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Office of the Comptroller of the Currency
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Washington, DC 20219

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
Attention: No. 2006-33
1700 G Street, N.W.
Washington, DC 20552

Re: *OCC Docket Number 06-09 (RIN 1557-AC91)*
Federal Reserve Board Docket No. R-1261
FDIC RIN 3064-AC73
OTS Docket No. 2006-33 (RIN 1550-AB56)

Risk-Based Capital Standards:
Advanced Capital Adequacy Framework

To the Agencies Addressed (the "Agencies"):

The following comments are submitted on behalf of Federated Investors, Inc. ("Federated") with respect to the Joint Notice of Proposed Rulemaking ("NPR") published by the Agencies in the Federal Register on September 25, 2006[1] relating to the implementation of the Basel Committee on Banking Supervision's Revised Framework for International Capital Measurement and Capital Standards ("Basel II").

Federated's comments relate solely to the impact of the NPR on the highest quality money market mutual funds ("MMFs").[2] Federated, a major issuer of MMFs, respectfully submits that the NPR would assign unreasonably high risk weights to top-rated MMFs, and would therefore create a needless and undesirable disincentive for institutions subject to Basel II to use these MMFs as a safe and efficient medium for managing cash and holding temporary liquidity.

Top-rated MMFs have characteristics that distinguish them from all other types of investment funds, including MMFs rated in lower categories. First, all MMFs are subject to special rules of the Securities and Exchange Commission ("SEC") intended to assure the quality and liquidity of MMF portfolios. Second, MMFs, rated in the highest rating category by the nationally recognized statistical rating organizations ("NRSROs"), must satisfy additional demanding requirements of the rating agencies relating to the liquidity, quality, maturity and diversification of the portfolio, as well as to the adequacy of management and internal controls. For these reasons, Federated requests that the final version of the Agencies rules implementing Basel II (the "Final Basel II Rules") recognize these special characteristics in the assignment of risk weights by affording top-rated MMFs the same treatment as top-rated tranches of securitizations.

I. <u>The Background of MMFs.</u>

A. <u>General.</u>

MMFs are open-end management investment companies registered under the Investment Company Act of 1940 (the "1940 Act") that have as their investment

[1] *Risk-Based Capital Standards: Advanced Capital Adequacy Framework and Market Risk; Proposed Rules and Notices*, 71 Fed. Reg. 55829 (Sept. 25, 2006) ("*Basel II NPR*").

[2] These comments may be considered as responsive to Question 59 in the NPR, *Basel II NPR*, *supra* note 1, 71 Fed. Reg at 55899.

objective the generation of income and preservation of capital and liquidity through investment in short-term, high quality securities. First introduced in 1972, MMFs today hold total assets of more than $2.3 trillion. MMFs offered by Federated hold total assets in excess of $160 billion.

MMFs seek to maintain a stable share price, typically $1.00 per share, which has encouraged investors to view MMFs as an alternative to bank deposits or checking accounts, even though MMFs do not have federal deposit insurance. The SEC has observed that "investors generally treat money market funds as cash investments."[3]

MMFs have been widely accepted by institutional investors. As the Investment Company Institute has noted, corporations have shown a preference to outsource cash management to MMFs rather than holding liquid securities directly.[4] By using MMFs institutions are able to obtain daily liquidity at par, together with true daily choice, flexibility and economies of scale that are unavailable through internal management of their liquid assets.[5] As of year-end 2005, U.S. businesses held about 19 percent of their short-term assets in MMFs.[6]

"Prime" MMFs typically invest in a variety of high-quality, short-duration assets, such as commercial paper, medium-term notes, bankers' acceptances, corporate debt, and certificates of deposit, as well as obligations of the U.S. government and government-sponsored agencies, and are highly rated by the NRSROs. Other funds may invest predominantly in U.S. Treasuries and obligations of government-sponsored enterprises, or solely in Treasuries ("government" funds), or in a variety of municipal securities ("municipal" funds). Government and municipal funds may also be rated by the NRSROs. **These comments address solely the NPR's impact on those prime, government and municipal funds that receive the highest ratings, typically Triple-A, from the NRSROs**

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[3] *Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 21837 (Mar. 21, 1996, 61 Fed. Reg. 13955, 13957 (Mar. 28, 1996) ("*Money Market Rule Revisions*").

[4] Investment Company Institute, Mutual Fund Fact Book at 30 (42d ed. 2002).

[5] *See id.*

[6] Investment Company Institute, 2006 Investment Company Fact Book at 25 (46th ed. 2006).

B. SEC Regulations Governing MMFs.

Under the 1940 Act and its implementing rules, mutual funds generally are required to value portfolio investments at market value (or if market values are not readily available, at fair value) and to calculate current net asset value per share as the basis for issuing or redeeming shares. However, the SEC has exempted MMFs alone from this requirement in order to enable MMFs to maintain a stable share price by using the "amortized cost" method of valuation or the "penny-rounding" method of pricing. The SEC's Rule 2a-7 under the 1940 Act[7] effectively prohibits a registered investment company from holding itself out to investors "as a money market fund or the equivalent of a money market fund" (and thus from taking advantage of the exception that allows MMFs to maintain a stable net asset value per share) unless it meets specified conditions relating to portfolio maturity, portfolio quality, portfolio diversification, and portfolio liquidity. These conditions may be summarized as follows[8]:

Portfolio Maturity. MMFs must maintain a dollar-weighted average portfolio maturity appropriate to the objective of maintaining a stable net asset value per share. They may not acquire any instrument having a remaining maturity of greater than 397 calendar days, and may not maintain a dollar-weighted average portfolio maturity of more than 90 days.

Portfolio Quality. MMFs may purchase only securities that are denominated in United States dollars, that pose minimal risk to the fund, and that qualify as "Eligible Securities" under the rule. "Eligible Securities" are defined generally as (1) securities that are rated in one of the highest two short-term rating categories by a nationally recognized statistical rating organization, or (2) comparable unrated securities. Such securities must be determined by the fund's board of directors to present minimal credit risks. MMFs other than government and municipal MMFs may not have more than 5

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[7] Securities and Exchange Comm., Rules and Regulations Under the Investment Company Act of 1940 §2a-7, 17 C.F.R. §270.2a-7.

[8] A more detailed discussion of SEC Rule 2a-7, including a description of the amortized cost and penny-rounding methodologies, is attached as Appendix A, together with the full text of the rule.

percent of their assets invested in Eligible Securities that are not in the highest rating category.

Portfolio Diversification. Rule 2a-7 subjects MMFs to a variety of requirements designed to limit the fund's exposure to the credit risk of any single issuer.

Portfolio Liquidity. SEC rules also subject MMFs to stringent portfolio liquidity standards. MMFs are limited to investing no more than 10 percent of their assets in illiquid securities. The SEC considers a security to be illiquid if it cannot be disposed of within seven days in the ordinary course of business at approximately the price at which the fund has valued it.[9]

As a result of these SEC rules, an MMF is effectively precluded from investing in securities having an equity risk, and as a consequence MMFs do not invest in equities.

C. The Rating of MMF Shares

Major NRSROs in the United States regularly rate MMFs, and their ratings criteria build significantly on the requirements of SEC Rule 2a-7. Indeed, an important aspect of the regular monitoring of MMFs by the rating agencies is to corroborate that the requirements of Rule 2a-7 relating to credit quality, diversification, maturity and liquidity are actually being observed. For an MMF to obtain a top rating, however, the NRSROs will apply even more stringent requirements than Rule 2a-7. For example, while Rule 2a-7 requires that an MMF maintain a weighted average maturity of 90 days or less in its portfolios, both Standard & Poor's and Fitch require a weighted average maturity of not more than 60 days in order to obtain a triple-A rating. S&P states explicitly that

> "there are significant differences between the minimum standards required by Rule 2a-7 and Standard & Poor's rating criteria for the highest rating categories. In fact, a fund that meets the minimum regulatory requirement would at best qualify for a 'BBB_m' rating from Standard & Poor's."[10]

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[9] *Money Market Rule Revisions*, *supra* note 3, 61 Fed. Reg. at 13966.

[10] Standard & Poor's, *Fund Ratings Criteria* at 9-10 (2005).

The NRSROs also go beyond the requirements of Rule 2a-7 by making their own assessments of a fund's policies, procedures, management and oversight.[11] As Fitch states, "an assessment of management's qualifications and specific track record in managing the fund under review. . . is an integral part of the fund rating process."[12] Similarly, Moody's will assess fund management, as well as the professional skills and track record of the fund's investment advisor, in addition to the fund's operational procedures and controls.[13]

While all MMFs must satisfy the requirements of Rule 2a-7, only those that also meet the most rigorous standards of the NRSROs are awarded the highest rating. As of January 16, 2007:

- 41 percent of all MMFs, representing 45 percent of total MMF assets, have at least one AAA rating;
- 19 percent of all MMFs, holding 21 percent of all MMF assets, are rated AAA by S&P and Moody's; and
- 7 percent of all MMFs, holding 14 percent of all MMF assets, are rated AAA by all three major rating agencies.[14]

D. <u>The Safety Record of MMFs.</u>

MMFs that may invest in the full range of securities permitted by Rule 2a-7 have had an impressive record of safety for over 34 years. The vast majority of such funds have never invested in any money market instrument that did not pay off at maturity. While there have been relatively isolated circumstances in which an MMF has experienced the potential for deviations between its stabilized share price and its market based per share net asset value by virtue of its investments in all but one of such instances

[11] We have attached at Appendix B excerpts from publications of Fitch, Moody's and Standard & Poor's describing their processes and requirements for rating MMFs.

[12] Fitch Ratings, *U.S. Money Market Fund Ratings*, p. 5 (March 3, 2006).

[13] Moody's Investor Services, *Moody's Managed Funds Credit Quality Ratings Methodolgy*, p.4 (June 2004)

[14] See Appendix C

the funds' investment advisers have purchased the distressed or defaulted securities from their funds at their amortized cost value, plus accrued interest, or have contributed capital to the fund to maintain the constant share price.[15] Despite these incidents, "no individual investor has ever lost money in a modern money market fund."[16]

Most important for the purposes of the Basel II NPR, **no investor, individual or institutional, has ever lost money in a top-rated prime, government or municipal MMF.**

II. The NPR's Treatment of MMFs.

A. The Look-Through Approach

The NPR defines four categories of asset exposures: wholesale credit, retail credit, securitizations, and equities.[17] Shares in an "investment fund"[18] are treated as equities.[19] While equities are generally risk-weighted at 300 percent, if they are publicly traded, or 400 percent, if they are not publicly traded, the NPR has proposed, in Section 54, special rules for equity exposures to investment funds.[20] Specifically, the NPR proposes to adopt a "look-through" approach with respect to shares in an investment

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[15] *Money Market Rule Revisions*, *supra*, 61 Fed Reg. at 13972 n.162. While MMF sponsors do not provide credit backing for their funds, Federated maintains uncommitted backup liquidity lines for various of its mutual funds with two different high quality banks.

[16] iMoneyNet, "Money Fund Basics," (available at http://www.imoneynet.com/mfBasics.htm) (accessed January 4, 2006).

[17] *Basel II NPR*, *supra*, 71 Fed. Reg. at 55858-60.

[18] An "investment fund" is defined as a company "(1) all or substantially all of the assets of which are financial assets; and (2) that has no material liabilities." *Basel II NPR*, *supra*, 71 Fed. Reg. at 55917.

[19] Although the NPR treats shares in investment funds as equities, it should be noted that the NPR definition of an "equity exposure" excludes ownership interests that are "redeemable.: *Basel NPR*, *supra*, 71 Fed. Reg at 55915. All MMF shares are fully redeemable.

[20] *Basel II NPR*, *supra*, 71 Fed. Reg. at 55945.

fund, so that the actual risk weighting for such shares would be based on the risk weightings for the exposures held or potentially held in the fund's portfolio. The NPR sets out three available methodologies:

The "Full Look-Through" Approach. This is essentially a weighted-average approach based on the fund's actual holdings. A bank may risk-weight its holding of fund shares as the greater of (1) the product of (i) the risk weights for each of the securities held by the fund (calculated as if they were held directly by the bank), and (ii) the bank's proportional ownership share of the fund, or (2) 7 percent of the carrying value of the bank's interest in the fund.

The Simple Modified Look-Through Approach. Where the bank cannot determine the composition of the fund, the risk weight for the bank's holding of fund shares would be the greater of the carrying value of the bank's interest times (1) the highest risk weight[21] applicable to any exposure the fund is permitted to hold, or (2) 7 percent.

The Alternative Modified Look-Through Approach. Under this approach the bank may risk-weight its fund shares on a pro rata assignment of risk weights applicable to the fund's holdings based on the investment limits in the fund's prospectus. If the sum of the investment limits exceeds 100 percent, the bank must assume that the fund invests to the maximum extent permitted in the assets with the highest risk weights, and then continues to make investments in assets with the next highest weight, and so on. However, the aggregate risk weight for the fund shares may not be less than 7 percent.

While these approaches may serve well for investment funds holding equities, or for MMFs that do not enjoy the highest ratings of the NRSROs, they significant penalize top-rated, prime MMFs, as well as MMFs holding only governments.

First, the "look-through" approaches would impose unduly high risk weights on the shares of top-rated prime or municipal MMFs in any case where these approaches would result in an overall weighted average risk weighting in excess of 7 percent. This would be the case under the "full look-through" approach, for example, where more than

[21] As determined by reference to Table 10 in the NPR, "Modified Look-Through Approaches for Equity Exposures to Investment Funds," *Basel II NPR*, *supra*, 71 Fed. Reg. at 55946.

35 percent of the fund's portfolio consisted of investments in securities having a risk weight of 20 percent. It would also be the case under the other two approaches where the fund's prospectus permitted unlimited investments in securities having a 20 percent risk weight.

The results with regard to government funds are even more onerous, since such funds invest predominantly, if not entirely,[22] in assets having a zero percent risk weighting, such as obligations of the U.S. government. In such cases, a "look-through" risk weighting of the fund shares would likely be less than 7 percent. Federated knows of no empirical basis for imposing a 7 percent minimum risk weighting on such shares, thus treating them as having a risk characteristic greater than the risks in the fund's portfolio.

III. A Proposed Alternative Treatment for MMFs.

Federated proposes and requests that the Final Basel II Rule exclude from the treatment otherwise provided for exposures to investment funds MMFs that comply with the SEC's Rule 2a-7[23] and that are rated in the highest category by the NRSROs.[24]

Specifically, Federated requests:

- That shares in prime MMFs rated in the highest rating grade by an NRSRO be assigned a risk weighting of 7 percent -- equivalent to that applicable to comparably rated securitization exposures; and
- That shares in government and municipal funds rated in the highest rating grade by an NRSRO be assigned a risk weighting calculated under one of the "look-through" approaches, but not more than 7 percent.

[22] Federated's U.S. Treasury Cash Reserves and Government Obligations Tax-Managed Funds, for example, invest only in short-term U.S. Treasury or agency securities.

[23] As indicated above, an investment fund subject to the SEC's jurisdiction cannot hold itself out as a money market mutual fund unless it is in compliance with Rule 2a-7.

[24] It should be emphasized that Federated is not urging this treatment for investment funds generally or for MMFs that do not enjoy the highest rating of the NRSROs.

We have set forth in Appendix D suggested amendments to Section 54 that would accomplish this alteration.

Federated believes that there are a number of compelling reasons for the Agencies to adopt the approach we have suggested:

- Most important, by using compliance with the SEC rule governing MMFs, as well as the attainment of the highest rating category of an NRSRO, as criteria for eligibility for special treatment for these MMFs, the Agencies would have an extremely strong basis for distinguishing the highest quality, least risky MMFs from other types of investment funds that may present greater risk characteristics or equity-like exposures. Moreover, by conditioning such special treatment on the requirements that an MMF both comply with Rule 2a-7 and maintain the highest rating grade, the Agencies can be comfortable that an investment in the shares of such an MMF does not present any market, credit, liquidity, or operational risk greater than that implied by a 7 percent risk weighting.

- Moreover, the treatment we propose would put qualifying MMFs on a par with the most highly rated senior securitization tranches, which the NPR affords a 7 percent risk weighting. This treatment of securitizations reflects the fact that the risks involved in holding senior tranches are mitigated by the existence of subordinate tranches, notwithstanding the risk characteristics of the underlying securities. It also recognizes the inherent difficulty of risk-weighting a security that represents an interest in an underlying pool. While prime MMFs do not have the protection of subordinated interests, they must meet stringent standards of quality, maturity, diversification and liquidity both under the SEC rule and in order to obtain an NRSRO rating comparable to that of the highest-rated securitizations.

- Highly-rated MMFs can serve an extremely important role for banks by providing them with a safe, proven and efficient cash management tool. The diversification that can be achieved through the use of an MMF diminishes, and does not increase, risk.

- While banks can hold directly the same investments that are permissible for MMFs, there are likely to be greater transaction costs involved, and thus greater inefficiencies, for a bank to attempt to achieve the same diversification as is available through an MMF. The Agencies should not create a needless disincentive for banks to forego the efficiencies and diversification that can be realized through MMFs.

- Finally, by assigning a flat 7 percent risk weight based on the top rating of an NRSRO, the rule would eliminate the cost and burden of having to risk-weight separately each of the hundreds of securities held in an MMF's portfolio. We understand that a similar concern was one of the considerations that led to the flat 7 percent charge on top-rated securitizations, and it is equally applicable with respect to MMFs.[25]

Respectfully submitted,

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[25] Federated provides institutional investors in its MMFs with month-end reports on the makeup of the funds' portfolios. An example of such a report is attached as Appendix E.

Appendixes A through E are available upon request from the Freedom of Information Office.