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I. Introduction

The following statement is submitted by Moody's Investors Service ("**Moody's**") to the National Association of Insurance Commissioners ("**NAIC**") Rating Agency Working Group in connection with its public meeting held on November 18, 2009. We understand that the NAIC is reassessing the use of credit ratings, including ratings assigned to municipal bonds, in its risk-based capital regulatory framework and that it also is interested in learning more about our approach to rating financial guarantors. Moody's believes in the importance of the NAIC's ongoing dialogue with credit rating agencies ("**CRAs**"), insurance companies and other market participants about the nature of credit ratings and possible approaches to encourage more informed and careful use of them. We welcome this opportunity to contribute further to the discussion that is already under way regarding the CRA industry both at the NAIC and more generally.

This statement is organized as follows. In Part II, I will provide an overview of the municipal finance market and how it has evolved in recent years. In Part III, I will describe Moody's rating system for that market, how we monitor those ratings, and how the municipal rating system differs from our global rating system. I also will outline the changes we have made, and are planning to make, to our rating system for municipal bonds as a result of our ongoing dialogue with investors, issuers and other users of our credit ratings. In Part IV, I will provide an overview of our methodological approach to rating financial guarantors, describe how their experience in the past two years has provided significant, new information about the risks and opportunities in the financial guarantor business model and describe how we have incorporated this information into our credit judgments about these firms. In Part V, I will describe Moody's approach to rating transactions wrapped by financial guarantees. In Part VI, I will discuss Moody's efforts to enhance the transparency of our credit ratings and the rating process. Finally, in Part VII, I will summarize Moody's views on the regulatory use of credit ratings.¹

II. OVERVIEW OF THE U.S. MUNICIPAL FINANCE MARKET

Moody's first began rating municipal bonds in 1918. Today, Moody's publishes ratings and research on a highly diverse group of issuers and securities, including bonds issued by states, cities, counties, school districts, special local government entities and pooled groups of issuers. Bonds may be backed by, among other things, taxes, leases, appropriations and/or land development fees. Many, but far from all, of these rated bonds are backed by a government issuer's "general obligation" pledge, meaning that all of the government issuer's pledged, tax revenue-producing powers are promised to satisfy the debt, including the government issuer's ability to levy taxes sufficient to pay such debt. These bonds are sometimes called "General Obligation" or "G.O. bonds".

We also assign ratings to another large and diverse group of bonds issued by public authorities and non-profit organizations, which we collectively refer to as enterprises. These issuers back their debt with a combination of tax revenues and user fees to, for example, finance colleges and universities, hospitals, housing agencies and a wide range of public

¹ These views are set out in more detail in the written statement provided by David Teicher to this Working Group in connection with its public hearing held on September 24, 2009.

infrastructure projects such as airports, ports, public power utilities, transportation facilities and water-sewer systems.²

A. Lower Overall Credit Risk than Other Credit Securities Markets

Historically, one of the most distinctive features of the U.S. municipal bond market has been the lower overall credit risk of most municipal bonds relative to other types of bonds. This has been especially true for G.O. bonds.³ Four of the principal reasons for this are summarized below.

- *Municipalities typically are perpetual entities providing essential public services.* They do not need to generate a return on equity but merely to break even or generate a small surplus in order to continue operating.
- *Municipalities have the power to levy taxes or impose tax-like charges* for those essential services and can secure their bonds with a “general obligation” pledge.
- *Unique bankruptcy laws* for municipal entities contribute to the lower credit risk of these bonds. For example, involuntary bankruptcy filings are not permitted, the municipality’s debts can be adjusted but it cannot be liquidated, and the municipality’s powers are not affected by any bankruptcy filing. It can continue operating during a bankruptcy, giving it the ability to raise revenue and make payments on any defaulted debt.
- *A municipality in financial distress might never reach default* because there are many avenues of relief available to most municipalities and, in some cases, a higher level of government, *e.g.*, the state or a third party credit provider, might take steps that prevent default on outstanding obligations. While very few Moody’s-rated bonds have experienced payment defaults, numerous issuers have experienced financial distress.⁴

Many other state and local government-related bond issuers, such as most water and sewer authorities and public university systems, have shared these low-risk characteristics because they possess dependable revenue streams and are very likely to receive financial support from their sponsoring authorities in the event of distress. By contrast, some tax-exempt issuers (such as not-for-profit hospitals and private universities) increasingly share certain “corporate-like” characteristics, in the sense that they are governed independently,

² I use the term “municipality” to refer to state and local governments as well as local authority issuers, which collectively comprise the overwhelming proportion, by number, of issuers in the U.S. public finance market. References to the “municipal market” or “municipal bonds” do not encompass tax-exempt industrial development bonds issued by corporations or bonds technically issued by governmental entities but backed solely by corporate entities such as financial institutions.

³ Bonds issued by municipal authorities or other public sector authorities to finance healthcare, housing, higher education or certain types of infrastructure projects exhibit credit risk that is more comparable to that of similarly rated corporate bonds.

⁴ In times of financial distress municipalities often can generate an internal solution to restore financial balance without involving a third party. However, there generally is a great deal of uncertainty with respect to the timing and content of the ultimate outcome.

they compete in a market for the users of their services to generate revenues and they receive fewer direct governmental subsidies.⁵

B. Evolving Interests of Municipal Bond Market Investors

In our experience, investors purchasing municipal bonds historically have done so with different perspectives and risk appetites than investors in corporate bonds, and our municipal ratings evolved to reflect those differences. For example, unlike corporate bond investors, municipal investors generally have been more risk-averse and have looked for tax-free alternative investment opportunities to U.S. Treasuries. Moreover, many of these investors historically were active solely in U.S. public finance markets and did not cross over to invest in other sectors. As a result, they have been less diversified in their investment portfolios, more concerned about the safety and liquidity⁶ of their investments, and in the case of individuals, often more dependent on debt service payments as a reliable source of income.

In particular, municipal investors generally have been highly intolerant of any diminished value or reduced liquidity in their investment portfolios, which can occur as a result of an issuer's financial distress even if the bonds do not default. Despite the low risk of default, valuation fluctuations may occur when a municipal issuer faces financial stress, because attempts either to resolve financial problems or have a third-party rescue the issuer or its bonds generally occur only after lengthy political and policy negotiations. Consequently, municipal investors historically have looked to Moody's credit ratings for an opinion on the likelihood that a municipal bond issuer will experience financial stress.

In the late 1990s, however, we began to see municipal bonds increasingly traded by a wider range of multi-disciplinary investors who were active in the taxable and tax-exempt municipal markets as well as other bond markets. In addition, a number of larger issuers began issuing cross-border taxable bonds, which were targeted to foreign investors with limited knowledge of the U.S. municipal market. As I discuss in more detail in Part III.E below, these developments led Moody's to start exploring the utility of enhancing comparability between municipal and non-municipal bond ratings.

C. Overview of Current Credit Market Conditions

Some tentative signs are emerging to indicate that a slowdown in the deterioration of macro-economic conditions has begun in some countries, including the United States. Nevertheless, global credit markets and economic conditions are likely to remain stressed and affected by significant uncertainties into 2010. The downturn we are experiencing is unusual in several important respects in terms of its impact on municipal issuers. First, the recent recession has been the longest running in the United States since the Great Depression. Moreover, while prior recessions in the U.S. were mostly regional in nature or industry-based, this recession encompassed every state in the nation. Job losses, depressed consumer spending and declining housing prices have reduced governmental revenues from

⁵ There have been, however, some instances of governmental intervention to support these types of issuers when they are in financial distress.

⁶ Historically, less active issuers often addressed investors' concerns about the liquidity of their investments by obtaining bond insurance.

income taxes, sales taxes, corporate taxes and property taxes. Consequently, this recession has been longer, broader and deeper than prior, recent recessions. We expect the recovery of state and local governments, not-for-profit hospitals and universities to be delayed until well after the broad economy recovers. Moreover, even after the economic recovery begins, questions about the credit positions of these issuers are likely to remain unanswered for some time.⁷

Meanwhile, the severe disruption in the availability of short-term liquidity that developed in 2008 is continuing and has created significant, new challenges for many municipal issuers. Some issuers are finding it difficult to access short-term markets, facing rising interest costs or changing debt amortization terms, dealing with the consequences of financial counterparties that default or are downgraded, and/or finding it difficult to obtain credit enhancement.

Many issuers can alter their behavior and undertake alternative plans of action to mitigate the impact of the current and near-term environment and maintain their strong credit ratings. A number of significant uncertainties, however, continue to affect credit market conditions for U.S. public finance issuers. These include uncertainties regarding:

- the duration and severity of the economic downturn;
- when the current disruption to public finance credit markets will be resolved;
- the potential for unanticipated changes to market access for certain issuers;
- the weakening liquidity of some states and municipalities, which is exacerbated by the ongoing disruption to some issuers' access to capital markets;
- the availability of credit and/or liquidity facilities;
- the declining credit quality of certain key counterparties; and
- how the deployment of the federal fiscal stimulus will benefit particular public finance issuers.

In this environment, Moody's has been continuing its ongoing surveillance of rated municipal issuers, keeping market participants informed about issuer-specific, sector-specific and broader trends that have the potential to affect long-term credit fundamentals, refining our rating methodologies and reporting on trends in ratings performance. Our approach to monitoring municipal bonds is described in more detail in Part III.B below.

III. Moody's Approach to Rating Municipal Bonds

A. Key Analytical Factors for Municipal Ratings

As I stated earlier, Moody's assigns ratings on a number of different types of municipal bonds. Broadly speaking, the issuers of these bonds can be divided into two categories: (1) state and local governments; and (2) enterprises. Moody's ratings of municipal bonds issued by state and local governments are based upon the analysis of the primary factors relating to municipal finance: the economy, the issuer's finances, debt, governance/management strategies, and the bonds' structural features.

⁷ See *Special Comment: Are U.S. Municipal Issuers on the Road to Recovery?*, August 2009 (Document 119381).

- *Economy*: Depending on the entity, we look at the breadth and diversity of the affected economy including its growth trends and comparative economic position to similar entities.
- *Finances*: We analyze information contained in audited financial statements as well as current budget information for the issuer and compare this information to sector statistics for comparable entities.
- *Debt*: Debt ratios are calculated to adjust for size (debt per capita) and wealth (debt to personal income or debt as a percent of full value), and are compared to sector medians.
- *Governance/management strategies*: We assess the type of governance, including legal powers to manage finances and any legal constraints on taxing, borrowing or spending.
- *Structural features of the bonds*: In addition to the fundamental credit analysis, Moody's analyzes the structure of the transaction, *e.g.*, the strength of the legal pledge of collateral to bondholders, the rights of other creditors and the nature and extent of external support.

All of these factors are important in assessing the entity's degree of financial flexibility to meet fiscal challenges and specific debt obligations. In each case, the factors are evaluated individually and for their interrelation with and impact on the other factors in the context of the municipality's ability to repay its debt and its relative degree of financial strength.

Moody's also rates enterprise bonds, such as bonds relating to the construction or improvement of airports, toll roads, water and sewer facilities, public power plants, and bonds issued by healthcare institutions, housing authorities, and higher education institutions. These enterprise ratings incorporate many of the same factors noted above, but they also take into account the financial and business activity characteristics of the public enterprise. For example, an analysis of bonds relating to the construction and operation of a toll road would look at vehicular traffic, competitive position (*e.g.*, the existence of competing toll-free roads), the local economy served by the toll road, the coverage of debt service by toll revenue and the obligation of the entity to raise tolls to ensure sufficient revenue to pay debt service on the bonds.

I discuss in more detail in Part V below Moody's approach to rating municipal bonds wrapped by financial guarantees.

B. Monitoring of Existing Credit Ratings

Once a rating is assigned to a municipal bond, it is monitored on an ongoing basis. More than 60 analysts are involved in monitoring Moody's ratings of municipal bonds. In general terms, the frequency with which Moody's periodically reviews the creditworthiness of issuers and obligations depends on the specific characteristics of each sector and asset class. In the U.S. public finance sector, the frequency of periodic reviews is linked to the complexity of the issuer or obligation being analyzed, the volatility of the sub-sector to which it belongs and the susceptibility of the credit to change. For example, there are certain issuers that are very active in the debt market, that are not highly rated and that are in

a more credit-sensitive sector. These issuers generally have their ratings reviewed on a more frequent basis than those that, in contrast, are small issuers in less volatile sectors who access the market very infrequently and whose credit characteristics are not as complex as some of the larger issuers.

In between periodic reviews, ratings are reviewed when analysts receive information indicating that the fundamental creditworthiness of a security could be materially affected. For example, developing economic, financial or demographic trends within a sector or for a specific issuer as well as specific material events, such as natural disasters, could prompt a review of potentially affected ratings.

C. Low Credit Risk and Default Rates for Moody's-Rated Bonds

Based on the historic performance of the public finance securities we have rated and the municipal sector's inherent credit strength and extremely limited default and loss experience, Moody's believes that the credit risk of the rated portion of the sector, particularly in the general obligation and essential service revenue sub-sectors, is very low. Even in the cases where default does occur, the severity of loss suffered by the bondholder is likely to be limited. For example:

- Between 1970 and 2006, just 41 out of approximately 29,000 Moody's-rated municipal issuers defaulted. Twenty two of these defaults occurred between 2001 and 2006.
- Sixteen of the 41 defaults were for housing projects; eighteen were for healthcare and other not-for-profit institutions; and seven related to local governments and related public sector issuers.
- Only one of the defaults among Moody's-rated municipal issuers involved an issuer of general obligation bonds, and this issuer recovered quickly and paid its obligations in full.

D. Comparing Moody's Municipal Rating System with Moody's Global Rating System

Investors in corporate or structured bonds typically have looked to Moody's ratings for an opinion on whether a bond or issuer will meet its payment obligations. Our opinion takes into account both the probability of default and the expected loss if a default occurs. Historically, however, this analysis alone has not been as helpful to municipal investors. This is because, if municipal bonds had global ratings, the great majority of our ratings likely would fall within just two rating categories: Aaa and Aa. This would make it more difficult to differentiate among various municipal bonds, which is something that many investors indicated to us that they wanted our rating system to do.

Accordingly, Moody's municipal bond ratings developed so that they distinguished more finely among the various municipal bonds and ranked one against the other on the basis of intrinsic financial strength. Because the risk and potential severity of loss historically have been relatively low for governmental issuers, Moody's municipal ratings, taking into account the factors described in Part III.A above, principally have focused on the risk that an issuer will face financial stress.

E. Moody's Planned Recalibration of Our Municipal Ratings

As I noted in Part II.B above, beginning in the late 1990s, Moody's began to observe a growing number of "cross-over", multi-disciplinary investors becoming active in both the taxable and tax-exempt municipal markets as well as non-municipal bond markets. Consequently, to ensure that our ratings were continuing to meet the needs of market participants, Moody's consulted the market and made several changes to reflect this evolution in the market and the feedback we received.

- **In 2001**, Moody's met with more than 100 market participants to understand their views on the need for and value of globally consistent ratings.⁸ The vast majority of participants surveyed indicated that they valued our municipal ratings in their current form. Additionally, many market participants expressed concerns that any migration of municipal ratings to be consistent with our global ratings would result in considerable compression of ratings in the Aa and Aaa range, thereby reducing the discriminating power of the rating and transparency in the market. However, a segment of the market indicated that it would value a greater ability to compare municipal credits to other bonds in other markets.
- **In 2002**, we published a default study that highlighted the limited default experience in the Moody's-rated market for public finance bonds,⁹ and we noted that some taxable bonds were starting to be placed outside of the United States. To accommodate the latter trend, we began:
 - 1) offering entities issuing tax-backed or essential service revenue-backed taxable bonds outside the U.S. the opportunity to request that, in addition to our municipal ratings, a global rating also be assigned; and
 - 2) providing broad guidance on how our municipal ratings would translate into our global ratings. In particular, we stated that it would be reasonable to conclude that nearly all Moody's-rated general obligation and essential service revenue bonds would be rated at or near the top of the global scale.
- **In 2006**, we published a *Request for Comment* asking market participants whether they would value greater transparency about the conversion of our municipal ratings to global ratings. We received more than 40 written responses and had telephone and in-person discussions with many other market participants. Generally, the majority indicated that they valued the distinctions the municipal ratings provide in terms of relative credit risk, but that they would endorse the expansion of assigning complementary global ratings to taxable municipal bonds sold inside the U.S.
- **In 2007**, based on the feedback described above and to further improve the transparency of our long-term municipal bond ratings, we:
 - 1) implemented a new analytical approach for arriving at the complementary global rating, thereby enabling investors to compare municipal bonds to corporate bonds

⁸ See *Special Comment: Moody's Municipal Default Study Highlights and Next Steps*, June 2002 (Document 75249).

⁹ It is important to note, however, that the time period studied did not include a period of extreme financial distress such as the Great Depression and the study covered only Moody's-rated bonds. Default experience in the unrated portion of the market is considerably higher.

while maintaining the existing municipal ratings that investors and issuers told us they valued; and

- 2) announced that, when requested by the issuers, we would assign a global rating to any of their taxable bonds, regardless of whether the bonds were issued within or outside the United States.¹⁰
- ***In 2007 and 2008***, the market continued to evolve. In early 2008, prompted by recent market events and developments in market sentiment, Moody's again proposed recalibration of its municipal ratings to align them with our global ratings and actively reached out to a wide range of constituency groups to ensure that the feedback we received represented all users of credit ratings.¹¹ The comments we received on our *Request for Comment* publications and in our outreach efforts showed that a larger portion of the market sought comparability between municipal ratings and those in other sectors.¹² Feedback from nearly 200 market participants – including issuers, bankers, financial advisors, trade associations and major institutional investors with substantial positions in U.S. municipal bonds – indicated that:
 - 1) recent market conditions had resulted in a greater interest in rating comparability between municipal and non-municipal bonds; and
 - 2) ratings that facilitated such comparability would be preferable.

As a result, on September 2, 2008, we announced our intention to recalibrate our municipal ratings. In mid-September, however, and for reasons unrelated to our announcement, global credit markets experienced a sudden and severe dislocation that sent shock waves around the world. We recognized that proceeding with our plans in the midst of such credit market turmoil could unintentionally lead to confusion and/or further market disruption. Consequently, on October 7, 2008, we announced that conditions in the credit markets would delay our planned recalibration of U.S. public finance ratings. The temporary suspension of the recalibration process remains in effect today because of ongoing volatility in municipal credit markets. Nevertheless, Moody's remains committed to our plan to apply our global ratings to U.S. public finance bonds, and we intend to move forward swiftly with the recalibration process once macro-economic conditions and credit markets stabilize.

We expect that the recalibration of our municipal ratings will begin and be completed sometime in 2010. We intend to make a public announcement approximately four weeks before we begin the recalibration to: (i) announce when the recalibration process will begin; and (ii) provide an estimated timetable for completion of that process. In

¹⁰ To put the demand for global ratings by municipal issuers into context, since we first began offering global ratings for taxable securities in 2002, approximately 25 issuers have requested that Moody's assign a global rating to their bonds.

¹¹ See *Request for Comment: Assignment of Global Ratings to Tax-Exempt Municipal Obligations*, March 2008 (Document 108116); *Special Comment: Assigning Global Scale Ratings to Municipal Tax-Exempt Obligations*, April 2008 (Document 108470); and *Announcement: Moody's Extends Comment Period on U.S. Public Finance Rating Scale*, June 2008 (Document 109143), all of which are available at moodys.com.

¹² See *Announcement: Moody's to Recalibrate its U.S. Municipal Bond Ratings to the Company's Global Rating Scale*, September 2008 (Document 110987), available at moodys.com.

addition, before we begin the recalibration, we plan to publish a methodology that provides more details to the market about how we plan to recalibrate municipal ratings to the global scale and explains how we will assign ratings to new issues during the migration. Once we begin, we expect that the recalibration of all the municipal ratings to the global scale will take approximately four to six weeks to complete.

IV. MOODY’S APPROACH TO RATING FINANCIAL GUARANTORS

A. Overview of Moody’s Rating Methodology

Moody’s approach to assigning insurance financial strength ratings (“**IFSRs**”) to financial guarantors is designed to assess the ability of a financial guaranty operating company to pay senior policyholder claims and obligations in a timely manner.¹³ The methodology focuses on five key factors: (1) franchise value and strategy; (2) portfolio characteristics; (3) capital adequacy; (4) profitability; and (5) financial flexibility. These interdependent factors form the basis of a financial guarantor’s operating dynamics and, in the aggregate, provide a comprehensive picture of its overall credit profile. As part of our evaluation, we consider the risk that such operating dynamics could change materially as a result of internal or external pressures, thereby altering the guarantor’s credit profile.

Of the five factors outlined above, capital adequacy receives the greatest weight in our analysis, and the developments of the last two years have reinforced its importance since other factors, such as financial flexibility and franchise value, have been observed to shift in response to deteriorating capital positions. Moody’s principal tool for measuring capital adequacy is a simulation model that projects portfolio losses based on credit assessments of each underlying exposure.¹⁴ Since late 2007, in view of the exceptional performance of mortgage-related exposures, we have supplemented this model’s output with individual, expected and stress case evaluations of residential mortgage-backed securities (“**RMBS**”) and related risks.

B. Re-examination of Key Rating Factors in Light of the Profound Dislocation Experienced by This Industry in the Past Two Years

Historically, high ratings within the financial guaranty sector had been based on the industry’s strategy of insuring investment grade transactions with modest performance volatility, thereby producing a well-diversified portfolio of low risk, insured exposures supported by strong, risk-adjusted capitalization levels. For years, this highly focused business model generated stable, risk-adjusted returns for shareholders and created substantial franchise value that validated and reinforced the industry’s operating strategy. The preservation of a low-risk business profile was held to be a core objective, given the importance to the overall business of maintaining a high level of creditworthiness. This, in turn, created a powerful incentive for a guarantor to take whatever actions feasible to preserve its credit profile and ability to pay claims.

¹³ The IFSR is a rating for the stand-alone entity before consideration of parental support. Other ratings that may be assigned within the group (*e.g.*, to securities issued by the guarantor or its parent company, or sister entities that operate in other regulated markets but are supported by the main operating company) typically are derived from the IFSR.

¹⁴ See *Moody’s Portfolio Risk Model for Financial Guarantors*, July 2000.

Recent events, however, altered significantly these operating dynamics. The severe dislocation in credit markets over the past two years has left many financial guarantors in precarious financial condition as a result of losses on mortgage-related exposures. The most adversely affected guarantors had large exposures to collateralized debt obligations of asset-backed securities (“**ABS CDOs**”) in addition to direct RMBS risks. The weak direct RMBS performance and the RMBS concentration and leverage in ABS CDOs contributed to large paid and projected losses at most guarantors. Of the eight Moody’s-rated guarantors active in 2007, only one group, Assured Guaranty (now with its FSA subsidiary), actively writes business today. Berkshire Hathaway Assurance Corporation, a recent entrant, is the only other potentially active guarantor. The other guarantors are essentially in a suspended state of operations.

The events of the past two years have illustrated that a guarantor’s franchise value is extraordinarily sensitive to changes in its risk profile, where even a moderate decline in financial strength may have a dramatic impact on a guarantor’s future business prospects. The high level of operating leverage associated with the financial guaranty business model increases the potential for such changes, especially given the significant correlation and volatility associated with certain exposures. As a result, there is a fine line between a thriving franchise and one with limited value for shareholders. In contrast, most highly-rated companies in other industries have franchises that are much more resistant to broad-based erosion in product demand.

The financial flexibility of many guarantors suffered in 2007-2008, leaving them with capital shortfalls relative to levels necessary to retain their customers’ confidence and thereby damaging future business prospects. This made it much more difficult for many firms to raise funds at reasonable cost and increased incentives for existing shareholders to withdraw capital.

Despite some positive signs in the broader economy, credit conditions have not improved sufficiently to provide a clear path to recovery for financial guarantors. Uncertainty about ultimate losses is such that many of the guarantors we rate have outlooks that are either developing or negative. The most common uncertainties relate to the actual performance of the guarantors’ insured portfolio, as exemplified by the wide spread between expected and stress losses on RMBS-related exposures or on the actual risk of commercial mortgage-backed securities resecuritizations. Other insured segments also may be exposed to some deterioration. Additionally, the outcome of some ongoing litigation could have substantial consequences for some firms’ credit profiles.

The magnitude of the stress faced by the industry has increased market skepticism about the guarantors’ business model. The remaining uncertainty about ultimate credit losses also is contributing to market discomfort. Some segments of the municipal market, such as large investors and strong municipal issuers, currently show limited interest in the product, and structured finance opportunities are rare as well.

The financial guarantors’ experience over the past two years has provided significant, new information about the risks and opportunities inherent in their business model. While we continue to rate financial guarantors based on our assessment of their positioning on the five key rating factors described in Part IV.A above, our views on those factors have changed in some respects and can be summarized as follows:

- **Franchise Value and Strategy.** The level of demand for financial guaranty insurance in the near to medium term is less certain than in the past. While there continues to be a market for municipal bond insurance, prospective opportunities in this sector may be narrower than in the past due to changing perceptions about municipal risk among buyers, lower confidence in the financial guaranty industry broadly and a trend toward alternative forms of execution, including the issuance of uninsured paper. However, credit enhancement for smaller or more complex credits and the benefits of third-party due diligence and liquidity are likely to continue influencing investors' demand for wrapped transactions in the future. This demand, however, may be unstable, with a sharp fall-off in demand possibly resulting from even a moderate decline in a guarantor's credit profile, creating a "demand cliff" beyond that observed in most other industries. Consequently, our assessment of franchise value in the current operating environment tends to fall in the A to Aa range for the best-positioned financial guarantors. By contrast, companies with Aaa ratings typically have franchises that are extremely resistant to erosion in product demand over time.
- **Portfolio Characteristics.** The leverage and complexity of some structured finance products made it difficult for the guarantors, like other market participants, to estimate accurately losses for certain segments of the insured portfolio. This is compounded by the fact that large and potentially correlated risk exposures can have a materially negative impact on a guarantor's financial strength should the performance of those exposures deteriorate. In contrast, the guarantors' municipal and infrastructure finance portfolios are generally seen as less exposed to correlation risk, except in the most severe stress scenarios, although large transaction sizes and rising credit pressures in a down credit market could prove problematic in certain instances. Accordingly, our appraisal of the industry's aggregate portfolio credit characteristics has shifted.
- **Capital Adequacy.** Historically, Aaa-rated companies generally maintained total capital ratios in the range of 1.4 to 1.6 times, providing them with a cushion above Moody's 1.3 times Aaa "target" level threshold. As the credit crisis unfolded, however, guarantors with significant mortgage-related exposures saw their risk-adjusted capital positions fall sharply due to the erosion of credit protection with certain exposures, as well as the realization of actual losses in some cases. At the same time, credit deterioration among financial guaranty reinsurers resulted in less reinsurance benefit for those primary companies that were heavy users of third-party reinsurance as a form of capital relief. Consequently, most firms in the industry have seen their capital ratios fall to levels that are no longer consistent with Aaa ratings. It is also clear that capitalization is subject to far greater volatility than we had previously anticipated.
- **Profitability.** The current volatility in the guarantors' profitability resulting from large mortgage-related losses creates a stark contrast to the historically stable profits enjoyed by the industry for years. We expect this volatility to continue over the near to medium term. While there may be some near-term opportunities for improved pricing on public finance business, over the longer term, public finance premium rates are likely to revert to historical levels and could even fall further as surviving

guarantors and new entrants compete in the mature U.S. municipal market. Consequently, the guarantors' ability to earn returns that are consistent with historical levels without taking undue risks could become more challenging.

- **Financial Flexibility.** Moody's longstanding view, based on observed experience, had been that the financial guarantors would: (1) be extraordinarily motivated to raise capital if they needed to bolster their financial resources; and (2) have broad access to a variety of financing sources, whether from committed owners or public markets. Recently observed performance and behavior no longer support these expectations. Consequently, Moody's currently views financial guarantors as having less financial flexibility than they had exhibited prior to the credit crisis. Even the best-positioned firms can experience a dramatic constriction of financing options if material losses occur or uncertainty about potential losses is high. Such sensitivity to event risk and market confidence typically is associated with financial strength scores falling below the Aaa level.

In light of these factors, since 2007, Moody's has downgraded all of the rated primary guarantors. Our current financial strength ratings on the U.S. financial guarantors are as follows:

Company Name	IFSR	Outlook	Last Action
Ambac Assurance Corporation	Caa2	Developing	7/29/2009
Assured Guaranty Corporation	Aa3	Review for downgrade	11/12/2009
Berkshire Hathaway Assurance Corporation	Aa1	Stable	4/8/2009
CIFG Assurance North America, Inc.	Withdrawn after downgrade to Ca		11/11/2009
Financial Guaranty Insurance Company	Withdrawn after downgrade to Caa3		3/24/2009
Financial Security Assurance Corporation	Aa3	Negative	11/21/2008
MBIA Insurance Corporation	B3	Negative	2/18/2009
National Public Finance Guaranty Corp.	Baa1	Developing	11/7/2008
Radian Asset Assurance Inc.	Ba1	Stable	3/12/2009
Syncora Guarantee Inc. (formerly XL Capital Assurance Inc.)	Ca	Developing	3/9/2009

Several market participants have formed, or proposed to form, separately capitalized "municipal-only" entities. While a municipal-only guarantor likely would have a lower risk profile than a guarantor exposed to structured risks, municipal markets are not immune to downward pressure. Furthermore, the susceptibility of product demand and financial flexibility to changes in risk profile is particularly pronounced in the municipal sector. Such a narrow business strategy in a mature market could also generate increased competitive pressures, which could be anticipated, over time, to degrade profitability and underwriting discipline. For these reasons, achieving a stand-alone Aaa rating for a municipal-only guarantor likely would be difficult absent the entity's ability to defend against product encroachment, secure reliable access to new funding in stress scenarios, and protect against the removal of capital and risk management resources in a run-off scenario.

V. MOODY'S APPROACH TO RATING TRANSACTIONS WRAPPED BY FINANCIAL GUARANTEES

A. General

Both rated and unrated municipal bond issuers can choose whether or not to obtain credit enhancement for their bonds. Credit enhancement is available in different forms, such as guarantees, letters of credit and bond insurance. The decision to purchase bond insurance rests solely with the municipal issuer, which weighs the costs and benefits of insuring its bond against its various other alternatives.¹⁵

When an insurer requests a credit rating for a wrapped bond issuance, Moody's analyzes the bond insurance policy to determine whether or not there has been full, effective credit substitution. Full credit substitution should insulate the investor from the issuer's financial condition, as well as from any legal or other risks associated with the mechanics of the transaction. Moody's examines the documentation for the transaction to determine, for example, whether all parties to the transaction have clearly defined responsibilities and whether the insurer is obliged to make timely payments on the security if the issuer does not make the required payments as scheduled. If the bond insurer's standardized policy includes any changes or endorsements, Moody's analyzes them to determine whether or not they create credit risk for the bondholder. If Moody's concludes that the structure of the bond provides for full, effective credit substitution, the bonds will receive the bond insurer's financial strength rating.

An issuer that proposes to issue a wrapped bond may ask Moody's for a rating only on the wrapped transaction. An issuer can also ask Moody's to provide a separate opinion about the underlying bond without factoring in the bond insurance. In such circumstances, the bond will then have two credit ratings – one for the underlying bond and one for the wrapped bond. At the time the issuer is informed of Moody's rating for the underlying bond, the issuer can decide whether or not it wants to have that rating published.¹⁶

B. Treatment of Insured Municipal Ratings When a Financial Guarantor's IFSR Drops below Investment Grade

Moody's long-term ratings address the possibility that a financial obligation will not be honored as promised. With respect to securities wrapped by financial guarantors, the financial obligation will be honored unless two events happen: (i) the underlying obligation defaults; and (ii) the guarantor defaults. Therefore, when the published rating on the underlying obligation of a wrapped transaction is higher than the guarantor's financial strength rating, the wrapped rating of the transaction can be higher than the guarantor's rating.¹⁷ Accordingly, Moody's practice has been to assign the higher of the IFSR and the published underlying rating to any insured, non-structured instruments, where both the IFSR

¹⁵ Insurance can also be purchased by investors in the secondary market, after the bonds have been issued.

¹⁶ Moody's, however, always reserves the right to exercise its editorial discretion and publish any rating without the issuer's consent.

¹⁷ With respect to municipal bonds, if the wrapped rating is driven by the guarantor's rating, it is understood to have a meaning consistent with Moody's global rating scale. If the rating is driven by an underlying municipal rating, it is understood to have a meaning consistent with Moody's municipal rating scale.

and the underlying, published rating are of investment grade. In respect of insured, structured instruments, Moody's practice has been to assign the higher of the IFSR and the published or unpublished, underlying rating.

In 2008 and 2009, Moody's downgraded many of the stand-alone ratings of the financial guarantors to below investment grade. Meanwhile, the vast majority of wrapped transactions, especially in the U.S. municipal market, international public finance market and certain sectors of the structured finance market, have an underlying credit obligation of investment grade quality. We do not believe it serves the market to maintain a rating on an instrument that is, in all likelihood, an inaccurate (*i.e.*, overly conservative) reflection of its credit risk. Therefore, in circumstances where we have downgraded financial guarantors below the investment grade rating range, we have withdrawn the wrapped ratings for non-structured instruments that do not have published, underlying ratings.¹⁸ For insured, structured securities, Moody's policy is to publish the underlying rating except in limited circumstances (*e.g.*, if the issuer or arranger had requested that the guaranty constitute the sole credit consideration).¹⁹

It has been our understanding that many investors have portfolio guidelines that compel them to sell securities if their ratings fall below investment grade, but that they may be able to continue holding the securities if they are unrated. Because investment policy guidelines are not uniform, we recognize that our policy may inconvenience some investors while benefiting others. On the whole, however, we believe, based on our discussions with market participants, that investors are better served by the withdrawal of wrapped ratings for non-structured securities upon a financial guarantor's downgrade below investment grade than by a downgrade of those ratings to the IFSR level.

VI. MOODY'S EFFORTS TO ADVANCE THE TRANSPARENCY OF CREDIT RATINGS AND THE RATING PROCESS

Moody's employs, or is in the process of introducing, a wide range of measures to enhance the transparency of its credit rating process, the ratings themselves and ratings performance.²⁰ One of the most significant ways Moody's promotes transparency is through the many publications we make available to the public free of charge. These include credit ratings, methodologies, rating performance reports, ratings history data and a number of our policies and procedures. For example:

- **Methodologies:** All of Moody's rating methodologies are made freely available to the public and are disclosed on moodys.com. In addition, any material modifications to methodologies and related significant practices, procedures and/or processes are

¹⁸ Although Moody's reserves the right to publish ratings without an issuer's consent, we generally receive the issuer's consent before publishing an underlying rating. In response to the downgrades and rating reviews of financial guarantors, a number of issuers of wrapped instruments requested that Moody's publish their underlying ratings, which we have done.

¹⁹ With structured securities there is, in effect, no issuer to consent and, therefore, we decided that it was appropriate to publish the underlying Moody's rating except in limited circumstances.

²⁰ My colleague David Teicher's written statement provided to this Working Group in connection with its public hearing held on September 24, 2009 describes an even wider range of measures Moody's has adopted, or is adopting, to promote quality and independence as well as transparency in the rating process. See also *Moody's Special Comment: Strengthening Analytical Quality and Transparency*, November 2009 (Document 119843).

published on our website; those that have a particularly broad reach also may be announced via a press release. After a new or revised methodology has been developed internally, Moody's may publish it as a Request for Comment to solicit the views of market participants prior to final adoption and implementation. In addition to promoting transparency, this process enables us to arrive at a more fully informed methodology.

In the past two years, Moody's also has taken a number of additional steps to facilitate market participants' access to our rating methodologies, particularly those concerning structured finance products. For example, we have posted files on moodys.com that represent an organized view of our rating methodologies and provided homepage dropdown links on moodys.com to "Rating Methodologies". We publish on moodys.com detailed summaries of our methodologies for rating U.S. RMBS and CDOs. We now issue press releases on at least a quarterly basis that summarize incremental changes to methodologies and rating procedures in the Structured Finance Group that have not been previously published. We also recently launched *Structured Finance Quick Check*, a weekly overview of structured finance rating activities, methodology changes and ratings criteria updates.

- **Credit Rating Announcements:** Our credit rating announcements are disseminated publicly and free of charge on moodys.com and distributed to major financial newswires. These announcements include the current rating action and our rationale for it. Subject to certain exceptions, they also reference the date of the last associated credit rating announcement, if any, and the principal action it announced. In addition, in recognition of how important methodological transparency is to the financial markets, subject to certain exceptions MIS also indicates in its credit rating announcements the principal methodology or methodology version that was used in determining the credit rating and where a description of that methodology can be found. Moody's also explains if a credit rating is based on more than one principal methodology and if a review of only one methodology might cause financial market professionals to overlook other important aspects of the credit rating. Moody's also indicates in the credit rating announcement where different methodologies and other important aspects factored into credit ratings can be found.
- **Ratings Performance and Ratings History:** Moody's analyzes the overall performance of our credit ratings to provide ourselves and third parties with information regarding the predictive quality of our credit ratings in the aggregate. Our published performance metrics generally relate to the two attributes of our credit ratings that we believe are the most important for market participants: (i) accuracy (*i.e.*, the correlation between credit ratings and default events); and (ii) stability (*e.g.*, frequency of credit rating changes).²¹ In addition, we now publish credit ratings histories in a downloadable, machine-readable file for a random sample of 10% of our credit ratings. We also maintain ongoing dialogues with regulators, academics and credit market participants to understand their perspectives on Moody's credit ratings performance and to communicate our own views.

²¹ MIS's corporate bond ratings are intended to be "accurate" and "stable" measures of relative credit risk, as determined by each issuer's relative fundamental creditworthiness and without reference to explicit time horizons.

- **Rating Process Policies:** We make a number of our significant rating process policies available to the public without charge, including our policy on *Designating Issuers That Do Not Participate in the Rating Process*, our policy on *Designating Unsolicited Credit Ratings*, our *Guidelines for Withdrawal of Ratings* and our *Core Principles for the Conduct of Rating Committees*.

In addition to the measures described above, we have recently undertaken a number of additional steps to promote transparency, including the following:

- **Transforming moodys.com:** We recognize that our website is an important mechanism in our transparency initiatives. To that end, we are completely revamping it to make it easier to use, with more powerful search capabilities, integrated content and more intuitive navigation. We also are reorganizing our page layouts to make it easier to find and view our content more efficiently.
- **Providing Additional Information on Structured Finance Credit Ratings:** Moody's has made the following enhancements to our structured finance credit ratings to enhance transparency and show the market that the information we use in assigning credit ratings to structured finance products is of sufficient quality to support a credible credit rating.
 - **V Scores and Parameter Sensitivities:** We have introduced two new risk measures for new issuances of structured finance securities. V Scores address the degree of uncertainty around the assumptions that underlie our structured finance credit ratings.²² Although our credit ratings already emphasize lifetime expected credit loss rates, V Scores are designed to signal to users of Moody's credit ratings which types of structured finance securities have greater exposure to data limitations and modeling assumptions. Parameter Sensitivities address the sensitivity of our credit ratings to changes in our key assumptions. They are designed to measure how the initial credit rating²³ of a security might have differed if key credit rating input parameters were varied, as opposed to how a credit rating might migrate over time.
 - **Increasing Transparency about Historical Performance Data for Underlying Assets:** As part of the disaggregation of the V Score, we have improved our disclosure concerning the limitations of the historical performance data used in rating structured finance securities. In particular, we disclose through the V Score, when applicable, those instances where we believe that there is limited historical data for the assets in the underlying pool.
 - **Loss Expectations and Cash Flow Analysis:** Moody's publishes information relating to initial loss expectations and cash flow analysis with respect to our structured finance credit ratings, as appropriate.

²² See *Special Comment: Updated Report on V Scores and Parameter Sensitivities for Structured Finance Securities*, December 2008 (Document No. 112998).

²³ Parameter Sensitivities only reflect the ratings impact of each scenario from a quantitative/model-implied standpoint. The results generated by quantitative models are one of the many inputs to the credit rating process. Qualitative factors are also taken into consideration in the credit rating process, so the actual credit ratings that would be assigned in each case could vary from the information presented in the Parameter Sensitivity analysis.

- **Key Statistics and Severity and Default Assumptions:** We have begun publishing key statistics and severity and default assumptions for all new structured finance credit ratings and for surveillance rating actions in major asset classes. We also now disclose information relating to pool losses. For certain sectors, such as RMBS, these disclosures are made in Special Comments. Where we have not published a Special Comment, we make the disclosures in the relevant press release.

We also engage in dialogue on an ongoing basis with issuers, investors and other users of our credit ratings to gain insight on how we can enhance further transparency in our rating methodologies, rating opinions and research, rating practices and ratings performance.

VII. THE USE OF RATINGS FOR REGULATORY PURPOSES

As we noted in our previous written statement submitted to the NAIC, the use of credit ratings in prudential regulation and other standards is understandable from a public policy standpoint. Identifying and using objective, widely accepted standards for financial markets can facilitate efficient regulation. Credit ratings are useful in this regard because they are broadly disseminated, independent and reliably predictive opinions about relative creditworthiness.

Notwithstanding these benefits, however, we have long been concerned about the regulatory use of ratings. As we summarized in David Teicher's prior written statement, we have serious concerns about how the widespread, regulatory use of ratings can adversely affect the behavior of market participants as well as regulators.

Consequently, Moody's supports efforts to discontinue or limit the use of ratings in regulation. We appreciate the efforts undertaken by the Rating Agency Working Group and the NAIC to analyze carefully the potential consequences of continuing, modifying or ceasing the regulatory use of ratings in insurance regulation. We support the healthy dialogue that meetings such as this one can foster.

VIII. CONCLUSION

Moody's is strongly committed to meeting the needs of investors, issuers and other participants in credit markets for assessment of the relative creditworthiness of issuers and obligations. In our ratings of municipal issuers, financial guarantors and every other type of issuer and issuance we rate, we are firmly committed to meeting the highest standards of integrity in our rating practices, quality in our rating methodologies and analysis, and transparency in our rating actions and rating performance metrics. In that regard, we welcome continued engagement with the NAIC as it continues to reassess its use of credit ratings and evaluates possible approaches to encourage informed and careful use of credit ratings.