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31 July 2007

Mr Fabrice Demarigny
Secretary General
Committee of European Securities Regulators
11-13 Avenue Friedland
75008 Paris
France

Re: CESR QUESTIONNAIRE REGARDING THE RATING OF STRUCTURED FINANCE INSTRUMENTS (Ref.: CESR/07-394)

Dear Mr Demarigny,

Moody's Investors Service ("**MIS**") welcomes the initiative by CESR to undertake a survey regarding the rating of structured finance instruments. MIS is pleased to respond to section A of the survey which addresses specific questions to the credit rating agencies.

MIS is an operating company owned by Moody's Corporation ("**MCO**"), a New York Stock Exchange traded company. MIS is the oldest bond rating agency in the world, having introduced bond ratings in 1909. Today, MIS publishes opinions and credit research on a broad range of credit obligors and obligations issued in domestic and international capital markets. MIS has rating relationships with more than 12,000 companies and more than 29,000 U.S. public finance issuers, and we have rated more than 96,000 structured finance obligations. MIS employs approximately 3,000 people worldwide, including more than 1,000 analysts and maintains a presence in 27 countries.

In responding to the questions below, we have at times made reference to MIS's Code of Professional Conduct ("**the MIS Code**") and to MIS's Report on the Code of Professional Conduct ("**the MIS Report**"). These documents can be found on the *regulatory affairs* page of our website – www.moodys.com. Capitalized terms used but not defined in this discussion are intended to have the meaning provided in the MIS Code and the MIS Report.

Please do not hesitate to contact me if you have any questions regarding the responses that we have provided below.

Yours sincerely,

/s/ Frédéric Drevon

Frédéric Drevon
Senior Managing Director and Head of Europe

A) QUESTIONS ADDRESSSED TO THE CREDIT RATING AGENCIES

Organisation

1. What proportion of your total rating revenue comes from structured finance related activity?

2. Do you offer non-rating "ex post" services related to structured finance products (i.e. pricing or valuation models,)? If yes, what proportion of your total structured finance derived revenue comes from those ancillary/advisory services?

MIS does not offer any non-rating "ex post" services related to structured finance products[1].

3. Please describe any specificities of the way you determine your fees for the rating of structured finance products as compared to the fees charged in corporate ratings.

MIS fees for rating structured finance transactions are generally based on the nominal issuance amount of the transaction, the applicable asset class and the anticipated complexity, as established in our fee schedules. Fees for ongoing monitoring of ratings are generally fixed amounts, either payable annually or at the time of the initial rating. This is similar to the ways in which fees are determined for corporate and financial institutions ratings.

4. How are the fees you charge for any "ex post" ancillary/advisory activities determined – are they determined separately from fees relating to the actual rating?

Please see response to question 2.

5a. How is staff remuneration determined for structured finance ratings analysts?

MIS assesses and takes into consideration general compensation levels in the market in order to hire and retain the staff that we believe can "carry out high-quality credit assessments of obligations and Issuers."[2]

The basis for remuneration remains the same across our rating groups. Analysts are neither evaluated on the basis of nor compensated for the revenue associated with the

1 As discussed in the MIS Report, MIS provides general credit training courses, some of which cover structured finance. Although we classify these courses as non-rating services, they are not specific ex-post services of the type we believe are referenced in this question.

2 Extract from provision 1.7 of the MIS Code.

entities they rate. Compensation of Analysts consists of a base salary and an annual bonus, with senior-level Analysts also eligible for grants of MCO equity. For Analysts below the Managing Director level, the annual bonus is based on MIS's overall financial performance and the qualitative performance of the individual Analyst. For Managing Directors, the annual bonus is based on MIS's overall financial performance as well as strategic objectives specific to individual Managing Directors, which can include areas such as rating group financial performance, rating quality initiatives, results of Issuer or investor surveys and development of new products.

5b. Is this different staff from staff that work on related ancillary/advisory services?

Please see response to question 2.

Rating process

6. Is the organisation of the rating process similar for corporate and for structured products? If not, please explain the differences.

The rating process in MIS's structured and corporate rating groups are similar.[3]

When MIS is requested to provide a rating opinion, the Issuer will present an issuance scenario and credit profile to the MIS Assigned Analyst. As described in greater detail in the MIS Report, generally, the Assigned Analyst will gather and assess information, and evaluate the scenario against our rating methodologies. Next, a rating committee will be convened to determine the MIS rating opinion. The rating is then communicated to the Issuer and disseminated. If the Issuer presents new facts or different issuance scenarios or credit profiles, they would be similarly evaluated.

From an analytical perspective, in rating a corporate entity as compared to a structured product, we believe the primary differences are:

- Except in fundamentally transforming circumstances, such as major corporate combinations, corporates are not usually able to materially change their credit characteristics because they are significantly dependent on industry structure, franchise position, strategy and operational approach, and management as well as financial characteristics.
- Structured finance vehicles, on the other hand, tend to have 1) more easily definable cash flows arising from specific assets or contractual obligations, 2) a prescribed transaction life to which the rating speaks, 3) greater flexibility to adapt structural features of a transaction in order to achieve a desired outcome, and 4) limitations on their legal ability to deviate from the stated purpose of the transaction.

Once a rating opinion has been assigned and published, our independent Credit Policy Research team[4] produces default and recovery studies and generates statistical analysis,

[3] For a more detailed discussion of the MIS rating process we refer you to the MIS Report pages 7 - 11. However, for ease of access, we have provided above an abbreviated description of our process.

data and metrics to assess the predictive content of our corporate and structured finance ratings.

7a. Which parties does your firm liaise with directly as part of the rating process?

Our primary contact is with the intermediary that arranges the transaction – the ***arranger*** – who sets up the structure, tranches the liabilities and markets the tranches. We may also deal with: one or more ***originators,*** who either originate the underlying assets in the course of their regular business activities or source them in the open market; the ***servicer,*** who collects payments and may track pool performance; the ***asset manager,*** who – in managed transactions – may assemble the initial pool and subsequently trades in and out of collateral assets; the ***trustee,*** who oversees cash distributions to investors and monitors compliance with transaction documentation; the ***financial guarantor,*** who may provide guarantees on principal and interest payments to, or sells credit default swaps on, particular tranches as part of its business model of underwriting high-grade credit risk; and the ***administrator*** of an Asset-Backed Commercial Paper (ABCP) conduit that funds several asset pools. In addition, it is not unusual for the arranger to ask us to communicate directly with the transaction lawyers in order for us to get a better understanding of the transaction structure.

7b. Are there clear policies governing how this relationship is conducted?

MIS has adopted policies and procedures to maintain our objectivity and independence, and to protect the integrity of our credit ratings and rating process, in order to minimize the risks arising from these relationships and other rating relationships. The framework for these policies and procedures is set out in the MIS Code and the Moody's Corporation Code of Business Conduct[5] ("**the MCO Code**") together with associated policies referred to in those Codes. (Several important policies and procedures are discussed below.)

The rating committee is one of MIS's most important control mechanisms for managing potential conflicts of interest and protecting the integrity of the rating process. The rating committee helps to minimize the potential for conflicts of interest by, for example, prohibiting conflicted individuals from committee participation. Moreover, because a majority vote is required for a rating action, the committee is the ultimate opinion-maker, thereby limiting the influence of any one individual.

MIS also takes a number of steps to eliminate or manage potential conflicts of interest at the Analyst level:[6]

- Analysts are not involved in discussions with Issuers or their agents regarding fees or payment[7].

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4 For more details on the rating performance metrics, please also see our response to question 11 and page 12 of the MIS Report.

5 The MCO Code is applicable to all Moody's Corporation employees, including all MIS employees. The MCO Code requires that employees maintain high standards of ethics and integrity in their business activities and comply with applicable laws and regulations.

6 For a more detailed discussion, please see the MIS Report, pages 17 – 18.

- Analysts are prohibited from selling research or data products (although they may be called upon from time to time to explain certain aspects of these products to MIS's research customers).
- Analysts are neither evaluated on the basis of, nor compensated for, the revenue associated with the companies they rate. (See response to question 5a for more information.)
- Moody's securities trading policy prohibits: (i) Analysts and their family members from owning or trading securities of any companies in an Analyst's rating team; and (ii) Analysts from participating in any rating action if they or their family members own any security that could be affected by that rating action.

8. What information about the remuneration for providing the rating is provided to the various parties to the deal?

Generally, the rating application, which includes the fee schedule, will be provided to the signatory of the application, which is either the Issuer or one of the parties mentioned in 7a above.

9. Please describe any specificity regarding your policy of publication of ratings in the structured finance segment.

The dissemination of our credit rating announcements is standardized across our rating groups. This is set out on page 10 of MIS's Report on the Code of Professional Conduct dated April 2006 ("the MIS Report"), which states:

> "Once a rating committee reaches a decision regarding a rating action that Moody's intends to publish, we typically contact the Issuer or its designated agent to inform them of the Credit Rating. Prior to public release of the Credit Rating, Moody's communicates its rating decision only to the Issuer and/or its designated agent. Where feasible and appropriate, Moody's also may provide the Issuer or its designated agent with a draft of the Credit Rating announcement so that the Issuer or its designated agent can review the draft to verify that it does not contain any inaccurate or non-public information. The Issuer may agree or disagree with the rating outcome, but if the rating opinion relates to an existing published Credit Rating, the opinion will be made public unless the Issuer or its designated agent provides us with relevant new information. If Moody's is not able to inform the Issuer or its agent of a Credit Rating prior to its publication, we will inform them as soon as practicable after publication, and generally will explain the reason for the delay.
>
> "Our Credit Rating announcements include the current rating action and our rationale therefor, and also reference the last associated rating. Once they are

[7] From time to time, an Issuer may want to discuss concerns or questions about its fees with an MIS representative who also understands the specific credit analysis and the nature of the analytical work involved. In such cases, we believe it is necessary and appropriate to make available to the Issuer a manager with the appropriate knowledge.

finalized, our Credit Rating announcements are disseminated publicly and free of charge on moodys.com and distributed to major financial newswires. They are available to the public on moodys.com for at least seven days. After that, the first few lines of the announcements, as well as the related Credit Rating history, continue to be available to the public on moodys.com free of charge. Thereafter, the full text of the Credit Rating announcements may be accessed by subscribers."

Rating methodologies

10a. How do you adapt your methodologies to market developments?

In structured finance, changes and adaptations to our methodologies are prompted primarily by market innovation, including evolution in asset classes, changes in the governing law or jurisprudence, or the development of new data sets. Methodologies are also informed by developments in the broader economy or specific sectors. While such developments may not lead to a change in our over-arching methodologies, they may lead, for example, to placing greater weight on one particular factor as opposed to another.

The Credit Policy function is charged with promoting consistency and transparency in our rating practices across MIS. It is comprised of the Credit Policy Committee ("CPC") which has operational arms in the form of rating group credit committees that oversee rating analytics and procedural issues in each of MIS's major ratings groups. The operational arm for the structured finance rating group is known as the Structured Finance Credit Committee, and similar to the other operational committees, it makes recommendations to the CPC on rating procedures, approves significant updates or changes in rating methodologies and reviews important research prior to publication[8].

All methodologies are freely accessible to all and made available through our website, www.moodys.com.

10b. Have you changed them recently?

MIS methodologies are subject to continuous evolution to increase transparency and to respond to market developments. In structured finance, most of our methodologies published in the last two years have either increased our level of transparency or addressed market innovation. Two examples of the former are the series of methodologies that we recently published for rating granular small and medium-sized enterprise (**SME**) transactions in Europe, the Middle East and Africa (**EMEA**)[9] and the recent methodology on MIS's approach to rating residential mortgage backed securities (**RMBS**) in emerging securitisation markets – EMEA[10]. An example of the latter would be our 2006 methodology for Credit Derivative Product Companies[11].

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8 For a more detailed discussion of the credit policy function, please see MIS Report, page 4-5).

9 Moody's Approach to Rating Granular SME Transactions in Europe, Middle East and Africa – 8th June 2007

10 Moody's Approach to Rating RMBS in Emerging Securitisation Markets – EMEA – 8th June 2007

11 Credit Derivative Product Companies – 6th March 2006

There have also been a small number of changes to existing methodologies, such as our changes to asset correlation assumptions for collateralized debt obligations ("**CDOs**")) backed by or referenced to structured instruments[12]. In addition, in 2007, we revised our methodology for emerging market CDOs[13].

10c. How do you apply the changes to the surveillance of rated transactions?

In situations where we have modified an existing methodology, our monitoring teams apply the changes to outstanding ratings through the monitoring process. Please see our response to question 13 for more information about our monitoring processes.

11. Do you consider that the track record of your ratings of structured finance products supports the appropriateness of your models?

MIS uses models as a tool to analyse structured transactions and collateral pools and to assist a rating committee in assigning a rating in accordance with published methodologies. However, models do not determine MIS credit ratings; rather, we consider other subjective and objective factors in addition to the items addressed in the model in determining the rating.

MIS's Credit Policy Research team, which is independent of the rating groups, publishes ratings performance reports that are posted on our website, www.moodys.com. These performance reports indicate a high degree of consistency between structured finance and corporate ratings and provide the track record on which to judge the performance of our ratings. We believe that this supports the appropriateness of our rating methodologies, which includes the models that are used as analytical tools in the rating process.

12a. To what extent can another rating agency's underlying ratings be incorporated into a structured finance rating by your firm?

When rating any structured product, MIS evaluates the credit risk characteristics of the collateral pool backing the securitisation in order to form its rating opinion on the securitisation as a whole. For most asset backed securities and residential mortgage backed securities transactions (which are backed by consumer assets that are not individually issued into the public debt markets), neither MIS nor any other CRA has previously rated the underlying collateral assets. In such cases, MIS studies a wide variety of data supplied by the sponsor and from other market sources in order to form an independent opinion about the credit risk characteristics of the underlying collateral pool.

In certain other asset classes (particularly, CDOs) MIS and other rating agencies may already have issued ratings on many of the individual assets in the collateral pool. This is

[12] Moody's Revisits its Assumptions Regarding Structured Finance Default (and Asset) Correlations for CDOs – 27th June 2005

[13] Moody's Revises its Methodology for Emerging Market CDOs – 11th April 2007

because the assets in CDOs are typically securities that have previously been individually issued into the public debt markets. For assets in the collateral pool for which MIS has already assigned a rating, we will incorporate the MIS rating into our evaluation of the collateral pool. For those assets for which MIS has not already assigned a rating opinion, we nevertheless must perform analysis in order to form a judgment on the related credit risk. MIS uses one of three methods for estimating the credit risk of the collateral that we have not already rated, and the sponsor of the securitisation generally has the option of selecting the method it would like us to employ:

(a) Rating estimates derived by MIS Analysts, using fundamental and quantitative analysis;

(b) Internal ratings supplied by the collateral manager, provided MIS can systematically review the manager's historical ratings, records, and procedures and develop a "mapping" from the manager's ratings to the ratings we believe MIS would have assigned to the same securities had we been asked to do so by the Issuer; or

(c) Ratings published by other credit rating agencies on the individual assets, provided MIS can develop a mapping between those agencies' ratings and the ratings we believe MIS would have assigned to the same securities had we been asked to do so by the Issuer.

Because credit ratings are forward-looking opinions about creditworthiness that address inherently uncertain future events, there is no single methodology for developing them. Two rating agencies looking at the same set of facts may legitimately reach different conclusions based on their individual points of view, understanding of market behaviour, or analytical methodologies. Moreover, capital markets constantly evolve, with changes in financial products, Issuers and the credit environment. As more CRAs enter the market, bringing different perspectives, analytical methods and areas of expertise, we believe there will be more differentiation among CRA ratings.

Because we believe that greater diversity in opinion is beneficial for the overall health of the market, we also believe that all of MIS's ratings, including ratings on structured securities and related collateral securities, must be based on our own independently formed credit opinions. Consequently, we do not treat the ratings of other CRAs as our own because we do not believe ratings are "fungible". In our view, if ratings of the various CRAs were treated interchangeably, it would negatively impact the motivation and ability of rating agencies to differentiate among one another on the basis of improving credit analysis. Over time, this would degrade the quality of ratings and undermine investors' confidence in our analysis.

12b. Are there any risks emerging from the use of another agency's ratings?

At present CRAs can conduct analysis independent of one-another, and if a given credit rating agency chooses to use another CRA's ratings in its analysis it can adjust such ratings in order to map them to the ratings it believes it would have assigned to the securities had it been asked to do so by the Issuer. We believe that such usage of other

CRAs' ratings does not create any additional risks because it allows each agency to develop its own independent opinion using its judgment.

However, we believe that any effort to compel the use of another CRA's ratings or induce harmonization of rating opinions and methodologies would expose the CRA industry and the credit markets to the following concerns:

- **Potential of increased "rating shopping".** There may be instances where an Issuer of securities will choose not to obtain a rating from a particular rating agency, because the methodology used by that rating agency would result in a lower rating than that of another agency. Today, CRAs can nonetheless compete by demonstrating the quality of their methodologies and opinions and generating market demand for their ratings despite the fact that they may not be the most favourable for Issuers. If CRAs were compelled to blindly accept the ratings of other CRAs, it would have the unintended consequence of encouraging CRAs to issue more favourable ratings, resulting in a "race to rate high".
- **Potential of misleading the market.** If a rating agency were required to treat other CRA's views as interchangeable with its own views, even if such views were inconsistent, the rating agency would be compelled either to disseminate information that may mislead the market, because it would be required to adopt ratings with which it disagreed, or not to rate the security. This outcome is tantamount to quashing independent views, and it may also contravene the market abuse provisions of the Market Abuse Directive to the extent that dissemination of such information could give, or is likely to give, a false or misleading impression[14].
- **Potential of increased systemic risk.** Rather than having access to a wide variety of opinions, the market would over-rely on a single, likely optimistic, rating opinion. Moreover, if CRAs were compelled to blindly accept the ratings of other CRAs into their ratings of structured finance transactions, any changes in those ratings may cause excessive market reactions, creating increased systemic risks.

On-going surveillance of the transactions

13a. How do you monitor rated structured products?

Provision 1.9 of the MIS Code states our policy regarding monitoring:

> " Except for Credit Ratings that clearly indicate they do not entail ongoing surveillance, once a Credit Rating is published, Moody's will monitor the Credit Rating on an ongoing basis and update it……"

[14] Article 1 (2) of the Market Abuse Directive states that:

"Market manipulation' shall mean:

> (c) dissemination of information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to financial instruments, including the dissemination of rumours and false or misleading news, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading…."

In structured finance, MIS generally has dedicated monitoring teams for specific asset classes, which are outside of the teams that rate securities on issuance. In the monitoring of outstanding ratings, the surveillance team generally receives updated asset performance data on a monthly basis. Using this data and other information, such as that set out in the table in question 13(b), we assess the database of transactions we have rated and flag potential rating "outliers" – securities whose asset performance indicates that the current rating may not be consistent with the current estimated risk of loss on the security. Once a specific rating is flagged, a surveillance Analyst will further analyse the status of the transaction and consider whether a rating change should be considered. If appropriate, a rating committee will be convened to consider the relevant information and determine whether a rating action (i.e. upgrade, downgrade, or review for upgrade or downgrade) should be taken. MIS has published a number of in-depth reports communicating our surveillance approach for various asset classes.

13b. What are the main inputs into your review process?

In the table below, we set out some of the inputs in our monitoring processes. The actual data analysed will depend on the relevant sub-asset class and the availability of information in different jurisdictions.

Asset Class	Inputs
ABS (1) - general[15]	• Regular reports and information from servicers and trustees of transactions • The ratings of counterparties or credit support providers • Macro-economic factors which are deemed to impact the performance of the securitized assets.
ABCP (2)	• Monitoring reports from conduit administrator with asset information (size, type, geography, seller name, etc.)
Derivatives (3)	• Trustee, manager and servicer reports • Collateral ratings • Swap counterparty ratings • “Macro” information: e.g. relevant indices, sovereign rating history and national statistics on performance of small companies among other things.

(1) Asset Backed Securities (2) Asset Backed Commercial Paper (3) CDOs and Repackaged Securities

14. Is there any difference between corporate credit ratings and structured finance ratings in terms of the frequency (ie. happen more often) and magnitude (ie. are larger) of rating amendments?

[15] The broad term “asset backed securities” refers to bonds or notes that are based on pools of assets, or collateralized by the cash flows from a specified pool of underlying assets. These asset pools can be made of any type of receivable from the common, like credit card payments, auto loans, and mortgages, or esoteric cash flows such as aircraft leases. Two of the more common ABS sub-sectors include RMBS and commercial mortgage backed securities (CMBS).

The table[16] below shows that rating changes occur more frequently for corporate ratings than for structured ratings. For example, the average upgrade rate for the period 1998 to 2006 for structured finance is 3.9% as compared to 9.3% for corporates. However, the average number of notches changed per rating action in the structured finance sector is larger than the average number of notches changed in the corporate sector. Therefore, compared to the unweighted downgrade and upgrades rates, the "notch-weighted" downgrade and upgrade rates are more similar between the two sectors.[17] For example, the averaged notch-weighted upgrade rate is 10.5% in structured and is 14.6% in corporate.

Average 12-Month Rating Transition Rates for European Structured & Corporate Finance: '98-'06

	Downgrades	Upgrades
	Unweighted	
Structured	4.1%	3.9%
Corporate	11.7%	9.3%
	Notch-Weighted	
Structured	15.9%	10.5%
Corporate	23.9%	14.6%

15. Is the internal process for amending a structured finance rating similar to the one for amending a corporate rating?

Yes. Once it has been determined that a rating that might not reflect our current view of the credit risk of the security in question, the relevant Analyst will assemble and analyse pertinent information and present a recommendation to a rating committee. Any rating action (upgrade, downgrade or placed on review for possible upgrade or downgrade) will be determined by the rating committee and then published in accordance with the procedures set out in our response to question 9.

Potential conflicts of interest

16a. Do you think that the iterative process inherent in rating structured finance transactions may involve additional conflicts of interest compared to those arising in corporate ratings?

MIS does not believe that the greater amount of analytical discussions we conduct in rating some structured finance transactions increases the conflicts of interest in our structured finance credit rating process compared to those arising in corporate ratings.

[16] For a more thorough discussion, please see European Structured Finance Rating Transitions: 1988-2006.

[17] As defined in the Appendix of the European Structured Finance Rating Transition study cited above, the "Weighted Downgrade (Upgrade) Rate" is computed as the number of securities downgraded (upgraded), weighted by the number of total notches changed per downgrade (upgrade) per year, divided by the total number of outstanding securities at the beginning of the 12-month period, after excluding half of the ratings withdrawn during that period. For example, a security downgraded from Baa1 to B1 over 12 months is counted as three downgrades in the calculation of a weighted downgraded rated, but counted as only one downgraded in the calculation of the unweighted downgraded rate.

Transaction complexity, innovation, pressure to meet an Issuer's timetable and a highly competitive market, while at times intensified in the structured finance area, are similar in nature to the potential conflicts encountered in corporate ratings. The key conflict across our rating groups remains the "Issuer Pays" model and the need to maintain our independence and objectivity and the quality of our analysis.

16b. If yes, how is your firm organised and what additional measures do you have in place to manage those potential conflicts?

As noted in question 16a, we do not believe that the structured finance rating process involves any additional conflicts of interest compared to those that arise in corporate ratings. The MIS Code and the MCO Code provide the policy framework to manage the conflicts. In particular we would mention our published methodologies, the existence of Chief and Regional Credit Officers and the role of rating committees as central elements underpinning the independence and objectivity of our opinions.

17. Do you perceive any potential conflicts of interest between the structured rating activity and any ancillary/advisory services mentioned in question 2?

Please see our response to question 2.