | | Proposal – Longer-Term Oct 09 | 6 months | 6 months or 12 months | 397 days & 2 yrs for FRN, max 10% > 1 yr | No explicit limit | VNAV |
| AMF (France) | 488 | Current | 0.5 duration | No explicit limit | No explicit limit | No explicit limit | VNAV |
| | | Proposal – Short-Term Sep 09 | 0.5 duration | 3 months | 1 year | No explicit limit | VNAV |
| | | Proposal – Broad Sep 09 | 0.5 duration | 6 months | 2 years | No explicit limit | VNAV |
| EFAMA/ IMMFA (Europe) | 1,350 | Proposal – Short-Term Jul 09 | 60 days | 0.5 years | 397 days & 2 yrs for FRN, max 10% > 1 yr | Min 5% O/N & 20% at 7 days | VNAV & CNAV |
| | | Proposal – Regular Jul 09 | 1 year | 1.5 years | 397 days & 5 yrs for FRN, max 10% > 2 yrs | No explicit limit | VNAV |
| IMMFA (Europe AAA) | 407 | Previous | 60 days | No explicit limit | No explicit limit | No explicit limit | CNAV |
| | | Current since Dec 09 | 60 days | 120 days | 397 days & 2 yrs for sov. FRN | Min 5% O/N & 20% at 7 days | CNAV |

Source: Fitch, SEC, CESR, AMF, EFAMA, IMMFA

In light of these proposed changes, and the recent consultation initiated by the CESR as regards the introduction of pan-European MMF definitions, Fitch sees the emergence

of a global convergence of standards as being likely, at least for the most conservative MMFs.

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