

**Executive Summary**

- As European Union leaders and global policymakers confront the sovereign debt crisis, money market fund managers are charged with separating headline risk from credit quality risk—and knowing where they intersect.
- The fiscal health among European banks varies greatly, challenging any who would paint eurozone banks with the same brush.
- Large, globally focused banks are broadly diversified in terms of their funding, operations and earnings. Most have operations in the U.S., subjecting them to U.S. regulatory authority and oversight.

**The European Debt Crisis and Money Market Funds**

***Looking Beyond the Headlines***

*While the global economy slowly emerges from a deep recession, impacts remain, including concern that debt problems in Greece and other peripheral nations could affect larger countries in and outside of the eurozone. As this lingering debt crisis continues, questions have also been raised regarding the use of debt issued by European banks in money market funds in light of the long-standing objectives of these funds to preserve principal and maintain daily liquidity.*

*Deborah A. Cunningham, chief investment officer for Federated taxable money market funds and Bill Jamison, senior credit analyst, have been closely monitoring and evaluating the European bank sector. This report provides their perspective on the current state of the European debt situation and money market funds, why they continue to see value in the use of European senior bank debt, the importance of separating risk from headline risk, and what may lie ahead.*

**The Economic Environment**

As has occurred in the U.S., the global recession has uncovered a host of financial woes throughout the eurozone. Many European nations have experienced high unemployment, large deficits within their governments and large debt to GDP ratios. After the severity of the sovereign debt crisis came to light in the spring of 2010, European Union leaders responded with a series of refinancing programs, austerity measures and coordinated policy efforts, particularly on behalf of the most troubled peripheral nations: Portugal, Italy, Ireland, Greece and Spain.

However, more than a year later, the so-called “PIIGS” are back in the spotlight, lead by renewed concern that Greece may default on its debt. “The consensus is that Greece and some of the other countries haven’t made cuts as deeply as they needed to and haven’t sold assets to raise money as quickly as others had hoped for,” said Jamison. Concerns surrounding Italy and Spain have been magnified because they are much larger economies. Overall, the financial markets are focused on the transmission of the risk in these peripheral countries to the core countries through the financial system.

Yet the fiscal health among European nations and their banks varies greatly, challenging those who would paint the eurozone and its financial situation with the same broad brush. “Germany, France and most of the Scandinavian countries have experienced far less severe impacts from the downturn and as a result are well along on their recovery

paths,” said Cunningham. She noted that Europe in general, having entered the recession sooner than the U.S., has not only experienced the pain of the downturn earlier, but is now ahead of the U.S. in dealing with the impact of exiting from some of its central bank support. “Typically, we would see the U.S. leading the world into and out of recoveries, but in this case Europe seems to be ahead, at least by some measures.”

As for the banks, there is a vast difference between a country’s regional banks and those that operate on a global level. In fact, eight of the world’s 10 largest banks are located outside of the U.S. Cunningham explained, “What money market fund investors should know is that Federated money funds invest primarily in the highest level of senior bank debt issued by institutions with operations that reach around the world. Generally, global banks should have the ability to withstand events occurring within their home countries.”

World’s Largest Banks		
	Bank	Total Assets (\$ in billions)
1	BNP Paribas SA	2,680
2	Deutsche Bank AG	2,556
3	Mitsubishi UFJ Financial Group, Inc.	2,487
4	HSBC Holdings Plc	2,455
5	Barclays Plc	2,333
6	Royal Bank of Scotland Group Plc	2,276
7	Bank of America Corporation	2,265
8	Crédit Agricole SA	2,138
9	JPMorgan Chase & Co.	2,118
10	Mizuho Financial Group, Inc.	1,939

Source: SNLi Database, 12/31/2010.

### The Use of European Debt in Money Market Funds

Money market funds have continued to use European senior bank debt from global institutions for two key reasons: they have been active in their issuance and have maintained sound credit profiles, even through an unsettled environment. “The difficulties we’ve been seeing from a European bank perspective have been in place since the financial crisis in 2008; they intensified again in late April of 2010,” said Cunningham. “We recognize that banks are a function of the economy and that’s precisely why the criteria for the use of

their debt are so stringent.” That said, Cunningham explained, a primary consideration when evaluating the debt issuance from any bank is the quality of the country where it is based. “Italy is an example of a country with a number of sound global banking institutions; however, we have not invested in Italian banks because of the country’s long-standing economic and political uncertainty. The same holds true for banks in Portugal, Ireland, and Greece.”

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Once a bank has passed the sovereign quality mandate, the real work begins. At Federated, only globally-focused banks that rank among the top 150 in the world by assets are considered for use in its money market funds. “The bottom line is every bank, no matter where it is located, must meet our minimal credit risk assessments, which are substantial,” said Jamison. “It’s a daily evaluation process. We are essentially kicking the tires every day, closely evaluating and monitoring the key metrics through which we determine the quality of any debt issuance.”

According to Jamison, those metrics are known as the “CAMEL” approach, with Federated’s credit team analyzing each bank’s capital, asset quality, management (including risk management) earnings and liquidity. “At the end of this process, out of those top 150 global banks, 22 European banks are currently on our approved list. We use a subset of those banks in our money market funds,” said Jamison. “Within each of their countries, these are among the top three to five largest banks. All have strong deposit bases, all have U.S. operations and they are all broadly diversified from profitability and capital standpoints. Basel III, which aims to establish international standards for banks, further supports strong liquidity and capitalization levels among banks worldwide,” he said. “This is a positive development for the credit profile of banks globally.”

Cunningham noted that the large European banks also bring geographical diversification to money market funds. “A bank may be based in the U.K. or France or Germany, but that bank is not just lending to companies within its own country,” she said. “It lends to businesses across the world, including the U.S.; these are highly diversified institutions in terms

of funding and earnings.” Cunningham said that most of the large European banks also have substantial operations in the U.S. and come under the purview of regulators here in addition to those in their home countries. “There’s no question that virtually all banks have suffered asset quality issues during this difficult economic cycle, but with their diversification and the capital they have in place, and with strong liquidity and funding, the top global banks are stable and well-positioned to navigate these challenges.”

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What about concerns that the fiscally stable nations such as Germany, France and countries outside the eurozone, including the U.S., are exposed to debt from the peripheral nations? “From our view, this isn’t as much a negative as it increases assurance that policy makers will do what is necessary to stabilize the fiscally weaker countries,” said Cunningham. “There’s no question that we remain watchful and realize that, escalating rhetoric, ratings downgrades and tension aside, there is some risk of default among certain of the peripheral nations—although in our view this remains a small risk,” she said. “At the end of the day, we believe that the European Union, the European Central Bank and other authorities will negotiate and support a mix of rescue packages that will allow the status quo to continue. They also will continue applying pressure to Greece and the other countries to take the difficult actions—make the budget cuts and sell its public property—to bring their economies in balance as much as possible on their own.”

In addition to monitoring how the European Union responds to the next phase of its debt situation, Jamison said that Federated also will be watching the second round of the European Union bank stress test due to be released in the summer of 2011. In 2010, 91 banks were tested, only seven of which failed the test, and there were no surprises given those banks’ small sizes and/or heavy investments in failed real estate. “There was a measure of skepticism after last

year’s test about whether the banks were stressed sufficiently, leading some to ask if the banks passed or the test failed,” said Jamison. According to Jamison, this year’s test is set to be more rigorous and will involve stressing each bank’s “core” Tier I ratio, a higher standard for bank capital that consists primarily of shareholders’ common equity in the bank.

“They are also attempting to stress test sovereign debt exposures,” he said. “It all serves as another piece of the credit analysis puzzle—all of the banks on Federated’s list are among those being tested. Should a bank fail the stress test, it would be required to raise additional capital, but we’re not expecting a failure from any of our approved banks.”

Is there anything that would cause Federated to re-evaluate its use of European bank senior debt issuance? “We are watching the eurozone economy as a whole, said Cunningham. “We are careful in our exposures to its senior bank debt and have shortened maturities, downgraded some names and eliminated others from our list of investable securities. Most of the securities that we invest in roll over at short, three-month intervals. That means if conditions from a bank or sovereign perspective deteriorate, we are in position to quickly readdress Federated’s exposure to any security.”

## Outlook

Much like in the U.S., many of the issues in the eurozone are regional and because certain regions within the European economy have begun to grow, the European Central Bank has raised interest rates and is likely to do so again in 2011. “It’s a balancing act,” said Cunningham. “The result of the first interest rate hike was a stronger euro, but for the peripheral countries like Greece, that stronger euro made it harder to reconcile their debt burdens. On the other hand, a weaker euro could result in inflation for the stronger economies such as Germany and France.”

Another factor to consider is the impact that Basel III may have on all banks, domestic and international. The changes are still being ironed out, but it is likely that banks may be incented to fund themselves using longer-dated securities. Meanwhile, the 2a-7 rules aimed at strengthening money market funds have limited the funds’ use of longer-dated securities. “This change clearly has the potential to reduce the percentage of holdings in bank issuance,” said Jamison.

Now that the U.S. economy is slowly improving, is there a trend away from using the debt issued by European banks? “A growing economy fixes a number of problems,” said

Cunningham, “And as companies grow, they need to finance working capital, which increases the supply of commercial paper available for us to invest in. We are optimistic about that.”

As has always been the case, supply and demand will remain a factor when it comes to pursuing investable securities for money market funds. When it comes to European senior bank debt, Federated’s money fund group sees no reason at present to exit from its use in any substantial way—at least not from a credit quality perspective. “The extensive credit work we do gives us confidence in our decision-making, said Cunningham. “There will be a lot of talk, speculation and gloomy headlines, but long-term, we believe the critical importance of these banks to the functioning of the global economy is such that bankers, fiscal policy makers, politicians and international governing authorities will continue working toward a resolution.”

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*Diversification does not assure a profit nor protect against loss.*

*Duration is a measure of a security’s price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.*

*International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards. Prices of emerging markets securities can be significantly more volatile than the prices of securities in developed countries and currency risk and political risks are accentuated in emerging markets.*

*Rule 2a-7 is a rule under the Investment Company Act of 1940 which permits a money market fund to use amortized cost to stabilize the value of its shares at \$1.00. Rule 2a-7 imposes various restrictions on the money market fund’s portfolio, including restrictions related to diversification, and credit quality and maturity of portfolio securities.*

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