# The Role of Credit Rating Agencies in the Portfolio Management of Money Market Funds

## Introduction

This memorandum is being written to accompany the oral testimony of Deborah A. Cunningham to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises at a hearing entitled "Rating the Rating Agencies: the State of Transparency and Competition," on Wednesday, April 2, 2003. Deborah A. Cunningham is a Senior Vice-President with Federated Investors, Inc. in charge of the firm's taxable money market area.

This memorandum addresses the role of Nationally Recognized Statistical Rating Organizations (NRSROs) in the context of portfolio management for money market funds. Rule 2a-7, which the Securities and Exchange Commission (SEC) promulgated under the Investment Company Act of 1940, dictates how money market funds must utilize NRSRO ratings to try and mitigate credit risk in such portfolios. All money market portfolio securities must be deemed to present minimal credit risks. This determination of minimal credit risks must be based on internal credit analysis but also be inclusive of any rating assigned to such securities by an NRSRO.

A money market fund may only hold Eligible Securities. An Eligible Security is a First Tier Security or Second Tier Security with a maturity of 397 days or less. To determine if a security is First Tier or Second Tier, we must first determine if it is a Rated Security. A Rated Security either (a) has received short-term ratings from NRSROs or (b) is comparable in priority and security to other obligations of the issuer that have received short-term ratings from NRSROs. A security that does not meet either criteria is an Unrated Security.

Currently, there are four NRSROs: Dominion Bond Rating Services ("DBRS"), Fitch Investors, Inc. ("Fitch"), Moody's Investors Service, Inc. ("Moody's") and Standard & Poor's ("S&P"). The following table identifies the two highest short-term rating categories for each NRSRO.

| **NRSRO** | **DBRS** | **Fitch** | **Moody's** | **S&P** |
|---|---|---|---|---|
| **Highest Category** | **R-1** | **F1+ or F1** | **Prime-1 or MIG-1** | **A-1+, A-1, SP-1+ or SP-1** |
| **2nd Highest Category** | **R-2** | **F2** | **Prime-2 or MIG-2** | **A-2 or SP-2** |

If a Rated Security (or the obligations to which it is comparable) received a short-term rating from only one NRSRO, then this rating determines its tier. If the rating is in the highest category, it is a First Tier Security. If the rating is in the second highest category, it is a Second Tier Security. If the rating is below the second highest category, it is not an Eligible Security.

If a Rated Security (or the obligations to which it is comparable) received short-term ratings from more than one NRSRO, then the ratings of the Requisite NRSROs determine its tier. Rule 2a-7 defines the Requisite NRSROs as the two NRSROs giving the highest short-term ratings. The lowest of these two NRSRO ratings then determines the security's tier, as shown in the following table.

| Number of Ratings | Ratings Received | Tier Under Rule 2a-7 |
|---|---|---|
| **Two NRSROs:** | **P-1/A-1** | **First Tier** |
| | **P-2/A-1** | **Second Tier** |
| | **P-3/A-1** | **Not an Eligible Security** |
| **Three NRSROs:** | **A-1/F-1/P-3** | **First Tier** |
| | **A-2/F-1/P-3** | **Second Tier** |
| | **A-3/F-1/P-3** | **Not an Eligible Security** |
| **Four NRSROs:** | **F-1/R-1/A-3/P-3** | **First Tier** |
| | **F-2/R-1/A-3/P-3** | **Second Tier** |
| | **F-3/R-1/A-3/P-3** | **Not an Eligible Security** |

In the case of an Unrated Security, the fund's Board of Directors must determine whether it is comparable to Rated Securities that are First Tier or Second Tier Securities. However, the Board may only make such a determination if the Unrated Security satisfies one of the following three conditions:

- At the time of issuance, the Unrated Security's maturity did not exceed 397 days.
- The Unrated Security has not received a long-term rating from any NRSRO.
- The Unrated Security has received long-term ratings within the three highest categories from the requisite NRSROs.

Demand Features and Guarantees. A money market fund may also treat a security as an Eligible Security based upon a Demand Feature or Guarantee. Guarantees include, along with ordinary guarantees, letters of credit, bond insurance and Unconditional Demand Features. A Demand Feature is Unconditional if it can be exercised notwithstanding a default on the underlying security.

If the Demand Feature or Guarantee qualifies as a First Tier Security (or Second Tier Security), then the fund may treat the underlying security as a First Tier Security (or Second Tier Security) also. However, the terms of the security must provide notice to the fund of any substitution of the Demand Feature or Guarantee. In addition, a Guarantee from a non-affiliated person of the issuer must quality as a Rated Security.

If a fund relies upon a Conditional Demand Feature for this purpose, then it must satisfy three additional requirements. First, the fund's Board of Directors must find a minimal risk that the Demand Feature will terminate before the fund can exercise it. Second, the events that would terminate the Demand Feature must meet one of the following criteria:

- The event must be an occurrence that a fund can readily monit or;
- The event must trigger a notice that gives a fund an opportunity to exercise the Demand Feature before it terminates; or
- The event must relate to the taxability of the security.

Finally, the underlying security must have received ratings from NRSROs in one of their two highest long-term or short-term categories, be comparable in priority and security to other obligations of the issuer that have received such ratings, or the Board must determine that they are comparable to securities receiving such ratings.

If a Guarantee or Demand Feature is not an Eligible Security, the fund may still treat the underlying security as an Eligible Security. However, the underlying security must qualify independently as a First or Second Tier Security. Moreover, if the security has a Demand Feature, the fund may not rely on the Demand Feature to determine the security's maturity or to provide liquidity for the security.

Asset Backed Securities. Rule 2a-7 defines an Asset Backed Security as a security issued by a Special Purpose Entity payable from cash flows from Qualifying Assets. A Special Purpose Entity is an entity that exists primarily to hold Qualifying Assets and service its securities. Qualifying Assets include any type of self liquidating financial asset. If the security is an Asset Backed Security, it must have received a rating from at least one NRSRO. The rating must apply to the Asset Backed Security itself, not to comparable obligations of the Special Purpose Entity. However, the rating may be long or short-term and does not have to be above a specific category. This requirement does not apply to an Asset Backed Security supported exclusively by municipal obligations.

Having established the role of the NRSROs as necessitated by the regulatory requirement, the following comments pertain to the quality of information received from the NRSROs. In general, the content of NRSRO write-ups has improved over time. Specifically, they have more qualitative content and are generally more timely. On the other hand, some most recent full reports on companies contain information over eighteen months out of date. There is normally a quantitative section that compares the specific company to industry peers which is relatively helpful. There are also usually charts showing financial trends over time for the specific company. The verbiage accompanying the charts and graphs generally explains any trends that should be noted. The summary is typically a list of positives and negatives that should be noted for the company. This summary provides the justification for the rating given to the company by the NRSRO.

In most cases, the NRSROs place a company on a watchlist, with either a positive or negative outlook, before changing that company's ratings. The watchlisted companies typically are accompanied by a list of items to consider in the further ratings developments for each company. Occasionally, however, a company's ratings are changed without any prior warning or without ever being placed on any type of watchlist. This is disruptive to the market and perhaps hints at either a sudden change in the company's creditworthiness that had not been foreseen, or a misinterpretation of previous company data by the NRSRO. It's these times of unexpected, sudden rating changes that should be accompanied by further clarification from the NRSRO.

Some clarification should be given to address the difference between corporate credit comments and asset-backed securities (ABS) credit comments. Because corporate issuers are generally operating companies with periodic financial statement filings, the NRSROs are usually quite up-to-date disseminating their interpretation of the most recent financial information and analysis. In contrast, ABS issuers are Special Purpose Entities (SPEs) that provide monthly financial data to the NRSROs. Because the corporate entities are publicly held, in large part, investors are able to obtain most information and substantiate minimal credit risk decisions. ABS issuers, however, are not publicly held and therefore are not required to submit the same detail to investors as is required by NRSROs. Increased and more timely disclosure in the ABS market by the NRSROs would benefit the investor in this marketplace.

Fees paid by fund companies managing money market funds are a substantial portion of the advisory fees for those funds. Although these fees may pale in comparison to issuer fees paid by a company to obtain that rating, it is incremental enough to cause the NRSROs to be considered unbiased third party experts.

In order to insure this unbiased quality, NRSRO analyst discussions with issuers they rate should be restricted to just those items that affect the financial health of the issuers. All contract negotiations between NRSROs and issuers should be separate and handled by an operations and administrative group, not the analysts.

With regard to additional fee-based businesses, the example used will be that of money market fund ratings. Some of the NRSROs that rate money market funds require that all securities owned within that money market fund contain that specific NRSROs ratings. Other NRSROs only require that the fund contain rated securities by any one of the NRSROs. The latter seems to be in line with good business practices if all securities held within the fund are indeed analyzable.

The SEC most recently recognized DBRS as a fourth NRSRO. Consolidation had caused what was a high of seven NRSROs to dwindle to three before this recent addition. The status afforded this NRSRO designation should be, and has appropriately been, treated with much debate and detail. The SEC's recognition of the current four NRSROs seems reasonable, although investors generally welcome all additional information. Allegations of anti-competitive or unfair practices against these NRSROs seems with little merit. Greater NRSRO oversight although, could come in the form of insuring that a "Chinese Wall" exists between the analysts and committees assigning the ratings and the executives negotiating the payment of fees.