

The Impact on Money Market Funds from the U.S. Debt Downgrade

After the markets closed on Friday, S&P downgraded the U.S. long-term rating from AAA to AA⁺ with a negative outlook and affirmed its short-term rating of A-1⁺. As a result, they also lowered the long-term ratings of Fannie Mae, Freddie Mac, Federal Farm Credit Banks and Federal Home Loan Banks from AAA to AA⁺. In our view, this rating action should not have a material impact on short-term markets and money market funds. Moody's Investors Service confirmed its Aaa rating but assigned a negative outlook, while Fitch Ratings confirmed its AAA ratings and is expected to conclude its scheduled review of the U.S. by the end of August.

This action was not a surprise. On July 14, S&P announced that it placed the U.S. on CreditWatch negative, signaling that a downgrade was imminent in the near term. At that time, S&P set an ambitious \$4tn deficit reduction target. According to S&P, "the US political system failed to adequately address deficit reduction in the compromise law." Consequently, a downgrade occurred.

The nature of the downgrade is especially significant for money market fund investors. The near-term impact of this one-notch long-term downgrade should be minimal for money market funds since the short-term rating has been affirmed. It is important for money market fund investors to note that U.S. Treasury securities still hold the highest short-term credit rating.

Money market funds are not forced to liquidate their Treasury holdings due to this downgrade. Additionally, the funds could continue to purchase U.S. debt since Rule 2a-7 defines a Tier 1 eligible investment as any US government security or security rated in the highest short-term category.

The Federal Reserve has announced that the rating actions will have no impact on risk weights for banks, and therefore no impact on capital requirements. On Sunday, the ECB issued a statement indicating their intent to purchase bond issues by Italy and Spain. Also, finance ministers and central bankers from the G7 group of industrialized nations said that they would intervene to provide stability and liquidity as needed. These actions should aid in calming markets and preventing contagion fears.

Our expectation is that repo haircuts will remain unchanged in the near-term as there is no direct link to ratings. However, if there is a period of sustained higher volatility in Treasury markets, haircuts may rise. Haircuts are meant to protect cash lenders from daily price fluctuations in the collateral.

On the municipal front, housing sector Variable Rate Demand Notes (VRDNs) collateralized by FNMA or FHLMC also remain money market fund eligible and won't initially be affected from a credit and liquidity standpoint. As we mentioned earlier, banks won't need to increase capital. This is good news for the municipal market, as banks won't necessarily be hamstrung in writing letters of credit business for VRDN issuers. As of June, approximately 78% of liquidity facilities on VRDNs received extensions from their banks. Municipal issuers tied to government aid commitments may also face possible downgrades as a result of the S&P U.S. downgrade. Short-term notes and tax exempt commercial paper sold by these affected issuers could experience price adjustments.

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From an interest rate perspective, it is likely that rates will remain at extremely low levels through 2012. Fed policy, constrained money market supply and regulatory factors are continuing to put downward pressure on rates.

At Western, we began preparations in July for the possibility of a downgrade. Utilizing our portfolio management, compliance and risk systems, we evaluated and assessed the impact of a potential downgrade on our money market funds. Our seasoned risk management team performed a rigorous money market analysis. This includes, but is not limited to, conducting scenarios analysis and applying stress tests. This analysis is utilized to gain a complete understanding of our funds liquidity and credit metrics.

Additionally, the money market fund regulatory changes implemented last year have allowed funds to become more resilient. Funds have greater liquidity, maintain shorter weighted average maturities and are more transparent. Our funds often maintain liquidity positions in excess of those required by regulations.

Regarding our Eurozone exposure, our USD funds exposure to the region has continued to decline. As of July 29, the average exposure of these funds is approximately 15%, with 1% to Italy. Our USD money market funds do not have any exposure to banks based in Greece, Ireland, Portugal or Spain.

At Western, our money market funds only hold securities with high short-term credit ratings which should ensure that Western Asset's rated money market funds will continue to maintain their AAAM and Aaa-mf ratings.

Western will continue to closely monitor the situation as it continues to evolve and will closely monitor its potential impact on the money markets.

For U.S. Funds please note that an investment in a money market fund is neither insured nor guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the fund.

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