IDC Independent Directors Council
Promoting Excellence in Fund Governance

Money Market Funds and Credit Ratings on US Treasury Securities: FAQs

These FAQs update an ICI resource from the 2011 debt ceiling crisis.

Money Market Funds and Credit Ratings on US Treasury Securities

Frequently Asked Questions

Why is the debate over of the US debt ceiling and deficit relevant to money market funds?

Would a downgrade of US Treasury debt affect US money market funds?

Would a downgrade in the short-term credit rating of the US government force money market funds to dispose of their holdings of Treasury debt?

What credit ratings correspond to first tier and second tier for money market funds?

What credit factors other than credit ratings must money market funds consider when buying or holding securities?

Would money market funds be able to add US government securities to their portfolios if the US government's short-term credit rating fell to second tier?

In the unlikely event that short-term US Treasury and agency debt were downgraded below second tier, what would money market funds be required to do?

What would be the consequences of failure by the US Congress and Administration to raise the debt ceiling before the government runs out of cash to pay all of its bills (currently estimated to be October 17, 2013)?

For a money market fund, what would constitute "default" in a US government security?

Why might a money market fund's board of directors choose not to dispose of a defaulted or severely downgraded security?

Why is the debate over of the US debt ceiling and deficit relevant to money market funds?

Failure to increase the US debt ceiling or address the long-term US spending and fiscal imbalance could adversely affect investors, markets, and economies across the globe—with severe consequences for interest rates, stock prices, investor confidence, and the day-to-day activities of businesses and consumers.

Money market funds are required to invest only in short-term, highly liquid securities that present minimal credit risk. As of August 31, 2013, money market funds owned $831 billion in US Treasury and agency securities—and held another $452 billion in repurchase agreements collateralized by Treasuries and agencies. Because these amounts are large, it is important to understand how a Treasury default or downgrade could affect financial markets.

For more information on money market funds, please visit our Money Market Fund Resource Center.

Would a downgrade of US Treasury debt affect US money market funds?

That depends on many factors. One of the most important is whether any downgrade affects only the government's long-term credit rating, or applies to both long-term and short-term debt. A money market fund's ability to purchase or hold a rated security depends

on the issuer's short-term credit rating. If the US government's long-term credit rating were to be downgraded, but not its short-term credit rating, there would be no implication for money market funds. If the US government short-term credit rating were downgraded, money market funds might be affected, but likely only if the short-term credit rating dropped below "investment grade."

In 2011, rating agency Standard & Poor's lowered its long-term sovereign credit rating on the United States from "AAA" to "AA+" with a negative outlook. Importantly, it maintained its "A-1+"—the the highest possible short-term rating—on the United States. The two other major ratings agencies—Moody's Investor Services and Fitch Ratings Ltd.—have, for now, kept their rating on the United States at "AAA," the highest possible rating.

Would a downgrade in the short-term credit rating of the US government force money market funds to dispose of their holdings of Treasury debt?

That's unlikely. Credit rating agencies would have to cut their ratings on short-term Treasury debt steeply—reducing them by at least seven steps on the long-term rating scale—to force such an action. Downgrading the US government's short-term rating below second tier would be the equivalent of taking its long-term credit rating down by at least eight steps, from AAA/Aaa to BBB+/Baa2 (see table below) for Fitch and Moody's and at least seven steps for S&P.

A security rated by multiple credit-rating agencies designated as Nationally Recognized Statistical Rating Organizations (NRSROs) is eligible for purchase by money market funds if two or more of those NRSROs rate the security in either their highest ("first tier") or second-highest ("second tier") short-term rating levels. The US government's short-term debt is currently rated as first tier by all of the NRSROs that have issued short-term ratings.

A downgrade of US government short-term debt from first to second tier would not preclude money market funds from purchasing or holding US government securities. Nor would it require money market funds to sell their current holdings of Treasury or agency securities.

What credit ratings correspond to first tier and second tier for money market funds?

Moody's Investor Services uses "P-1" and "P-2" as its symbols for the two highest short-term ratings categories. Standard & Poor's Rating Services uses "A-1+" and "A-1" for first tier and "A-2" for second tier. Fitch Ratings Ltd. uses "F-1+" and "F-1" for first tier and "F-2" for second tier.

The following table shows how these major credit rating agencies align their long-term and short-term ratings, and which short-term ratings constitute first tier and second tier:

<table>
<tr><th colspan="2">Money market fund category</th><th colspan="2">Moody's</th><th colspan="2">Standard & Poor's</th><th colspan="2">Fitch</th></tr>
<tr><td></td><td></td><td>Long-term</td><td>Short-term</td><td>Long-term</td><td>Short-term</td><td>Long-term</td><td>Short-term</td></tr>
<tr><td rowspan="3">Eligible securities</td><td rowspan="2">First Tier</td><td rowspan="2">Aaa
Aa1
Aa2
Aa3
A1
A2*
A3*</td><td rowspan="2">P-1</td><td>AAA
AA+
AA
AA-</td><td>A-1+</td><td>AAA
AA+
AA
AA-
A+*</td><td>F-1+</td></tr>
<tr><td>A+
A*</td><td>A-1</td><td>A+*
A
A-*</td><td>F-1</td></tr>
<tr><td>Second Tier</td><td>A2*
A3*
Baa1
Baa2*</td><td>P-2</td><td>A*
A-
BBB+
BBB*</td><td>A-2</td><td>A-*
BBB+
BBB</td><td>F-2</td></tr>
<tr><td>Ineligible securities</td><td>Third Tier</td><td>Baa2*
Baa3</td><td>P-3</td><td>BBB*
BBB-
BB+*</td><td>A-3</td><td>BBB*
BBB-</td><td>F-3</td></tr>
</table>

Non-investment grade	Ba1 to B3 Caa1 to Ca	Not Prime	BB+* to CCC* B* to CC	B C	BB+ to B- CCC to C	B C
In default	C	Not Prime	SD, D	SD, D	RD, D	RD, D

*All three agencies allow some overlap in rating categories.

Sources: Moody's Investor Services, Standard & Poor's Global Credit Portal, Fitch Ratings, Bank for International Settlements

As the table shows, short-term rating bands are broader and contain fewer rating "steps" than long-term ratings. An issuer whose long-term rating was downgraded from AAA to AA would still be rated A-1+ and, hence, first tier for short-term debt.

What credit factors other than credit ratings must money market funds consider when buying or holding securities?

A money market fund must limit its investments to securities that pose a "minimal credit risk," as determined by the fund's board. That determination is made independently of any credit rating. The board of directors normally delegates the power to make that determination to the fund adviser, following policies set by the board.

Would money market funds be able to add US government securities to their portfolios if the US government's short-term credit rating fell to second tier?

Yes. The Securities and Exchange Commission's Rule 2a-7—the rule governing money market funds—deems government securities to be first tier securities as long as they are eligible for purchase (i.e., rated in the first or second tier by two or more NRSROs). Rule 2a-7 places no limits on the share of a fund's portfolio that can be invested in first tier securities. In addition, though Rule 2a-7 generally limits a money market fund's holdings of securities from any one issuer, this diversification requirement does not apply to US government securities.

Any decision to purchase US government securities would depend on the fund's determination that those securities continue to pose minimal credit risk.

In the unlikely event that short-term US Treasury and agency debt were downgraded below second tier, what would money market funds be required to do?

If short-term US Treasury and agency debt were downgraded below second tier, a money market fund would be required to dispose of the downgraded securities in an orderly manner, unless the fund's board determined that disposing of the securities would not be in the best interests of the fund and its shareholders.

What would be the consequences of failure by the US Congress and Administration to raise the debt ceiling before the government runs out of cash to pay all of its bills (currently estimated to be October 17, 2013)?

The US Treasury "estimates that extraordinary measures will be exhausted no later than October 17" unless the statutory debt ceiling is raised from its current level of $16.7 trillion. In that event, Treasury says, "the government would have to stop, limit, or delay payments on a broad range of legal obligations, including Social Security and Medicare benefits, military salaries, interest on the national debt, tax refunds, and many other commitments." Policymakers have discussed a number of options for giving priority to particular obligations (e.g., military salaries and Social Security payments).

For a money market fund, what would constitute "default" in a US government security?

If the US government fails to pay interest or principal when due on a security in a money market fund's portfolio, the security would

be in default. The fund must then dispose of the security in an orderly way, unless the fund's board determines that disposing of the security would not be in the best interests of the fund and its shareholders. In deciding, the board may consider market conditions and other factors. If the security accounts for 0.5 percent or more of the fund's portfolio, the fund also must report the default to the SEC.

In addition, the US government's failure to pay its obligations could trigger a severe downgrade of its short-term credit rating by NRSROs. In that case, US government securities may no longer be eligible securities (i.e., may no longer be rated first or second tier by at least two NRSROs), or a money market fund's board or its delegate may determine that the credit risk of those securities is no longer minimal. In either of those events, the fund would be required to dispose of those securities, unless the fund's board determines that disposing of the securities would not be in the best interests of the fund and its shareholders.

Why might a money market fund's board of directors choose not to dispose of a defaulted or severely downgraded security?

Rule 2a-7 requires a money market fund to dispose of a security that is no longer eligible (i.e., first or second tier) or that is in default "as soon as practicable consistent with achieving an orderly disposition," unless the board finds that "disposal of the security would not be in the best interests of the money market fund (which determination may take into account, among other factors, market conditions that could affect the orderly disposition of the portfolio security)..."

In unsettled markets following a default on US government securities, a board could determine that disposal of its US Treasury securities would not be in the best interests of the fund or its shareholders, particularly if the default was expected to be short-lived and the board expected that the Treasury would likely make full repayment of interest and principal in the near future.

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