

Special Comment

Moody's Global Credit Policy

February 2008

Request for Comment:

Should Moody's Consider Differentiating Structured Finance and Corporate Ratings?

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In response to the recent events in the credit markets, Moody's Investors Service ("Moody's") has supported specific measures to demonstrate our independence and integrity, and to increase confidence in the credit rating process. In addition Moody's has been working to enhance our analytical methodologies and to refine the models we use in our ratings. Finally, Moody's has endeavored to be a constructive participant in the broader debate of restoring market confidence by suggesting and supporting possible market-level reforms that may help improve credit market transparency and stability.¹

While reactions to these initiatives have been generally favorable, some public authorities and some market participants have called for additional steps. In particular, they have asked whether the credit rating agencies should (i) differentiate ratings assigned to structured products from those assigned to corporate² and government-related issuers, and/or (ii) provide information content about attributes of structured products other than credit risk.

In this request for comment Moody's discusses possible alternatives for differentiating structured finance ratings from non-structured finance ratings, highlights potential features and limitations of these options, and seeks market opinion on the next step – or combination of steps – that may be appropriate for us to take. To facilitate the collection and assessment of market feedback on this proposal, please provide your views by completing our survey by Friday, 29 February 2008. The survey is accessible at www.moodys.com/ratingsurvey. (Responses can be provided on an anonymous basis.) Alternatively, you are welcome to submit comments via e-mail to Moody's Credit Policy inbox at CPC@moodys.com. We hope to provide the market with an analysis of the responses received within the following two to three months.

¹ Moody's Proposes Enhancements to Non-Prime RMBS Securitization" Moody's *Investors Service Special Report*, September 25, 2007.

² For purposes of this paper, the term "corporate ratings" encompasses ratings on industrial, utility, and financial institution companies.



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Summary of Proposed Rating Scale Options

Options for consideration are discussed in greater detail below, but in brief they are:

1. Move to a completely new rating scale for structured securities, for example, numerical rankings of 1-21. These would continue to contain ordinal rankings of expected credit risk and would probably map to corporate ratings.
2. Add a modifier to all structured ratings utilizing the existing rating scale, e.g., Aaa.sf. This would designate the issue as structured, but add no other additional information.
3. Add a suffix to the existing rating scale for structured ratings that contains additional information – for example, estimates of multi-notch rating transition risk. This could be Aaa.v1, Aaa.v2, etc. We would derive these gradations through an analytical process that would be disclosed to the market.
4. Use the existing rating scale for structured securities, and put additional analytical information in a separate scale that would exist in a separate data field. For example, an issue could have a “Aaa rating, with a ratings change risk indicator of v1”. The added field would be analogous to our existing ratings outlooks and watchlists.
5. Make no changes to the rating scale, but provide additional information and commentary through written research.

Background

Moody's credit ratings are forward-looking opinions that address just one characteristic of fixed income obligations – an assessment of the likelihood that such obligations will be repaid in accordance with their terms. Our role in the structured finance market is fundamentally the same as the role Moody's has played over the last hundred years in the corporate bond markets. Moody's rating processes are very similar in the two sectors and, across a range of aggregate measures, our ratings performance reveals a high degree of consistency between structured finance and corporate ratings.³

Nonetheless, some performance characteristics of structured securities – including characteristics not measured by current ratings – have demonstrated behaviors in certain asset classes that are different from those of corporate and governmental securities.⁴ Consequently, some clearer form of distinction has been called for in the interests of transparency and market awareness. The main driver of this view is that over the past eight months a large number of highly rated structured securities have experienced rapid and larger rating transitions, as well as expectations of poorer ultimate credit performance, than historically has been observed among similarly rated non-structured securities.⁵ Conversely, and although it has not been a matter of similar market concern, in previous periods various classes of structured securities have exhibited collectively stronger performance than similarly rated corporate securities.⁶

It is reasonable to assume that many structured ratings will continue to be based on methodologies that rely in part on quantitative models. Modeling uncertainties, together with structural features and asset pooling characteristics of structured products, could continue to cause greater rating transitions – resulting in both

³ These publications include a wide variety of metrics, including a measure of the accuracy of ratings as predictors of the relative risk of credit losses. See, for example, the following Moody's Special Comments, “Default and Recovery Rates of Corporate Bond Issuers, 1920 – 2005” (January 2007), “The Performance of Moody's Corporate Bond Ratings: March 2007 Quarterly Update” (April 2007), “Default & Loss Rates of Structured Finance Securities: 1993-2006” (April 2007), and “The Performance of Structured Finance Ratings: Full-Year 2006 Report” (May 2007).

⁴ Moody's notes that performance or behavioral distinctions between structured securities and corporate or government securities necessarily generalizes or “smooths” performance distinctions that exist within each sector. For example, regulated utilities in the U.S. have historically shown lower ratings transition risk than technology companies, though both are corporate bond issuers.

⁵ Moody's has published regularly on observed differences in rating transitions between structured and corporate securities. See, for example, “Structured Finance Rating Transitions: 1983-2006, *Moody's Special Comment*,” January 2007.

⁶ Moody's attributes greater rating transition behavior and performance correlation in structured securities to, among other things, deal structures that pool relatively homogenous assets originated at similar points in time. While these features have generally not created significant differences in mean expected credit loss for the universe of structured products, they have contributed to greater variance in rating transitions and loss distributions.

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larger and more frequent upgrades and downgrades – in certain structured finance asset classes relative to corporate securities.

Consequently, some market participants have asserted that structured and non-structured securities possess inherently different risk characteristics, such that, for example, Aaa-rated structured securities may not have the same risk characteristics as Aaa-rated corporate securities. Distinguishing the ratings of structured securities from non-structured securities could help raise investor awareness of potential differences in meaning and behavioral attributes between the two categories of securities, providing further information to investors in their investment decision-making processes. Moody's has not yet formulated an opinion on this topic and is therefore seeking market input.

Details on the Options for Consideration

1. *Create an entirely separate and different scale for rating structured products*

Moody's could rate structured finance products on an entirely different scale. By way of example, such a scale could be calibrated from 1 to 21 and would therefore distinguish a structured security from a corporate or government security. Under this option, Moody's would not attempt to add additional information concerning possible differences in performance attributes beyond those implied by the different rating scale itself. Upon establishing a suitable mapping between the two rating scales, Moody's could continue to aspire to measure similar mean credit loss rates across "similarly rated" structured and non-structured transactions while simultaneously making clear to the market that those securities rated on the 1 – 21 scale are for "structured products".

Some market participants, including certain institutional money managers, have questioned the value of separate scales, citing that bond purchasers invariably know whether they are buying a structured security, a corporate bond, or a government bond, and they do not need separate rating scales to identify the category of security in which they are investing. However, the proposal may be relevant if the principal beneficiaries are identified as the "primary investors"⁷ that hire money managers and the regulators that supervise financial institutions,

These primary investors and regulators often use ratings as a guide to overall portfolio risk in monitoring and delineating the risk-taking of others, and, to do so, they sometimes employ explicit ratings-based portfolio governance rules. A different rating scale for structured securities could provide greater clarity about differences in, for example, transition or liquidity risk across different portfolios and could encourage market participants to consider the potentially different characteristics of structured and non-structured securities in designing ratings-based governance rules.

A different rating scale for structured securities that would encourage further attention to potential differences between the behaviors of ratings across sectors is both the strength and the challenge of this proposal. Many of the ratings-based portfolio governance schemes currently in use by market participants assume that structured and non-structured securities are rated using the same long-term rating scale. If ratings on structured finance securities were placed on a different scale, it is possible that investors might be unable to buy those securities or might need to trade out of their current holdings until their governance rules were amended. On a practical level, investors would also need to adjust their internal information systems to accommodate the new symbols. And finally, in certain other instances, changes in governance rules may require governmental legislation and/or the issuance of new regulations.

2. *Modify the existing scale for rating structured products*

Moody's could continue to rate structured products on our existing Aaa – C scale, but we could nonetheless distinguish them from other ratings by modifying the existing long-term rating scale. This modification could be achieved by, for example, appending a simple modifier, such as an '.sf' subscript to the rating: 'Aaa.sf'.

⁷ "Primary investors" are distinct from asset managers. While both are investors, the asset manager or portfolio manager is ultimately investing on behalf of the primary investor.

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This approach may be less disruptive to overall market operations because market participants would be able to differentiate between a structured rating and a non-structured rating but portfolio guidelines and regulations that incorporate ratings may not need to be immediately revised to account for the change in scale. Moreover, if the existing scale were largely retained in the presentation of structured finance ratings, Moody's would likely continue to aspire to common mean credit performance rates for "similarly rated" structured finance and corporate securities.

3. Add a suffix with information content to the existing rating scale

Moody's could continue utilizing our existing Aaa – C scale for assigning ratings to structured finance products, but add a suffix that embeds additional information content. By way of example, the suffix could provide an indication of potential rating volatility – i.e., the greater likelihood of rapid, large ratings transitions (favorable or unfavorable) that may be less likely for most corporate or governments ratings – connoted through Aaa.v1, Aaa.v2, etc. Such a rating volatility or uncertainty indicator could also serve to differentiate between structured and non-structured securities.

4. No changes to the existing rating scale, but provide scores on other risk factors

Moody's could continue to use our existing rating scale for structure finance securities, but provide additional analytical information in the form of scores and/or commentary reported in separate data fields that would constitute supplementary "product labeling" for structured products. The additional credit characteristics could be conveyed through symbols that would not be physically appended to the rating but instead provided in separate data fields, analogous to other existing rating signals such as rating outlooks and watchlists. This approach would avoid entanglement with the existing rating system – a potential issue for both rating agencies and users of ratings data – and would encourage the addition of more information content over time because such information would not have to be appended to the rating itself. For example, an issue could have a "Aaa rating, with a ratings transition risk indicator of v1, with a data quality indicator of q3, and a model complexity indicator of m2."

We also welcome comments about the types of additional information content, if any, that would be of greatest market value and the format in which it should be presented.

5. No changes to the existing rating scale, but provide more detailed analysis of the risk characteristics of structured securities

Moody's could continue to use the existing scale for structured ratings and not provide an additional score. However, we could provide additional commentary to the market on the nature and attributes of the structured products that are being rated. We believe most investors of rated securities would welcome additional analysis about the potential risk characteristics of different structured finance securities. While Moody's ratings generally try to speak to differences in expected loss rates, investors are also interested in pure probabilities of default rates, loss-given-default rates, expected rating transition rates, data quality and completeness, model complexity, and vulnerability to event risk. In our written research, we could also provide detailed sensitivity analysis to changes in our assumptions and project the performance of individual securities under different risk scenarios. We are very interested in learning which types of analysis would be most useful to investors.

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Moody's Related Research

Special Comments:

- [Default and Recovery Rates of Corporate Bond Issuers, 1920 – 2005 \(January 2007\)](#)
- [The Performance of Moody's Corporate Bond Ratings: March 2007 Quarterly Update \(April 2007\)](#)
- [Default & Loss Rates of Structured Finance Securities: 1993-2006 \(April 2007\)](#)
- [The Performance of Structured Finance Ratings: Full-Year 2006 Report \(May 2007\)](#)
- [Structured Finance Rating Transitions: 1983-2006, Moody's Special Comment January 2007.](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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