

Special Comment



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Rating of Transactions Wrapped by Financial Guarantors: Frequently Asked Questions

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Following Moody's announcement of November 8, 2007 regarding our evaluation of financial guarantors in the context of deterioration in the US mortgage market, we have received many questions regarding the assignment of ratings to securities wrapped by the guarantors. This document provides our answers to the most frequently asked questions. We encourage market participants to contact us with additional questions by emailing cpc@moodys.com

Q1: If a security is wrapped by a financial guarantor, and has a published underlying rating that is higher than the guarantor's rating, what is the Moody's rating on the security?

A: The Moody's rating is the higher of (i) the guarantor's financial strength rating and (ii) any published underlying rating (i.e., absent consideration of the guaranty) on the security. For US municipal securities, we also consider any enhanced rating based on a state credit enhancement program. For structured finance securities, we also consider any published rating on a pari passu (i.e., at the same level of seniority) non-sequential tranche or more junior tranche of the same transaction.¹

Should a guarantor be downgraded, if there is significant new information to be considered with regard to the underlying security such as a restructuring plan or a recapitalization, the rating may be placed on Watchlist.

¹ Should the payment structure be sequential, Moody's may derive the underlying rating from published ratings on other tranches of the same transaction.



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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: (1) the underlying obligation defaults and (2) 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.

Underlying ratings may be published in research reports or press releases, and/or the ratings database on moodys.com.

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 driven by an underlying municipal rating, it is understood to have a meaning consistent with Moody's municipal rating scale. For a more complete discussion of the relationship between these rating scales, please refer to the research links at the end of this report.

Q2: Will Moody's apply a Joint Default Analysis (JDA) approach for deals that are jointly supported by an underlying obligation and a financial guarantee policy?

A: Moody's will not apply JDA to deals wrapped by financial guarantors. To date, we have adopted JDA only in a limited number of sectors, including banking, government related issuers, and regional and local governments outside the United States, in which JDA is based on explicit or implicit support from a sovereign government. We have also applied JDA to structured finance transactions and to certain municipal bonds backed by bank letters of credit.

In order to apply JDA to guaranteed deals, we would need to consider correlation or default dependency between the guarantor and the underlying obligation. These would depend, among other things, on the underlying obligation's sector and geography, and each individual guarantor's portfolio concentrations along these dimensions. We will continue to study the feasibility of applying JDA in this market.

Q3: Will Moody's publish its unpublished underlying (also known as "shadow" or "estimated") ratings for securities wrapped by financial guarantors?

A: Moody's publishes underlying ratings only upon receipt of the issuer's specific request or consent.

Q4: Are there special considerations for Variable Rate Demand Obligations² (VRDOs) wrapped by financial guarantors and for Tender Option Bonds³?

A: For insured variable rate demand obligations (VRDOs), a two-component insured rating is assigned: a long-term debt rating and a short-term demand obligation rating. The long-term, component represents Moody's evaluation of the degree of risk associated with scheduled principal and interest payments, using the long-term rating scale. The short-term component represents Moody's evaluation of the degree of risk associated with the ability to receive the purchase price upon demand ("demand" or tender feature"), which is usually based on a liquidity agreement with a financial institution ("liquidity bank"). This component uses the Variable Municipal Investment Grade or VMIG rating scale. For example, a security rated Aaa/VMIG 1 has a rating of Aaa on scheduled principal and interest ratings, and a VMIG 1 rating on the demand (tender) feature of the bonds.

The long-term component of the rating on insured VRDOs is equal to the higher of the guarantor's financial strength rating or the published underlying rating, if any. The short-term component is linked to two elements: (1) the short-term rating of the liquidity bank, and (2) the guarantor's financial strength rating, regardless of the long-term rating on the specific transaction. This is because, if the guarantor is downgraded below investment

² A variable rate demand obligation is a floating rate obligation that has a nominal long-term maturity but has a coupon rate that is reset periodically (e.g., daily or weekly). The investor has the option to put the bonds back to the trustee or tender agent at any time with specified notice (e.g., seven days notice). The put price is par plus accrued interest. In the event that a tendered security cannot be remarketed to other holders, the liquidity bank is required to purchase the bonds. The bank's obligation to purchase terminates upon certain credit events including downgrade of the issuer (or guarantor, if any) below investment grade, or bankruptcy or insolvency of the issuer (or guarantor, if any). The issuer is required to repay the bank for the tendered securities under the terms of the agreement. The repayment term could be as short as 30 days or as long as 3-5 years.

³ A tender option bond (TOB) is a variable rate security with a put option, issued by a trust that owns a fixed-rate municipal bond. In the event that a tendered security cannot be remarketed to other holders, the liquidity bank is required to purchase the bonds. The bank's obligation to purchase terminates upon certain credit events including downgrade of the issuer (or guarantor, if any) below investment grade, or bankruptcy or insolvency of the issuer (or guarantor, if any). The issuer is not required to repay the bank, and the bank's ability to resell the tendered securities depends on market conditions.

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grade or goes into bankruptcy, the obligation of the liquidity bank usually terminates automatically without a final payment.

A similar approach will be used for tender option bonds (TOBs) secured by an insured bond. The long term component of the TOB rating will be equal to the long-term rating of the deposited bond. The short-term component of the rating will incorporate the rating of the liquidity bank as well as the financial guarantor's rating, if the obligation of the liquidity bank terminates automatically upon downgrade below investment grade or bankruptcy of the guarantor.

In structured finance, wrapped transactions with a P-1 short-term rating which do not benefit from a demand (tender) feature will be evaluated individually.

Q5: Will Moody's assign Global Scale Ratings (GSRs) to the underlying ratings of tax-exempt US municipal bonds?

A: In March 2007, Moody's expanded our use of GSRs in the US municipal market to include all taxable municipal bonds and obligations under swaps, regardless of sector. However, we have continued to use the municipal rating scale as the exclusive rating scale for the tax-exempt market. We believed that this approach best met the needs of the majority of buyers and sellers of municipal bonds. Recently, a number of market participants have asked us to reconsider the expansion of GSRs to tax-exempt securities.

At this time, Moody's is carefully considering the analytical and logistical issues that would result from an expansion of GSRs on US municipal bonds to the tax-exempt market. Investors who are interested in understanding what their tax-exempt bonds would be rated on the global scale can use the tools that are provided in our March 2007 publication, The U.S. Municipal Bond Rating Scale (link provided at the end of this report). In addition, we continue to welcome market feedback about the application of GSRs to tax-exempt US municipal securities.

Q6: If an issuer has multiple series or tranches of pari passu debt, and only a subset of the series have underlying ratings assigned to them, will Moody's apply the underlying rating to all pari passu series?

A: Upon the request or consent of the issuer, Moody's will assign an underlying rating to other series of pari passu debt.

Moody's Related Research

- Nov. 8, 2007 Release: Moody's to Update Rating Opinion on Financial Guarantors

Special Comment

- The Incorporation of Joint-Default Analysis into Moody's Corporate, Financial and Government Rating Methodologies, February 2005 (91617)
- Financial Guarantors' Subprime Risks: From RMBS to ABS CDOs, September 2007 (104811)

Rating Methodology

- Moody's Rating Methodology for the Financial Guaranty Insurance Industry, September 2006 (98408)
- The U.S. Municipal Bond Rating Scale: Mapping Municipal Bonds to the Global Rating Scale and Assignment of Global Scale Ratings to Municipal Obligations, March 2007 (102249)
- Mapping of Moody's Municipal Ratings to the Global Scale: Frequently Asked Questions, June 2007 (103423)

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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