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June 3, 2013

VIA ELECTRONIC MAIL

Rule Comment Number 4-661
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20002-4224

Dear All:

I am commenting on the Credit Ratings Roundtable held at the Washington headquarters of the U.S. Securities and Exchange Commission (SEC) on May 14, 2013 (ABS Roundtable.) The ABS Roundtable focused primarily on credit rating opinions of asset-backed securities.

My standing to comment on the distorted committee processes and the flawed methodologies that produce inaccurate rating opinions of asset-backed securities is strong. From 1999 to 2010, I was a senior analyst in the Derivatives Group at Moody's Investors Services (Moody's.) Moody's Derivatives Group assigns rating opinions to all manner of asset-backed securities such as collateralized debt obligations (CDOs) and catastrophe bonds as well as Derivative Product Companies.

My bona-fides are listed on LinkedIn and may be accessed with following hyperlink: Willam J. Harrington, Critiquing Inaccurate Ratings of ABS & Counterparty Exposure.

In expressing my opinions, I exercise my right to freedom of speech in a responsible manner that is backed by robust analysis and unclouded by conflict-of-interest. NRSROs don't even try to make the same claim with respect to rating opinions of asset-backed securities. At the ABS Roundtable, NRSRO panelists did not back their rating opinions as accurate or even valid but merely offered that applicable methodologies are freely available on their companies' websites.

In short, users of NRSRO rating opinions beware. In particular, users of NRSRO rating opinions of both asset-backed securities with derivative exposure and associated bank counterparties beware.

I am sharing my opinions with the SEC as a private citizen who is concerned that inaccurate ratings of asset-backed securities and bank counterparties are fomenting yet another financial catastrophe. I am not a claimant under any whistleblower statutes.

Improve the quality of NRSRO speech by letting money squawk
The SEC need only withdraw its No-Action Letter of November 23, 2010 to Ford Motor Credit Company LLC (ABS No-Action Letter) to improve accuracy of rating opinions of asset-backed securities. Doing so will activate a mothballed Dodd-Frank provision that allows for claims for money damages against an NRSRO that fails to meet certain criteria in assigning rating opinions to asset-backed securities. Specifically, withdrawing the ABS No-Action Letter will obligate an NRSRO to consent to be named as an expert when assigning a rating opinion to an asset-backed security registered under Regulation AB.

Absent withdrawal of the ABS No-Action Letter, no checks prevent an NRSRO from assigning inaccurate rating opinions to asset-backed securities. For instance, an NRSRO is not subject to an objective standard in developing methodologies to assign rating opinions to asset-backed securities but is merely required to make methodologies freely available on a website. As a result, NRSROs do not assign rating opinions in an integrated manner that rigorously balances credits in one asset-backed sector with offsetting debits in others but merely extend rating credits to all asset-backed sectors.

In a particularly egregious instance, NRSRO methodologies specify that the same individual derivative contract be modeled in one manner for an asset-backed security and in a second, mutually exclusive manner for a Derivative Product Company. Without the double-counting, NRSROs would be obligated both to downgrade most asset-backed securities worldwide and to allow the Derivative Product Company sector to fade away.

NRSRO opinion-makers absent from ABS Roundtable to improve NRSRO opinions
I attended the Roundtable as an observer after having offered to participate in Panel 3: Alternative Compensation Models. Agenda items such as a "licensing and certification requirement for NRSRO analysts" warranted practical input from an NRSRO analyst.

I also urged the SEC to invite other NRSRO analysts to participate in Panel 3 and proposed discussion themes for all three Roundtable panels. Please see Appendices A-D herein, beginning page 7.

My offer to serve on Panel 3 received no SEC acknowledgment and my suggestion that other NRSRO analysts participate in the ABS Roundtable was not taken up. No NRSRO analyst was among the 26 panelists at the ABS Roundtable.

On August 8, 2011, I filed a counter-proposal to the SEC Proposed Rules for NRSROs that proposed common-sense steps to mitigate NRSRO conflict-of-interest. My counter-proposals refute a misperception as to how NRSRO conflict-of-interest operates, namely that a lead analyst operates on behalf of an issuer to bamboozle a majority of committee members into voting for a rating opinion that is inaccurate. Please see Appendix D, page 14.

NRSRO conflict-of-interest operates internally between senior-most management and a rating committee and not laterally between a lead analyst and an issuer. NRSRO management approves each methodology, votes in each committee, forces do-overs of committee votes, assigns lead analysts to issuers and evaluates analyst performance for purposes of compensation and career advancement.

A lead analyst is unequivocally responsible for her committee recommendation, for properly briefing committee members in support of her recommendation and for her lone committee vote. Equally, every other committee member is responsible for her own committee conduct and her own committee vote. Any committee member may offer an alternative to the lead recommendation and all committee members vote in an ostensibly independent manner to accept or reject a recommended rating opinion.

Committees are comprised of NRSRO managers and analysts of all levels who work closely together in hierarchical fashion day in and year out. Managers and analysts alike are highly knowledgeable of subject matter, each other's work and the NRSRO pecking order.

A lead analyst cannot be held responsible for being outvoted in a committee. Nor for serving in committee with cowed colleagues who routinely vote with management. Nor for having a committee vote overturned by NRSRO management. Nor for being handcuffed by a deficient methodology that has been locked-in by NRSRO management.

SEC proposals to eyeball analysts as a means of improving accuracy of rating opinions of asset-backed securities miss the mark entirely. For an NRSRO to produce accurate rating opinions each analyst must vote her own opinion in committee and challenge methodologies continually, not learn them by rote. SEC-specified training, certification and sanctions for analysts merely give NRSRO management more tools to harass analysts who balk at assigning inaccurate rating opinions to asset-backed securities.

Bamboozling colleagues on behalf of external entities may be standard operating procedure in revolving door institutions such as regulators, law firms and lobbying practices but is a red herring with respect to inaccurate rating opinions of asset-backed securities. The SEC doth project too much, methinks.

Best remedy for bad speech is good speech

Subsequent to filing my 2011 counter-proposal with the SEC, I have mapped repeated violations of SEC policy by Moody's and other NRSROs. The most serious violations arise under methodologies that ignore derivative risks incurred by asset-backed issuers that are counterparty to FDIC-insured bank subsidiaries and vice-versa. Backed by the deficient methodologies, NRSROs assign inaccurate rating opinions both to most asset-backed securities worldwide and associated counterparties such as Derivative Product Companies and FDIC-insured banks.

In short, NRSRO derivative methodologies don't add up. For example, Moody's proposes to use two different schemes in assigning rating opinions to asset-backed securities, depending on whether a new opinion is being assigned or an existing one is being reviewed. Rating opinions of new issuances will ignore derivative risk entirely whereas rating opinions of existing issues will incorporate derivative risk when a counterparty breaches a rating trigger. (Moody's Comment Request: Approach to Assessing Linkage to Swap Counterparties in Structured Cashflow Transactions, July 2, 2012.)

Moody's proposal violates common sense, runs afoul of SEC policy and contradicts a global aim of regulators worldwide and Moody's itself. Common sense dictates that an over-arching derivative contract adds to the risk of an asset-backed security. SEC policy states that an NRSRO cannot use different schemes in assigning rating opinions to new issuances of asset-backed securities and existing ones.

At the ABS Roundtable, European Securities and Markets Authority (ESMA) participant Mr. Felix Flinterman re-iterated a prime ESMA aim of ridding transaction guidelines of rating triggers that force distressed liquidations. Moody's Managing Director of Global Regulatory Affairs Ms. Farisa Zarin cited Moody's long-standing adherence to similar guidance on the matter by the Group of 20.

Moody's July 2, 2012 proposal further adds to systemic risk in that it strips asset-backed issuers of contractual provisions that protect against counterparty-inflicted losses but models asset-backed securities as if the protections remained intact. Most asset-backed securities worldwide are subject to Moody's proposal, given that bank counterparties can unilaterally retro-fit the diluted provisions into existing derivative contracts via Moody's fiat. Bank counterparties have long under-estimated the costs of adhering to derivative contracts with asset-backed issuers and will continue to accrue losses for so long as current provisions remain in force.

On August 31, 2012, I submitted a detailed critique of Moody's proposal to Mr. Michel Madelain, President and COO of Moody's, and cc:ed several parties including the SEC and ESMA. My August 31, 2012 critique forms part of today's comment and is attached to the delivering email as "WJH Response to Moody's LINKAGE Comment Request."

As of June 3, 2013, Moody's proposal remains stalled by its own internal contradictions. On one hand, Moody's characterizes an interest rate swap between an asset-backed issuer and a bank counterparty (securitization swap) as "a plain vanilla swap" with zero credit and event risk for either party. On the other hand, securitization lobbyists describe the same securitization swaps as highly idiosyncratic in requesting confirmation from the U.S. Commodities Futures Trading Commission (CFTC) that securitization swaps will not be subject to the expanded clearing mandate of June 10, 2013.

On October 15, 2012, Moody's published a related methodology "Moody's Approach to Rating Derivative Product Companies" that is intertwined with Moody's evaluation of securitization swaps. On April 1, 2013, I submitted a detailed critique of the Derivative Product Company (DPC) methodology to Mr. Madelain and cc:ed several parties including the SEC and ESMA. The critique is attached to the delivering email as "Moody's 2012 DPC Update - WJH Comments."

My critique highlighted the inaccurate rating opinions of DPCs and of asset-backed securities that flow from the methodology. For a start, Moody's DPC methodology doubles down on rating triggers by embedding a first set that severs a DPC from its sponsor and a second set that severs a DPC from asset-backed issuers. The DPC methodology also embeds real-world losses in DPCs that transact with asset-backed issuers and the associated securities and ultimately rests on Moody's explicit rationale that government support will once again be extended to large banks.

Would that there were more good speech - there's no shortage of bad speech
Forward looking opinions of asset-backed securities must scrutinize and evaluate over-arching derivatives contracts without crediting possible government support. For a start, rating opinions of asset-backed securities should exclude reliance on a "too-big-to-fail" assessment of bank counterparties.

The term "asset-backed security" misleads in that most such securities are backed by both a derivative contract and a pool of assets rather than by a pool of assets alone. Losses may originate from a derivative counterparty, from an asset pool or from both in cumulative manner. "Swapped-asset-backed securities" (SWABs) more correctly indicates that swapped receipts from a derivative counterparty and not asset flows themselves are "sliced and diced" into rated securities.

To-date, re-assessment of swapped-asset-backed securities has been backwards-looking with primary focus on improving evaluation and scrutiny of asset pools. Several panelists at the ABS Roundtable averred that an NRSRO must have a good track record in evaluating an asset sector in order to assign rating opinions to the sector's swapped-asset-backed securities.

Likewise, an NRSRO must have a track record in assessing derivatives in a common-sense manner that is defensible in the real world. Issuers of swapped-asset-backed securities enter into derivative contracts to hedge mismatches between assets and rated liabilities with respect to basis rates, interest-rates and currencies. The derivative contracts occupy a senior place in transactions' priority of payments and can leave many swapped-asset-backed issuers owing termination payments to the same bank counterparty at once. Last go-round, bank-bail outs kept the domino of counterparty risk upright and protected swapped-asset-backed securities from incurring losses attributable to counterparty impairment.

Prior to Moody's, I worked as a trader on derivatives desks for international fixed-income and currencies at Merrill Lynch. Few at Moody's had similar practical experience of transacting and managing risk in markets that underlay most ratings of swapped-asset-backed securities and financial institutions. The lack of derivative expertise has not been rectified at Moody's or other NRSROs.

I became Moody's "go-to" person regarding interest-rate and currency derivatives in swapped-asset-backed securities. In 2002, I authored Moody's "Guidelines for CDO Hedge Counterparties." In 2004, I authored "Capping Hedge Termination Payments in Moody's Rated Structured Notes Following Default of the Underlying Debt Instrument."

From 2003 to 2006, I spearheaded development of a comprehensive set of structural and legal protocols for implementation by swapped-asset-backed issuers when entering into securization swaps to hedge basis risk, interest-rate risk and currency risk. In 2006, I co-authored the resulting methodology "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions" (Hedge Framework).

Moody’s Hedge Framework remains operational in near original form although it supports inaccurately high rating opinions for most swapped-asset-backed securities worldwide. Analogous methodologies of other NRSROs do the same.

In 2009, I co-authored Moody’s rating methodology "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies."

Sincerely yours,

William J. Harrington

Appendix A: WJH/SEC Correspondence on May 14 Roundtable on NRSROs

From: Losice, Abraham <[redacted]>

Subject: RE: May 14 Roundtable on Credit Rating Agencies

To: "Bill Harrington" [redacted], [redacted]"
[redacted] "Senator Chuck Schumer"
<[redacted]>, "Senator Kirsten Gillibrand"
[redacted]>, "Representative Jerry Nadler"
[redacted]>, "[redacted]" [redacted]>,
[redacted]>
Cc:[redacted] <[redacted]>,
[redacted]" [redacted], [redacted]"
[redacted]>

Date: Thursday, May 2, 2013, 3:59 PM

Dear Mr. Harrington,

The Securities and Exchange Commission has announced the agenda for its Credit Ratings Roundtable, which will be held at the SEC's headquarters in Washington, D.C., on May 14. The attached is a link to the press release, which includes the agenda and details about the time of the event.

http://www.sec.gov/news/press/2013/2013-71.htm

Thank you,

Abe Losice

From: Bill Harrington [redacted]>

Subject: May 14 Roundtable on Credit Rating Agencies

To: [redacted]

Date: Thursday, May 2, 2013, 12:31 PM

Dear Mr. Losice:

I will attend the SEC May Roundtable on Credit Rating Agencies on May 14. What time will the Roundtable convene? Please advise at your earliest convenience as I am making travel plans.

Appendix A (continued): WJH/SEC Correspondence re: May 14 Roundtable on NRSROs

When will an agenda be published? I have submitted numerous working papers to your colleagues and you which should form a basis for general discussion.

I am uniquely qualified to discuss ongoing misrating of asset-backed securities and derivative exposure in general as well as committee processes that produce inaccurate ratings. Are other former rating agency analysts doing the same?

Best regards,

Bill Harrington

Appendix B: WJH Offer to Serve on Panel 3 of May 14 Roundtable on NRSROs

From: Bill Harrington <wjharrington@yahoo.com>

Subject: File Number 4-661 (May 14 Roundtable on Credit Rating Agencies)

To: rule-comment@sec.gov
Cc: "Bill Harrington" <[redacted]

Date: Friday, May 3, 2013, 9:16 PM

Mr. Losice:

Thank you for the link for the May 14 agenda. I will submit materials to aid the roundtable next week.

Also, I volunteer to serve as panelist for the third panel. Several topics fall into areas that I have assessed for the benefit of the SEC and other bodies. My goal is to help avoid another bank bail-out attributable to inaccurately rated securities backed by assets and derivatives.

For instance, Structured Credit Investor (structuredcreditinvestor.com) published the following interview on April 10 in which I discuss broad improvements to the market for securities backed by assets and derivatives.

Both the link to Structured Credit Investors and the interview text are included below.

Best regards,

Bill Harrington

P.S. Please advise if I am incorrect in assuming that the SEC values the free speech of highly-informed and unencumbered private citizens at least as much as the self-serving free speech of rating agencies, bond counsel for securities backed by assets and derivatives, regulatory consultants, etc.

http://www.structuredcreditinvestor.com/story.asp?article=Ratings%20differentiation&PubID=250&ISS=22662&SID=38111&SM=ALL&SearchStr=Harrington

"Ratings differentiation
Call for improved assessment of derivatives risk"
'Too big to fail' is emerging as a mainstream concern and with it come calls for the assessment of derivatives risk to be improved. For securitisation investors, better differentiation of risk in credit ratings is being put forward as one solution.

"In a hypothetical scenario, where the securitisation industry could start over with regards to ratings frameworks, ex-Moody's svp William Harrington believes that ratings should be capped at single-A for deals that contain derivative hedges. At present, senior ratings don't distinguish between transactions that have a derivative at the top of the waterfall and ones that don't, even though downgrade risk is significantly higher for the former.

"Ratings caps would facilitate a more rational investment landscape that enables asset managers to look at their overall portfolio and identify which other factors - not just credit risk in the underlying - they might be sensitive to," he argues. "They could then hedge out their currency risk, for instance, on an exchange or leave the transaction unhedged and be compensated for associated risk. It would engender a better understanding of performance."

Appendix B (continued): WJH Offer to Serve on Panel 3 of May 14 Roundtable on NRSROs

"Harrington says that better differentiation of risk in ratings would create a clearer alignment of investment objectives across the spectrum from conservative institutional investors to risk-savvy sophisticated investors. He suggests that three distinct investment profiles could be targeted in this way: investors who would like to eliminate derivatives risk entirely; investors who can accept index/exchange risk but don't want derivatives risk; and investors seeking exposure to both index/exchange risk and derivative risks.

At issue is the limited number of ratings categories for structured finance, which means that hundreds of different outcomes converge on only 19 different ratings. "Different types of risks can be borne in securitisations and at present there is no way of distinguishing them. If variegated risks are reflected appropriately in a rating, it's then up to the investor which ones they can bear. A better way to gauge these risks would be to, say, designate them on a scale of one to a hundred," suggests Harrington. This would also lessen the 'cliff effect' observable in current ratings approaches, whereby the minimal difference in expected loss between triple-A, double-A and single-A means that mild losses can move sharply down the capital structure.

"Another issue that needs to be remedied, according to Harrington, is that information - such as differing underwriting standards, as well as nuances between asset classes and derivative type and counterparty - isn't typically disclosed to the end-users of ratings. Doing so would help investors and regulators gain a more granular sense of the risk involved.

"Publishing the vote tally in ratings committees would also help investors form opinions about contentious decisions, as well as follow rating patterns over time," he adds.

"Harrington expects the drive towards central clearing of OTC positions will mean that derivatives return to their original function as hedging instruments. It may also force asset managers to scrutinise their derivatives documentation in more detail, thereby shedding light on how confirms are changing over time, for example.

"The broader issue is that assessment of derivatives risk needs to be improved," he observes. "It is analogous to the Y2K systems overhaul in that asset managers should be undertaking as much due diligence on derivatives risk as they do on credit risk. They now have two hedging options - via futures exchanges and OTC clearing."

"Finally, event risk should be explicitly modelled by rating agencies, according to Harrington. This would include monitoring how many deals a counterparty is exposed to or whether any counterparty has an oversized exposure to a certain sector.

"There should be an upfront linkage between the ratings of a counterparty and the potential for flip clauses to be triggered," he concludes. "Ultimately, securitisations should be modelled according to whether they are fully hedged, partially hedged or unhedged. An overlay pertaining to where flip clauses are enforceable can be added where necessary."

Appendix C: WJH Credentials/Themes for Panel 3 of May 14 Roundtable on NRSROs

From: Bill Harrington <[redacted]>

Subject: May 6, 2013: Rule 4-661 (May 14 Roundtable on Credit Rating Agencies)

To: [redacted]

Date: Monday, May 6, 2013, 8:36 AM

Mr. Losice: I sent below to rule-comment@sec.gov this morning.

From: Bill Harrington <wjharrington@yahoo.com>

Subject: Rule 4-661 (May 14 Roundtable on Credit Rating Agencies)

To: rule-comment@sec.gov, LosiceA@SEC.GOV
Cc: "Bill Harrington" <wjharrington@yahoo.com>

Date: Monday, May 6, 2013, 6:29 AM

Mr. Losice:

On Friday 5/May I volunteered to participate on "Panel 3 - Alternative Compensation Models" of the SEC May 14 Roundtable on Credit Rating Agencies. Below, I present my credentials and suggest other rating agency specialists who would similarly inform panel discussion (NRSRO analysts trained in U.S. law who can discuss treatment of "flip clauses" when rating debt backed by assets and derivatives.)

I was a (non-attorney) analyst in the Derivatives Group of Moody's Investors Services from 1999 to 2010 and participated in 1700 structured finance committees (conservatively assuming 3 committees per week.) I was the lead analyst for roughly 700 of the 1700 committees, preparing committee memos, making rating recommendations, defending my recommendations in committee and communicating committee decisions to structured finance issuers and their agents.

(Agents were generally arrangers and underwriting banks. Structured finance issuers are legal fictions that exist solely for purposes of registration in domiciles such as the Cayman Islands. With respect to structured finance, the "issuer-pay" model is more properly termed the "arranger-pays-with-issuer-money" model.)

Each Moody's rating opinion emanates from a committee vote and is accurate only to the extent that committee proceedings are robust, particularly with respect to voting. Unless each committee member votes independently after fully informing herself, she votes inaccurately, the committee as a whole votes inaccurately and the rating is inaccurate. Robust discussion in committee undermines rating accuracy unless it is followed by equally robust voting.

Appendix C (continued): WJH Credentials/Themes for Panel 3 of May 14 Roundtable on NRSROs

Comparatively few people can discuss voting practices at Moody's and fewer still can discuss committee voting on structured finance ratings. According to an autumn 2012 report by the SEC, Moody's employs fewer than 1,000 analysts worldwide in all sectors - corporate, sovereign, municipal, financial, project finance and structured finance. The profile is similar at S&P and Fitch. Again per the SEC fall 2012 report, the 10 NRSROs employ 4,000 analysts worldwide across all sectors.

In contrast, the SEC employs more than 4,000 professionals, Capitol Hill employs some 15,000 staffers and the large U.S. banks each employ 200,000 people or more. Discussion of how to improve rating agency opinions is being led by observers who have no experience working in rating agencies, let alone voting in committees. External observation of flawed rating outcomes does not provide the same insights as voting 1700 times in committee or as leading 700 committees.

Separately, I spearheaded development of two derivative methodologies, one of which is used throughout structured finance worldwide (Framework for De-Linking Counterparty Risks from Global Structured Finance Transactions or "Moody's Hedge Framework.")

Moody's continues to apply the Hedge Framework in near original form although it has proved severely deficient. Moody's has proposed to remedy the deficiencies by application of the second methodology that I spearheaded (Termination Derivative Product Companies and Continuation Derivative Product Companies.) I will forward my working papers on the topic later this week.

As has been the case previously, the analogous two methodologies of S&P and Fitch (and now DBRS and Kroll) mirror each other and the Moody's methodologies almost exactly. In fact, a Moody's colleague who formerly worked for S&P structured finance offered that the Moody's Hedge Framework had been used there as well. Incentives driving the herd mentality among five NRSROs rating structured finance must be considered when discussing Panel 3 topics such as "NRSRO rotation" and "small" rating agencies.

Currently, Moody's faces no obstacle in applying a deficient methodology in rating some $1 trillion ($2 trillion?, $3 trillion?) of structured finance debt. The deficiency is particularly pronounced when a structured finance issuer is subject to U.S. bankruptcy law given the 2010 decision by Judge Peck of the Lehman bankruptcy proceedings to vitiate "flip clauses."

I propose that the SEC ask one or more NRSRO analysts trained in U.S. law (and not outside counsel) to discuss the treatment of "flip clauses" in structured finance transactions governed by U.S. law. For a start, the non-enforceability of "flip "clauses" under U.S. bankruptcy law makes the Panel 3 topic of "subordination" incomplete, given that affected structured finance transactions might pay termination payments at the top of a priority of payments.

Following are my Moody's publications.
June 2010 "Update on the Lehman Brothers Derivative Products Companies' Bankruptcy"
July 2009 "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies"
June 2006 "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions"
2004 "Capping Hedge Termination Payments in Moody's Rated Structured Notes Following Default of the Underlying Debt Instrument"
2002 "Guidelines for CDO Hedge Counterparties"

Regards,

Bill Harrington

Appendix D: WJH Themes for Panels 1 & 2 of May 14 Roundtable on NRSROs

From: Bill Harrington <[redacted]

Subject: Fw: Panels 1 & 2 - Rule Comment 4-661 (May 14 SEC Roundtable on Credit Rating Agencies)

To: [redacted]

Date: Friday, May 10, 2013, 10:32 AM

Mr Losice:

I forwarded following to rule-comment@sec.gov this morning. As noted, I will collate my series of comments ahead of the June 3 deadline.

I cc:my representatives as well as staff of the Senate Banking committees for two reasons. The committee has oversight of the SEC and the unassessed derivative risk that is rife in NRSRO ratings for banks, sovereigns, municipalities and ABS increases the likelihood of yet another round of bank bail-outs.

With respect to the area I know best, ABS are not produced by "slicing and dicing." Rather, ABS are produced by "swapping with an FDIC-insured bank counterparty and the swapped proceeds are sliced and diced."

AAA and AA ABS ratings rest on the "too-big-to-fail" rationale that provides "rating uplift" from "stand-alone" bank ratings.

--- On Fri, 5/10/13, Bill Harrington [redacted] wrote:

From: Bill Harrington [redacted]>

Subject: Panels 1 & 2 - Rule Comment 4-661 (May 14 SEC Roundtable on Credit Rating Agencies)

To: rule-comment@sec.gov
Cc: "Bill Harrington" <[redacted]

Date: Friday, May 10, 2013, 10:21 AM

Mr. Losice:

I am providing comments for Panels 1 & 2. I did the same for Panel 3 earlier this week.

I will collate my series of comments into one document ahead of the June 3 deadline for comments on Rule 4-661.

Appendix D (continued): WJH Themes for Panels 1 & 2 of May 14 Roundtable on NRSROs

An introductory question: ***Has the SEC action against Egan-Jones chilled small firm assessment of ABS ratings?***

2011 SEC Proposed Rules for NRSROs - Fortunately Not Yet Implemented
On August 8, 2011, I commented on the 2011 SEC Proposed Rules for NRSROs http://www.sec.gov/comments/s7-18-11/s71811-33.pdf.

The Proposed Rules were poorly conceived. I observed that, had the Proposed Rules been in place prior to the financial crisis, the financial crisis would have been worse. Please see following sections of my August 8, 2011 Comment.
- Section A, pps 3-6
- Section B, pps 6-9
- Section H, pps 35-36
- Section I, pps 36-53.

Alternative rules of a practical and costless nature would better achieve the central aim of Dodd-Frank with respect to rated ABS, namely that ratings and rating processes be made more transparent. Please see following sections of my August 8, 2011 Comment:
- Section B6, p7
- Section E, pps 15-20
- Section G, p24.

I have read all comments submitted in response to the 2011 SEC Proposed Rules for NRSROs. http://www.sec.gov/comments/s7-18-11/s71811.shtml#comments. ***How does the SEC incorporate previously submitted comments into current analysis?***

Most ABS worldwide mis-rated - non-assessed derivative risks cap ABS ratings at low-to-medium investment grade
Ongoing narrative on the failure of ABS centers around poor underwriting of assets such as U.S. residential mortgages. The process of producing an ABS has often been described as "slicing and dicing asset flows into rated ABS debt."

In fact, asset flows are generally swapped with an FDIC-insured bank counterparty and the swapped proceeds are "sliced and diced." Rather than "ABS," a more correct acronym is "SWABS," swapped-asset-backed securities.

Bank bail-outs kept upright the ABS domino of event risk from failure of a counterparty to an ABS issuer. Event risk is sizable given the few derivative providers to ABS issuers, the failure of the "replacement" market and the non-enforceability of "flip clauses" under U.S. bankruptcy law.

Non-enforceability of "flip clauses" will obligate ABS issuers to pay unscheduled termination payments on a senior basis to FDIC-insured bank counterparties. Had a major hedge provider entered bankruptcy in 2008 (Lehman was not a major hedge provider to cashflow ABS issuers), senior RMBS debt that fell to $0.30 would have fallen further to $0.10 or less.

Appendix D (continued): WJH Themes for Panels 1 & 2 of May 14 Roundtable on NRSROs

Rating agencies assign a probability of zero to event risk under derivative contracts that occupy a senior-most position in ABS priority of payments. Rather than downgrade existing AAA and AA ABS and cap new ratings at A or BBB, rating agencies are ignoring derivative risk and maintaining inaccurate AAA and AA ratings.

Panel 1 should consider "past performance" of NRSROs as if bank bail-outs did not occur and also recognize the circularity of "performance," given that each NRSRO self-monitors its own ratings. NRSROs give themselves and each other a free pass to ignore derivative risk in rating ABS which makes post-2008 performance appear better than the is the case.

Panel 1 should also consider a Big Picture challenge - are NRSROs accountable in any manner? NRSROs implement methodologies without external oversight, evolving legal standards regarding NRSRO free speech don't apply until after injury (i.e. the next financial crisis) and an NRSRO self-monitors its own ratings.

Can NRSROs be required to report rating assumptions across all sectors in a holistic manner? For instance, rating agencies rationalize substantial "rating uplift" to FDIC-insured banks and associated bank holding companies by assuming open-ended government support to bail-out bank bondholders. In a holistic system, the "rating uplift" credit to banks will be offset by a corresponding rating debit to a sovereign rating and neither will be "open-ended." Rather, an NRSRO will estimate the size of future taxpayer assistance for banks both as holders of ABS debt and as counterparties to ABS issuers.
Can an independent body monitor existing NRSRO ratings or comment on forward-looking challenges?

For ABS, "issuer-pay" model more properly termed "arranger/underwriter pays with issuer money"
ABS issuers do not exist, most are post-office boxes in Wilmington Delaware or the Cayman Islands. Rather, ABS arrangers/underwriters act as agent to an ABS issuer with corresponding fiduciary responsibility. ABS arrangers underwriters choose vendors to an ABS closing, such as rating agencies, outside counsel, auditors, collateral managers and agents, paying agents, servicers and note trustees.

With the exception of note trustees, ABS vendors such as rating agencies treat an ABS arranger/underwriter rather than an ABS issuer as client. ABS vendors are paid upfront and in aggregate may claim 2.00% or more of issuer proceeds, i.e. 10 X more than vendors to a corporate bond offering. As a result, ABS start underwater and are structured to be downgraded or even fail.

Can ABS issuers be required to report total closing costs?

Regards,

Bill Harrington

William J. Harrington
[redacted]

April 1, 2013

VIA ELECTRONIC MAIL

Mr. Michel Madelain
President and Chief Operating Officer
Moody's Investors Service
7 World Trade Center, 250 Greenwich Street
NY, NY 10007

Dear Mr. Madelain:

I am writing with respect to "Moody's Approach to Rating Derivative Product Companies" dated October 5, 2012 (2012 DPC Update.)

Moody's classifies derivative product companies (DPCs) as structured finance operating companies. Counterparties to DPCs are fundamental entities such as corporations, municipalities, sovereigns and supra-national entities.

The 2012 DPC Update specifies an inadequate amount of assets for a DPC to hold so that it may pay counterparties in full and on time following a trigger event. Consequently, many Moody's ratings of DPCs are inaccurate in that they indicate better outcomes for DPC counterparties than are likely to be the case.

The degree of inaccuracy grows when a DPC enters into a derivative contract with an issuer of asset-backed securities (ABS.) Associated ABS ratings grow more inaccurate, as well. (Moody's pairs the 2012 DPC Update in tag-team fashion with a second, deficient Moody's protocol that is used by ABS issuers to structure derivative contracts.)

Moody's ratings do not distinguish between DPCs with fundamental counterparties only and DPCs that are counterparties to ABS issuers as well – all DPC ratings carry the indicator "(sf)" that denotes them as structured finance instruments. Moody's also classifies an ABS rating as a structured finance instrument that is similarly denoted by the indicator "(sf)."

Moody's knowingly maintains inaccurate (sf) ratings of DPCs that transact with ABS issuers and vice-versa. For twenty years, Moody's Structured Finance Group has rated both DPCs and Collateralized Debt Obligations (CDOs), a large ABS sector. Day in and decade out, the same Moody's analysts assess ratings of DPCs and CDOs, the same Moody's committees vote on ratings for DPCs and CDOs, the same Moody's teams develop DPC and CDO methodologies and the same two-or-three Moody's managers approve each DPC rating action and each CDO rating action.

Fitch Ratings and Standard & Poor's also rate DPCs and ABS and like Moody's, they recently issued updates that encourage DPCs to enter into derivative contracts with ABS issuers. Each agency presents conjoined derivative risk between DPCs and ABS issuers as negligible so as to preserve ABS franchises for all, i.e. rating agencies, issuers, bankers, counsel, auditors, lobbyists, regulators and other ABS vendors.

April Fools' Day - Moody's pencils in government support for DPCs!
The 2012 DPC Update and its kissing cousins also preserve the tax-payer franchise in insuring banks that bulk up on derivative risk. (Taxpayers have a near-monopoly in writing perpetual/no-fault/no-lifetime-cap policies that activate in event of derivative catastrophe.)

A DPC enters into a mirror trade with its sponsor to hedge each derivative contract with a non-affiliate counterparty such as an ABS issuer. DPC sponsors include Bank of America N.A. and should Morgan Stanley Group Inc. follow competitors in shuttling derivatives in-house, Morgan Stanley Bank, N.A. Goldman Sachs, Inc. and Citigroup Inc. also sponsor DPCs and likewise assume derivative risk.

Moody's rates DPCs four-to-five notches above "standalone" ratings of sponsors, with two-to-three notches "reflecting Moody's assumption of a very high likelihood of government support for bondholders or other creditors in the event such support was needed to prevent a default" ("Moody's downgrades firms with global capital markets operations" 21 June 2012.) DPCs also hold capital assets and collateral posted by a sponsor under mirror trades.

Appendices A-P contain Moody's announcements from 1993 to 2012 that detail DPC methodologies, DPC rating actions and protocols for ABS issuers that enter into derivative contracts. Appendices J, Q and R contain similar announcements by Fitch Ratings and Standard & Poor's.

I am distributing this letter widely, for instance to public officials who have expressed interest in inaccurate ratings of structured finance instruments such as the Attorney General of the United States and to the attorneys general of several states. I do so as a private citizen and not as a claimant under whistleblower statutes.

LinkedIn lists my bona-fides and Moody's publications (William J. Harrington, Critiquing Inaccurate Ratings of ABS & Counterparty Exposure, Greater New York City Area.)

Sincerely yours,

William J. Harrington

DPC ratings reclassified as (sf) structured finance instruments in June 2012
On June 28, 2012, Moody's re-classified DPC ratings as structured finance instruments.[1],[2] Previously, DPC ratings did not carry the (sf) indicator.

(At the same time, Moody's also re-classified ratings of Credit Derivative Product Companies (CDPCs) and covered bond programs, citing a March 21, 2012 regulation by the European Securities and Markets Authority as having driven the collective changes.

In a letter of June 11, 2012, I alerted the addressee to a significant misrepresentation of his in Moody's August 8, 2011 Comment Regarding SEC Proposed Rules for NRSROs as related to DPC methodology and ratings, namely that "MIS credit ratings speak only to credit risk." Building on the misrepresentation, the addressee expressed "concern that the wording of the proposed attestation could inadvertently lead users of credit rating to believe that credit ratings address other types of risk, such as liquidity risk, market value risk or price volatility." (P16, *Annex – Technical Comments, 3. Disclosures Accompanying Credit Ratings, C. Attestation Requirement, II. Credit Ratings Speak Only to Credit Risk.*)

My letter apprised the addressee that "(T)he counterparty ratings of DPCs also address the full exposure to market risk that exists AFTER a trigger event. The dynamic capital and collateral requirements…are determined via simulations of possible market values, price risk and liquidity estimates for the derivatives portfolio.

"In the case of a termination DPC such as MSDP[3], a major component of the rating addresses the ability to pay termination amounts to MSDP counterparties. These termination amounts are determined by marking-to-market the portfolios of each MSDP counterparty, i.e. they are solely a function of market value risk and price volatility.

"In the case of continuation DPCs such as MLDP[4], the rating addresses the ability of MLDP to preserve sufficient liquidity to make indexed-linked payments under existing derivative portfolios while also negotiating to terminate them. As with termination DPCs, the termination amount of a continuation DPC takes the mark-to-market of a derivative portfolio as a starting point. A DPC also holds additional capital in recognition that market conditions (including liquidity) for a given derivative will impact its termination value.")

Moody's props inaccurate (sf) ratings on assumptions piled on assumptions, piled on…
Moody's bases an (sf) rating upon both assessments that certain actions will be undertaken by a structured finance issuer and, equally importantly, assessments that certain other actions will not be undertaken by the issuer. For instance, the (sf) rating of a DPC rests equally on Moody's assessments that a DPC collects termination amounts from counterparties in a timely manner at minimal cost and that a solvent DPC does not file for voluntary bankruptcy.

[1] Please see Appendix P.
[2] Did Moody's inform regulators informed that DPC sponsors such as Bank of America N.A. faced re-classified risk profiles under mirror trades with DPCs?
[3] Morgan Stanley Derivative Products Inc.
[4] Merrill Lynch Derivative Products AG

Underpinned by a suite of Moody's assessments with respect to a structured finance issuer, an (sf) rating imparts less information than may be inferred from the equivalent rating of a fundamental entity. For instance, the (sf) rating of a DPC is not a useful proxy for assessing the general capacity of a DPC to post collateral. Even a highly-rated DPC is constrained in its capacity to post collateral[5] and moreover, such a DPC does so at the expense of non-collateralized counterparties (and in theory its (sf) rating.[6]) In contrast, a bank's ratings provide guidance as to the bank's general capacity to post collateral.

An (sf) rating imparts no information where one structured finance issuer transacts with another, given that Moody's suite of assessments for the two issuers may overlap in some instances and contradict in others. In assigning (sf) ratings, Moody's does not assess losses that accrue to a structured finance instrument after it incurs an event of default in tandem with a second type of structured finance instrument. Working backwards from inter-related events of default, (sf) ratings also ignore real-world losses[7] imposed on one type of structured finance instrument by downgrades of a second type and vice-versa.

Given that two (sf) ratings are rendered meaningless when the associated structured finance issuers transact with each other, both (sf) ratings have embedded cliff risk of sudden, significant downgrade. In 2008, the cliff proved to be pretty high with respect to (sf) ratings of CDOs whose issuers held downgraded residential mortgage-backed securities (RMBS).

The (sf) ratings of severely downgraded CDOs were inaccurate from the outset in that Moody's double-counted overlapping suites of rating assessments, first with respect to an RMBS issuer and subsequently with respect to a CDO issuer.[8] Moody's triple-counted the same overlapping suites of rating assessments in inaccurately rating debt issued by structured finance issuers such as SIVs and CDO^2 that bought CDOs whose issuers held RMBS.

Downgrade (sf) ratings of DPCs and ABS, not comingle them

The 2012 DPC Update skates over the contradictory assessments by Moody's that underpin the (sf) ratings of DPCs on one hand and of ABS on the other.[9] In entering into a derivative contract with an ABS issuer, a DPC raises the expected losses posed both to existing fundamental counterparties and to associated ABS. Moreover, co-dependent (sf) ratings of DPCs and ABS grow more inaccurate with each ABS issuer that is added to a DPC's book of counterparties. Who wins?

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[5] A DPC sources collateral to post to counterparties from capital assets. To avoid double-counting, collateral posted to counterparties must be removed from calculations of DPC assets.

[6] A DPC that posts collateral to some counterparties and not to others poses skewed expected losses that are lower for collateralized counterparties and higher for non-collateralized counterparties.

[7] "Real losses" as distinct from fluctuations in "market value" prior to maturity.

[8] For instance, Moody's assessment that a derivative contract brought no credit or market risk to an ABS was counted once with respect to RMBS and counted a second time with respect to CDOs.

[9] Section 4.2.2.3, p11 of the 2012 DPC Update inadvertently lays out a major contradiction. Unlike fundamental counterparties to a DPC, ABS issuers are passive entities that are unable to act quickly to preserve rights under derivative contracts with DPCs. "If D&O insurance is terminated for any independent director, or if an independent director is removed or resigns, transparency would be increased if the DPC notifies the DPC's non-affiliated counterparties within one business day."

For two decades, Moody's has based the (sf) rating of ABS upon an assessment that no expected losses accrue where an ABS issuer adheres to a Moody's protocol[10] for entering into derivative contracts.[11] Effectively, Moody's treats a counterparty to an ABS issuer as being rated better than Aaa. One eligible counterparty is as reliably excellent as another and none bring an additional loss of even a single basis point to any ABS anywhere in the world.

In fact, Moody's ABS models don't register counterparties on an individual basis at all but simply record scheduled payments under a derivative contract as flowing to and from a generic placeholder. Given that generic placeholders rarely file for bankruptcy or otherwise warrant a downgrade, Moody's models the placeholder as never obligating an ABS issuer to pay an unscheduled amount such as a termination payment or a re-hedging fee.

A derivative contract that complies with Moody's Hedge Framework directs a counterparty that has been downgraded to withdraw from the contract at its own expense in favor of a higher-rated entity ("replacement.") Meanwhile, Moody's bases the (sf) rating of a DPC upon an assessment that a DPC will terminate derivative contracts at minimal cost after having incurred a trigger event (albeit with different timing for termination DPCs and continuation DPCs.)

Conjoined ABS issuers are "irreplaceable" for DPCs
"Replacement" is a rating-agency construct that is increasingly repudiated and is long overdue for re-assessment. I made this point separately to Fitch Ratings and to Moody's in 2012 comment letters that critiqued respective proposals to salvage "replacement" and other derivative contract protocols for ABS issuers.[12],[13] (To-date, Moody's has not implemented "Approach to Assessing Linkage to Swap Counterparties in Structured Finance Cashflow Transactions: Request for Comment" of July 2, 2012.)

Trotting out (largely defunct) DPCs won't resuscitate "replacement" or otherwise validate inaccurate (sf) ratings of ABS. The same one derivative contract cannot be both always in place for an ABS issuer and always terminated at essentially full value for a DPC.

In the real world, downgraded banks are balking at "replacing" themselves as counterparties to ABS issuers. Essentially, a "replacing" bank is a distressed liquidator that books an irreversible loss on each contract that is "replaced" and retains remaining contracts that cannot be "replaced" at any price. Where "replacement" does not occur (the majority of cases), back-up provisions obligate a downgraded counterparty to post collateral to an ABS issuer or alternatively to terminate at costs that range from unfavorable to prohibitive.

[10] "Moody's Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Transactions" dated October 18, 2010 (Moody's Hedge Framework). Moody's Hedge Framework was first published in in 2006 to unify disparate protocols that had previously been in place across Moody's ABS groups.
[11] From 1999 to 2010, I prodded management to improve functionality regarding interest-rate swaps and terminations in CDO and ABS models to no avail.
[12] "WJH Comment on Fitch Exposure of Draft of 12 March 2012," April 28, 2012 and "WJH Response to Moody's LINKAGE Comment Request," August 31, 2012, respectively.
[13] "Replacement" will become a graver concern for ABS ratings as banks are downgraded to "standalone" ratings that are two-to-three notches below long-term senior ratings. Currently, Moody's adds "rating uplift" of several notches to "standalone ratings" owing to the "assumption of a very high likelihood of government support for bondholders or other creditors in the event such support was required to prevent a default."

A DPC that has been downgraded to a "replacement" rating is unlikely to do better than a large bank in effecting "replacement," given that the DPC will most likely have incurred a trigger event and be severely constrained in operations and assets.

Clearly, a termination DPC such as MSDP cannot be counterparty to an ABS issuer and vice-versa.[14] Trigger event schedules and valuation methods of a termination DPC provide neither the time for an ABS issuer to "replace" a hedge nor the means to do so in full.[15] Conversely, a termination DPC must assign a zero probability to receiving a termination payment from an ABS issuer if the DPC is to pay fundamental counterparties in full and on time following a trigger event.

A continuation DPC such as MLDP is no better at providing a derivative contract to an ABS issuer without debasing (sf) ratings all around and leaving Moody's assessments in tatters. For a start, a contingent manager plans for a continuation mode that is much shorter than the life of derivative contracts with ABS issuers and is incentivized to negotiate terminations ahead of the point at which a DPC must re-pay its former sponsor.[16] Additionally, Moody's expects an ABS issuer to have a highly-rated counterparty for the life of its derivative contract but is agnostic as to whether a DPC in continuation mode will be highly-rated.[17]

In entering into derivative contracts with ABS issuers, a continuation DPC must reserve against its own downgrade[18] by setting aside assets both to fund "replacement" (for contracts that are "replaced") and to honor back-up provisions regarding collateralization and termination (under contracts that are not "replaced.") Absent the assets (which are considerable and not specified in the 2012 DPC Update), the (sf) rating of a continuation DPC that enters into a derivative contract with an ABS issuer is inaccurate from the get-go.

The (sf) rating of ABS whose issuer is counterparty to a DPC is likewise inaccurate from the get-go. A derivative contract that is not "replaced" and is a mark-to-market asset for an ABS issuer directs a downgraded DPC to post collateral thereunder.[19] In practice, a continuation DPC will not post collateral to an ABS issuer - posting obligations to hedging counterparties have first priority. Given that an ABS issuer cannot expect collateral from a DPC, Moody's assessment that an ABS issuer can preserve its derivative contract at zero cost fails (again.)

A downgraded DPC that fails to post collateral to an ABS issuer incurs an event of default under the derivative contract that obligates the DPC to terminate on unfavorable terms. In turn, an event of default under one derivative contract may trip cross-default provisions with fundamental

[14] See also Appendix O3, p60, footnote 75.

[15] Termination DPCs specify valuation as mid-market based on market polling or DPC models - both fall short of the "replacement" bid by a new, highly-rated counterparty.

[16] Generally no more than two years.

[17] In calculating required assets each week, a DPC targets expected losses associated with its current (sf) rating rather than a stable, independent measure unaffected by changes to the (sf) rating. Under this self-referencing scheme, a DPC may choose to target higher expected losses after having been downgraded, record an asset surplus and reduce assets rather than replenish them (or at least petition Moody's to be allowed to do so.) As a result, a DPC may allow itself to be cannibalized by its sponsor with asset deficiencies becoming apparent only after a trigger event has occurred. The 2009 DPC Methodology Update did not offer DPCs self-referencing targets for required assets. Please see Appendix N1, p47, footnote 74.

[18] For more on the self-referencing nature of credit risk posed to a counterparty of an ABS issuer under Moody's Hedge Framework, please see "Moody's Approach to Counterparty Instrument Ratings" dated February 12, 2012.

[19] A "springing liability."

and hedging counterparties that likewise enable them to terminate at the expense of the DPC. Assets will bleed out of the DPC in a manner that is not reflected in the existing (sf) rating of a DPC or in the 2012 DPC Update.

“Retracting assets” (flipside to “springing liabilities” with ABS issuers)
A “flip clause” is the analog to collateralization in instances where the mark-to-market of a derivative contract is a liability for an ABS issuer rather than an asset. So-called because it “flips” the seniority with which an ABS issuer makes a termination payment to a counterparty that is insolvent or otherwise non-performing, a “flip clause” effectively exempts an ABS issuer from paying any termination amount at all.[20]

Under a derivative contract that is subject to a “flip clause,” a DPC is exposed chiefly to its own credit risk rather than that of an ABS issuer. Prime examples are counterparties to issuers of CDOs that have been downgraded to Caa but continue to receive derivative payments on schedule. Bail-outs kept banks solvent and let sleeping “flip clauses” lie dormant.

“Flip clauses” are the most onerous termination provisions and, where valid, obligate a DPC to write-off 100% of mark-to-market assets with ABS issuers. Where the validity of “flip clauses” has not been established, a DPC must do still more and not only write-off 100% of mark-to-market assets with ABS issuers but also hold additional reserves to pay legal fees. “Flip clauses” have been upheld under U.K. law, struck down under U.S. law and have unclear status in other domiciles such as Switzerland and France.

The presence of “flip clauses” in derivative contracts clouds the determination of whether a DPC is solvent or insolvent in the first place, inviting still more legal inquiry. Crediting mark-to-market assets that are subject to “flip clauses” as money-good receivables may suggest that a DPC is solvent whereas writing-off the same assets may suggest that the DPC is insolvent and thus entitled to relief under the relevant bankruptcy code.

Focus (sf) ratings of DPCs on trigger event outcomes for all counterparties
While at Moody’s from 1999 to 2010, I worked to keep DPCs from entering into derivative contracts with ABS issuers as well as to constrain the types of approved products and counterparties for DPCs in general. (Moody’s has leverage to dissuade a DPC from entering into new types of derivative contracts via a refusal to issue Rating Agency Condition (RAC).)

During committee deliberations on whether to issue RAC, I argued that a committee should vote to do so only where the expected losses posed to existing DPC counterparties would not increase upon implementation of the proposal under consideration. In other words, Moody’s should not issue RAC so as to enable a DPC to privilege new counterparties at the expense of existing ones.

In my view, a DPC rating was accurate only where it conveyed the expected losses posed to all counterparties in all foreseeable circumstances, most notably after the occurrence of a trigger event. Otherwise, a DPC was merely a souped-up version of its sponsor with an identical probability of default but enhanced recovery prospects.

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[20] A “retracting asset.”

Pre-trigger event, a DPC is a trading entity that books derivative contracts in support of its sponsor's wider franchise and so becomes a repository of dormant, idiosyncratic risks. In return, a non-triggered DPC preserves its (sf) rating at sponsor expense by requesting additional assets or by re-balancing its portfolio of derivative contracts and adjusting mirror trades accordingly.

The sponsor backstop vaporizes upon occurrence of a trigger event and a DPC instantly transforms into an asset-constrained liquidator of a legacy portfolio that is fully exposed to market and credit risk. Moreover, the obligation of a DPC to pay amounts owed its sponsor under mirror trades doesn't vaporize with a trigger event but is merely deferred. The sponsor remains a DPC creditor, one that is subordinate to DPC counterparties during the deferral period and senior to DPC counterparties afterwards.

Will Moody's pull the trigger and downgrade the (sf) rating of a continuation DPC?
Fundamental counterparties will closely evaluate expected losses posed by a continuation DPC that has incurred a trigger event and reference the (sf) rating for a potentially lengthy period. (In contrast, the (sf) rating of a termination DPC becomes irrelevant within weeks of a trigger event. Counterparties that are owed termination payments either will have been paid in full and on time by the DPC or not.)

The (sf) rating of a continuation DPC is likely to mislead counterparties at every stage of continuation mode from immediate aftermath to passive run-off a few years later, particularly where a DPC is counterparty to ABS issuers.[21] A rating team will be pressured to avoid laying bare irreconcilable differences between a DPC in continuation mode and ABS issuer counterparties that necessitate ABS downgrades and set off interlocking ABS and DPC events of default.[22]

In the immediate wake of a continuation DPC incurring a trigger event, Moody's rating team and a contingent manager have a shared interest in seeing the (sf) rating affirmed event so as not to undermine the manager's re-hedging efforts. Nonetheless, an initial downgrade of the (sf) rating may be warranted as indication of increased expected losses posed by a portfolio that is no longer hedged but instead exposed to heightened market volatility associated with failure of a DPC sponsor.

Even the best re-hedging program will not replicate the insulation provided by mirror trades and so will not stabilize expected losses posed to DPC counterparties sufficiently to shore up a stale (sf) rating. Moreover, a contingent manager signs up hedging counterparties by agreeing to post collateral at the expense of non-collateralized counterparties,[23] skewing expected losses by counterparty type. Expected losses posed to all counterparties will climb to the extent that the

[21] Fitch Ratings maintained misleading ratings for continuation DPCs that had not incurred trigger event. Please see Appendix Q1, page 72, footnote 80.
[22] With a stale rating, a DPC in continuation mode that is counterparty to ABS issuers will resemble a monoline insurer that has written credit protection on RMBS and other ABS.
[23] Per the 2012 DPC Update, Section 3.2.4. p9, "(w)e have a particular concern that counterparties may be reluctant to trade with a DPC, even if it remains highly rated, after the contingent manager takes control." Surprisingly, however, the 2012 DPC Update also posits that counterparties are more likely to post collateral to a DPC than vice-versa. For instance, '(T)he DPC may also post or (more likely) receive collateral under its Master Agreements with unaffiliated third parties" (footnote 21, 2012 DPC Update.)

portfolio remains un-hedged and climb again for the subset of legacy counterparties that will not hold DPC collateral.

A contingent manager actively negotiates terminations with counterparties and re-hedges the portfolio to the extent possible until a DPC re-pays amounts owed a sponsor under terminated mirror trades, generally one-to-two years after a trigger event. The looming deadline favors a manager in negotiating terminations as counterparties may conclude that their best option is to terminate at a loss rather than remain counterparty to a rump DPC.[24] Where counterparties are routinely terminating at steep discounts, an (sf) rating must be downgraded to reflect expected losses consistent with a distressed DPC or is irrelevant.

1993 to 2008: DPCs are perpetually Aaa and what's a trigger event, anyway?
Until 2008, no DPC had incurred a trigger event or been downgraded - Moody's had maintained DPC ratings at their initial levels (generally Aaa.[25]) Rating stasis fostered a sunny view among DPC constituents that Aaa ratings were self-sustaining irrespective of risks that accumulated in DPC portfolios or that were introduced by new trades. And why not? A perpetual-Aaa rating could support any number of DPC undertakings and so benefit not only a DPC but its sponsor, certain counterparties and, where the certain counterparties were ABS issuers, Moody's as well.

DPCs in my purview were taken-off auto-pilot and re-assessed both generally and individually. In response to my team's concerns (and suggestions), DPCs refrained from entering into certain trades, terminated existing ones and revised calculations of required collateral and capital so as to hold more assets courtesy of respective sponsors.

DPCs rarely included sufficient assets to stabilize expected losses for existing counterparties when presenting Moody's with initial proposals to book new derivative types. Rather than advance each and every deficient DPC proposal onward to a committee vote, I distinguished between proposals that might work with improvement and ones that would not work under any circumstances.

(Management had long conveyed that my responsibility was not merely to identify deficiencies in DPC proposals but to propose solutions as well, particularly where I possessed singular experience. Structured finance management did not consistently warn analysts not to "structure deals" until late 2008.)

My teams' general skepticism regarding DPC proposals was validated by events in 2008 and thereafter. For instance, I flatly refused to consider DPC feelers to sell credit default swaps and only sparingly recommended that committees issue RAC for DPCs to trade emerging market currencies.

My teams also played a part in ensuring that two Lehman DPCs appeared to have had sufficient resources to pay counterparties at the time of having incurred a dual trigger event in 2008.[26] Each

[24] Repayment obligations to a DPC sponsor may also complicate determinations as to whether a DPC in continuation mode is solvent or insolvent.
[25] All but two DPCs (and all active DPCs) were rated Aaa prior to 2008. Please see Appendix B.
[26] Solvency of the two Lehman DPCs did not preclude them from filing for voluntary bankruptcy as part of the wider Lehman bankruptcy proceedings. Please see Appendix I.

DPC was counterparty to comparatively few ABS issuers and held capital and collateral resources in cash and highly liquid U.S. government securities. (I refused a request by the DPCs to credit a new monoline guarantee to capital resources upon expiry of a prior guarantee that had been in place since formation of the DPCs.)

DPCs generally denied RAC for ABS trades, with major exception that proved the rule
Moody's assessments with respect to DPCs and to derivative contract protocols for ABS issuers fell into my sweet-spot – I was Moody's lead DPC analyst as well as co-author of Moody's Hedge Framework.[27]

Keeping DPCs apart from ABS issuers was common sense as was the more general recognition that the "structure" of one type of structured finance instrument often conflicted or overlapped with the "structure" of a second type. For example, in evaluating CDPCs, I successfully argued that CDOs within a CDPC portfolio should be subject to additional stress. The reasoning was not that CDOs would fall apart entirely (although they did), but simply that there was a great deal of overlap among Moody's assessments for all types of structured finance instruments.

In evaluating DPC proposals to enter into derivative contracts with ABS issuers, my touchstone was that existing, fundamental counterparties be protected against DPC shortfalls attributable to "flip clauses." I rejected proposals by terminations DPCs outright given that termination payments would not be paid by ABS issuers in short order after a trigger event had occurred.

Continuation DPCs were prodded to refine proposals so as to mitigate exposure to their own sponsors under "flip clauses," for instance by stipulating that a downgraded sponsor transfer additional assets into a DPC. Continuation DPCs generally complied and then concluded that entering into derivative contracts with ABS issuers was too costly to pursue.

Bear Stearns DPC proves the rule (don't comingle (sf) ratings of DPCs and ABS)
The 2012 DPC Update ignores insights gained by my team during a comprehensive review of Bear Stearns Financial Products Inc. (BSFP) that was conducted from 2006 to 2009. BSFP was alone among DPCs in being counterparty to a significant number of ABS issuers, specifically RMBS issuers. BSFP also had a large number of fundamental counterparties, primarily U.S. municipalities.

(Goldman Sachs Mitsui Marine Derivative Products L.P. (GSMMDP) was counterparty to ABS issuers, including CDO issuers, and was rated by Moody's Structured Finance Group. However, GSMMDP is not a true DPC in that it does not hold assets. Rather, it has its derivative obligations jointly guaranteed by Goldman Sachs, Inc. and Mitsui Sumitomo Insurance Company, Ltd.

Prior to 2008, Moody's managers provided letters upon request from GSMMDP as a "business accommodation" stating that the senior-most debt of CDO issuers that were counterparty to GSMMDP was rated Aaa. The letters indicated both to the joint guarantors and their respective Moody's analysts that the CDO issuers posed negligible risk as counterparties to GSMMDP. In fact, GSMMDP assumed the same risks and obligations as other counterparties to CDO issuers,

[27] Please see Appendices C-O.

risk that both supported the Aaa ratings of the CDOs and correspondingly weighed down the ratings of the two guarantors.)

I was assigned as lead analyst for BSFP in mid-2005 and was surprised at the size of its sub-portfolio with RMBS issuers. Since 2000, I had highlighted to Moody's structured finance analysts, managers and committees and to DPC management that the rating assessments for DPCs conflicted directly with the rating assessments for ABS.

I made the case to my managers that BSFP required a comprehensive evaluation which would serve a dual purpose of evaluating DPC methodology generally. (Moody's DPC methodologies had never been updated and the sector had long been ignored. Until 2008, I was one of a few quantitative analysts assigned to DPCs and the sole one to make DPCs a priority.[28]) I didn't think in terms of whether the Aaa rating of BSFP was accurate or inaccurate (and my managers did not suggest inquiry into the matter in okaying my request to devote additional time to BSFP.) I simply believed that Moody's had an obligation to better understand its own DPC ratings.

If BSFP proved to have insufficient capital or collateral to justify a Aaa rating, it could rectify the insufficiency within days by tapping its sponsor for additional capital as specified by Moody's. Other DPCs had done so in response to Moody's feedback[29] – we kept laundry lists of items to address during ongoing review of DPCs. For instance, I earmarked evaluation of BSFP to also scrutinize subordination clauses under derivative contracts with municipal issuers.

BSFP was a continuation DPC and its evaluation highlighted shortcomings in the ability of a continuation DPC to honor commitments after a trigger event. After a joint meeting with BSFP and its continuation manager (CIBC), we remained dubious that a contingent manager could seamlessly re-hedge market risk, negotiate terminations optimally and generally operate in a manner that would preserve the Aaa rating of BSFP during a wind-down period.[30]

However, BSFP identified a new concern – the DPC might incur a trigger event when the mark-to-market of mirror trades with its sponsor happened to be close to zero. In such a case, BSFP would hold little collateral and so would be constrained in its ability to negotiate counterparty terminations. To ensure access to working capital after a trigger event, BSFP secured a $750MM liquidity facility from third-party providers[31] that could be drawn only in the event that a trigger event was continuing.

As an analyst, I was gratified that a DPC had identified and rectified an issue that might have significantly impaired its ability to pay counterparties after a trigger event. Moreover, BSFP implemented the liquidity facility without having first obtained credit in weekly calculations of required capital and collateral. (Ultimately, Moody's concluded that the liquidity facility could

[28] As with Moody's Hedge Framework, I found DPCs interesting and valued the opportunity to assess the nexus of market and credit risk from the point of view of end-users, i.e. counterparties.

[29] Prior to a trigger event, a DPC replenished collateral resources and, if necessary, capital on at least a weekly basis courtesy of its sponsor. In contrast, most other types of structured finance issuers (and DPCs that had incurred trigger events) were funded only once and made due with finite assets at hand.

[30] A Moody's manager reflected that the stability of a Aaa rating was more a philosophical issue than a practical one (Aaa stability was one of many topics under task-force review by senior management.) In the manager's view, a DPC that incurred a trigger event would most likely be downgraded.

[31] i.e., not from Bear Stearns & Co., Inc. or its affiliates.

not be included in calculations of BSFP assets. Draws on the facility represented short-term borrowings to be re-paid in 182 days on average and in 364 days at the outside, i.e. before many BSFP counterparties.)

In December 2006, I cited the liquidity facility in recommending that a committee approve a BSFP petition for RAC to continue providing balance-guarantee swaps to RMBS issuers without conforming to a key provision of the newly-issued Moody's Hedge Framework.[32] Committees issued RAC for a six-month trial in December 2006 and renewed the RAC for an additional six months twice more in June 2007 and in December 2007.[33]

(I would have rejected the BSFP petition for RAC outright had I known that Moody's was prohibited by law from greenlighting exemptions to published methodology.[34] From my vantage within Moody's Structured Finance Group, methodology was a fluid guide at best.

For instance, while evaluating BSFP I was simultaneously working with CDPC committees to improve deficiencies of the published CDPC methodology. We opted to communicate changes directly to CDPC management – there was no time both to improve the methodology and to publish a revision. CDPCs were instructed to add conservative measurements of capital sufficiency to redress shortfalls that resulted under the published methodology. Along similar lines, we emailed identical written specifications to each CDPC for use in defining suspension and wind-down events so that capital would not be withdrawn from a credit-impaired CDPC.

Moreover, few if any CDO issuers based in the United States complied with any portion of Moody's Hedge Framework prior to 2009.[35] I had been rebuffed in a request that lawyer colleagues help with implementation. Instead, managers decided that CDO issuers could continue abiding by the defunct 2002 Counterparty Guidelines for CDOs[36] (older guidelines that had ostensibly been supplanted by Moody's Hedge Framework and had been removed from Moody's website.)

More generally, CDO methodology was in constant flux, given that new features were continuously being proposed by underwriters and meeting concurrently with acceptance from some committees and rejection by others.)

Bank bail-outs saved DPCs and salvaged some ABS - more ahead for (sf) ratings?
Bank consolidation masked quadruple-counting of Moody's rating assessments with respect to RMBS issuers and DPCs. Had JPMorgan not acquired BSFP along with Bear Stearns & Co., the damage from Moody's having assigned inaccurate ratings to all manner of structured finance instruments might have been worse.

[32] Under the RAC, BSFP presented RMBS issuers with a derivative contract that made failure by BSP to post collateral at the Second Trigger an Additional Termination Event rather than an Event of Default. The BSFP rationale in petitioning for RAC was that balance-guarantee hedges with RMBS issuers could not be replaced and BSFP lacked resources to post collateral for the duration of each balance-guaranteed swap.

[33] Copies of the RACs may be found in Moody's Operating Guidelines for BSFP.

[34] In spring 2012, I spoke of the BSFP RACs to Mr. Reed Brodsky of the U.S. attorney's office in Manhattan. Follow-up calls to Mr. Brodsky were not returned and follow-up emails bounced back with the message that the recipient's mailbox was full.

[35] As late as 2009, a manager stated in a committee that Moody's had never indicated that implementation of the Hedge Framework was manadatory. Please see Appendix M3.

[36] Please see Appendix E.

In 2008, BSFP incurred a trigger event which, had it proceeded,[37] would have locked BSFP and its RMBS counterparties in a vicious loop of mutual write-offs and downgrades. Associated RMBS would have been even more severely impaired than was the case, given that "flip clauses" are not enforceable in U.S. bankruptcy court and issuers would have paid deep-in-the-money termination amounts to an insolvent BSFP.

U.S. municipalities that were counterparty to BSFP would have been trapped in the loop as well as CDO issuers and SIVs that held RMBS issued by counterparties to BSFP (and SIVs and CDO^2 that held CDOs that held RMBS issued by counterparties to BSFP and so on and so on and so on.)

The 2012 DPC Update misinforms that the post-trigger experiences of BSFP and three other DPCs[38] generally validated Moody's assessments of required capital and collateral for a DPC.[39] Rather, the post-trigger experience of BSFP showed the benefits to a DPC, to DPC counterparties and to a Moody's DPC rating of being rescued a deep-pocketed institution.[40],[41]

(A similar inference may be drawn with respect to MLDP, a continuation DPC domiciled in Switzerland that avoided a trigger event via transfer to a better-capitalized sponsor. Had Bank of America Corp. not acquired Merrill Lynch, MLDP would likely have incurred its own endless cycle of mutual write-offs and downgrades with counterparties. While MLDP was not counterparty to many ABS issuers, the DPC invested surplus capital in structured finance instruments.

MLDP counterparties followed the BSFP counterparties in being transferred a second time to a sponsor with still deeper pockets, i.e. the U.S. taxpayer. In fall 2011, Bank of America Corp. transferred legacy Merrill Lynch derivatives, including the MLDP portfolio, to Bank of America, N.A., an FDIC-insured bank subsidiary.[42])

The 2008 experiences of DPCs indicate that Moody's should re-evaluate its own DPC assessments. After a trigger event, a DPC with even a "plain-vanilla" portfolio will be under-hedged and unable to tap additional capital or collateral. Unless assets held by a DPC prior to a

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[37] Please see Appendices H & L.

[38] Four DPCs incurred trigger events in 2008. Two were Bear Stearns DPCs (BSFP and Bears Stearns Trading Risk Management Inc. or BSTRM) and two were Lehman Brothers DPCs (Lehman Brothers Derivative Products Inc. or LBDP and Lehman Brothers Financial Products Inc. or LBFP). Please see Appendices H & L.

[39] For instance, the 2012 DPC update cites BSTRM, the second Bear DPC, as having paid its counterparties in full post-trigger event. True, but BSTRM was a dormant DPC and had fewer than 10 trades at the time of the trigger event.

[40] In 2008, BSFP owed Bear Stearns Capital Markets Inc. (a subsidiary of Bear Stearns & Co., Inc. (Bear Stearns)) a net $2 billion under mirror trades and also held $400MM capital. To preserve the assets (the net mark-to-market of mirror trades grew to $3 billion in 2009), JPMorgan named BSFP as a beneficiary under a guarantee issued with respect to Bear Stearns and certain affiliates. The JPMorgan guarantee covered existing counterparties of BSFP and future ones which, along with the capital of BSFP, preserved the BSFP rating post-trigger event. Please see Appendix H2.

[41] In 2009, BSFP counterparties had their derivative contracts transferred to JP Morgan Chase Bank, N.A. (an FDIC-insured subsidiary of Bank of America Corporation) and BSFP was merged into JP Morgan Chase Bank N.A. Upon the merger, Moody's downgraded the rating of BSFP to that of JP Morgan Chase Bank N.A. and then withdrew the BSFP rating. Please see Appendix L, p37.

[42] Bloomberg article of Nov 18, 2011 "BofA Said to Split Regulators Over Moving Merrill Derivatives to Bank Unit".

trigger event suffice to pay counterparties in full and on time after a trigger event, Moody's (sf) rating will have misinformed from the outset.

Appendix A: 1993-1995 Moody's DPC Methodologies and Ratings

1. **"Moody's Assigns Aaa Rating to Salomon Swapco Inc. for Counterparty Risk"** March 1993 (Gluck, Backman & Curry)

2. **"Moody's Approach to Evaluating Derivative Products Subsidiaries"** October 15, 1993 (Gluck & Clarkson)

3. **"Counterparty Risk and Capitalization for Derivative Product Companies"** September 14, 1994 (Gluck et al)

4. **"Moody's Assigns Aaa Rating for Counterparty Risk to Tokai Derivative Products Limited"** February 1995

5. **"Moody's Assigns Aaa Rating for Counterparty Risk to the Credit Lyonnais Derivatives Program"** October 1995

Appendix B: Structured Finance – Moody's DPC Ratings (08/24/1999 & 03/2013)

Derivative Product Company	Date Rated	Rating 08/24/99	Rating 03/2013
1. BT Credit Plus Program	8/12/96	**Aaa**	**--**
1. Credit Lyonnais S.A., New York Derivatives Program	2/27/95	**Aaa**	**--**
5. Goldman Sachs Mitsui Marine Derivative Products	2/28/96	**Aaa**	**Aa2**
1. ING Barings Financial Products	1/30/96	**Aa2**	**--**
2. Lehman Brothers Financial Products	1/10/94	**Aaa**	**--**
5. Merrill Lynch Derivative Products	11/26/91	**Aaa**	**Aa3**
5. Morgan Stanley Derivative Products	1/10/94	**Aaa**	**A2**
3. Paribas Derives Guarantis	12/20/93	**Aaa**	**--**
5,6. SBCM Derivative Products, Limited	5/9/95	**Aaa**	**Aa1**
5. Salomon Swapco Inc	3/10/93	**Aaa**	**Aa2**
1. Goldman Sachs FInancial Products International, L.P.	3/19/92	**Aaa**	**--**
1. Sakura Global Capital Inc.'s "Sakura Prime" Derivatives Program	12/16/96	**Aaa**	**--**
1. First Chicago Tokio Marine Financial Products	1/9/98	**Aa1**	**--**
4. Bear Stearns Financial Products	7/30/96	**Aaa**	**--**
3. Bear Stearns Trading Risk Management, Inc.	7/30/96	**Aaa**	**--**
3. Bank of America Financial Products, Inc.	12/12/96	**Aaa**	**--**
2. Lehman Brothers Derivative Products	7/16/98	**Aaa**	**--**
5. Nomura Derivative Products Inc.	8/07/00	**Aaa**	**Aa1**

Notes on DPC wind-downs subsequent to August 24, 1999

1. **Ceased operations prior to 2009 DPC Methodology Review (Appendix K1, p33)**
2. **Filed for voluntary bankruptcy October 2008 (Appendix I, p27)**
3. **Fewer than 10 trades at time during 2009 reviews of DPC methodology. Wound-down entirely shortly thereafter.**
4. **Triggered March 2008 (Appendix H1-2, pps23&25)**
   Merged into JPM Chase Bank N.A. May 2009 (Appendix L, p37)
5. **Still in operation as of March 2013**
6. **Removed $100MM of excess capital in 2011 (Appendix O4, p69)**

Appendix C: 2000/20001 Moody's Special Comments on Individual DPCs

1. **"Moody's Assigns Aaa Ratings For Counterparty Risk to Bear Stearns Financial Products Inc. and Bear Stearns Trading Risk Management Inc."** May 2000 (Gluck, May & Harrington)

2. **"Moody's Assigns Aaa Rating For Counterparty Risk to Morgan Stanley Products Inc."** May 2000 (Gluck, May & Harrington)

3. **"Moody's Assigns Aaa Ratings For Counterparty Risk to Merrill Lynch Derivative Products AG"** June 2000 (Gluck, May & Harrington)

4. **"Moody's Assigns Aaa Rating For Counterparty Risk to Lehman Brothers Financial Products Inc."** July 2000 (Gluck, May & Harrington)

5. **"Moody's Assigns Aaa Ratings For Counterparty Risk to Nomura Derivative Products Inc."** February 2001 (May, Wyszomierski & Harrington)

Appendix D: Moody's Confirms DPC Ratings in Aftermath of September 11, 2001

Rating Action: MOODY'S CONFIRMS THE RATINGS FOR CERTAIN DERIVATIVE PRODUCT COMPANIES

Global Credit Research - 01 Oct 2001

New York, October 01, 2001 -- The events of September 11, 2001 had an immediate impact on many companies that operate in the financial markets. Especially hard hit were those companies that were located in or near the World Trade Center. These companies were faced with the daunting task of relocating their physical operations and starting business anew while reassuring their client base that they were open for business and ready to trade. This was, obviously, an extraordinary test of these companies' disaster preparedness plans as well as the flexibility and determination of their management and employees. Five of the derivative product companies ("DPCs") had at least part of their operations in or near the World Trade Center: Lehman Brothers Financial Products ("LBFP"); Lehman Brothers Derivative Products ("LBDP"); Nomura Derivative Products International ("NDPI"); Salomon Swapco ("Swapco") and Merrill Lynch Derivative Products ("MLDP").

Moody's has had extensive discussions with the managers of all five DPCs regarding their reaction to and recovery from the World Trade Center disaster. Topics covered have included the status of trades and portfolios in the days following the disaster and the outlook for the proper functioning of their companies in the near future. Some temporary problems common to most of the DPCs in the days following the disaster came to light: difficulty getting marks for certain types of trades, lack of liquidity in the markets, difficulty reestablishing review by the external auditors. A couple of the DPCs had trouble tracking the status of their collateral portfolios because their custodian was located near the World Trade Center and the custodian's disaster recovery plans were inadequate to get it up and running in the days after the disaster. Overall, however, the DPCs did a remarkable job of recovering quickly from the disaster and we expect them to remain fully functional and ready for business.

In view of the ability of these DPCs to continue operating following the disaster without serious operational problems, we hereby confirm the Aaa ratings for each of the five named DPCs. We also note that those DPCs with operations housed well away from the site of the disaster also faced illiquid markets, but did not suffer any setbacks that could call into question their creditworthiness.

New York – Structured Finance Group – Moody's Investors Services

William May
Senior Vice President

William Harrington
Senior Analyst

Appendix E: Moody's 2002 Counterparty Obligations to CDO Issuers

Rating Action: MOODY'S PUBLISHES GUIDELINES FOR CDO HEDGE COUNTERPARTIES

Global Credit Research - 04 Nov 2002

As Banks Face Credit Pressures, Safeguards May Shield Senior Investors from Credit Risk

New York, November 04, 2002 -- Moody's Investors Service has published a series of guidelines delineating the steps by which a CDO hedge counterparty can better detach its own credit risk from the CDO itself.

The guidelines are being published as senior noteholders and hedge counterparties in the banking industry compete increasingly for seniority, the agency says. They are intended to limit the level of expected loss arising from counterparty risk, with an eye toward better protecting CDOs' senior tranches, the agency said.

Included are detailed specifications for the posting of collateral when a hedge counterparty is downgraded and for the appointment of a more highly-rated counterparty should the counterparty's ratings decline significantly. The guidelines also address the use of hedge guarantees from more highly-rated institutions as an added option.

"These processes were implemented with the understanding that the universe of eligible counterparties is generally restricted to those with very high credit ratings[43] and that the hedge structure must incorporate viable remedies in the event that a counterparty suffers a credit decline," says Bill Harrington, a Moody's senior analyst.

There are cases in which slightly lower-rated counterparties or the absence of remedies may be workable, but in those cases, Moody's says it would require very specific modeling of any incremental increase in expected loss.

HEDGE COUNTERPARTIES ARE CLIMBING THE WATERFALL

Over the last two years swap counterparties have insisted on becoming increasingly higher in CDOs' priority of interest and principal payment.

"In virtually every CDO with a swap counterparty, the counterparty is pari-passu or senior to the senior liabilities," says Harrington. "In exchange for this seniority, a Moody's rated CDO typically incorporates safeguards into its hedges to ensure their continued viability should the creditworthiness of the counterparty deteriorate. Without these, a CDO might incur additional hedging costs not contemplated at the time the hedge was initiated."

New York – Structured Finance Group – Moody's Investors Services

William Harrington
Senior Analyst

Jeremy A. Gluck
Managing Director

[43] DPCs excepted as detailed in preceding letter to the Appendices.

Appendix F: Moody's 2005 Proposal – Counterparty Obligations to ABS Issuers

MOODY'S REQUESTS COMMENTS ON PROPOSAL FOR SWAPS IN HIGHLY-RATED STRUCTURED FINANCE CASH-FLOW TRANSACTIONS

Global Credit Research - 30 Mar 2005

New York, March 30, 2005 -- Moody's Investors Service is considering several changes to its approach for reviewing counterparty swaps used in highly-rated structured finance cash-flow transactions, and is inviting market participants to comment on the proposed changes.

The changes relate to Moody's creation of a new template that it will use when reviewing swaps in connection with its rating reviews for the aforementioned transactions. In its final form, the template will apply to cash-flow transactions in which the contribution of the swap counterparty to the expected loss of the transaction is not modeled.[44]

"In such cases, the swap counterparty will have an opportunity at the outset to adhere to the rating triggers and remedies specified in the template," said Nicolas Weill, chief credit officer for Moody's asset finance group. "These measures are designed to mitigate the impact of counterparty exposure on the cash-flow transaction's expected loss."

MARKET EVOLUTION CALLS FOR UNIFORM APPROACH

In the past year, Moody's has consulted privately with many swap market participants active in the European and North American structured finance markets. The current draft template represents the culmination of this consultative process. Moody's plans to apply these guidelines to rated transactions globally once the template has been finalized and is released publicly later in 2005.

As the use of swaps in structured finance cash-flow transactions has evolved in recent years, hedge counterparties have encountered multiple types of rating triggers for similar classes of transactions, the triggers differing by product type and geographic region. The rating agency's aim in forging the new template is to bring greater consistency to the market by providing hedge counterparties with a reliable set of rating triggers and collateral standards that can be applied globally.

Moody's notes that these guidelines will be helpful to banks -- and other swap counterparties -- seeking to quantify the effect that a downgrade of their credit rating would have, in terms of their obligation to supply collateral to structured finance cash-flow transactions.[45]

The changes to Moody's approach are unlikely to affect outstanding deals. Depending on what individual deals allow, the parties to some deals and/or counterparties may wish to change their deals' terms retroactively, while others may not, Moody's said.

"Our intent, however, is for these changes to occur prospectively, rather than retroactively," said William Harrington, a VP/senior credit officer with Moody's.

DETAILS OF THE PROPOSAL

The new proposal differs from Moody's current approach in several ways. First, it would consolidate the types of rating triggers, which have displayed variation between North America and Europe. Second, it would recognize the risks of different hedge types through varying collateral requirements, rather than by varying rating triggers. The new proposal also specifies these collateral requirements ahead of time, rather than leaving them for the counterparties to negotiate after a trigger is breached.

Finally, the template articulates a specific set of concerns identified by Moody's as they pertain to hedges in structured finance products, such as automatic posting of collateral, the collateral requirements for balance-guaranteed hedges, the mechanics needed to effect replacement, and so on.[46]

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[44] "Contribution of the swap counterparty to the expected loss" of newly-issued ABS is not modeled by Moody's, S&P, Fitch, Kroll or DBRS. In 2012, Moody's, S&P and Fitch each proposed to model the "contribution of the swap counterparty to expected loss" for existing ABS only and not for newly-issued ABS. Modeling newly-issued ABS differently from existing ABS is a violation of SEC policy.

[45] Downgraded DPCs, i.e. ones that will be obligated to post collateral to ABS issuers as specified by rating agencies, lack the resources to do so.

The proposed template is organized into four separate tables as follows:

1) Table 1 provides the minimum allowable ratings needed for an institution to provide a hedge to a cash-flow transaction, as well as the rating level triggers at which a counterparty is contractually obliged to act to insulate the credit risk of both the swap transaction and the highly rated structured finance transaction from its own increasing credit risk.

2) Table 2 lists the advance rates applicable to posted collateral.

3) Table 3 sets out the main contractual terms that will apply to a counterparty in performing the requisite actions upon being downgraded to a given trigger level, sanctions applicable if the counterparty fails to perform these requisite actions, as well as various other timing and documentation issues. These obligations and sanctions incorporate the practical concerns aired by swap counterparties and participants in structured finance transactions, including the length of time typically required to post collateral under automatic notification, the time needed to effect replacement,[47] and the potentially limited universe of replacement counterparties.

4) Table 4 sets out guidelines for the application, disapplication, and modification of the swap events related to default and termination proceedings.

The rating agency is requesting comments on these changes from market participants during the next 60 days, after which time a decision will be made concerning the final version of the guidelines. Moody's final decision will then be communicated to the public via a press release.

Please send comments in written form to the office addresses given below on or before May 27, 2005:

FOR EUROPE, THE MIDDLE EAST AND AUSTRALASIA:
Contacts:
Marlow Gereluk
Nicholas Lindstrom

IN NORTH AMERICA:
Nicolas Weil
William Harrington

[46] DPCs honor these commitments at the expense of fundamental counterparties.
[47] "Time needed to effect "replacement" is converging with infinity.

Appendix G: Moody's 2006 Hedge Framework – Finalized Counterparty Obligations to ABS Issuers

MOODY'S UNIFIES HEDGE FRAMEWORK FOR HIGHLY RATED STRUCTURED FINANCE CASH FLOW TRANSACTIONS

Global Credit Research - 25 May 2006

New System Provides Extra Security to Investors, Cost Certainty to Banks & Insurers

New York, May 25, 2006 -- Moody's Investors Service has devised a global framework that will allow the ratings of most highly rated structured finance transactions to "de-link" from those of the deals' hedge counterparties. This move will provide extra security to investors in the event a counterparty is downgraded while giving banks and insurance companies a definitive forecast of the costs[48] involved in participating in swap arrangements.

Hedges are most often used in securitizations containing currency risk as well as those with significant mis-matches between fixed assets and floating liabilities, such as collateralized debt obligations (CDOs).

The ratings of outstanding deals will not be affected but, beginning on Sept. 1, all new cash flow transactions rated Aa3 and higher that seek to insulate themselves from rating actions that solely affect their hedge counterparties will operate under the new framework. This will apply to all cash flow transactions rated globally by Moody's.

Moody's initiated this process about one year ago by discussing the proposed changes with many investment banks and money center banks plus reinsurance companies[49] that act as counterparties in structured finance transactions.

"While we adhere to the International Swaps and Derivatives Association's market standards whenever possible, the prescribed contractual terms tend to be more appropriate for counterparties that are much more active participants in the derivative markets than is the case for an individual cash flow transaction," said Moody's Vice President William Harrington.

Moody's revised framework uses ISDA market standards but adjusts them when necessary to address the limited resources and capacities of the special-purpose vehicles involved in securitizations.

"By modeling the hedge's likely contribution to a deal's expected loss, we have developed a dynamic, real world approach to quantifying the collateral that should be posted by a counterparty in the case of a credit event," said Nicolas Weill, managing director and the Structured Finance Group's chief credit officer.

In the past, counterparties pledged a variable amount of monetary support to maintain a transaction's rating. With Moody's revised framework, hedge participants will now be able to accurately forecast the cost of posting collateral, or, if necessary, replacing themselves. Effectively, some banks and insurers may be able to post less collateral than had been required in the past.

To achieve this, hedge counterparties will enter into collateral support agreements (CSAs) at the closing of all cash flow structured finance transactions. The CSA will establish the process for handling situations in which a counterparty's rating is downgraded below a certain level.

Moody's revised framework is explained in a new report. Titled "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions," it is available on the company's website, www.moodys.com.

New York – Structured Finance Group – Moody's Investors Services

Nicolas S. Weill
Managing Director - Chief Credit Officer
Structured Finance Group

William Harrington
VP - Senior Credit Officer

[48] Costs have increased since 2006 given difficulties in obtaining "replacement" or a swap guarantee.

[49] Note omission of DPCs "as counterparties in structured finance transactions." This was intentional given that lead analyst for Moody's Hedge Framework was also Moody's lead analyst for DPCs.

Appendix H1: Bear Stearns DPC Incurs Trigger Event/Moody's Analysts for Financial Institutions Learn About Derivative Risk (March 2008)

(March 15, 2008 Email Exchange between Mr. Robert Young (Managing Director, Moody's Financial Institutions Group) & William J. Harrington regarding trigger event of Bears Stearns Financial Products Inc. (a Bear Stearns DPC with value of $2 billion)

From: "Young, Robert" <Robert.Young@moodys.com>
To: Bill Harrington <wjharrington@yahoo.com>; "Harrington, William" <William.Harrington@moodys.com>; "Frantz, Blaine" <Blaine.Frantz@moodys.com>
Cc: "Nerby, Peter" <Peter.Nerby@moodys.com>;
Sent: Saturday, March 15, 2008 8:34 PM
Subject: RE: Trigger Event of BSFP (Aaa-Interest Rate DPC)

Thanks for your help Bill.
Bob

From: Bill Harrington [mailto:wjharrington@yahoo.com]
Sent: Sat 3/15/2008 6:56 PM
To: Young, Robert; Harrington, William; Frantz, Blaine
Cc: Nerby, Peter;
Subject: RE: Trigger Event of BSFP (Aaa-Interest Rate DPC)

I looked through BSFP documents again & the basic points stand.

1) Contingent Manager (not a Bear entity) takes over BSFP immediately upon a Trigger Event. The Contingent Manager is responsible for BSFP only - it has no obligations to Bear.

2) BSFP already holds $415MM capital - it does not require Bear to hand it over.

3) Sometime over the next week (as early as Tuesday, as late as maybe following Tuesday), BSFP & Bear will terminate their book of trades. If BSFP is determined to owe money to Bear, it does not pay until two years later, unless all claims of BSFP counterparties are satisfied before that point.[50] As I mentioned, the mark was roughly $2 billion in favor of Bear at last weekly reporting.

I am unavailable for rest of evening, have covered everything germane from Bear point of view. I wanted you to have this info prior to Monday morning's call.

I'll revert tomorrow to extent that I can.

"Young, Robert" <Robert.Young@moodys.com> wrote:

Do we have a schedule that shows the run-off of the trades, and is there any other way for them to extricate themselves from this?[51] Can the trades be assigned (terminology?) elsewhere with Bear working with the assignee to settle any differences and release any trapped capital?

-----Original Message-----
From: Harrington, William
Sent: Saturday, March 15, 2008 4:40 PM
To: Frantz, Blaine; Young, Robert; 'Bill Harrington'

[50] The $2.5 billion loss to Bear Stearns was averted by JPMorgan Chase take-over of Bear Stearns & Co. and affiliates such as the Bear DPC. Please see second half of this Appendix, p25 and also Appendix L, p37.
[51] Mr. Young is asking if Bear Stearns can repudiate derivative agreements with DPC affiliate Bear Stearns Financial Products, Inc (BSFP) in light of the onerous impacts described in this Appendix.

Subject: Trigger Event of BSFP (Aaa-Interest Rate DPC)

Blaine:

S&P downgrade of Bear's short-term rating to A-3 has caused a Trigger Event with respect to Bear Stearns Financial Products ("BSFP"), the Aaa-rated interest rate subsidiary whose primary business was providing interest rate hedges to muni's and RMBS transactions.

As a consequence of the Trigger BSFP is essentially jettisoned from Bear and goes into run-off mode with respect to its portfolio of trades. Any amounts owed Bear the parent are subordinate to making the counterparties whole.

From your point of view, the Trigger Event has two impacts.
1) BSFP keeps all of its capital, approximately $416MM, which was provided by Bear.
2) BSFP terminates al of its trades with Bear without paying any termination fee. That amount is approximately $2 billion, from the most recent report that I have.

Bear is not entitled to either amount, or any remainder, until all of BSFP's counterparties have been paid.[52] As the majority of BSFP counterparties are continuation ones, i.e. they do not automatically terminate in a Trigger Event, there is no clear date when all payments owed them are satisfied, short of the maturity of the longest trade.

I don't have access to work email for the rest of the weekend, but you may email at home, above, with any follow-up questions.

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[52] Impact of DPC trigger event on the estate of DPC sponsor, Bear Stearns & Co. loses additional $2.5 billion as follows:
41a. Bear Stearns & Co. writes off $416mm capital investment in BSFP; and
41b. Bear Stearns & Co. writes off $2 billion mark-to-market of net mirror trades with BSFP. Technically, the DPC was obligated to re-pay this amount to Bear Stearns but had a two-year deferral period to continue paying DPC counterparties. During the two-year deferral period, the DPC would have been exposed to un-hedged market risk and its first obligations would be to negotiate terminations with DPC counterparties. Moreover, Bear Stearns & Co. had no recourse if BSFP could not pay the $2 billion at the end of the two-year deferral period, e.g. if RMBS issuers refused to pay lump-sum termination payments or were unable to do so.

Appendix H2: Bear Stearns DPC Guaranteed by JPMorgan Chase & Co. (Jun 2008)

Moody's Announcement - 04 Jun 2008 – "Moody's issues rating confirmation for Bear Stearns affiliate"

Rating agency confirmation follows amendments waiving impact of trigger event that occurred on March 14, 2008 and reflecting change of parent post-merger.

Moody's Investors Service (Moody's) announced today that it has issued rating agency confirmation (RAC) to two amendments to the Operating Guidelines of Bear Stearns Financial Products Inc. (BSFP). BSFP is a derivative products company to which Moody's assigns a counterparty rating. The first of the two amendments, which waives actions that BSFP is to undertake following the trigger event mentioned below, was approved by BSFP's board of directors (Board) on March 17, 2008. The second amendment clarifies certain ambiguities to the Operating Guidelines that resulted from the merger of The Bear Stearns Companies Inc. (BSC) with a subsidiary of JPMorgan Chase & Co. (JPMC) and does not require Board approval to be implemented.

The Operating Guidelines of BSFP specify several trigger events, including the downgrade by Standard & Poor's of the short-term debt rating of BSC to below A-2. This trigger event occurred on March 14, 2008, when Standard & Poor's downgraded BSC's short-term debt rating to A-3 (BSC Downgrade).

The BSFP Operating Guidelines require that certain actions be performed following a trigger event, including that BSFP terminate transactions with several BSC entities, including Bear Stearns Trading Risk Management Inc. (BSTRM) and Bear Stearns Capital Markets Inc. (BSCM). The first amendment waives, on a look-back basis, the consequences of any trigger event that resulted from the BSC Downgrade and suspends those same consequences going forward until BSFP's board of directors votes to repeal the suspension. The second amendment clarifies JPMC's role as parent of BSFP post-merger.

In issuing RAC, Moody's considered several factors, including the guaranty provided by JPMorgan Chase & Co. as of March 16, 2008 (JPMorgan Guaranty) and actions undertaken by BSFP subsequent to the trigger event. The JPMorgan Guaranty covers BSC itself, as well as the obligations of certain BSC affiliates, including BSFP and BSCM, to make payments and post collateral under derivative contracts. While material, Moody's does not view the JPMorgan Guaranty alone as a sufficient basis for issuing RAC, due to the rating of JPMorgan, certain termination provisions of the guaranty and an end-date beyond which new transactions are not covered by the JPMorgan Guaranty.

However, Moody's views actions taken by BSFP subsequent to the March 14, 2008 trigger event as providing the additional support needed to issue RAC. These actions demonstrate management's commitment to adhering to the Operating Guidelines of BSFP and BSTRM, and have the effect of limiting the vehicle's operational and market risk. These actions include the following: 1) maintaining required capital; 2) having the contingent manager on-site immediately following notice of the trigger event, as required by the Operating Guidelines; 3) terminating all trades with BSTRM counterparties, according to the timeline specified in BSTRM's Operating Guidelines; 4) limiting trades to those which are risk-reducing, per the Operating Guidelines; 5) arranging a Liquidity Facility under which, in certain circumstances, BSFP may draw[53]; and 6) communicating regularly with Moody's regarding the status of BSFP.

Counterparty ratings assigned to derivative product companies are opinions of the financial capacity of an obligor to honor its senior obligations under financial contracts, given appropriate documentation and authorizations.

[53] The new Liquidity Facility replaced an expiring facility that BSFP had put in place should a trigger event occur (as it subsequently did.) Working capital might be needed as a bridge loan to help the contingent manager negotiate terminations with counterparties or to post collateral in hedging market risk. BSFP was clear that the Liquidity Facility could not be used to post collateral to its sizeable portfolio of RMBS issuers. The term of the Liquidity Facility was 364 days. BSFP expected RMBS issuers would need collateral for much longer than 364 days, i.e. until final maturity of each RMBS, given that balance-guarantee hedges used by RMBS issuers could not, in the opinion of BSFP, be replaced.

New York - Structured Finance Group - Moody's Investors Services

Yvonne F. Fu
Managing Director

William Harrington
Senior Vice President

Appendix I: 2008/2009 Downgrades of Lehman DPCs (Post-Bankruptcy Filings)

1. Rating Action - 16 Sep 2008 - "Moody's Places Lehman Brothers Derivative Products on Watch"

Rating Action - Moody's Investors Service announced today that it has put the Counterparty Rating of Lehman Brothers Derivative Products Inc. ("LBDP") on watch for possible downgrade.

According to Moody's, the rating action is the result of the operational risk in administering LBDP's termination as a derivative products company. The bankruptcy filing of Lehman Brothers Holdings Inc. has caused a trigger event for LBDP, which as a termination vehicle requires LBDP to unwind its portfolio.

The last rating action was taken on October 1, 2001 when the Aaa rating of LBDP was confirmed.

Moody's derivative products company rating methodology was applied in this rating action.

New York – Structured Finance Group – Moody's Investors Services

William May
Managing Director

Rudolph Bunja
Senior Vice President

2. Rating Action - 06 Oct 2008 - "Moody's Downgrades Lehman Brothers Derivative Product Companies"

Moody's Announcement - Moody's Investors Service announced today that it has downgraded the Counterparty Rating of Lehman Brothers Derivative Products Inc. ("LBDP") to Baa3 with direction uncertain from Aaa on review for possible downgrade, and the Counterparty Rating of Lehman Brothers Financial Products Inc. ("LBFP") to Baa3 with direction uncertain from Aaa.

According to Moody's, the rating actions are the result of the voluntary bankruptcy filings of LBDP and LBFP on October 5, 2008 and the expectation that LBDP and LBFP will be unable to make scheduled payments as a result of the automatic stay caused by the bankruptcy filings. Although both LBDP and LBFP are currently sufficiently capitalized to make scheduled payments, there is uncertainty as to when they will be made as a result of the bankruptcy proceedings. Factors such as the lifting of the automatic stay could have a positive impact on the Counterparty Ratings. Conversely, negative rating action may be warranted if there is a significant delay in issuing the payments or the capitalization of LBDP and LBFP becomes inadequate.

The last rating action for LBDP was taken on September 16, 2008 when its Aaa rating was placed on review for possible downgrade.

The last rating action for LBFP was taken on October 1, 2001 when its Aaa rating was confirmed.

New York – Structured Finance Group – Moody's Investors Services

William May
Managing Director

Rudolph Bunja
Senior Vice President

3. Rating Action - 10 Oct 2008 - "Moody's Downgrades Lehman Brothers Derivative Product Companies"

Rating Action - Moody's Investors Service announced today that it has downgraded the Counterparty Ratings of Lehman Brothers Financial Products Inc. ("LBFP") and Lehman Brothers Derivative Products Inc. ("LBDP") from Baa3 with direction uncertain to B1 on review for downgrade.

According to Moody's, the voluntary bankruptcy filings made on October 5, 2008 were unexpected due to the fact that both LBDP and LBFP are solvent companies, with adequate capital to cover their scheduled payments, and were structured to be legally separate from Lehman Brothers Holdings Inc. (the "Parent").

There is continued uncertainty regarding the timing of LBDP's and LBFP's payments to their counterparties. If the bankruptcy court upholds LBDP and LBFP's legal separateness, Moody's expects that the assets of LBDP and LBFP should not be substantively consolidated with their Parent's bankruptcy estate and therefore counterparties of LBDP and LBFP should ultimately receive payments due to them.

The last rating action for LBDP was taken on October 6, 2008 when its Aaa rating on review for possible downgrade was downgraded to Baa3 with direction uncertain.

The last rating action for LBFP was taken on October 6, 2008 when its Aaa rating was downgraded to Baa3 with direction uncertain.

New York – Structured Finance Group – Moody's Investors Services

William May
Managing Director

Wai-Yin Yu
Asst Vice President – Analyst

4. Rating Action - 20 Jan 2009 - "Moody's Downgrades and Withdraws Ratings on Lehman Brothers DPCs"

Rating Action - Moody's Investors Service announced today that it has withdrawn the Counterparty Ratings of Lehman Brothers Derivative Products Inc. ("LBDP") and Lehman Brothers Financial Products Inc. ("LBFP").

The Counterparty Ratings of LBDP and LBFP were each also downgraded immediately prior to withdrawal. The rating actions are as follows:
Lehman Brothers Derivative Products Inc.
Current Counterparty Rating: Withdrawn
Counterparty Rating Immediately Prior to Withdrawal: B3
Former Counterparty Rating: B1 on review for downgrade
Lehman Brothers Financial Products Inc.
Current Counterparty Rating: Withdrawn
Counterparty Rating Immediately Prior to Withdrawal: Caa3
Former Counterparty Rating: B1 on review for downgrade

The Counterparty Ratings were withdrawn because Moody's believes it lacks adequate information to maintain and monitor the ratings. Please refer to Moody's Withdrawal Policy on moodys.com.

The downgrade of each Counterparty Rating immediately prior to withdrawal results primarily from the bankruptcy filings of LBFP and LBDP on October 5, 2008 ("DPC Bankruptcy Filing"), which left each entity unable to make scheduled payments as a result of the automatic stay. Moody's notes that, as of the date of the DPC Bankruptcy Filing, based on information provided by both vehicles to Moody's, LBFP and LBDP were each sufficiently capitalized to make scheduled payments.

In the case of LBDP, the key driver behind its downgrade is the delay in making scheduled payments that has persisted since the DPC Bankruptcy Filing. Due to LBDP's structure as a termination vehicle, its operating guidelines required that all of its outstanding trades be terminated as a result of the trigger event caused by the earlier bankruptcy of Lehman Brothers Holdings, Inc. on September 15, 2008 ("Lehman Bankruptcy Filing"). Pursuant to LBDP's operating guidelines, the associated termination payment amounts were set as of the termination date and therefore are not subject to further market or credit risk. As of the date of the DPC Bankruptcy Filing, based on information LBDP provided to Moody's, LBDP was sufficiently capitalized to make these termination payments. However, the due date for LBDP's payment of its termination amounts had passed without LBDP confirming that it had made such payments to its counterparties, and the ultimate date of payment is highly uncertain due to its dependence upon the resolution of the bankruptcy proceedings. As a result, Moody's further downgraded the Counterparty Rating of LBDP immediately prior to the withdrawal of the rating to B3 from B1 on review for downgrade.

In the case of LBFP, the key driver behind its downgrade is a delay in making scheduled payments similar to that experienced by LBDP. However, LBFP is also subject to the additional factor of unhedged market risk which has the potential to impair capital sufficiency and the ability to make scheduled payments.[54] LBFP is a continuation vehicle, which means that upon the Lehman Bankruptcy Filing, LBFP could not enter into new customer transactions but existing ones would continue until either their legal final maturity or, where agreed with individual counterparties, earlier novation or termination.[55] Until the outstanding trades mature or are otherwise terminated or novated, LBFP is obligated to make all scheduled payments under each swap, evidence of which has not been provided to Moody's. In addition, as a result of the Lehman Bankruptcy Filing, the mirror trades between LBFP and an affiliate of its parent were terminated pursuant to LBFP's operating guidelines and therefore LBFP's portfolio became unhedged. Although one of the responsibilities of LBFP's continuation manager was to establish replacement hedges to protect LBFP's portfolio from market risk, Moody's was informed by LBFP that the continuation manager was terminated prior to it having accomplished this task. According to reports provided by LBFP to Moody's at the time of the DPC Bankruptcy Filing, LBFP had sufficient capital to make its scheduled payments at that time, but continuation of the unhedged market risk increases the chance of capital insufficiency in the future.[56] For the reasons stated above, Moody's further downgraded the Counterparty Rating of LBFP immediately prior to the withdrawal of the rating to Caa3 from B1 on review for downgrade.

The last rating actions for both LBFP and LBDP were taken on October 10, 2008 when the Counterparty Rating for each was downgraded to B1 on review for possible downgrade from Baa3 with direction uncertain. In addition to the specific factors discussed above, the methodology used in the rating actions taken today is described in the following publications available on Moodys.com: Counterparty Risk and Capitalization for Derivative Product Companies (9/14/1994); Moody's Approach to Evaluating Derivative Products Subsidiaries (10/15/1993).

New York – Structured Finance Group – Moody's Investors Services

William May
Managing Director

William Harrington
Senior Vice President

[54] Unhedged market risk may have resulted in LBFP no longer having "sufficient capital to make its scheduled payments" at a later date.
[55] Transactions with ABS issuers would likely persist until "their legal final maturity." ABS issuers risk downgrade if forced to accept a loss on a derivative contract.
[56] Even re-hedged market risk "increase(s) the chance of capital insufficiency in the future." New hedging counterparties will require collateral which may be posted by a continuation DPC only at the expense of long-standing counterparties.

Appendix J1: Moody's Assesses DPC Methodology & Ratings Post-Lehman

Announcement: Moody's Reviews Bankruptcy Risk of Derivative Product Companies

Global Credit Research - 12 Dec 2008

New York, December 12, 2008 -- Moody's announced today that it is reviewing several issues regarding the operations of derivative product companies ("DPCs"), including the risk of voluntary bankruptcy and, for a subset of DPCs, the role of continuation managers. DPCs are special purpose operating companies typically established and sponsored by investment banks to transact in derivative products such as interest rate swaps. Their Aaa ratings are based on factors such as bankruptcy remoteness from their sponsor, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity and adherence to a set of operating guidelines that, among other things, restricts the types of products the DPC may transact in.

In light of the October 5, 2008 bankruptcy filings by Lehman Brothers Derivative Products Inc. ("LBDP") and Lehman Brothers Financial Products Inc. ("LBFP"), two DPCs sponsored by Lehman Brothers, Moody's highlights the risk that well-capitalized DPCs which otherwise merit their Aaa counterparty rating may file for voluntary bankruptcy. As a result of LBDP's and LBFP's bankruptcy filings and persisting uncertainty over the timing of their payments to their counterparties, Moody's downgraded the counterparty ratings of LBDP and LBFP from Aaa to Baa3 with direction uncertain on October 6, 2008, and further to B1 on review for downgrade on October 10, 2008. LBDP's Aaa counterparty rating was initially placed on review for downgrade on September 16, 2008 due to operational risk in administering LBDP's termination as a derivative products company. The bankruptcy filing of Lehman Brothers Holdings Inc. had caused a trigger event for LBDP, which as a termination vehicle required LBDP to unwind its portfolio.

Moody's is engaged in active dialogue with DPCs to assess their susceptibility to voluntary bankruptcy and possible mitigants to that risk. For DPCs whose operating guidelines specify the activation of a contingent manager under certain circumstances, Moody's is also discussing the role of such a contingent manager.

With respect to the risk of voluntary bankruptcy, issues of concern to Moody's include mechanisms to preserve the independence of the board of directors, procedural requirements for filing voluntary bankruptcy, safeguards against the improper removal and replacement of independent directors, and transparency and timely communication of bankruptcy-related board actions to interested parties, including counterparties. Moody's is also interested in whether counterparties have an adequate opportunity to contest an invalidly filed application for voluntary bankruptcy.

In Moody's view, voluntary bankruptcy poses a significant risk that, at the very least, counterparties will not receive payments due to them on a timely basis. In some circumstances, the ability of a DPC to ultimately meet its obligations in full may be compromised by a bankruptcy filing. Although DPCs have existing features that protect their bankruptcy remoteness, the bankruptcy filings of the Lehman DPCs have called into question the sufficiency of those measures. As a result, Moody's will be reviewing the actions undertaken by each DPC to address the risk of voluntary bankruptcy and analyzing their adequacy. Moody's will be issuing a publication on both the potential mitigants to the risk of voluntary bankruptcy and findings with respect to continuation managers, followed by an invitation for comments from market participants.

New York – Structured Finance Group – Moody's Investors Services

William May
Managing Director

William Harrington
Senior Vice President

Appendix J2: Fitch Withdraws AAA Rating of Lehman DPC/No Downgrade (2008)

Fitch Withdraws Ratings of Lehman Brothers Derivative Products Inc.

Business Wire

NEW YORK -- October 17, 2008

Fitch Ratings has withdrawn the 'AAA' long-term Issuer Default Rating (IDR) and counterparty rating of Lehman Brothers Derivative Products Inc. (LBDP). All trades intermediated by LBDP have been terminated, in accordance with the operating guidelines. Most incoming third party settlements have been received. Any required distributions will be satisfied with capital on hand, which has historically exceeded prescribed levels.[57]

On Sept. 15, 2008, Lehman Brothers Holdings Inc. (LBHI) and its subsidiary Lehman Brothers Special Financing (LBSF) voluntarily filed for Chapter 11 reorganization. LBHI is LBDP's parent. LBDP's offset trading counterparty is LBSF, a wholly owned over-the-counter derivatives company whose obligations are guaranteed by LBHI. The filings represent a "trigger event" resulting in the imminent cessation of LBDP's operations.

The following ratings are withdrawn:

Lehman Brothers Derivative Products Inc.

-- Long-term IDR 'AAA'

--Counterparty Rating 'AAA'

Fitch's rating definitions and the terms of use of such ratings are available on the agency's public site, www.fitchratings.com. Published ratings, criteria and methodologies are available from this site, at all times. Fitch's code of conduct, confidentiality, conflicts of interest,[58] affiliate firewall, compliance and other relevant policies and procedures are also available from the 'Code of Conduct' section of this site.

Contact:

Fitch Ratings

[57] Does Fitch DPC methodology assess timely payment by DPC?
[58] Fitch's conflict of interest is manifest in having withdrawn DPC ratings in 2011, re-issuing DPC ratings in 2013 and okaying DPC transactions with ABS issuers. Please see Appendices Q1-Q2, pps 72 & p74.

Appendix J3: Fitch Downgrades Lehman Continuation DPC (2008)

Fitch Downgrades Lehman Brothers Financial Prods' LT IDR to 'D', Counterparty to 'B/RR1'

CHICAGO--(Business Wire)--
Lehman Brothers Financial Products, Inc. (LBFP) has filed for reorganization under Chapter 11 October 6, 2008. This was deemed a strategic measure to protect its assets from creditor actions related to Lehman Brothers Holdings Inc. (LBHI) and Lehman Brothers Special Financing (LBSF). LBSF is a counterparty to LBFP, subsidiary guaranteed by LBHI and the market risk manager that is owed monies from LBFP. Fitch Ratings downgraded the long-term Issuer Default Ratings (IDR) to 'D' and the counterparty rating to 'B/RR1'. The 'RR1' Recovery Rating (RR) indicates a very low probability that any counterparties will ultimately incur a loss. LBFP continues to have sufficient capital in highly liquid funds that is more than sufficient to cover current payments due.[59]

LBFP's portfolio was in the process of being transferred to its contingent manager, West LB AG, following the declared bankruptcy of its sponsor. The guarantor's bankruptcy constituted a 'trigger event,' requiring the installation of its contingent manager to administer the trading book and facilitate an orderly wind-down of the portfolio over the remaining life of its contracts. On Sept. 17, 2008, Fitch placed LBFP's ratings on Rating Watch Negative upon the occurrence of the trigger event.

At this time, LBFP's trading book is in a net receivable position with a pool of highly rated counterparties. In addition, capital is maintained in money market accounts with large, independent, reputable third-party money managers. Capital levels remain in excess of obligations and are not dependent upon receipt of any receivables from counterparties. Future capital levels should be protected by the existing excess and any hedges established as the portfolio is wound down.

The following ratings were downgraded by Fitch:

Lehman Brothers Financial Products Inc.

--Long-term IDR to 'D' from 'AAA';

--Counterparty Rating to 'B'/RR1' from 'AAA'.

[59] Does Fitch DPC methodology assess timely payment?

Appendix K1: Moody's Proposed 2009 DPC Methodology Update

Announcement: Moody's Requests Comments Regarding Derivative Product Companies

Global Credit Research - 16 Mar 2009

New York, March 16, 2009 -- Moody's Investors Service announced today that it has published a Request for Comment titled "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies." The Request for Comment expands upon concerns that Moody's had previously articulated in its press release titled "Moody's Reviews Bankruptcy Risk of Derivative Product Companies" on December 12, 2008, namely that voluntary bankruptcy has serious negative implications for an otherwise solvent derivative product company's ("DPC") ability to make timely swap payments to its counterparties.

The Request for Comment notes a proposed approach to assess the risk of voluntary bankruptcy for all DPCs whose ratings depend, in part, on analysis of their bankruptcy remoteness. The concern is particularly pronounced with respect to DPCs domiciled in the United States, as U.S. law allows a company to make a voluntary petition for Chapter 11 bankruptcy while solvent. One purpose of the Request for Comment is to ascertain market opinion of Moody's conclusion that these changes would effectively mitigate the risk consistent with the highest rating levels for U.S.-domiciled termination DPCs. The following five termination DPCs had counterparty ratings from Moody's at the date of this Request for Comments:

☐ Bear Stearns Trading Risk Management (domiciled in United States, wholly owned & guaranteed subsidiary of Bear Stearns Financial Products, a continuation DPC listed below whose sponsor = JPMorgan Chase & Co.)

☐ Morgan Stanley Derivative Products (domiciled in United States, sponsor = Morgan Stanley Group Inc.)

☐ Nomura Derivative Products Inc. (domiciled in United States, sponsor = Nomura Securities Co., Ltd.)

☐ Paribas Derives Garantis (domiciled in France, sponsor = BNP Paribas)

☐ Citi Swapco (domiciled in United States, sponsor = Citigroup Inc.)

In addition, the Request for Comment identifies two more concerns that affect only continuation DPCs: unhedged market risk and the limited effectiveness of continuation managers. No effective solutions for these two additional concerns have been proposed. The following four continuation DPCs had counterparty ratings from Moody's at the date of this Request for Comment:

☐ Banc of America Financial Products (domiciled in United States, sponsor = Bank of America N.A.)

☐ Bear Stearns Financial Products (domiciled in United States, sponsor = JPMorgan Chase & Co.)

☐ Merrill Lynch Derivative Products (domiciled in Switzerland, sponsor = Merrill Lynch & Co.)

☐ SMBC Derivative Products (domiciled in United Kingdom, sponsor = Sumitomo Mitsui Banking Corporation)

Moody's welcomes feedback and or suggestions from interested market participants. Comments should be addressed to dpc@moodys.com by April 17, 2009. Moody's expects to publish its final approach on this topic in May 2009 and thereafter to begin applying this approach to relevant DPCs.

New York – Structured Finance Group – Moody's Investors Services

Gus Harris
Managing Director

William Harrington
Senior Vice President

Appendix K2: Continuation DPCs Placed on Watch Per DPC Proposal (Mar 2009)

1. **Rating Action – 17 March 2009 - "Moody's Places MLDP AG on Review for Possible Downgrade"**

   Moody's Investors Service announced today that it has placed the counterparty rating of Merrill Lynch Derivative Products AG, on review for possible downgrade. The rating action is as follows:
   MERRILL LYNCH DERIVATIVE PRODUCTS AG
   Counterparty Rating
   Prior Rating: Aaa
   Prior Rating Date: October 1, 2001
   Current Rating: Aaa on review for possible downgrade

   Derivative product companies (DPCs) are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness from their sponsor, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

   As detailed in Moody's Request for Comment of March 16, 2009 regarding "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies", Moody's is reviewing several issues regarding the operations of these companies. Merrill Lynch Derivative Products AG is a continuation DPC whose counterparty rating is based in part on the ability of its respective continuation manager to undertake certain actions should its services be activated. Chief among these actions is re-hedging market risk, which ongoing evaluation by Moody's suggests may be difficult to achieve for any continuation DPC, given their current structure.

   The issue of re-hedging market risk and other responsibilities of a continuation manager after it has stepped in are responsible for today's rating action.

   The principal methodology used in this press release was "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) which can be found at www.moodys.com in the Credit Policies and Methodologies directory, in the Ratings Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating these entities can also be found in the Credit Policy & Methodologies directory.

   New York – Structured Finance Group – Moody's Investors Services

   Gus Harris
   Managing Director

   William Harrington
   Senior Vice President

2. **Rating Action - 17 Mar 2009 – "Moody's Places Bear Stearns DPC on Review for Possible Downgrade"**

   Moody's Investors Service announced today that it has placed the counterparty rating of Bear Stearns Financial Products Inc. on review for possible downgrade. The rating action is as follows:
   BEAR STEARNS FINANCIAL PRODUCTS INC.
   Counterparty Rating
   Prior Rating: Aaa
   Prior Rating Date: July 20, 1996
   Current Rating: Aaa on review for possible downgrade

Derivative product companies (DPCs) are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness from their sponsor, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

As detailed in Moody's Request for Comment of March 16, 2009 regarding "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies", Moody's is reviewing several issues regarding the operations of these companies. Bear Stearns Financial Products Inc. is a continuation DPC whose counterparty rating is based in part on the ability of its respective continuation manager to undertake certain actions should its services be activated. Chief among these actions is re-hedging market risk, which ongoing evaluation by Moody's suggests may be difficult to achieve for any continuation DPC, given their current structure.

Additionally, Bear Stearns Financial Products Inc., is domiciled in the United States, whose bankruptcy law permits solvent entities to file for Chapter 11 protection. As the Request for Comments highlights, two DPCs sponsored by Lehman Brothers and domiciled in the United States, Lehman Brothers Derivative Products Inc. and Lehman Brothers Financial Products Inc., made such filings for voluntary bankruptcy on October 5, 2008.

The domiciling issue and the issue of re-hedging market risk and other responsibilities of a continuation manager after it has stepped in are responsible for today's rating action.

The principal methodology used in this press release was "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) which can be found at www.moodys.com in the Credit Policies and Methodologies directory, in the Ratings Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating these entities can also be found in the Credit Policy & Methodologies directory.

New York - Structured Finance Group - Moody's Investors Service

Gus Harris
Managing Director

William Harrington
Senior Vice President

3. Rating Action – 17 Mar 2009 – "Moody's Places SMBC DPC on Review for Possible Downgrade"

Moody's Investors Service announced today that it has placed the counterparty rating of SMBC Derivative Products Limited on review for possible downgrade. The rating action is as follows:
Prior Rating: Aaa
Prior Rating Date: May 9, 1995
Current Rating: Aaa on review for possible downgrade

Derivative product companies (DPCs) are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness from their sponsor, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

As detailed in Moody's Request for Comment of March 16, 2009 regarding "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies", Moody's is reviewing several issues regarding the operations of these companies. SMBC Derivative Products Limited (SMBCDPC) is a continuation DPC whose counterparty rating is based in part on the ability of its respective continuation manager to undertake certain actions should its services be activated. Chief among these actions is re-hedging market risk, which ongoing evaluation by Moody's suggests may be difficult to achieve for any continuation DPC, given their current structure.

The issue of re-hedging market risk and other responsibilities of a continuation manager after it has stepped in are responsible for today's rating action.

The principal methodology used in this press release was "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) which can be found at www.moodys.com in the Credit Policies and Methodologies directory, in the Ratings Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating these entities can also be found in the Credit Policy & Methodologies directory.

New York – Structured Finance Group – Moody’s Investors Services

William May
Managing Director

Ivan Jiang
Vice President - Senior Analyst

Appendix L: Bear DPC Merged into FDIC-Insured JPM Chase Bank, NA (2009)

Rating Action - 29 May 2009 - "Moody's Downgrades and Withdraws Bear Stearns Financial Products Rating"

Moody's Investors Service ("Moody's") announced today that it has withdrawn its Counterparty Rating for Bear Stearns Financial Products Inc. ("BSFP") at the request of BSFP.

The Counterparty Rating of BSFP was also downgraded immediately prior to withdrawal to the long-term issuer rating of JPMorgan Chase Bank, National Association ("JPMCB") as a result of BSFP's merger into JPMCB on May 26, 2009. The rating action is as follows:
Bear Stearns Financial Products Inc.
Current Counterparty Rating: WR
Counterparty Rating Immediately Prior to Withdrawal: Aa1
Prior Rating: Aaa, on review for possible downgrade
Prior Rating Date: March 17, 2009

BSFP has requested the withdrawal of rating for business reasons as a result of BSFP's merger into JPMCB on May 26, 2009. Please also refer to Moody's Withdrawal Policy on moodys.com.

BSFP was a derivative products company organized in Delaware. The methodology used in the rating action taken today is described in the following publications available at www.moodys.com in the Credit Policies and Methodologies directory, in the Ratings Methodologies subdirectory: Counterparty Risk and Capitalization for Derivative Product Companies (9/14/1994); Moody's Approach to Evaluating Derivative Products Subsidiaries (10/15/1993). Other methodologies and factors that may have been considered in the process of rating these entities can also be found in the Credit Policy & Methodologies directory.

New York – Structured Finance Group – Moody's Investors Services

William Harrington
Senior Vice President

Wai-Yin Yu
Asst Vice President – Analyst

Appendix M1: Moody's 2009 DPC Methodology Update

Announcement: Moody's Publishes Methodology Update on Derivative Product Companies

Global Credit Research - 16 Jul 2009

New York, July 16, 2009 -- Moody's Investors Service announced today that it has published a Methodology Update titled "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies." The Methodology Update incorporates comments from market participants received in response to Moody's similarly titled Special Comment published on March 16, 2009, which had articulated Moody's concerns about a derivative product company's ("DPC") voluntary bankruptcy following a trigger event, and the subsequent impairment to a DPC's ability to make timely payments that may result. The concerns regarding voluntary bankruptcy are centered on those DPCs domiciled in the United States. Additionally, the Special Comment identified unhedged market risk and the limited effectiveness of continuation managers as the main negative consequences for continuation DPCs post-trigger event, regardless of domicile.

For U.S.-domiciled termination DPCs, the Methodology Update described an approach that if adopted, would effectively mitigate the risk of voluntary bankruptcy consistent with the highest rating levels. Four termination DPCs had counterparty ratings from Moody's at the date of this Methodology Update:

• Morgan Stanley Derivative Products (domiciled in United States, sponsor = Morgan Stanley Group Inc.)

• Nomura Derivative Products Inc. (domiciled in United States, sponsor = Nomura Securities Co., Ltd.)

• Paribas Derives Garantis (domiciled in France, sponsor = BNP Paribas)

• Citi Swapco Inc. (formerly named Salomon Swapco Inc., domiciled in United States, sponsor = Citigroup Inc.)

For continuation DPCs, the Methodology Update remarked that no satisfactory solution to the unhedged market risk and continuation manager's limited effectiveness has yet been proposed. Therefore, while continuation DPCs face these challenges, their counterparty rating will be subject to rating action potentially to the level of their respective parent sponsor and in any event no higher than Aa1. The following three continuation DPCs had counterparty ratings from Moody's at the date of this Methodology Update:

• Banc of America Financial Products (domiciled in United States, sponsor = Bank of America N.A.)

• Merrill Lynch Derivative Products (domiciled in Switzerland, sponsor = Merrill Lynch & Co.)

• SMBC Derivative Products (domiciled in United Kingdom, sponsor = Sumitomo Mitsui Banking Corporation)

New York – Structured Finance Group – Moody's Investors Services

William Harrington
Senior Vice President

Wai-Yin Yu
Asst Vice President - Analyst

Appendix M2: Continuation DPC Downgrades per 2009 DPC Methodology Update

1. **Rating Action – 16 Jul 2009 - "Moody's Investors Service announced today that it has both downgraded the counterparty rating of Merrill Lynch Derivative Products AG and left it on review for possible downgrade."[60]**

   The rating action is as follows:
   MERRILL LYNCH DERIVATIVE PRODUCTS AG
   Counterparty Rating
   Prior Rating: Aaa on review for possible downgrade
   Prior Rating Date: March 17, 2009
   Current Rating: Aa1 on review for possible downgrade

   Derivative product companies (DPCs) are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with their sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

   Merrill Lynch Derivative Products AG ("MLDP") is a continuation DPC whose counterparty rating is also based, in addition to the above factors, on the ability of its continuation manager to undertake certain actions should its services be activated following a trigger event. Chief among these actions is re-hedging market risk, which Moody's has concluded may be difficult to achieve, at least in the manner originally contemplated when continuation DPCs were first rated. Concern regarding the ability of a continuation DPC to make scheduled payments to non-affiliated counterparties where it has been unable to re-hedge market risk was the prime driver of the prior rating action of March 17, 2009. Subsequently, on July 16, 2009, Moody's issued a Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update") in which it noted that, while continuation DPCs continue to make progress in this area, none had yet proposed a plan that addressed unhedged market risk in a sufficiently robust manner to warrant a counterparty rating higher than Aa1. Today's rating action reflects both the new cap of Aa1 applicable to all continuation DPCs until such concerns are fully addressed, as well as the uncertain outcome that will follow from review of MLDP.

   The Methodology Update also contemplates that the rating of a DPC sponsor will play an increasingly prominent role in rating outcomes where key concerns are not addressed by a DPC. With respect to today's rating action, Moody's notes both that the counterparty rating of MLDP remains above the A2 senior unsecured rating of its sponsor Merrill Lynch & Co, Inc.[61] and that the ratings of the two entities are unlikely to converge following resolution of its review of MLDP. Among the most important factors supporting a rating of MLDP that is higher than of its sponsor, Moody's cites: 1) the Swiss domicile of MLDP, which alleviates certain concerns regarding the potential for a solvent entity to file for voluntary bankruptcy; 2) the substantial progress that MLDP continues to make in implementing a new continuation management agreement addressing concerns expressed in the Methodology Update; and 3) the capital and collateral resources of MLDP. Moreover, Moody's notes that MLDP management continues to engage in constructive dialogue with

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[60] Please see Appendix M3, p42 regarding attempt by Moody's Compliance Department to reverse the MLDP downgrade.

[61] Sponsorship of MLDP was subsequently transferred to FDIC-insured Bank of America, N.A. in 2011 as part of a wholesale transfer of legacy Merrill Lynch derivatives from Bank of America Corporation. Please see attached link to 27-Oct-2011 Bloomberg article of "Bank of America Derivatives Transfer Attracts Lawmaker Scrutiny." http://www.bloomberg.com/news/2011-10-27/bank-of-america-derivatives-transfer-attracts-lawmaker-scrutiny.html.

Moody's regarding both ongoing operations and in addressing concerns expressed in the Methodology Update.

The principal methodology used in this press release was "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (July 2009) and "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) which can be found at www.moodys.com in the Credit Policies and Methodologies directory, in the Ratings Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating these entities can also be found in the Credit Policy & Methodologies directory.

New York – Structured Finance Group – Moody's Investors Services

William Harrington
Senior Vice President

Claudia Green
Vice President - Senior Analyst

2. Rating Action – 16 Jul 2009 – "Moody's Downgrades & Leaves on Review SMBC Derivative Products Ltd."

Moody's Investors Service announced today that it has both downgraded the counterparty rating of SMBC Derivative Products Limited and left it on review for possible downgrade. The rating action is as follows:
SMBC Derivative Products Limited
Counterparty Rating
Prior Rating: Aaa on review for possible downgrade
Prior Rating Date: March 17, 2009
Current Rating: Aa1 on review for possible downgrade

Derivative product companies (DPCs) are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness from their sponsor, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

SMBC Derivative Products Limited ("SMBC DP") is a continuation DPC domiciled in the United Kingdom whose counterparty rating is also based, in addition to the above factors, on the ability of its continuation manager to undertake certain actions should its services be activated following a trigger event. Chief among these actions is re-hedging market risk, which Moody's has concluded may be difficult to achieve, at least in the manner originally contemplated when continuation DPCs were first rated. Concern regarding the ability of a continuation DPC to make scheduled payments to non-affiliated counterparties where it has been unable to re-hedge market risk was the prime driver of the prior rating action of March 17, 2009. Subsequently on July 16, 2009, Moody's issued a Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update") in which it noted that, while continuation DPCs continue to make progress in this area, none had yet proposed a plan that addressed unhedged market risk in a sufficiently robust manner to warrant a counterparty rating higher than Aa1. Today's rating action reflects both the new cap of Aa1 applicable to all continuation DPCs, as well as the uncertain outcome of ongoing efforts by SMBC DP to find a qualified continuation manager. SMBC DP's current lack of a continuation manager is a main driver for its counterparty rating to remain on watch for possible downgrade. Furthermore, Moody's will continue to review the impact of unhedged market risk on SMBC DP's portfolio were a trigger event to occur.

The Methodology Update also contemplates that the rating of a DPC sponsor will play an increasingly prominent role in rating outcomes where key concerns are not addressed by a DPC. With respect to today's rating action, Moody's notes that the counterparty rating of SMBC DP remains above the senior unsecured rating of its sponsor Sumitomo Mitsui Banking Corporation, currently at Aa2 on review for possible downgrade. Among the most important factors supporting a higher rating of SMBC DP than that of its sponsor, Moody's cites: (1) the domicile of SMBC DP in the United Kingdom, which alleviates concerns described in the Methodology Update regarding the ability of a solvent entity to file for voluntary bankruptcy, due to certain statutory requirements for such filings imposed by the laws of the United Kingdom; (2) the amount of SMBC DP's capital resources, and (3) the product mix of its derivative portfolio, which may enable SMBC DP to develop a hedging strategy to at least partially address market risk were a trigger event to occur. Moody's notes that SMBC DP's management continues to engage in constructive dialogue with Moody's regarding both ongoing operations and in addressing concerns expressed in the Methodology Update.

The principal methodology used in this press release was "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (July 2009) and "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) which can be found at www.moodys.com in the Credit Policies and Methodologies directory, in the Ratings Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating these entities can also be found in the Credit Policy & Methodologies directory.

New York – Structured Finance Group – Moody's Investors Services

Ivan Jiang
Vice President - Senior Analyst

Wai-Yin Yu
Asst Vice President – Analyst

Appendix M3: Moody's Compliance Dept Directs Structured Finance Committee to Re-Think Downgrade of Merrill DPC "Replacing" Counterparty for AIG (2009)

On July 16, 2009, a Moody's structured finance committee voted 11-0 to downgrade MLDP to Aa1 on review for possible downgrade[62] and voted 12-0 to downgrade SMBC Derivative Products Ltd in an identical manner. Pre-downgrade, MLDP and SMBC Derivative Products Ltd. were both rated Aaa on review for possible downgrade. MLDP and SMBC Derivative Products Ltd. are continuation DPCs domiciled in Switzerland and the U.K., respectively.

The July 16, 2009 committee also voted to place the Aaa rating of MSDP on review for downgrade.[63] MSDP is a termination DPC domiciled in the United States.

The committee voted the three rating actions as directed by the 2009 DPC Methodology Update that had been published the same day.[64] (In the same manner, a March 17, 2009 committee had voted unanimously to place the Aaa ratings of MLDP and SMBC Derivative Products Ltd. on review for possible downgrade in conjunction with that day's publication of the comment request predecessor to the 2009 DPC Methodology Update.[65])

The 2009 DPC Methodology Update indicated significant downgrades for DPCs in general, hence the committee decision to not only downgrade the ratings of the two continuation DPCs on July 17, 2009 but also place them on review for further downgrade.

On December 11, 2009, a structured finance committee concluded the reviews of continuation DPCs by voting unanimously to downgrade MLDP to Aa3 and to affirm SMBC Derivative Products Ltd. at Aa1.[66] On December 21, 2009, the committee voted in a near tie to downgrade three termination DPCs domiciled in the U.S. (including MSDP) and leave the ratings on review for further downgrade.[67]

Hey SEC! Moody's analyst with "conflict-of-interest" helped put downgrades of "conflicted" rating in motion
In the July 2009 committee, one member abstained from voting on the MLDP rating in accordance with new trading policies that were being phased-in. The abstaining analyst owned stock in the MLDP sponsor Merrill Lynch/BoA and was divesting according to an ongoing schedule that had been approved by management.

The analyst's conflict of interest was well known in the structured finance group as the analyst had helped colleagues with similar conflicts understand how to comply with the new trading policy. Moreover, the analyst's participation in DPC committees was critical owing to the analyst's continuous involvement with DPCs from the time that two Bear Stearns DPCs and two Lehman DPCs had incurred trigger events in 2008. In contrast, three senior committee members, including me, had taken family leaves/leaves of absence during the period.

More importantly, the analyst's work of the several years had been clearly leading to mandatory downgrades of DPCs including MLDP. Effectively, the analyst had voted to downgrade MLDP over-and-over again ahead of the July 2009 committee, trading policy or no trading policy. "The "conflict-of-interest" was a red herring both with respect to the MLDP committee and the more general narrative as to why structured finance ratings had imploded in 2008. Moody's analysts faced a conflict of interest with respect to Moody's management, not individual investment portfolios.

The chair for the July 2009 committee (a senior monitoring analyst) committed a minor infraction by not directing the abstaining analyst to leave the committee room for the duration of the MLDP vote (as distinct from the analyst's participation in lengthy DPC deliberations that preceded the vote, which was allowable.) The requirement was

[62] Please see Appendix M2, p39.
[63] Please see Appendix N1, p46.
[64] Please see Appendix M1, p38.
[65] Please see Appendices K1&2, pps 33-34.
[66] Please see Appendix N1, p46.
[67] Please see Appendix N2, p49.

seemingly a new one - I deduced its existence after when filing a post-committee wrap-up for submission to Compliance, dutifully ticking off two new boxes: (1) “yes” a committee member had a conflict of interest with respect to a rating and had abstained from voting; and (2) “no” the abstaining analyst did not leave the committee room during the vote.

Moody’s Compliance Dept. “replaces” MLDP committee for having voted independently

Soon after, Moody’s Compliance directed the Structured Finance Group to re-consider the rating of MLDP as if no downgrade had occurred. An entirely new committee that excluded all 12 members of the July 2009 committee (those with most DPC experience) was formed to analyze the rating of MLDP afresh. The new committee members with little-to-no DPC experience worked for more than a month but were prohibited from discussing MLDP with experienced members of the July committee. Rather, the (temporary) lead analysts for MLDP compiled questions and were twice allowed to consult the DPC Team Leader (me) about the 2009 DPC Methodology Update generally (but not MLDP specifically.)

MLDP was not informed of the internal re-assessment. I remained lead MLDP analyst for public purposes such as discussing the MLDP rating with MLDP counterparties and for communicating with MLDP. In August 2009, the new committee concluded the internal re-assessment by voting the same MLDP rating as the July committee, i.e. Aa1 on review for downgrade. The shadow committee then disbanded.

The December 2009 committees for DPCs were largely comprised of members from the July 16, 2009 committee (although members from the August 2009 committee were invited.) For instance, the committee member who abstained from voting on the MLDP rating in July did not abstain in December – the “conflict-of-interest” had been fully resolved.

After MLDP was downgraded to Aa3 on December 12, 2009, Moody’s Compliance re-visited the “tainted” MLDP committee of July 2009. I described the meeting in “RMBS/Compliance to Contributor: Hop on Down to a Kangaroo Court!” of WJH Comment to SEC on Proposed Rules for NRSROs (p70) submitted along with other SEC contributors such as Mr. Michel Madelain of Moody's on August 8, 2011.

AIG can’t “replace” swaps with CDOs two years after having been downgraded to “replacement” rating

MLDP accepted the July and December 2009 downgrades with little comment. In contrast, AIG complained to me during a 2009 conference call that an already complex series of transactions with MLDP had been made more complex still by the downgrade. Had I (as MLDP analyst and separately as co-author of Moody’s Hedge Framework) considered the impact on U.S. taxpayers (who had bailed-out AIG and were owed $85 billion)?

On October 3, 2008, AIG had been downgraded to A3 which constituted a “replacement” rating for interest-rate swaps with 40+/- issuers of CDOs. The swaps were deep-in-the-money assets to AIG (although in many cases senior CDOs had been downgraded significantly.)

AIG was at risk of losing the assets entirely owing to “flip clauses” that were being activated by AIG failure to “replace.” With no “replacement” counterparties willing to “replace,” AIG was negotiating with Bank of America to use MLDP as a highly-rated intermediary between the CDO issuers and AIG.

During 2009-2010, a Moody’s task force evaluated many permutations of the proposed MLDP/AIG intermediations from the opposing vantages of the CDO issuers and of MLDP. My litmus test in assessing the MLDP proposals was whether MLDP counterparties would be at least as well off after MLDP executed intermediations on behalf of AIG as beforehand. If not, the MLDP rating was not valid and RAC should not be issued. Even after the downgrade of December 2009, the MLDP rating of Aa3 indicated that expected losses posed to existing (non-AIG/non-CDO) counterparties were almost negligible. For Moody’s to issue RAC and maintain an accurate rating of MLDP, expected losses should remain negligible and not climb so as to privilege AIG and its constituents.[68]

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[68] A Bank of America banker whose primary work was with CDOs objected that the approach was unreasonable - didn’t MLDP have a sub-bucket for trades that did not meet rating standards as CDOs did?

Moody's mgmnt can't "replace" structured finance committees voting independently of AIG/BoA presssure

In 2010, management continued to treat committee independence with respect to MLDP, Bank of America and AIG as a hindrance.

Per my June 2010 entry "Exasperated Management: It's High Time to Let AIG Have Its Way" in WJH Comment to SEC on Proposed Rules for NRSROs (p73-74). "Nicolas Weill of Credit Policy[69] interrupted an AIG/MLDP committee by asking why the transfer wasn't simpler, given MLDP's Aaa rating? (The rating of MLDP was Aa3.)

"Mr. Weill apparently didn't remember the outcome of the DPC methodology update which he had presided over and capped the rating of DPCs at Aa1.[70] Mr. Weill also believed that if a DPC were still rated Aaa (none were at this point), no further analysis was needed. In fact, the overlap of credit relied upon by both the Hedge Framework and the DPC methodology was not captured in either CDO or DPC ratings. The same level of analysis would have been required had MLDP remained Aaa. For this reason, DPCs typically did not provide such hedges.

"The DPC team had pointed out since 2000 the conflict between the two methodologies in these instances. This was the same subject that had been raised in the conference call with Mr. Geoff Witt of Merrill Lynch in which Mr. Witt had been given a "hard time," according to Brian Clarkson.[71]

"Ms. Eun Choi[72] concluded the AIG/MLDP committee by telling the members that they were "crazy" for having assessed the proposal so closely. In addition to Ms. Choi, the committee was comprised of an attorney, two DPC specialists and two market-value specialists, all of whom Ms. Choi freely admitted had pertinent experience in the areas, whereas she had none."

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69 Mr. Weill continues as Moody's Chief Credit Officer of Structured Finance.

70 2009 DPC Methodology Update

71 WJH Comment to SEC on Proposed Rules for NRSROs p55.

72 Ms. Choi was a Managing Director in Moody's Structured Finance Group.

Appendix M4: Termination DPC Placed on Watch per 2009 Methodology Update

1. **Rating Action – 16 Jul 2009 – "Moody's Places Morgan Stanley Derivative Products Inc. On Review for Possible Downgrade"**
   Moody's Investors Service announced today that it has placed the counterparty rating of Morgan Stanley Derivative Products Inc. on review for possible downgrade. The rating action is as follows:
   MORGAN STANLEY DERIVATIVE PRODUCTS INC.
   Counterparty Rating
   Prior Rating: Aaa
   Prior Rating Date: January 10, 1994
   Current Rating: Aaa on review for possible downgrade

   Derivative product companies (DPCs) are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

   Morgan Stanley Derivative Products ("MSDP") is a termination DPC whose counterparty rating is based, among other things, on its bankruptcy remoteness. On July 16, 2009, Moody's issued a Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update") in which it noted that additional mitigants would be necessary to address Moody's concerns about voluntary bankruptcy in order for a termination DPC domiciled in the United States to maintain a Aaa rating. To date, no specific additional mitigants have been proposed by MSDP addressing Moody's concerns in this area. Today's rating action reflects Moody's continued concern in this regard as well as an acknowledgment that MSDP is potentially capable of fully addressing Moody's concerns. MSDP reports that it is working on proposals with the intention of fully addressing Moody's concerns. Upon receipt and review of such proposals, Moody's will take further rating action as appropriate.

   The Methodology Update contemplates that the rating of a DPC sponsor will play an increasingly prominent role in rating outcomes where key concerns are not addressed by a DPC. With respect to today's rating action, Moody's notes that whether the counterparty rating of MSDP approaches the A2 senior unsecured rating of its sponsor, Morgan Stanley Group, following resolution of its review of MSDP, depends on whether MSDP implements changes that address Moody's concerns as expressed in the Methodology Update.

   The principal methodology used in this press release was "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (July 2009) and "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) which can be found at www.moodys.com in the Credit Policies and Methodologies directory, in the Ratings Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating these entities can also be found in the Credit Policy & Methodologies directory.

   New York – Structured Finance Group – Moody's Investors Services

   William Harrington
   Senior Vice President

   David H. Burger
   Vice President - Senior Analyst

Appendix N1: More Downgrades of Continuation DPCs per Methodology Update

1. Rating Action – 11 Dec 2009 - "Moody's Downgrades the Counterparty Rating of MLDP, a Derivatives Product Company, to Aa3"

Moody's downgraded the counterparty rating of MLDP to Aa3. The rating action is as follows:
MERRILL LYNCH DERIVATIVE PRODUCTS AG
Counterparty Rating
Prior Rating: Aa1 on review for possible downgrade
Prior Rating Date: July 16, 2009
Current Rating: Aa3

Moody's today downgraded the counterparty rating of Merrill Lynch Derivative Products AG ("MLDP") to Aa3 following a period of review during which Moody's and MLDP have identified a number of items, both in documentation and modeling, that warrant clarification and updating. In addition, more work needs to be done to address market risk that would exist were a Disintermediation Event ("trigger event") to occur, though there has been much progress in that regard.

MLDP is a continuation DPC domiciled in Switzerland, and, as such, its counterparty rating is bound by a cap of Aa1 on the upside and the A2 senior unsecured rating of its sponsor, Merrill Lynch & Co.,[73] on the downside. The Aa3 rating assigned to MLDP as of today reflects both the resources of MLDP and its having engaged BlackRock Financial Management, Inc. as a continuation manager, which, together with other factors, warrant a rating higher than its sponsor. The factors mentioned in the preceding paragraph keep the rating below Aa1.

The counterparty rating of MLDP is based, in large part, on the ability of its continuation manager to hedge and unwind the book following a trigger event and, in so doing, maximize the ability of the DPC to make all scheduled and termination payments owed non-affiliated counterparties. Concern regarding the ability of a continuation DPC to make these payments given the challenges of re-hedging market risk was the prime driver of the sector-wide rating actions of March 17, 2009, one of which placed the then-current Aaa rating of MLDP on review for possible downgrade.

Subsequently, on July 16, 2009, Moody's issued a Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update") in which it noted that, while continuation DPCs continue to make progress in this area, none had yet proposed a plan that addressed unhedged market risk in a sufficiently robust manner to warrant a counterparty rating higher than Aa1. Accordingly, on July 16, 2009, Moody's downgraded MLDP to Aa1 and MLDP remained on review for further downgrade because Moody's considered that a full scale review of MLDP was due in light of MLDP's unique portfolio of derivative products.

The review highlighted a number of issues in various aspects of the model and the documentation where clarification and updating would be required. For example, some calculations would be adjusted to reflect revised expectations for the continuation process. Observation of trigger events which have occurred in other DPCs during 2008 has underscored the importance of clarity in documents, model calculations and procedures that will be relied upon following a trigger event. Today's rating action also reflects that work remains to fully assess the extent to which market risk can likely be hedged over the potentially lengthy

[73] Sponsorship of MLDP was subsequently transferred to FDIC-insured Bank of America, N.A. in 2011 as part of a wholesale transfer of legacy Merrill Lynch derivatives from Bank of America Corporation. Please see attached link to 27-Oct-2011 Bloomberg article of "Bank of America Derivatives Transfer Attracts Lawmaker Scrutiny." http://www.bloomberg.com/news/2011-10-27/bank-of-america-derivatives-transfer-attracts-lawmaker-scrutiny.html.

continuation period that would follow a trigger event, though Moody's notes that MLDP has strengthened its continuation procedures by engaging BlackRock Financial Management, Inc. ("BlackRock") as continuation manager. MLDP and BlackRock have made progress in implementing their continuation plans and BlackRock continues to prepare to take over effectively immediately upon a trigger event, however this process is not yet complete.

Moody's notes that MLDP management continues to engage in constructive dialogue with Moody's regarding both ongoing operations and in addressing concerns. Moreover, MLDP has observed an important feature of the Methodology Update by continuing to hold capital and collateral resources as if it had preserved its original rating, rather than reduce them after having been downgraded.[74]

Moody's also notes that the counterparty rating of MLDP remains above the A2 senior unsecured rating of its sponsor Merrill Lynch & Co, Inc. The factors Moody's expressed in its July 16, 2009 press release, including the lower risk of voluntary bankruptcy while solvent due to the domicile of MLDP in Switzerland and the considerable capital and collateral resources of MLDP, continue to be relevant in supporting a higher rating of MLDP than that of its sponsor. In addition, the higher rating is supported by MLDP's engagement of BlackRock as continuation manager and their substantial progress toward implementation of a readiness plan.

The principal methodology used in this press release was "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (July 2009) and "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) which can be found at www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website. Moody's also publishes a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our website, at www.moodys.com/SFQuickCheck.

New York – Structured Finance Group – Moody's Investors Services

Yvonne F. Fu
Managing Director

William Harrington
Senior Vice President

2. Rating Action – 11 Dec 2009 – "Moody's Confirms Aa1 Rating of SMBC Derivative Products Ltd."

Moody's Investors Service announced today that it confirms the counterparty rating of SMBC Derivative Products Limited and removes it from review for possible downgrade. The rating action is as follows:
SMBC Derivative Products Limited
Counterparty Rating
Prior Rating: Aa1 on review for possible downgrade
Prior Rating Date: July 16, 2009
Current Rating: Aa1

The removal of SMBC DP's counterparty rating from review for possible downgrade is due to efforts by SMBC DP to address the areas of concern underlying the July 16, 2009 rating action. Chief among those

[74] Without this feature, MLDP can reduce its capital after each downgrade and raise expected losses posed to counterparties beyond those signaled by the downgrade itself. In other words, capital requirements that are rating-dependent introduce circularity into the counterparty rating of a DPC and make the rating unreliable. How does Moody's assess subsequent capital reductions by DPC management in response to a downgrade?

concerns was SMBC DP's lack of a contingent manager, which has since been resolved with SMBC DP's engagement of BlackRock Financial Management, Inc. ("BlackRock") as contingent manager. Both SMBC DP and BlackRock have been in constructive dialogue with each other in refining existing post-trigger event procedures and developing a hedging strategy to ensure that if a trigger event were to occur, the operational and market risk faced by SMBC DP will be reduced. Additionally, SMBC DP has undertaken changes to its portfolio to simplify the task of rehedging the market risk should a trigger event occur.

Moody's notes that the counterparty rating of SMBC DP remains above the senior unsecured rating of its sponsor Sumitomo Mitsui Banking Corporation, currently at Aa2. The factors Moody's expressed in its July 16, 2009 press release, including the lower risk of voluntary bankruptcy while solvent due to the domicile of SMBC DP in the United Kingdom, the amount of its capital resources and the product mix of its derivative portfolio, continue to be relevant in supporting a higher rating of SMBC DP than that of its sponsor.

The rating of SMBC DP's sponsor has a limited influence on SMBC DP's counterparty rating so long as the aspects described above are maintained. However, the rating of SMBC DP's sponsor may have a greater influence on SMBC DP's counterparty rating in the future if any development negatively impacts the adequacy of SMBC DP's capital resources. On the upside, as noted in Moody's July 2009 Methodology Update, non-US domiciled continuation DPCs such as SMBC DP are not precluded from attaining a Aaa counterparty rating in the future if they can demonstrate that unhedged market risk after a trigger event can be satisfactorily addressed throughout the entire continuation period within the parameters of a Aaa rating.

The principal methodology used in this press release was "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (July 2009) and "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) which can be found at www.moodys.com in the Credit Policies and Methodologies directory, in the Ratings Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating these entities can also be found in the Credit Policy & Methodologies directory.

New York – Structured Finance Group – Moody’s Investors Services

Ivan Jiang
Vice President - Senior Analyst

Wai-Yin Yu
Asst Vice President – Analyst

Appendix N2: Termination DPC Downgrades per 2009 Methodology Update

1. **Rating Action – 21 Dec 2009 – "Moody's Downgrades Nomura Derivative Products Inc.; On Review for Possible Downgrade."**

   Moody's Investors Service announced today that it has downgraded the counterparty rating of Nomura Derivative Products Inc., to Aa1 and placed the rating on review for possible downgrade. The rating action is as follows:

   NOMURA DERIVATIVE PRODUCTS INC.
   Counterparty Rating
   Prior Rating: Aaa
   Prior Rating Date: August 7, 2000
   Current Rating: Aa1 on review for possible downgrade

   Derivative product companies (DPCs) are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

   Nomura Derivative Products ("NDPI") is a termination DPC whose counterparty rating is based, among other things, on its bankruptcy remoteness. On July 16, 2009, Moody's issued a Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update") in which it noted that additional mitigants would be necessary to address the risk of voluntary bankruptcy in order for a termination DPC domiciled in the United States to maintain a Aaa rating.

   NDPI has developed plans to address in detail the issues raised in the Methodology Update and continues to devote considerable resources to the task. However, implementation has proved to be a challenging process. While NDPI, like all termination DPCs, is potentially capable of fully addressing the risk of voluntary bankruptcy, the time needed to do so is uncertain. Today's rating action reflects the risk that NDPI may voluntarily file for bankruptcy if NDPI's affiliates do so, even though it would be expected to have sufficient resources to pay all counterparties in full. In such an event, payment of amounts owed to counterparties may be delayed by a considerable period of time.

   The Methodology Update contemplates that the rating of a DPC sponsor will play an increasingly prominent role in rating outcomes where key concerns are not addressed by a DPC. Moody's notes that the counterparty rating of NDPI remains well above the Baa1 senior unsecured rating of its sponsor, Nomura Securities Co. Inc. However, there can be no assurance that NDPI will ultimately mitigate the risk of voluntary bankruptcy and in that case, further rating action may be warranted, with the counterparty rating of NDPI potentially converging with the senior unsecured rating of its sponsor. Alternatively, if NDPI completes its response to the Methodology Update and delivers all updates which fully mitigate the risk of voluntary bankruptcy, positive rating action may be warranted.

   The principal methodology used in this press release was "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (July 2009) and "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) which can be found at www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

Further information on Moody's analysis of this transaction is available on www.moodys.com. In addition, Moody's publishes a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our website, at www.moodys.com/SFQuickCheck.

New York – Structured Finance Group – Moody’s Investors Services

William Harrington
Senior Vice President

Yvonne F. Fu
Managing Director

2. Rating Action – 21 Dec 2009 – “Moody's Downgrades Citi Swapco Inc. to Aa1; Rating On Review for Possible Downgrade”

Moody's Investors Service announced today that it has downgraded the counterparty rating of Citi Swapco Inc. to Aa1 and placed the rating on review for possible downgrade. The rating action is as follows:
CITI SWAPCO INC.
Counterparty Rating
Prior Rating: Aaa
Prior Rating Date: March 15, 1993
Current Rating: Aa1 on review for possible downgrade

Derivative product companies (DPCs) are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

Citi Swapco Inc. ("Swapco") is a termination DPC whose counterparty rating is based, among other things, on its bankruptcy remoteness. On July 16, 2009, Moody's issued a Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update") in which it noted that additional mitigants would be necessary to address the risk of voluntary bankruptcy in order for a termination DPC to maintain a Aaa rating.

Swapco has dedicated substantial time and resources to addressing the issues raised in the Methodology Update. This has resulted in several constructive proposals in order to mitigate the risk of voluntary bankruptcy. Nevertheless, these remain in preliminary form. While Swapco, like all termination DPCs, is potentially capable of fully addressing the risk of voluntary bankruptcy the time needed to do so is uncertain. Today's rating action reflects the risk that in a situation where its sponsor becomes insolvent, Swapco may also voluntarily file for bankruptcy, even though it would be expected to have sufficient resources to pay all counterparties in full. In such an event, payment of amounts owed counterparties might be delayed by a considerable period.

The Methodology Update contemplates that the rating of a DPC sponsor will play an increasingly prominent role in rating outcomes where key concerns are not addressed by a DPC. Moody's notes that Swapco remains well above the A3 senior unsecured rating of its ultimate sponsor, Citigroup Inc. However, there can be no assurance that Swapco will ultimately mitigate the risk of voluntary bankruptcy and in that case, further rating action may be warranted, with the counterparty rating of Swapco potentially converging with the senior unsecured rating of its sponsor. Alternatively, if Swapco completes its response to the Methodology Update and delivers all updates which fully mitigate the risk of voluntary bankruptcy, the watch status may be resolved and positive rating action may be warranted.

The principal methodology used in this press release was "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (July 2009) and "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) which can be found at www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

Further information on Moody's analysis of this transaction is available on www.moodys.com. In addition, Moody's publishes a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our website, at www.moodys.com/SFQuickCheck.

New York – Structured Finance Group – Moody's Investors Services

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Managing Director

Ivan Jiang
Vice President - Senior Analyst

3. Rating Action – 21 Dec 2009 – "Moody's Downgrades Morgan Stanley Derivative Products Inc.; Review Continues."

Moody's today downgraded the counterparty rating of Morgan Stanley Derivative Products ("MSDP") to Aa2. The rating remains on review for downgrade. The rating action is as follows:
MORGAN STANLEY DERIVATIVE PRODUCTS INC.
Counterparty Rating
Prior Rating: Aaa on review for downgrade
Prior Rating Date: July 16, 2009
Current Rating: Aa2 on review for possible downgrade

Although MSDP has made progress in addressing the issue of voluntary bankruptcy since the prior rating action of July 16, 2009, its plans to do so remain under development and a clear path to implementation has yet to be established. In its Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update.") Moody's has stated that additional mitigants would be necessary to address voluntary bankruptcy in order for a termination DPC domiciled in the United States to maintain a Aaa rating, and, where such mitigants are not introduced, that the rating of a DPC sponsor will play an increasingly prominent role in rating outcomes of a DPC.

MSDP is, like all termination DPCs, potentially capable of fully addressing the risk of voluntary bankruptcy. Subsequent to the July rating action, MSDP has stated that its goal is not only to do so with respect to voluntary bankruptcy, but also in regard to any additional items identified during the review process. However, overall progress has been slower than anticipated. Today's rating action reflects the risk that MSDP may voluntarily file for bankruptcy if MSDP's affiliates do so, even though it would be expected to have sufficient resources to pay all counterparties in full. In such an event, payment of amounts owed counterparties may be delayed for a considerable period of time.

With today's rating action, the counterparty rating of MSDP remains well above the A2 senior unsecured rating of its sponsor, Morgan Stanley. However, there can be no assurance that MSDP will ultimately implement a plan that fully mitigates the risk of voluntary bankruptcy and in that case, further rating action may be warranted, with the rating of MSDP potentially converging with the senior unsecured rating of Morgan Stanley. Alternatively, should MSDP complete its response to the Methodology Update and deliver all updates which fully mitigate the risk of voluntary bankruptcy, positive rating action may be warranted.

The principal methodology used in this press release was "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (July 2009) and "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) which can be found at www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

Further information on Moody's analysis of this transaction is available on www.moodys.com. In addition, Moody's publishes a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our website, at www.moodys.com/SFQuickCheck.

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Appendix O1: Further Actions per 2009 DPC Methodology Update – NDPI

1. **Moody's Announcement – 22 Apr 2010 – "Moody's: NDPI rating unchanged by new agreement & amendments"**

Moody's Investors Service has determined that entry by Nomura Derivative Products Inc. ("NDPI") into the Security and Collateral Trust Agreement with Deutsche Bank Trust Company Americas and into the Amendments to its Certificate of Incorporation and Operating Guidelines, each dated as of April 21, 2010 (the "Agreements"), and performance of the activities contemplated therein will not, in and of themselves and at this time cause NDPI's counterparty rating to be lowered or withdrawn. Moody's does not express an opinion as to whether the Agreements could have non-credit related effects.

The Agreements represent part of a two-pronged approach by NDPI to address the risk raised in Moody's July 16, 2009 Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update"). The first prong of NDPI's approach, which has been completed by implementation of the Agreements, clarifies, among other things, the role of independent directors.

The second prong of NDPI's approach is intended to ensure that if NDPI were to file for voluntary bankruptcy, counterparties would be paid all amounts owed to them when due. The Security and Collateral Trust Agreement creates a security structure whereby counterparties would be entitled to close out under the safe harbor provisions of the Bankruptcy Code even if NDPI should file for voluntary bankruptcy. With the security structure in place, the calculations for NDPI's capital and collateral resources are being reviewed in the specific instance of a voluntary bankruptcy filing.

Concerns about voluntary bankruptcy were the key driver behind the rating action of December 21, 2009, when Moody's downgraded the counterparty rating of NDPI to Aa1 and placed it on review for possible downgrade. At that time, Moody's stated that "if NDPI completes its response to the Methodology Update and delivers all updates which fully mitigate the risk of voluntary bankruptcy, positive rating action may be warranted." Moody's continues to believe that if NDPI completes its quantitative updates, positive rating action may be warranted.

Derivative product companies (DPCs) are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

The principal methodology used in monitoring the counterparty rating of NDPI is Moody's "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (July 2009) and "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) available on www.moodys.com, in the Ratings Methodologies subdirectory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the counterparty rating of NDPI can also be found in the Rating Methodologies subdirectory on Moody's website. In addition, Moody's publishes a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our website, at www.moodys.com/SFQuickCheck.

Moody's will continue monitoring this rating. Any change in the rating will be publicly disseminated by Moody's through appropriate media.

New York – Structured Finance Group – Moody's Investors Services

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2. **Rating Action – 18 Nov 2010 – “Moody's confirms the counterparty rating of Nomura Derivative Products Inc., a termination derivative product company, at Aa1”**
Moody's Investors Service announced today that it has confirmed the counterparty rating of Nomura Derivatives Products Inc. ("NDPI"), a derivatives product company ("DPC"), at Aa1. The previous rating action occurred on December 21, 2009, when Moody's downgraded the counterparty rating of NDPI to Aa1 from Aaa and placed it on review for possible further downgrade. Moody's initially outlined its concerns regarding derivatives products companies' exposure to a sponsor's insolvency in the July 16, 2009 Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update").

Concerns about voluntary bankruptcy were the key driver behind the downgrade of NDPI's counterparty rating in December 2009. At that time, Moody's stated that "if NDPI completes its response to the Methodology Update and delivers all updates which fully mitigate the risk of voluntary bankruptcy, positive rating action may be warranted." NDPI has now addressed a number of Moody's concerns and for that reason, Moody's is no longer reviewing NDPI for possible downgrade.

Among the measures NDPI has taken is the creation of a collateral trust for the benefit of all counterparties other than counterparties that are affiliates of NDPI. NDPI has granted a security interest in its accounts and certain receivables from counterparties as collateral to the trustee for the trust. The trustee will then have the ability to exercise the rights of a secured party in the collateral for the benefit of NDPI's unaffiliated counterparties should an NDPI trigger event occur.

Capital adequacy is another consideration for the rating of NDPI. Moody's committee considered back testing results and capital adequacy measures, such as NDPI's capital model output under certain assumptions, in determining an appropriate rating. Moody's committee felt the evidence was sufficient to support a Aa1 rating.

Derivative product companies are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

The principal methodology used in monitoring the counterparty rating of NDPI is Moody's "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (July 2009) and "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) available on www.moodys.com, in the Ratings Methodologies subdirectory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the counterparty rating of NDPI can also be found in the Rating Methodologies subdirectory on Moody's website. In addition, Moody's publishes a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our website, at www.moodys.com/SFQuickCheck.

Moody's will continue monitoring this rating. Any change in the rating will be publicly disseminated by

Moody's through appropriate media.

Moody's adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources Moody's considers to be reliable including, when appropriate, independent third-party sources. However, Moody's is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

Please see ratings tab on the issuer/entity page on Moodys.com for the last rating action and the rating history.

The date on which some Credit Ratings were first released goes back to a time before Moody's Investors Service's Credit Ratings were fully digitized and accurate data may not be available. Consequently, Moody's Investors Service provides a date that it believes is the most reliable and accurate based on the information that is available to it. Please see the ratings disclosure page on our website www.moodys.com for further information.

Please see the Credit Policy page on Moodys.com for the methodologies used in determining ratings, further information on the meaning of each rating category and the definition of default and recovery.

New York – Structured Finance Group – Moody's Investors Services

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3. Moody's Announcement – 03 Dec 2010 – "Moody's: recent amendments will not change the counterparty rating of Nomura Derivative Products Inc."

Moody's Investors Service has determined that certain amendments by Nomura Derivative Products Inc.("NDPI"), a derivatives product company, to its operating guidelines will not, in and of themselves, cause the current Moody's counterparty rating of NDPI to be reduced or withdrawn at this time. Before amendments become effective, NDPI's operating guidelines call for Moody's to provide confirmation that any amendments to the guidelines will not result in a reduction or withdrawal of NDPI's counterparty rating. Moody's does not express an opinion as to whether the implementation of the amendments to the operating guidelines could have non-credit-related effects.

NDPI has amended its operating guidelines in a number of respects. Most significantly, this amendment completes NDPI's efforts to address Moody's concerns about risks to counterparties in the event of a derivatives product company's voluntary filing for bankruptcy. NDPI previously set up a security structure which would enable counterparties to close out under the safe harbor provisions even if NDPI should file for bankruptcy. The latest amendment further specifies that only funds covered by the security interest will be given credit when determining the available capital of NDPI for the purpose of capital adequacy tests.

Under the amendments to the operating guidelines, this change in the calculation of available capital will also be reflected in the "agreed-upon-procedures" (AUPs) performed by NDPI's external auditors. Other revisions to the AUPs required by the amendments include review of any changes to the NDPI's capital model, and verification of back-testing results of the model.

Other changes to the operating guidelines include an increase in the capacity of trades done by its two affiliates that NDPI may guarantee, update to the discount factors applicable to eligible investments and collaterals, and approval of a one-time derivative transaction referencing an inflation-index. It is Moody's opinion that these changes will not have a material impact on NDPI's credit rating.

Derivative product companies (DPCs) are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

The principal methodology used in monitoring NDPI's counterparty rating is "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (July 2009) and "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) which can be found at www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating these entities can also be found in the Rating Methodologies sub-directory on Moody's website. In addition, Moody's publishes a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our website, at www.moodys.com/SFQuickCheck.

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Appendix O2: Further Actions per 2009 DPC Methodology Update – Citi Swapco

1. **Rating Action – 18 Nov 2010 – "Moody's downgrades Citi Swapco Inc., a termination Derivative Product Company, to Aa2."**

   Moody's Investors Service announced today that it has downgraded the counterparty rating of Citi Swapco Inc. ("Swapco") to Aa2.

   The rating is no longer on watch for possible downgrade. The previous rating action occurred on December 21, 2009, when the counterparty rating of Swapco was downgraded to Aa1, review for possible downgrade, from Aaa.

   RATINGS RATIONALE

   Moody's initially outlined its concerns regarding derivatives products companies' exposure to a sponsor's insolvency in a July 16, 2009 Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update"). These concerns about voluntary bankruptcy were the key driver behind the previous rating action on December 21, 2009. At that time, Moody's stated that "there can be no assurance that Swapco will ultimately mitigate the risk of voluntary bankruptcy and in that case, further rating action may be warranted."

   Since the last rating action, Swapco has dedicated substantial time and resources to addressing the issues raised in the Methodology Update. This has resulted in several constructive proposals in order to mitigate the risk of voluntary bankruptcy. Included in the proposals is the addition of a trust structure and a trustee to hold assets on behalf of Swapco's counterparties. In this structure, the trustee will hold the assets in trust, the trustee is granted a security interest in the assets for the benefit of Swapco's unaffiliated counterparties and the trustee would seize and distribute the assets in the case of a Swapco bankruptcy. The distribution, however, would require Swapco's direct involvement throughout the termination process.

   Today's rating action reflects Moody's belief that while Swapco's proposed structure is a positive step, Swapco's required involvement throughout the process means that the risk of voluntary bankruptcy is not fully mitigated. While Moody's believes that Swapco's proposed structure will keep its assets available for its counterparties, the actual payments to and from counterparties will require the active involvement of Swapco even after it has declared bankruptcy.

   Moody's notes that today's rating action is based on the expectation that Swapco will implement the proposals it has presented to Moody's. If Swapco fails to implement these plans, further rating action may be warranted, with the counterparty rating of Swapco potentially converging with the senior unsecured rating of its sponsor.

   Capital adequacy is another consideration for the rating of Swapco. Moody's committee considered back testing results and capital adequacy measures, such as Swapco's capital model output under certain assumptions, in determining an appropriate rating. Committee felt the evidence was sufficient to support a Aa2 rating.

   Derivative product companies (DPCs) are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

   The principal methodology used in monitoring the counterparty rating of Swapco is Moody's "Mitigating

Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (July 2009) and "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) available on www.moodys.com, in the Ratings Methodologies subdirectory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the counterparty rating of Swapco can also be found in the Rating Methodologies subdirectory on Moody's website. In addition, Moody's publishes a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our website, at www.moodys.com/SFQuickCheck.

Moody's will continue monitoring this rating. Any change in the rating will be publicly disseminated by Moody's through appropriate media.

REGULATORY DISCLOSURES
Information sources used to prepare the credit rating are the following: parties involved in the ratings.

Moody's Investors Service considers the quality of information available on the issuer or obligation satisfactory for the purposes of maintaining a credit rating.

Moody's adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources Moody's considers to be reliable including, when appropriate, independent third-party sources. However, Moody's is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

Please see ratings tab on the issuer/entity page on Moodys.com for the last rating action and the rating history.

The date on which some Credit Ratings were first released goes back to a time before Moody's Investors Service's Credit Ratings were fully digitized and accurate data may not be available. Consequently, Moody's Investors Service provides a date that it believes is the most reliable and accurate based on the information that is available to it. Please see the ratings disclosure page on our website www.moodys.com for further information.

Please see the Credit Policy page on Moodys.com for the methodologies used in determining ratings, further information on the meaning of each rating category and the definition of default and recovery.

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Appendix O3: Further Actions per 2009 DPC Methodology Update – MSDP

1. **Moody's announcement – 18 Nov 2010 – "MSDP Ratings Unaffected by Amendments"**
Moody's Investors Service has determined that entry by Morgan Stanley Derivative Products Inc. ("MSDP") into the Amendments to its Certificate of Incorporation and Operating Guidelines, each dated as of November 11, 2010 (the "Amendments"), and performance of the activities contemplated therein will not, in and of themselves and at this time cause MSDP's counterparty rating to be lowered or withdrawn. Moody's does not express an opinion as to whether the Amendments could have non-credit related effects.

The Amendments represent steps taken by MSDP to partially address the risks raised in Moody's July 16, 2009 Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update"). The Amendments clarify the role of independent directors and strengthen the corporate governance of the company.

Concerns about voluntary bankruptcy were the key driver behind the rating action of December 21, 2009, when Moody's downgraded the counterparty rating of MSDP to Aa2 and kept it on review for possible downgrade. MSDP's rating remains on review for possible downgrade.

Derivative product companies ("DPCs") are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

The principal methodology used in monitoring the counterparty rating of MSDP is Moody's "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (July 2009) and "Moody's Approach to Evaluating Derivative Products Subsidiaries" (October 1993) available on www.moodys.com, in the Ratings Methodologies subdirectory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the counterparty rating of MSDP can also be found in the Rating Methodologies subdirectory on Moody's website. In addition, Moody's publishes a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our website, at www.moodys.com/SFQuickCheck.

Moody's will continue monitoring this rating. Any change in the rating will be publicly disseminated by Moody's through appropriate media.

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Senior Vice President

2. **Rating Action – 17 Dec 2010 – "Moody's downgrades Morgan Stanley Derivative Products Inc., a termination Derivative Product Company"**
Moody's Investors Service announced today that it has downgraded the counterparty rating of Morgan Stanley Derivative Products Inc. ("MSDP") to Aa3, on review for possible downgrade.

The previous rating action occurred on December 21, 2009, when the counterparty rating of MSDP was downgraded to Aa2, on review for possible downgrade, from Aaa.

RATINGS RATIONALE

Voluntary bankruptcy concerns prompted the previous and current downgrade. Moody's initially outlined its concerns regarding exposure to a sponsor in a July 16, 2009 Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update"). These concerns about voluntary bankruptcy were the key driver behind the previous rating action on December 21, 2009. At that time, Moody's stated that "there can be no assurance that MSDP will ultimately mitigate the risk of voluntary bankruptcy and in that case, further rating action may be warranted."

Since the last rating action, MSDP has made substantial effort, but it has only partially addressed the issues raised in the Methodology Update, leaving MSDP vulnerable to voluntary bankruptcy in Moody's view. MSDP's efforts culminated in its recent Amendments to its Certificate of Incorporation and Operating Guidelines, each dated as of November 11, 2010 (the "Amendments"). Although they are helpful in strengthening the corporate governance of MSDP, the Amendments do not fully allay Moody's concerns as expressed in the Methodology Update. In particular, the Amendments do not grant counterparties a first priority perfected security interest in the assets of the company. While MSDP has indicated that it continues to evaluate what additional steps it may take in order to fully address the risks raised in the Methodology Update, there are no concrete proposals at this time, nor does Moody's expect any significant changes to MSDP over the next few months.

MSDP's vulnerability to voluntary bankruptcy risk poses a risk to its counterparties consistent with a Aa3 rating, assuming MSDP is sufficiently capitalized. Moody's believes there is a significant likelihood that MSDP would be filed into bankruptcy, following the bankruptcy of its sponsor Morgan Stanley Capital Services Inc., an event which is assessed to be consistent with an A2 rating. Assuming MSDP is highly capitalized, counterparties who are owed termination payments would likely recover substantially more than typical senior unsecured creditors and quite likely all that MSDP owes, but with a possibly significant delay as the bankruptcy process is worked out. Such a likelihood of default together with the risks of the bankruptcy process and otherwise full, but delayed recoveries[75] is consistent with a Aa3 rating.

MSDP's counterparty rating remains on review for possible downgrade as Moody's continues to evaluate MSDP's capital adequacy. Capital adequacy is another important consideration for the rating of MSDP. Moody's committee considers various capital adequacy measures, such as MSDP's capital model output under certain assumptions, in determining an appropriate rating. Moody's believes more investigation is needed to support a Aa3 rating.

Derivative product companies (DPCs) are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

There are many considerations in the overall rating of a DPC. Moody's methodology is continually evolving as Moody's reevaluates the stress testing and capital adequacy measures that are commensurate with its rating.

[75] “Delayed recoveries” are inconsistent with Moody’s assumptions regarding derivative contracts for ABS issuers as set forth in Moody’s Hedge Framework. In other words, the Aa3 rating of MSDP misinforms as to the suitability of MSDP as counterparty to an ABS issuer.

The principal methodologies used in this rating were "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" published in July 2009 and "Moody's Approach to Evaluating Derivative Products Subsidiaries" published in October 1993.

Moody's will continue monitoring this rating. Any change in the rating will be publicly disseminated by Moody's through appropriate media.

Further information on Moody's analysis of this transaction is available on www.moodys.com. In addition, Moody's publishes a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our web site, at www.moodys.com/SFQuickCheck.

REGULATORY DISCLOSURES
Information sources used to prepare the credit rating are the following: parties involved in the ratings, parties not involved in the ratings, and public information.

Moody's Investors Service considers the quality of information available on the issuer or obligation satisfactory for the purposes of maintaining a credit rating.

Moody's adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources Moody's considers to be reliable including, when appropriate, independent third-party sources. However, Moody's is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

Please see ratings tab on the issuer/entity page on Moodys.com for the last rating action and the rating history.

The date on which some Credit Ratings were first released goes back to a time before Moody's Investors Service's Credit Ratings were fully digitized and accurate data may not be available. Consequently, Moody's Investors Service provides a date that it believes is the most reliable and accurate based on the information that is available to it. Please see the ratings disclosure page on our website www.moodys.com for further information.

Please see the Credit Policy page on Moodys.com for the methodologies used in determining ratings, further information on the meaning of each rating category and the definition of default and recovery.

New York – Structured Finance Group – Moody’s Investors Services

Algis Remeza
Senior Vice President

Rodrigo Araya
Senior Vice President

3. Rating Action – 12 Dec 2011 – “Moody's confirms rating of Morgan Stanley Derivative Products Inc., a termination Derivative Product Company”

Moody's Investors Service announced today that it has confirmed the counterparty rating of Morgan Stanley Derivative Products Inc. ("MSDP") at Aa3.

The previous rating action occurred on December 17, 2010, when the counterparty rating of MSDP was downgraded to Aa3, on review for possible downgrade, from Aa2, on review for possible downgrade.

RATINGS RATIONALE

Moody's believes that MSDP is sufficiently capitalized to support the current counterparty rating of Aa3, although Moody's continues to perceive voluntary bankruptcy risk with respect to MSDP, particularly in the event its sponsor, Morgan Stanley Capital Services Inc., were to ever file for bankruptcy.

Voluntary bankruptcy concerns prompted the previous downgrade on December 17, 2010. Although counterparties might recover amounts owed them in the event of a bankruptcy, assuming MSDP is highly capitalized, such recoveries might involve a significant delay as the result of the bankruptcy process. MSDP's counterparty rating remained on review for possible downgrade as Moody's continued to evaluate MSDP's capital adequacy. Moody's initially outlined its concerns regarding exposure to a sponsor in a July 16, 2009 Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update").

Capital adequacy is another important consideration for the rating of derivative products companies ("DPCs") such as MSDP. Moody's considers various capital adequacy measures in its ratings of DPCs and in this case performed its own independent analysis to complement MSDP's capital model output, which is currently in compliance with MSDP's operating guidelines. As part of its analysis, Moody's utilized certain value-at-risk measures over a horizon that is consistent with MSDP's operating guidelines.

In addition, in light of the voluntary bankruptcy risk, Moody's considers MSDP's rating to be linked to the senior unsecured debt rating of MSDP's and its sponsor's ultimate parent, Morgan Stanley, which is currently rated A2 on negative outlook. Though we expect that the recovery of MSDP's counterparties under MSDP's current obligations would be high even in the event of a bankruptcy, Moody's views the potential delays of recovery in such an event as linking MSDP's rating to any movements which might occur in Morgan Stanley's rating. Thus, among other factors, Moody's rating is a reflection of voluntary bankruptcy risk as well as the adequacy of MSDP's current capital holdings, resulting in a Aa3 rating two notches above Morgan Stanley's current rating.

DPCs are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

There are many considerations in the overall rating of a DPC. Moody's methodology is continually evolving as Moody's re-evaluates the stress testing and capital adequacy measures that are commensurate with its rating.[76]

The methodologies used in monitoring the counterparty rating of MSDP were "Moody's Approach to Evaluating Derivative Products Subsidiaries" published in October 1993, and "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" published in July 2009. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies. Both publications are available in the Credit Policy page on www.moodys.com.

Other methodologies and factors that may have been considered in the counterparty rating of MSDP can also be found in the Rating Methodologies subdirectory on Moody's website.

[76] "Capital adequacy measures that are commensurate with its rating" introduces circularity to a DPC rating. Under this scheme, a DPC that has been downgraded can reduce capital with the result that it will raise expected losses posed to counterparties beyond those signaled by downgrade itself. How does Moody's assess possible capital reductions by DPC management in response to a downgrade?

Moody's will continue monitoring this rating. Any change in the rating will be publicly disseminated by Moody's through appropriate media.

REGULATORY DISCLOSURES

Although this credit rating has been issued in a non-EU country which has not been recognized as endorsable at this date, this credit rating is deemed "EU qualified by extension" and may still be used by financial institutions for regulatory purposes until 31 January 2012. ESMA may extend the use of credit ratings for regulatory purposes in the European Community for three additional months, until 30 April 2012, if ESMA decides that exceptional circumstances arise that may imply potential market disruption or financial instability. Further information on the EU endorsement status and on the Moody's office that has issued a particular Credit Rating is available on www.moodys.com.

For ratings issued on a program, series or category/class of debt, this announcement provides relevant regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides relevant regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides relevant regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

Moody's considers the quality of information available on the rated entity, obligation or credit satisfactory for the purposes of issuing a rating.

Moody's adopts all necessary measures so that the information it uses in assigning a rating is of sufficient quality and from sources Moody's considers to be reliable including, when appropriate, independent third-party sources. However, Moody's is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

Please see Moody's Rating Symbols and Definitions on the Rating Process page on www.moodys.com for further information on the meaning of each rating category and the definition of default and recovery.

Please see ratings tab on the issuer/entity page on www.moodys.com for the last rating action and the rating history. The date on which some ratings were first released goes back to a time before Moody's ratings were fully digitized and accurate data may not be available. Consequently, Moody's provides a date that it believes is the most reliable and accurate based on the information that is available to it. Please see the ratings disclosure page on our website www.moodys.com for further information.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

New York – Structured Finance Group – Moody’s Investors Services

Rudolph Bunja
Senior Vice President

Rodrigo Araya
Senior Vice President

4. Moody's Announcement – 17 Feb 2012 – "Moody's places rating of Morgan Stanley Derivative Products Inc., a termination derivative product company, on review for possible downgrade"

Moody's Investors Service announced today that it has placed the counterparty rating of Morgan Stanley Derivative Products Inc. ("MSDP") on review for possible downgrade.

Counterparty Rating, Aa3 Placed on Review for Possible Downgrade; previously on December 12, 2011 Confirmed at Aa3.

RATINGS RATIONALE

Today's rating action was prompted by Moody's placement of the senior unsecured debt rating of Morgan Stanley on review for possible downgrade. Moody's considers MSDP's rating to be linked to the senior unsecured debt rating of its sponsor's ultimate parent, Morgan Stanley, whose A2 rating was placed on review for possible downgrade (see "Moody's Reviews Ratings for European Banks" dated 16 February 2012).

Concerns of an MSDP voluntary bankruptcy in the event its sponsor, Morgan Stanley Capital Services LLC, were to ever file for bankruptcy creates the link between the ratings of MSDP and its sponsor's ultimate parent Morgan Stanley. Moody's initially outlined its concerns regarding exposure to a sponsor's insolvency in a 16 July 2009 Methodology Update "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update").

Although counterparties might recover amounts owed them in the event of a bankruptcy, such recoveries might involve a significant delay as the result of any such bankruptcy process. In the event of a bankruptcy, we expect that the recovery of MSDP's counterparties under MSDP's current obligations would ultimately be high based on our assessment of capital adequacy and the unlikelihood of consolidation with its sponsor in bankruptcy. Nevertheless, the potential for delays in recovery in bankruptcy, and the risk that the bankruptcy of MSDP's sponsor would prompt a voluntary bankruptcy of MSDP itself, diminishes the value of that recovery, limiting our ratings to two notches above its sponsor. Thus, among other factors, Moody's rating is a reflection of voluntary bankruptcy risk as well as the adequacy of MSDP's current capital holdings and timeliness of recovery in bankruptcy.

Capital adequacy is one important consideration for the rating of derivative products companies ("DPCs") such as MSDP. Moody's considers various capital adequacy measures in its ratings of DPCs including the capital model output, which is currently in compliance with MSDP's operating guidelines.

DPCs are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

There are many considerations in the overall rating of a DPC. Moody's methodology is continually evolving as Moody's re-evaluates the stress testing and capital adequacy measures that are commensurate with its rating.

The methodologies used in this rating were "Moody's Approach to Evaluating Derivative Products Subsidiaries" published in October 1993, and "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" published in July 2009. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

Moody's will continue monitoring this rating. Any change in the rating will be publicly disseminated by Moody's through appropriate media.

REGULATORY DISCLOSURES
Although this credit rating has been issued in a non-EU country which has not been recognized as endorsable at this date, this credit rating is deemed "EU qualified by extension" and may still be used by financial institutions for regulatory purposes until 30 April 2012. Further information on the EU endorsement status and on the Moody's office that has issued a particular Credit Rating is available on www.moodys.com.

For ratings issued on a program, series or category/class of debt, this announcement provides relevant regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides relevant regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides relevant regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

Moody's considers the quality of information available on the rated entity, obligation or credit satisfactory for the purposes of issuing a rating.

Moody's adopts all necessary measures so that the information it uses in assigning a rating is of sufficient quality and from sources Moody's considers to be reliable including, when appropriate, independent third-party sources. However, Moody's is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

Please see Moody's Rating Symbols and Definitions on the Rating Process page on www.moodys.com for further information on the meaning of each rating category and the definition of default and recovery.

Please see ratings tab on the issuer/entity page on www.moodys.com for the last rating action and the rating history. The date on which some ratings were first released goes back to a time before Moody's ratings were fully digitized and accurate data may not be available. Consequently, Moody's provides a date that it believes is the most reliable and accurate based on the information that is available to it. Please see the ratings disclosure page on our website www.moodys.com for further information.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

New York – Structured Finance Group – Moody's Investors Services

Rudolph Bunja
Senior Vice President

Jian Hu
MD - Structured Finance

5. Rating Action – 17 Jun 2012 - "Moody's downgrades rating of Morgan Stanley Derivative Products Inc., a termination derivative product company"

Moody's Investors Service announced today that it has downgraded the counterparty rating of Morgan Stanley Derivative Products Inc. ("MSDP").

Counterparty Rating A2; previously on February 17, 2012, Aa3 Placed on Review for Possible Downgrade.

For additional information on Structured Finance ratings, please refer to the webpage containing Moody's related announcements http://www.moodys.com/eusovereign.

RATING RATIONALE

Moody's rating action for MSDP was prompted by the credit deterioration of Morgan Stanley that resulted in Moody's downgrade of Morgan Stanley's senior unsecured debt rating. Moody's considers MSDP's rating to be linked to the senior unsecured debt rating of Morgan Stanley as MSDP's sponsor's ultimate parent. Morgan Stanley's rating was downgraded from A2 to Baa1 (see "Moody's downgrades firms with global capital markets operations" dated 21 June 2012).

The link between the ratings of MSDP and Morgan Stanley is created by concerns that, in the event MSDP's sponsor, Morgan Stanley Capital Services LLC, were to ever file for bankruptcy, MSDP would voluntarily file for bankruptcy as well. Moody's initially outlined its concerns regarding exposure to a sponsor's insolvency in a 16 July 2009 methodology update, "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" (the "Methodology Update").

Although MSDP's counterparties might recover amounts owed them in the event of a bankruptcy, such recoveries might involve a significant delay[77] as the result of any such bankruptcy process. In the event of a bankruptcy, we expect that the recovery of MSDP's counterparties under MSDP's current obligations would ultimately be based on our assessment of MSDP's capital adequacy and the unlikelihood of consolidation with its sponsor.

Capital adequacy is one important consideration for the rating of derivative products companies ("DPCs") such as MSDP. Moody's considers various capital adequacy measures in its ratings of DPCs, including the capital model output. MSDP's current capital model outputs are in compliance with MSDP's operating guidelines.

Nevertheless, the potential for delays in recovery in bankruptcy, and the risk that the bankruptcy of MSDP's sponsor would prompt a voluntary bankruptcy of MSDP itself, diminishes the value of that recovery, limiting our ratings to two notches above its sponsor. Thus, among other factors such as capital adequacy, Moody's rating is a reflection of voluntary bankruptcy risk and the timeliness of recovery in the event of such a bankruptcy.

DPCs are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

There are many considerations in the overall rating of a DPC. Moody's methodology is continually evolving as Moody's re-evaluates the stress testing and capital adequacy measures that are commensurate with its

[77] "A significant delay" in recoveries is inconsistent with Moody's assumptions regarding derivative contracts for ABS issuers as set forth in Moody's Hedge Framework. In other words, the A2 rating of MSDP misinforms as to the suitability of MSDP as counterparty to an ABS issuer.

rating.[78]

The methodologies used in this rating were "Moody's Approach to Evaluating Derivative Products Subsidiaries" published in October 1993, and the Methodology Update. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

Moody's will continue monitoring this rating. Any change in the rating will be publicly disseminated by Moody's through appropriate media.

For additional information on Structured Finance ratings, please refer to the webpage containing Moody's related announcements http://www.moodys.com/eusovereign.

REGULATORY DISCLOSURES
The Global Scale Credit Ratings on this press release that are issued by one of Moody's affiliates outside the EU are endorsed by Moody's Investors Service Ltd., One Canada Square, Canary Wharf, London E 14 5FA, UK, in accordance with Art.4 paragraph 3 of the Regulation (EC) No 1060/2009 on Credit Rating Agencies. Further information on the EU endorsement status and on the Moody's office that has issued a particular Credit Rating is available on www.moodys.com.

For ratings issued on a program, series or category/class of debt, this announcement provides relevant regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides relevant regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides relevant regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

Information sources used to prepare the rating are the following: parties involved in the ratings, parties not involved in the ratings, and public information.

Moody's considers the quality of information available on the rated entity, obligation or credit satisfactory for the purposes of issuing a rating.

Moody's adopts all necessary measures so that the information it uses in assigning a rating is of sufficient quality and from sources Moody's considers to be reliable including, when appropriate, independent third-party sources. However, Moody's is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

Please see the ratings disclosure page on www.moodys.com for general disclosure on potential conflicts of interests.

Please see the ratings disclosure page on www.moodys.com for information on (A) MCO's major shareholders (above 5%) and for (B) further information regarding certain affiliations that may exist between directors of MCO and rated entities as well as (C) the names of entities that hold ratings from MIS that have

[78] "Capital adequacy measures that are commensurate with its rating" introduces circularity to a DPC rating. Under this scheme, a DPC that has been downgraded can reduce capital with the result that it will raise expected losses posed to counterparties beyond those signaled by downgrade itself. How does Moody's assess possible capital reductions by DPC management in response to a downgrade?

also publicly reported to the SEC an ownership interest in MCO of more than 5%. A member of the board of directors of this rated entity may also be a member of the board of directors of a shareholder of Moody's Corporation; however, Moody's has not independently verified this matter.

Please see Moody's Rating Symbols and Definitions on the Rating Process page on www.moodys.com for further information on the meaning of each rating category and the definition of default and recovery.

Please see ratings tab on the issuer/entity page on www.moodys.com for the last rating action and the rating history.

The date on which some ratings were first released goes back to a time before Moody's ratings were fully digitized and accurate data may not be available. Consequently, Moody's provides a date that it believes is the most reliable and accurate based on the information that is available to it. Please see the ratings disclosure page on our website www.moodys.com for further information.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

New York – Structured Finance Group – Moody’s Investors Services

Ruth Olson
Vice President - Senior Analyst

Algis Remeza
Senior Vice President

Appendix O4: Further Actions per 2009 DPC Methodology Update – SMBC DP

1. **Moody's Announcement – 28 Oct 2011 – "Proposed Capital Reduction of Up to $100 Million Will Not Change Moody's Counterparty Rating of SMBC Derivative Products Ltd., a Derivative Product Company"**

   Moody's Investors Service has determined that the proposed capital reduction of up to $100 million by SMBC Derivative Products Ltd. ("SMBC DP") will not, in and of themselves, cause Moody's counterparty rating of SMBC DP to be reduced or withdrawn at this time. Moody's does not express an opinion as to whether the proposal could have non-credit-related effects.

   SMBC DP proposed reducing its capital by cancelling and extinguishing up to $100 million of its US$1.00 ordinary shares, before the end of 2011, subject to its board receiving all of the necessary approvals from the firm's supervisory regulator in the UK, the satisfactory completion of certain required board resolutions, and providing a Statement of Solvency as required under UK law.

   The proposed capital reduction has no material impact to Moody's assessment of SMBC DP's counterparty rating because the remaining capital is sufficient to support the current rating. The capital of SMBC DP is primarily reserved to mitigate any credit losses due to counterparty defaults. Over the past few years, the size of SMBC DP's derivative portfolio has decreased substantially.

   SMBC DP is a derivative product company ("DPC"). DPCs are structured financial operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency derivative products. Their counterparty ratings are based on factors such as bankruptcy remoteness, non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event) and adherence to a set of operating guidelines that, among other things, restricts the types of products in which the DPC may transact.

   The methodologies used in this rating were "Moody's Approach to Evaluating Derivative Products Subsidiaries" published in October 1993, and "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies" published in July 2009.

   Other methodologies and factors that may have been considered in the counterparty rating of SMBC DP can also be found in the Rating Methodologies subdirectory on Moody's website. In addition, Moody's publishes a weekly summary of structured finance credit, ratings and methodologies, available to all registered users of our website, at www.moodys.com/SFQuickCheck.

   New York – Structured Finance Group – Moody's Investors Services

   Ivan Jiang
   Vice President - Senior Analyst

   Algis Remeza
   Senior Vice President

Appendix P: Moody's Re-Classifies DPC Ratings as (SF) Instruments (2012)

Announcement: Moody's Updates Definition of Securities Constituting SF Instruments

Global Credit Research - 28 Jun 2012

Adds (sf) Indicator to Ratings

New York, June 28, 2012 -- Moody's Investors Service today has updated its definition of the types of securities it considers "structured finance instruments." As a result, it will apply the (sf) indicator to credit ratings it assigns to certain derivative product companies, structured covered bonds, and insurance-linked notes. A list of the securities and issuers today's update affects appears at the end of this release.

The original list of securities Moody's considers structured finance instruments appeared in its 14 July 2010 press release on its structured finance ratings indicator. Subsequent updates appeared in Moody's 28 December 2010 press release on the list of ratings receiving the (sf) indicator and the 23 September 2011 press release updating the determination of types of securities constituting structured finance instruments.

Today's update follows the adoption of regulatory technical standards by the European Securities and Markets Authority. The full name of the regulation is "COMMISSION_ DELEGATED REGULATION_ (EU) of 21.3.2012 supplementing Regulation (EC) _No 1060/2009 of the European Parliament and of the Council with regard to regulatory technical standards on the content and format of ratings data periodic reporting to be submitted to the European Securities and Markets Authority by credit rating agencies."

Derivative Product Companies

Moody's will apply the (sf) indicator to some but not all counterparty ratings of derivative product companies (DPCs). DPCs are wholly owned operating company subsidiaries of financial institutions. Their primary function is to trade interest rate and currency swaps with non-affiliated counterparties. The list of structured finance instruments will continue to exclude DPCs whose counterparty ratings rely exclusively on the credit support of non-(sf) entities.

Credit Derivative Product Companies

Moody's counterparty ratings of credit derivative product companies (CDPCs) will include the (sf) indicator. CDPCs are a type of operating company whose sole business consists of selling credit protection for corporate entities through credit default swaps. Moody's treats CDPCs as "derivative product companies" as referred to in regulations.

Structured Covered Bonds

Moody's ratings of structured covered bonds will include the (sf) indicator. Structured covered bonds are covered bonds that are not enabled by a specific legal framework and have one or both of the following characteristics:

1) at issuance, payments depend primarily on the performance of the assets in the cover pool

2) the programme that issues the bonds issues more than one class of debt.

Insurance-linked Notes

Moody's ratings of credit-linked notes will include the (sf) indicator. Insurance-linked notes are fixed income securities that

1) a special purpose vehicle, or special purpose reinsurer or entity related to the special purpose reinsurer, issues

2) are part of a transaction whose main purpose is to transfer to investors the risk of losses associated with a clearly defined set of insurance exposures

3) are part of a transaction for which the lifespan of the issuer aligns with the tenor of the issued securities

Regulations of the EU and the US rely on definitions of structured finance. To satisfy both EU and US regulations, in assigning ratings, Moody's relies on a single definition of a structured finance instrument, reflecting its interpretation of

1) the definition of "structured finance instrument" in the EU regulation

2) the description of "structured finance product" in sections (a)(3) and (b)(9) of the Securities and Exchange Commission's Rule 17g-5 (Amended Rule) as applicable under the Securities and Exchange Act of 1934

3) similar concepts in other legislation and international principles such as Basel II

4) market practices for instruments that were difficult to categorize

Moody's decision to apply the (sf) indicator to new financial products will remain dynamic and subject to feedback from market participants including regulators.

Securities and Issuers Affected

Moody's is adding the (sf) indicator to its counterparty ratings of the following DPCs and CDPCs:

Athilon Capital Corp.

Athilon Asset Acceptance Corp.

Channel Capital Plc

Citi Swapco Inc.

Koch Financial Products, LLC

Merrill Lynch Derivative Products AG

Morgan Stanley Derivative Products Inc.

Nomura Derivative Products Inc.

SMBC Derivative Products Limited

Theta Corporation

Moody's is adding the (sf) indicator to its ratings of the following structured covered bonds:…..

New York – Structured Finance Group – Moody's Investors Services

Maria Leibholz
VP - Senior Credit Officer

Algis Remeza
Senior Vice President

Appendix Q1: Fitch Ceases Rating DPCs in 2011

1. Fitch Withdraws Derivative Product Company Criteria

NEW YORK--(BUSINESS WIRE)--Fitch Ratings has withdrawn its ratings of derivative product companies (DPCs). As a result, Fitch has also withdrawn its related criteria report, 'Derivative Product Company Criteria,' dated Nov. 10, 2010. The criteria report was withdrawn because Fitch no longer rates any DPCs and there are no ratings outstanding under the criteria.

Additional information is available at 'www.fitchratings.com'.

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: HTTP://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS. IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEBSITE 'WWW.FITCHRATINGS.COM'. PUBLISHED RATINGS, CRITERIA AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE 'CODE OF CONDUCT' SECTION OF THIS SITE.

2. Fitch Withdraws Merrill Lynch Derivative Product Company AG's Rating

NEW YORK--(BUSINESS WIRE)--Fitch Ratings has withdrawn the Issuer Default Rating (IDR) and counterparty ratings of Merrill Lynch Derivative Products AG (MLDP). The ratings of MLDP have been withdrawn because they are no longer considered by Fitch to be relevant[79] to the agency's coverage. Fitch no longer rates any derivative product companies (DPCs), and there are no ratings outstanding under the criteria.

MLDP is a DPC that intermediates over-the-counter derivative transactions between highly rated external counterparties and Merrill Lynch affiliates including Merrill Lynch Capital Services, Inc. (MLCS) and Merrill Lynch International Bank Limited (MLIB). MLDP offsets all market risk to MLCS and MLIB via 'back-to-back' mirror transactions.

As a continuation vehicle, MLDP engages the services of a contingent manager to manage the portfolio when particular trigger events occur. MLDP has engaged BlackRock to be its contingent manager.

Fitch has withdrawn the following ratings:
Merrill Lynch Derivative Products AG (MLDP)
-- Long-term IDR 'AAA[80]';

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[79] Did the ratings remain relevant to counterparties of MLDP?

[80] Fitch maintained AAA rating of MLDP despite risks to counterparties of continuation DPCS identified in 2008 and 2009.

-- Counterparty rating 'AAA[81]'.

Additional information is available at 'www.fitchratings.com

[81] Fitch maintained AAA rating of MLDP despite risks to counterparties posed by continuation DPCS as evidenced in 2008 by trigger events of BSFP (Bear continuation DPC) and LBFP (Lehman continuation DPC.)

Appendix Q2: Fitch Ratings Revives DPC Ratings in 2013

Fitch: Updated Criteria for Rating Derivative Product Companies[82]

NEW YORK--(BUSINESS WIRE)--

Link to Fitch Ratings' Report: Derivative Product Company Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=696817

In its updated rating criteria for derivative product companies (DPCs) published today, Fitch Ratings clarified that it will look to the DPC's stand-alone credit strength, as well as the sponsor's, when rating DPCs engaging in standardized, liquid derivatives.

A DPC's ratings may be de-linked from the rating of the sponsor at a certain level, termed a 'ratings floor.' A ratings floor of 'A' will apply for continuation DPCs that are well-capitalized and appropriately structured, whereas a ratings floor of 'AA' may assigned to termination DPCs. Fitch's new criteria applies to DPCs that are separate legal and operating entities and benefit from capital and structural protections that seek to make them legally, financially, and operationally distinct from their sponsor. DPCs are typically wholly owned subsidiaries of financial services companies who serve as a DPC's sponsor. The criteria addresses DPCs that intermediate or guarantee 'plain vanilla' derivative transactions on behalf of the sponsor.

The DPC's final rating will also reflect the credit strength of the sponsor, if the sponsor is a higher rated entity. The DPC's final rating is expected to be the higher of the DPC's stand-alone rating floor or one notch above the sponsor's long-term issuer default rating. The rating is expected to migrate with the sponsor's rating until the rating floor is reached in most cases. Ratings linkage to the sponsor may continue at rating levels below the proposed rating floors where a DPC shows weakness in capital level, structure or operational separateness.

DPCs face counterparty, market and liquidity risk as the main financial risk factors. These risk factors are addressed via the DPCs capitalization, collateral posting arrangements, and hedging/unwind mechanisms. Well-defined counterparty and portfolio diversification limits help serve to identify and control these risks. Distinct and well-defined governance standards and operating procedures also play an important role in achieving legal and operational separateness from the sponsor.

Fitch's rating criteria also addresses considerations for DPCs acting act as a counterparty or guarantor for structured finance (SF) transactions. Derivatives associated with SF transactions, even liquid derivatives with standardized terms, raise certain unique issues when analyzing

[82] When will these criteria be withdrawn? For how long will DPC ratings be "relevant to the agency's coverage?" (Please see immediately preceding Appendix Q1, p72.) Will Fitch preserve high ratings for DPCs in light of future challenges?

DPCs. Likewise, a DPC's particular structure and trigger events should not negatively impact the SF transaction, relative to Fitch's SF counterparty criteria.[83]

This criteria does not apply to more bespoke derivatives, including those that may be associated with SF transactions such as balance guaranteed swaps or swaps with highly customized reference rates.[84] Fitch will continue to dialogue with the market to assess various proposals that are designed to intermediate more bespoke derivatives.

The criteria report, titled 'Derivative Product Company Rating Criteria' (Jan. 7, 2013), is available at 'www.fitchratings.com' or by clicking on the link.

Additional information is available at 'www.fitchratings.com'.

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[83] An impossible dream. Fitch's SF counterparty criteria track Moody's Hedge Framework closely. Both protocols and those of rating agencies S&P, Kroll Bond Ratings and DBRS all model ABS nearly identically, i.e. as incurring zero unscheduled costs under a derivative contract.

[84] All derivative contracts with ABS are "bespoke" by virtue of the constraints and obligations imposed on an ABS counterparty by Fitch SF Counterparty Criteria, Moody's Hedge Framework, etc.

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Appendix R1: S&P Requests Comments on Proposed DPC Update (2012)

March 2 - Standard & Poor's Ratings Services is requesting comments on its proposed methodology and assumptions for rating derivative product companies
(DPCs). This proposal follows "Advance Notice Of Proposed Criteria Change: Methodologies And Assumptions For Analyzing Derivative Product Companies," published Dec. 23, 2010.

The proposed criteria would represent a material change in our rating methodology and are intended to further enhance the comparability of DPC ratings with ratings in other sectors, such as financial institutions,[85] corporates, and other areas of structured finance.[86] The proposed criteria would constitute a specific methodology and assumptions under our "Principles Of Credit Ratings," published Feb. 16, 2011.

Our proposal and the specific requests we are making are outlined in the article "Request For Comment: Derivative Product Companies: Rating Methodology And Assumptions," published March 1, 2012.

The proposed criteria would apply to any DPC set up by a sponsor bank/firm where the DPC has an intermediation arrangement with the bank/firm and risk-based "termination" or "continuation" triggers. Certain specific characteristics of the proposed methodology would apply to either "termination" or "continuation" DPCs as highlighted in this request for comment (RFC). The proposed criteria would not apply to structures that do not have a dominant back-swap counterparty.

The changes proposed in this RFC would limit the highest rating on the DPC to three notches above the rating on the sponsor bank, assuming the DPC meets certain minimum standards, and, in certain circumstance, may result in the rating on the DPC being below the rating on the sponsor bank. This proposal, if adopted, would significantly recalibrate the analytical framework for rating DPCs.

Our initial analyses of the ratings impact under the proposed methodology show that most of the five DPCs we currently rate would likely be rated in the 'AA' rating category,[87] given the current ratings on their sponsor banks and the general analytical framework incorporated in their operating guidelines.[88] These initial results may be affected by changes in the final criteria based on feedback received through this RFC. Additionally, if this proposed analytical framework is adopted, the ratings on the DPCs may change if the sponsor bank experiences rating changes in the future.

RESPONSE DEADLINE

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[85] S&P misinforms. DPC ratings depend on structural features that constrain operations, for instance the ability to post collateral or to continue in business for years after having incurred a trigger event. DPC ratings are not comparable to ratings of financial institutions.

[86] S&P, like Moody's, denotes DPCs as structured finance. As such, S&P should heed its own history of issuing inaccurate ratings where two types of structured finance transaction, for instance CDOs of RMBS.

[87] Conveniently, S&P proposes that counterparties to ABS post lower collateral if rated AA. Please see second half of Appendix below.

[88] MSDP will be rated "AA" despite challenges described in Appendix O3, 1-5, pps 59-68?

All interested market participants are encouraged to submit written comments on these proposed criteria. Please send your comments to CriteriaComments@standardandpoors.com by March 30, 2012. Once the comment period is over, we will review the comments and then finalize and publish the

criteria.

RELATED CRITERIA AND RESEARCH

-- Request For Comment: Counterparty And Supporting Obligations Methodology and Assumptions--Expanded Framework, published Nov. 21, 2011.[89]

-- Banks: Rating Methodology And Assumptions, published Nov. 9, 2011.

-- Principles Of Credit Ratings, published Feb. 16, 2011.

-- A New Level Of Enterprise Risk Management Analysis: Methodology For Assessing Insurers' Economic Capital Models, published Jan. 24, 2011.

-- Advance Notice Of Proposed Criteria Change: Methodologies And Assumptions For Analyzing Derivative Product Companies, published Dec. 23, 2010.

-- Request For Comment: Methodology And Assumptions For Market Value Securities, published Aug. 31, 2010.

-- Credit Rating Model: CDO Evaluator 5.1, published Aug. 16, 2010.

-- Legal Criteria For U.S. Structured Finance Transactions: Special-Purpose Entities, published Oct. 1, 2006.

-- Eligible Investment Criteria For 'AAA' Rated Structured Transactions, published June 25, 2001.

-- Rating Derivative Product Companies, published Jan. 27, 2000.

-- Derivative Product Companies: Risks and Future Directions, published Jan. 24, 2000.

[89] Described immediately below in second half of Appendix R2, p79.

Appendix R2: S&P Updates Counterparty Obligations to ABS (2012)

Credit FAQ:

What's Behind The Updates To The Counterparty Risk Criteria Framework And Related Criteria?

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*(**Editor's Note:** This article, originally published on June 6, 2012, has been republished to add further questions following the November 2012 update to the counterparty risk criteria framework.)*

On Nov. 29, 2012, Standard & Poor's updated paragraph 27 of the counterparty criteria relating to fiduciary accounts. We also made some corrections to the advance rates for certain currencies and clarified the criteria relating to bank accounts collateralized by cash in funded synthetic transactions. The following questions relate to these changes and provide further clarification regarding the treatment of intraday risk under our counterparty criteria.

What changed with respect to fiduciary accounts?

Does paragraph 27 apply to U.S. state chartered banks that are subject to laws similar to the Title 12 Regulations?

Does table 1 of the counterparty criteria apply to bank accounts for which cash is only held intraday?

Were there other changes as part of the November 2012 update of the counterparty criteria?

Yes. We made some corrections to the advance rates for certain currencies in Tables 10a, 10b, and 10c following the publication of two related articles: "S&P Corrects Error In Currency Advance Rate Calculator Tool; Ratings Are Unaffected" and the criteria article "Stressing Foreign Currency Risk In Unhedged Or Partially Hedged Structured Finance Transactions," both published on Nov. 29, 2012.

We have taken the opportunity to clarify further the treatment under our criteria of bank accounts collateralized by cash in funded synthetic transactions and of other functionally equivalent obligations in those transactions (see paragraphs 25, 52, 54, 56, 59, and 128 in the criteria article). We have also clarified the applicable remedy period for certain type of derivative structures that use alternative termination provisions (see paragraph 79). Finally, we clarified the application of the counterparty criteria in some of the examples that are shown in Appendix 4.

On May 31, 2012, Standard & Poor's Ratings Services published an update to its counterparty risk criteria framework,"Counterparty Risk Framework Methodology And Assumptions," (republished on Nov. 29, 2012, following the change discussed above) and to three related criteria articles: covered bonds counterparty criteria, investment criteria, and defeasance criteria (respectively, "Covered Bonds Counterparty And Supporting Obligations Methodology And Assumptions," "Global Investment Criteria For Temporary Investments In Transaction Accounts," and "Methodology And Assumptions: Assigning Ratings To Bonds In The U.S. Based On Escrowed Collateral," which remain as they were).
In an effort to provide a better understanding of these revised criteria, the frequently asked questions below address the rationale behind and the primary changes to the counterparty risk criteria framework, as well as how the four criteria updates are related.

Frequently Asked Questions

What is the rationale for the updated counterparty risk criteria framework?

The updated counterparty risk criteria framework addresses the counterparty risk principle, one of the fundamental principles of ratings analysis described in "Principles Of Credit Ratings," published Feb. 16, 2011. We consider counterparty exposure an important factor when assessing the credit risk of structured finance and certain other securities because a counterparty's failure to perform on its obligations may lead to a payment default on the supported securities, notwithstanding the underlying assets' performance.[90]

Our rationale for assigning a rating to a security that is higher than the rating on the counterparty[91] reflects the counterparty's commitment to replace itself within a remedy period when its rating falls below a certain level. The changes to the counterparty risk criteria framework, for derivatives in particular, further support the criteria's fundamental premise of a counterparty's commitment to replace itself by providing for additional replacement options, enhancing swap agreement liquidity, and reducing swap transaction costs.[92]

Credit FAQ: What's Behind The Updates To The Counterparty Risk Criteria Framework And Related Criteria?

Why is counterparty risk important?

Counterparties are involved in transactions primarily to provide some benefit to the noteholders, such as by hedging against rising interest rates. While the engagement of counterparties is intended to reduce risks to the transaction through the provision of their services, the existence of counterparties gives rise to the incremental risk that the counterparty may fail to meet its obligations at some time in the future.[93] For example, a counterparty might stop performing if it suffers financial or operational distress or goes out of business. In the case of a counterparty default, the securitized transaction would be forced to negotiate the counterparty's replacement (which is likely to involve incremental costs[94]) or bear the market and/or financial risks previously contracted out to the counterparty (potentially resulting in a downgrade of the notes).[95]

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[90] S&P assigns a probability of zero to this outcome in assigning upfront ratings to ABS, i.e. S&P uses different criteria to rate new issues of debt and existing ones.

[91] The rating of a counterparty is not the correct floor for the rating of ABS. The correct (much lower) floor is obtained from weighting outcomes when: 1) an ABS is modeled as unhedged (when the derivative contract is an asset to the ABS issuer) and, alternatively; 2) an ABS is liable to pay a senior termination payment (when the derivative contract is a liability to an ABS issuer.)

[92] At what cost to a DPC?

[93] S&P assigns a probability of zero to this outcome in assigning upfront ratings to ABS, i.e. S&P uses different criteria to rate new issues of debt and existing ones.

[94] At what cost to a DPC?

[95] S&P assigns a probability of zero to this outcome in assigning upfront ratings to ABS, i.e. S&P uses different criteria to rate new issues of debt and existing ones.

To ameliorate this risk, securitization structures usually include specific mitigants to minimize the chance that such events would disrupt the transaction.[96] Such a mitigant is a replacement framework that includes a minimum eligible counterparty rating and collateral posting. We believe that a replacement framework can significantly mitigate a securitization's exposure to counterparty default and, therefore, allow for higher ratings on the supported securities.

How are the four criteria updates related?

Each of the criteria updates addresses counterparty risk.

The counterparty risk criteria framework is the foundation piece that provides the overall methodology for assessing counterparty risk by looking at the nature of the obligation, its structural features, and any economic incentives.

According to the criteria, for a given maximum potential rating on the supported security, there is a corresponding minimum eligible counterparty rating[97] below which a counterparty commits to replace itself.

We explain below how the other criteria updates align to the counterparty risk criteria framework for similar types of exposure.

The covered bond counterparty criteria primarily extend the assessment of derivative exposures. The premise of these criteria is that the dual-recourse nature of covered bonds (to the covered bond issuer and cover pool assets) and the usage of multiple counterparties unrelated to the issuer may mitigate the risk to derivative counterparties and bank account providers. In our view, derivative counterparties may be more easily replaced because the issuer's ability to manage and mitigate counterparty risk, combined with a diverse pool of derivative counterparties in a covered bond program, may increase the issuer's flexibility to replace the derivative obligations more quickly with existing counterparties.[98]

Because covered bond funding is so important, issuers may be motivated to manage their covered bond programs so as to maintain access to this funding source. The investment criteria update clarifies how we assess temporary investments, which we had previously assessed using either our eligible investment criteria or our counterparty and supporting obligations criteria (as discussed in "Eligible Investment Criteria For 'AAA' Rated Structured Transactions," published June 25, 2001, and "Counterparty And Supporting Obligations Methodology And Assumptions," published Dec. 6, 2010). Because the investment criteria also rely on a replacement framework (i.e., cash is continuously reinvested or replaced with new eligible investments), similar to the counterparty risk criteria framework, we look to the rating on the obligor to determine a transaction's reliance on its ability and willingness to repay a financial obligation in full and on time. However, given that exposure to temporary investments is typically short-term, the updated investment criteria look to the short-term rating on the obligor.

Finally, the rating assigned to a defeased bond will reflect the escrowed collateral's credit quality and the counterparty's exposure to the escrow agent. Because the defeased bond relies on collateral to make future payments, the collateral comprising cash holdings and/or investments should typically satisfy the investment criteria.

Furthermore, since the collateral is deposited into an escrow account, the escrow agent is also a rating consideration. An assessment of the counterparty's exposure to the escrow agent considers the minimum

[96] Minimization of outcomes is not the same as assigning a probability of zero to such outcomes occurring. Given the extremely small loss tolerances associated with ratings of ABS, non-zero probability caps ratings of ABS with derivative hedges at "A" or "BBB."

[97] Do DPCs have resources to arrange "replacements" and to pay "replacement" costs? A DPC that has experienced a trigger event has finite capital and collateral and few employees.

[98] Correspondingly, counterparties to non-covered bonds, i.e. ABS, will be "replaced" with more difficulty.

escrow agent rating, the rating on the defeased bond, the exposure period to the escrow agent, and, if applicable, the replacement covenant.

There have been multiple changes[99] to the counterparty criteria over the past few years. What sectors are affected by these updates and which criteria are superseded?

The counterparty risk criteria framework has the widest scope and applies to all new and existing structured finance securities, covered bonds, and counterparties supporting corporate and government issues that have structured finance characteristics.

The updated counterparty risk criteria framework fully supersedes prior counterparty criteria (mainly "Counterparty And Supporting Obligations Methodology And Assumptions," published Dec. 6, 2010) and partially supersedes several other criteria articles (see Appendix 6 of "Counterparty Risk Framework Methodology And Assumptions," for a list of the superseded criteria).

The covered bonds counterparty criteria, investment criteria, and defeasance criteria have a narrower scope (see the respective criteria articles for the superseded articles).

What are the main changes to the criteria for derivatives?

The most notable change is the expanded framework for derivatives with four replacement options. According to the criteria, similar credit quality may be achieved by balancing the minimum eligible counterparty rating and the collateral amount.[100],[101],[102]

In particular, higher minimum eligible counterparty ratings result in lower collateral amounts[103],[104]. These criteria consider that the counterparty's commitment to replace itself at a higher rating level[105] balances the need for collateral as an incentive to replace because the security rating is closer to the counterparty's issuer credit rating.[106]

In keeping with the premise[107] of counterparty replacement, we introduced further changes[108] that should result in more market-standard derivative instruments, leading to increased liquidity.[109] The changes are as follows:

- Removing the requirement for the provision of external marks;

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[99] Will there be multiple changes in future depending on S&P business interests?

[100] Does this apply to DPCs, given that they can post collateral only to a limited extent and only at the expense of other DPC counterparties?

[101] How does S&P account for collateral posted by a DPC to an ABS issuer? Is the amount removed from calculations with respect to non-collateralized counterparties? Does the S&P rating of a DPC address the better outcomes posed to collateralized counterparties or the worse outcomes posed to non-collateralized counterparties?

[102] Pre-trigger event, how does a DPC fund collateral posting, given that it receives collateral under mirror trades with a sponsor on a net basis? Post-trigger event, how does a continuation DPC fund collateral posting, given its finite resources and need to post collateral under contracts to re-hedge market risk?

[103] Is this similar to pre-2008 assessment that high ratings of RMBS resulted in lower subordination levels for CDOs?

[104] Conveniently, S&P proposes to rate most DPCs AA. Please first half of Appendix R1, p77.

[105] What resources do DPCs have to fund replacement costs? What are risks to ratings of ABS debt if a downgraded DPC cannot replace or post collateral?

[106] Will S&P refrain from downgrading DPCs so as not to obligate DPCs to post additional collateral to ABS issuers?

[107] ***Faulty*** premise of counterparty “replacement,” surely.

[108] Collectively, the changes weaken the relative position of ABS issuers and increase expected losses on ABS – how is this consistent with assigning a probability of zero to an ABS becoming un-hedged or an ABS issuer paying unscheduled costs?

[109] We thought the same at Moody’s in introducing Moody’s Hedge Framework in 2006. However, “replacement” is not occurring and banks are ignoring contractual obligations to ABS issuers.

• Expanding the netting provisions;
• Using a derivative's weighted-average life (assuming a low prepayment rate) in the determination of volatility buffers;
• Introducing lower volatility buffers for ratings below 'AAA',[110] and
• Accommodating the posting of collateral in currencies other than that of a derivative counterparty's payment obligation (subject to additional collateral to compensate for the additional currency risk).[111]

(See Appendix 6 of "Counterparty Risk Framework Methodology And Assumptions," for more detail.) Furthermore, the covered bond counterparty criteria provide an additional methodology to assess derivatives with certain features. This methodology links the rating on the covered bond to the covered bond issuer, as well as the rating on the derivative counterparty.

Credit FAQ: What's Behind The Updates To The Counterparty Risk Criteria Framework And Related Criteria?

Why is there a new category for bank accounts?

The updated criteria reclassify the three categories of counterparty risk (other support obligations, direct support obligations, and derivatives) to bank accounts, indirect support obligations, direct support obligations, and derivatives to improve clarity and provide an easier way to apply the criteria. Under the previous criteria, bank accounts were classified as either direct or other support obligations.

If a counterparty obligation reflects the counterparty risk criteria framework, does this mean that replacement will occur?

Not necessarily.[112] The counterparty risk criteria framework outlines those elements that we believe would lead to a greater likelihood of replacement (e.g., replacement commitment, collateral posting, termination provisions[113]). If there are no other mitigating factors and replacement has not occurred, we may lower the rating on the security to the counterparty's issuer credit rating.[114],[115]

Is the counterparty risk criteria framework the only methodology that allows Standard & Poor's to rate a transaction higher than the rating on the counterparty?

There are alternatives to a replacement commitment[116] (e.g., collateral posting, credit enhancement) that enable the security rating to be delinked from the counterparty rating (see paragraph 22 of "Counterparty Risk Framework Methodology And Assumptions").

When will the criteria changes be effective and what is the ratings impact?

The counterparty risk criteria framework is effective immediately. We expect the impact on outstanding ratings will be limited to a small number of transactions[117]. In particular, we may lower the ratings on funded synthetic transactions with instruments and associated counterparty obligations that support all, or substantially all, of principal repayments. In addition, we may raise the ratings on supported securities

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[110] Are AA and A ratings stable with lower collateral? Loss tolerances for AA and A ratings are very small and sensitive to incremental increases in risk.

[111] The purpose of a derivative contract is to hedge existing interest-rate or currency risk of an ABS, not introduce new, additive currency risk.

[112] Why isn't "not necessarily" incorporated into upfront ratings of ABS?

[113] How are "flip clauses" assessed for ABS governed by U.S. bankruptcy law?

[114] For ABS governed by U.S. bankruptcy law, the correct floor of the rating is that obtained from weighting outcomes when: 1) an ABS is modeled as unhedged (when the derivative contracts is an asset to the ABS issuer) and, alternatively; 2) an ABS is liable to pay a senior termination payment (when the derivative contract is a liability to the ABS issuer.)

[115] Is using more stringent criteria to rate existing ABS than newly-issued ABS consistent with SEC policy?

[116] How does collateral make-up for "replacement" where an ABS governed by U.S. bankruptcy law owes a mark-to-market amount to a counterparty?

[117] What will be the impact going forward, given that swap counterparties cannot be de-linked from ABS issuers?

with certain bank accounts and a small number of Japanese structured finance securities with deposit-insured accounts.

The covered bond counterparty criteria are effective as of July 12, 2012. We may lower the ratings on up to 50% of covered bond programs, absent any actions that a covered bond issuer may take.

The investment criteria are effective immediately. We do not expect any impact on outstanding ratings. The defeasance criteria are effective immediately. We will be reviewing the ratings on defeased bond transactions within the next six months.

Related Criteria And Research

- Counterparty Risk Framework Methodology And Assumptions, published Nov. 29, 2012.
- Covered Bonds Counterparty And Supporting Obligations Methodology And Assumptions, published May 31, 2012.
- Global Investment Criteria For Temporary Investments In Transaction Accounts, published May 31, 2012.
- Methodology And Assumptions: Assigning Ratings To Bonds In The U.S. Based On Escrowed Collateral, published May 31, 2012.
- Counterparty And Supporting Obligations Methodology And Assumptions, published Dec. 6, 2010.
- Eligible Investment Criteria For 'AAA' Rated Structured Transactions, published June 25, 2001.

Moody's Hedge Framework for *LINKING/DE-LINKING* Structured Finance Notes from Derivative Risk and Allied Methodologies for Bank Counterparties

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August 31, 2012

VIA ELECTRONIC MAIL

Mr. Michel Madelain
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Dear Mr. Madelain:

I am submitting comments with respect to several publications that have been issued by the structured finance group of Moody's Investors Services (Moody's).

My aim is to draw attention to inflated ratings that permeate all sectors of structured finance worldwide. The LIBOR scandal shows that large institutions can distort widely-referenced benchmarks for prolonged periods - Moody's is doing just this in resuming its practice of minting **Aaa(sf)** after **Aaa(sf)** (often to opposing obligations of the same transaction.)

The publications in question reference a comprehensive suite of contractual provisions that a structured finance transaction may include in a bi-lateral derivative contract so as to ***de-link*** note ratings from the corresponding bank counterparty. Most structured finance transactions worldwide base their derivative contracts on the Moody's provisions – otherwise, Moody's deems notes as ***linked*** to a counterparty and will not rate them **Aaa(sf).**

Replacement, a Moody's construct and a core ***de-linkage criterion***, is not occurring, and structured finance ratings worldwide remain ***linked*** to downgraded bank counterparties.

Linkage mandates widespread downgrades of structured finance notes with derivative exposure to **A(sf)** or below. Instead, Moody's proposes to take a bifurcated approach: to assume ***de-linkage*** in rating new issues **Aaa(sf)** and acknowledge ***linkage*** only for seasoned notes whose bank counterparties have been downgraded to **A3** or below.

By inflating structured finance ratings, Moody's is embedding losses both in rated notes and derivative portfolios of the large banks that are ultimately backstopped by taxpayers.

How did the web of inflated ratings for derivatives, banks, and sovereign risk play out last time?

William J. Harrington

MOODY'S PUBLICATIONS RELATING TO DERIVATIVE RISK FOR STRUCTURED TRANSACTIONS AND FOR BANK COUNTERPARTIES

Moody's Hedge Framework

In October, 2010, Moody's affirmed the rating implementation guidance report "De-Linkage Framework for De-Linking Swap Counterparty Risks from Global Structured Finance Cashflow Transactions" (Hedge Framework). Most structured finance transactions worldwide implement some variant of the Hedge Framework; absent it or similar accommodation from Moody's, few sectors of structured finance would be viable in their present forms.

The Hedge Framework stipulates a suite of contractual provisions for inclusion into a bi-lateral derivative contract between a structured finance transaction and its bank counterparty; most provisions benefit a transaction by specifying obligations for the bank counterparty to execute after having been downgraded to a specified rating. The provisions are intended to operate in the real world – they are not tools used by Moody's to represent the real world when modeling structured finance transactions.

In modeling a structured finance transaction that has implemented the Hedge Framework or a facsimile, Moody's treats a derivative contract as performing perfectly vis-à-vis the transaction irrespective of the credit of a bank counterparty. Individual counterparties may come (when highly rated) and go (when downgraded or insolvent), but the counterparty du jour ***always*** pays the structured finance transaction according to the schedule laid out in the derivative contract and ***never*** defaults. In this happy land, a structured finance transaction ***always*** receives scheduled swap payments with which to pay rated notes and a transaction ***never*** pays a termination amount or other unscheduled amount to a bank counterparty.

Moody's invokes the "replacement" provisions of the Hedge Framework to justify the perfect derivative contracts of structured finance and treats "replacement" as fail-safe; "replacement" is both 100% costless and 100% achievable for every transaction worldwide.

Were "replacement" acknowledged as being less-than-100% achievable, Moody's would be compelled to model the event risk that is associated with a derivative contract and take significant downgrades. Notes issued by structured finance transactions with derivative risk would be rated no higher than **A(sf)**.

Moody's Counterparty Instrument Rating

On February 23, 2012, Moody's published the rating methodology "Moody's Approach to Counterparty Instrument Rating." A counterparty instrument rating (CIR) evaluates the ability of a structured finance transaction to make certain payments that are owed to a bank counterparty under a derivative contract that is compliant with the Hedge Framework.

Together, the Hedge Framework and the CIR methodology enable Moody's to award new ratings of **Aaa(sf)** to two conflicting obligations of a structured finance transaction that has entered into a derivative contract: the obligation to pay rated notes and the obligation to make all payments owed under a derivative contract. The two obligations conflict most notably where a bank counterparty is in default and thereby owed a termination payment.

The Hedge Framework and the CIR methodology recite a quartet of self-referencing assertions to reconcile the competing claims of rated notes to be paid on a timely basis and of a bank counterparty in default to be paid a rated termination payment.

1. A structured finance swap is deemed to be a "liquid" swap;
2. A credit-impaired or defaulted bank counterparty to a "liquid" swap will be "replaced" by a higher-rated bank at no cost to a transaction;
3. A transaction will never pay a termination amount owed to a bank counterparty in default; the termination amount will be paid by the "replacement" counterparty; and
4. Given that a "replacement" counterparty will pay a termination amount owed a defaulted bank, the enforceability of a Hedge Framework-specified "flip clause" has no bearing on the ability of a transaction to pay rated notes given.
   ("Where the validity of flip clauses is uncertain, there is a possibility that the courts will affirm the effectiveness of flip clauses prior to counterparty default. However, the effect of this is off-set by the possibility that the courts will confirm that flip clauses are valid" CIR methodology footnote 12, page 8.)

(Question Time
Each question below corresponds to similarly numbered assertion immediately above.

1. **Should swaps with structured finance transactions be placed on central clearinghouses with other *liquid* swaps?**

2. **Are bank analysts apprised of *replacement* costs that bank counterparties freely agree to incur when entering into derivative contracts that hew to the Hedge Framework?**

3. **What is the impact on the ratings of new structured finance issues from modeling payment of *termination* amounts in a holistic manner with other transaction risks?**

4. **Do the attorneys in the U.S. structured finance group dismiss the impact of *"flip clauses"* under U.S. law as blithely as the U.K.-based authors of these publications?**
   a. *"flip clauses"* have been repudiated in the Lehman bankruptcy case and left intact in U.K. bankruptcy proceedings.)

The confident assertions of the Hedge Framework and the CIR methodology are, in fact, abstractions. The entire banking sector worldwide is being downgraded, and triggers specified in the Hedge Framework are being tripped right and left. However, *replacement* is not occurring.

Under perfect circumstances, obtaining *replacement/guarantee* for 100% of the structured finance swaps in the portfolio of a downgraded or defaulted bank is not achievable. Under currently imperfect circumstances, little if any *replacement/guarantee* is occurring at all. Structured finance transactions are wholly ***linked*** to bank counterparties and are exposed to multiple event risks should bank counterparties default.

Linkage must be the starting point in rating both new issues and existing ones. Widespread downgrades of structured finance notes are warranted – none issued by a transaction that may enter into derivative contracts should be rated higher than **A(sf)**.

Moody's chooses to publish rather than to downgrade and see its structured finance franchise perish

The Special Report "Possible Solutions to Swap Triggers in Securitisation and Covered Bond Transactions," released on February 27, 2012 described a successful petition to Moody's for RBS to unilaterally amend existing derivative contracts with 35 structured finance transactions that covered 90 swaps. The RBS amendments diluted the real-world contractual provisions that benefited the 35 transactions (albeit no longer to a **Aaa(sf)** standard.)

RBS had been downgraded and had not discharged its contractual obligations, such as the obligation to *replace* itself. Rather than downgrade rated notes that were ***linked*** to RBS, Moody's green-lighted the RBS proposal via issuance of a Rating Agency Condition letter (RAC). According to Moody's, this outcome "has demonstrated that following a downgrade of a swap counterparty, solutions can be found to some of the practical difficulties of taking action within the documented cure period."

Diluting de-linkage criteria at the behest of a bank counterparty is indeed a solution and a practical one at that. Moreover, what's good for one goose is good for all gander.
On the busy market day of July 2, 2012, Moody's released "Approach to Assessing Linkage to Swap Counterparties in Structured Finance Cashflow Transactions: Request for Comment" (***LINKAGE Comment Request***) and scheduled an explanatory webinar for July 5, 2012 at 10:00 AM EST.

The ***LINKAGE Comment Request*** mentions that, in order to make structured finance methodologies more transparent to end-users, Moody's will review third-party comments throughout the summer holidays until the cut-off date of August 31, 2012.

My experience with the Hedge Framework began in 1999 when I joined the Derivatives Group at Moody's. I used forerunners of the Hedge Framework in rating CDOs, evaluated the costs of providing derivatives that complied with the Hedge Framework in evaluating Derivative Product Companies (DPCs) and served on a multi-year taskforce charged with developing a hedge contract protocol for worldwide use. In 2006, I co-authored the Hedge Framework protocol - it remains operational in near-original form at the time of this writing. (My June 11, 2012 letter to you regarding DPCs and the Hedge Framework is included here as Appendix B.)

Moody's Quest for a Silver Bullet

In 2010, I worked on Moody's taskforces that were examining the validity of the Hedge Framework in light of a ruling by Judge Peck of the Lehman bankruptcy case that repudiated "flip clauses." I also worked on a taskforce charged with producing a methodology for Counterparty Instrument Ratings.

In each taskforce I argued that the respective methodology relied too heavily on *replacement* but made little headway. The taskforces seemed intent on finding a panacea that would preserve the methodologies in their existing forms rather than on critically examining them.

Why? Critical examination was beyond Moody's capabilities. (Monitoring groups did not track counterparties to swap agreements or, often, whether transactions had entered into derivative contracts. "Balance-guaranteed swaps," a mainstay of the RMBS issuance, never should have been included in the Hedge Framework in the first place – it was too late to discuss their *replacement* prospects. Moody's had already downgraded RMBS and CDOs to **Ca(sf)** – was another round of downgrades needed?

Further, Judge Peck was only one U.S. bankruptcy judge and he had not even entered his decision formally – the Lehman cases did not establish precedent regarding "flip clauses" and the ipso facto clause of U.S. bankruptcy law. Other U.S. courts might decide differently. Moreover, Judge Peck had invited U.K. bankruptcy judges to reconsider their decision to leave "flip clauses" intact. International law provided for summit-like proceedings to iron out just these types of disagreements – maybe the U.K. justices would persuade Judge Peck to see things differently.)

Waiting things out so that Moody's could invent a silver bullet to kill threats to ***de-linkage*** was the best course. The publications discussed in this comment letter followed in due course.

Happy Labor Day - Things Can Always Get Worse
Prior to Moody's I worked for ten years on trading desks for international derivatives at Merrill Lynch and as an international economist at The WEFA Group. These experiences showed me that derivative mark-to-markets grow in the wrong direction at the wrong time and that economic forecasts contain information about the present but not the future.

My bona fides may be found on Linked-In (William J. Harrington, Greater New York City Area – Public Policy.)

Hedge Contract Protocols underlie much of structured finance
The respective hedge contract protocol or ***de-linkage criteria*** of each rating agency grants the same modeling expediency to underwriters, namely that a cash-flow transaction incurs ***no attendant losses*** from being party to a derivative contract. Where two structured finance transactions are otherwise identical except that one is party to a derivative contract and the second is not, the two are subject to identical modeling and are assigned identical ratings.

Without Hedge Contract Protocols and their progenitors, many sectors of structured finance would not exist and none would have expanded its investor base beyond that of its own currency area.

Hedge Contract Protocols treat "BBB" banks as better than "AAA." Each protocol specifies obligations for a bank counterparty to perform upon being downgraded to "BBB" or lower and relies on the same core obligations of collateralization, replacement and subordination.

Structured finance transactions that enter into derivative contracts hew to the respective Hedge Contract Protocol of each agency that rates its notes. Collectively, the ratings of these transactions assume that the worldwide banking industry performs perfectly forevermore.

Specifically, every structured finance transaction in the world ***unfailingly*** receives amounts owed under derivative contracts. Collateral posted to each transaction is ***always*** sufficient to pay replacement costs where necessary. Highly-rated entities are ***continually*** bidding to replace bank counterparties as they are downgraded. ***No transaction*** anywhere in the world pays termination costs to its bank counterparty. ***All transactions*** are rendered completely immune from contagion should a bank counterparty become insolvent

Small recognition of derivative event risk mandates multi-notch downgrades. In structured finance, the thresholds for expected loss that distinguish "AAA," "AA" and "A" are minute and clustered together. In that congested edge of the scale, very small additions to expected losses result in large changes in rating.

A Simple Benchmark to Evaluate a Hedge Contract Protocol

Consider two structured finance transactions with identical pools of assets that pay floating-rate coupons indexed to 3-month sterling LIBOR. The first transaction issues sterling liabilities that also pay floating-rate coupons indexed to 3-month LIBOR, i.e. there are no payment mismatches to hedge and consequently the transaction is not party to a derivative contract.

The second transaction issues euro liabilities that pay fixed-rate coupons, a significant mismatch that the transaction hedges by entering into a currency derivative. The derivative obligates the transaction and its bank counterparty to exchange euro par for sterling par at the outset, to re-exchange the two par amounts at maturity and to exchange 3-month sterling for a fixed euro payment each intervening quarter.

The second transaction pays amounts owed to its derivative counterparty from a very senior position in its waterfall. Failure to pay the 3-month sterling floating payment in any quarter or sterling par at maturity each constitute an event of default under the derivative contract with significant consequences for rated notes. Losses from the sterling-denominated assets do not lessen the obligation of the transaction to pay the derivative provider – they are passed on to the rated notes.

The second transaction depends mightily upon its bank counterparty to perform perfectly. Without each quarter's fixed euro payment, the transaction may not have sufficient funds to pay that quarter's bond coupon(s) due one or more classes of rated notes. Without the euro par amount at maturity, the transaction may be unable to re-pay one or more classes of rated notes. Seniority of the bank within the priority of payments brings event risk in the form of flip clause activation or protracted legal proceedings should the bank default

1. **Does a hedge contract protocol bring the second transaction in line with the first?**

MOODY'S *LINKAGE* COMMENT REQUEST

This 34-page section addresses components of the ***LINKAGE Comment Request*** in the order of their introduction and uses corresponding section headings and paragraph references.

The LINKAGE Comment Request is exceptionally complicated (which is telling on its own) but not comprehensive. The majority of structured finance swaps, such as all those with transactions governed by U.S. bankruptcy law and those that hedge currency risk, will be examined on a "case-by-case" basis rather than by reference to four **linkage** tables. (Page 13 lists 18 citations of swaps being assessed on a "case-by-case basis.")

The authors use inductive reasoning from the outset although they cloak it as empirical observation. Every step seems reasonable (if legalistic), but no step holds up either alone or en toto.

The LINKAGE Comment Request preserves ***de-linkage*** as the only possible starting point for assigning new ratings to structured finance transactions with derivative exposure. After all, structured finance swaps are *liquid*, downgraded or defaulted banks are *replaceable*, a transaction never pays a termination amount to a defaulted counterparty and "*flip clauses*" are irrelevant.

Where notes are self-evidently ***de-linked***, the impacts of event risk that may arise under a derivative contract are not modeled in assigning initial ratings. Moody's rates two capital structures identically if they mirror each other in all respects save that one transaction has entered into a derivative contract but deemed to be ***de-linked*** and the second transaction that may not enter into a derivative contract.

Credit enhancement, reserves and other transactions protections are sized to offset risks that are modeled holistically in assigning an initial rating; they are earmarked for purposes other than offsetting linkage deemed to spring upon a transaction when a bank counterparty is downgraded to **A3** or below.

The ***LINKAGE Comment Request*** gloms onto credit enhancement and other protections for purposes of absorbing losses that may arise from any number of features in a derivative contract. However, modeling results were based on treating each rated tranche as a stand-alone transaction rather than one of several tranches that is allocated cash via a transaction's priority of payments.

SUMMARY (Paragraphs 1-7)

The ***LINKAGE Comment Request*** proposes to model new issuances of structured finance notes more leniently than seasoned ones.

2. **Is modeling new issues of structured finance notes more leniently than seasoned issues consistent with Moody's best practice?**
   a. Do regulators encourage rating agencies in the practice of rating new issues leniently?
   b. Do investors appreciate buying new structured finance issues with embedded downgrade risk?

Paragraph 1

Moody's acknowledges that there is a "rating impact of ***linkage*** to swap counterparties in structured finance cashflow transactions" but proposes to ignore ***linkage*** and hence its "rating impact" at time of issuance. In effect, Moody's will kick the can down the road – no upfront evaluation of the impact of ***linkage*** on the rating of structured finance notes but maybe, belated evaluation of the impact of ***linkage*** at some later time, say when a counterparty is downgraded to **A2** or below. When a counterparty defaults, Moody's will **definitely** evaluate ***linkage***.

3. **Does Moody's track number of swaps with structured finance transactions for each bank counterparty?**
   a. How many structured finance transactions will be downgraded following the downgrade of their bank counterparty to below **A2**?
   b. What magnitude of structured finance downgrades will follow default of a bank counterparty?

4. **Does kicking the can down the road with respect to assessing the impact of *linkage* on structured finance ratings promote stability of the wider financial system?**
   a. Does the financial system benefit from widespread multi-notch downgrades of structured finance notes in the aftermath of default by a large bank?

Paragraph 2

Moody's avers that "transaction parties have chosen to include robust provisions that significantly mitigate counterparty credit risk," when in fact the "transaction parties" engage Moody's at every step; banks lobby Moody's incessantly for lenient provisions whereas transactions look to Moody's for guidance in how to ***de-link*** from bank counterparties.

Overall, the banks are winning - Moody's concedes that it has rated structured finance transactions as if they have implemented the existing Hedge Framework in all respects when in fact compliance has been spotty. To whit, "for transactions that **substantially comply** with the ***de-linkage framework***, the likelihood of becoming ***unhedged*** is generally so low that our analysis does not involve an assessment of the impact that may result from a loss of hedging," i.e. from ***linkage*** to default of a bank counterparty.

Non-compliance with Hedge Framework benefits bank counterparties and harms the correspondingly ***linked*** structured finance transactions. The ***LINKAGE Comment Request*** proposes to tip the imbalance further in favor of bank counterparties by diluting the real-world provisions of the Hedge Framework that benefit structured finance transactions. New issues of structured finance notes will be continue to be rated as if ***de-linked*** from bank counterparties despite having weaker protections than existing transactions and correspondingly higher probabilities of remaining ***linked*** to a bank default.

5. **Is a problem (banks are reneging on *de-linkage* obligations to structured finance transactions) best addressed by re-defining the problem (striking out existing *de-linkage criteria* that banks find objectionable) so that there are no more problems? (banks can't renege on *de-linkage obligations* that no longer exist)?**

The ***LINKAGE Comment Request*** clears the way for Moody's to green-light petitions from banks to unilaterally strip existing derivative contracts of provisions that benefit structured finance transactions. The green-lighting mechanism (Moody's issuance of a Rating Agency Condition Letter – RAC for shorthand) is used widely by structured finance issuers that seek to make changes to transactions without obtaining note-holder consent. Moody's issues RAC after having determined that a proposed action will not prompt an immediate downgrade of rated notes (RAC is silent regarding future downgrade risk.)

Changes implemented via RAC are sweeping – they typically impact ALL structured finance transactions that face the bank counterparty lobbying for RAC. *Footnote 3* (page 21) states that "Moody's itself is not a party to any swap agreement or other transaction document." However, Moody's has sole discretion to approve changes to swap agreement and other transaction documents via its decision to issue RAC. Bank counterparties will request RAC to retro-fit the diluted provisions of the ***LINKAGE Comment Request*** into existing derivative contracts.

Moody's takes a lax approach in determining whether to issue RAC – the determination is largely a tautological one. Moody's frames the problem – whether to issue RAC to a proposed action – by reference to a decision that is solely Moody's to make, i.e. whether to downgrade rated notes in response to implementation of the proposed action.

Step 4 Tables A-I: ***Linkage***-Adjusted Ratings (pages 6-14) contain three categories for each rating that are used internally by Moody's for monitoring purposes and for acceding to RAC requests. Each of the three categories ("+," "**neutral**," and "**-**") is released publicly as the same unified rating without modifier, granting Moody's considerable discretion in issuing RAC. For instance, a petition by a bank counterparty to dilute existing contractual provisions may be evaluated by Moody's as downgrading the internal rating of a structured finance note to **Aa1(sf)(-)** from **Aa1(sf)(+)**, leaving the public rating unchanged at **Aa1(sf)** and presenting no obstacle to issuing RAC.

The special report "Possible Solutions to Swap Triggers in Securitisations and Covered Bond Transactions" of February 27, 2012 describes Moody's issuance of RAC in response to a unilateral request by RBS to change contractual provisions for its portfolio of derivative contracts with structured finance transactions. "The swaps for which RBS implemented the solution provide that RBS may cure a trigger breach "in one of four ways including: "taking some other action, without the consent of other parties to the transaction that does not negatively impact the rating of the notes." "Other parties to the transaction" are the transactions that paid Moody's to consider RAC and had no say in the face of the RBS request; note holders relied entirely on Moody's to decide whether existing derivative contracts would be restructured in favor of RBS.

6. **Have the internal ratings of "+," "neutral" and "-" been approved by Moody's committee for symbols and ratings or are they merely a rough working tool for the structured finance group?**
   a. Does Moody's publish expected loss tables for the three internal sub-groups by each unified public rating?
   b. Does Moody's share the internal ratings (**"+," "neutral" and "-"**) with issuers,

investors, bank counterparties, underwriters or other third parties impacted by RAC?

7. **Who pays Moody's to consider a proposal to issue RAC?**

8. **Is the decision to issue RAC better described as an exercise in tautology or in sophistry?**

Paragraph 3

Substantially comply is defined to mean that *rating triggers* for posting collateral and for *replacement/guarantee* are omitted from derivative contracts between structured finance transactions and bank counterparties.

"We have observed a trend in which the *rating triggers* in swaps are becoming less consistent with the Hedge Framework." "Recent pressures on swap counterparties ratings," i.e. downgrades of swap counterparties, is the driving force of non-compliant *rating triggers*.

(Note the passive voice describing pro-active decisions by all parties to a structured finance transaction. Bank counterparties omit core elements of the Hedge Framework, i.e. *rating triggers,* from derivative contracts; underwriters, issuers and outside counsel do not insist on preserving *rating triggers* that protect the transaction ostensibly being represented; and Moody's cites ***de-linkage*** to bank counterparties in awarding **Aaa(sf)** to senior notes despite material ***linkage*** from the outset.

The ***issuer-pay*** model has been decried as incentivizing Moody's to award inappropriately high ratings. Here the issuer, i.e. the structured finance transaction, pays vendors such as Moody's, underwriters, deal counsel and outside auditors, all of whom promptly horse-trade away provision after provision that would have benefited rated notes. In structured finance, the arranger - such as a bank underwriter - is the paymaster who chooses vendors and the vendors act accordingly regardless of their responsibilities to the issuer, to note holders or to a rating itself. ***Underwriter-pays-with-issuer-money*** is, in fact, the model that incentivizes Moody's to award inappropriately high ratings to structured finance transactions with active participation of other vendors.)

"Possible Solutions to Swap Triggers in Securitisations and Covered Bond Transactions" echoes the point that bank counterparties are suddenly waking up to the costs of contractual obligations freely undertaken. "Given the negative outlook on all European banking sectors, European swap counterparties are increasingly focused on the consequences of rating downgrade provisions in their swap agreements."

9. **What are the "consequences of rating downgrade provisions" in derivative contracts with structured finance transactions.**
   a. Posting collateral?
   b. Incurring irreversible losses from effecting *replacement*?
   c. Paying ongoing fees to a *guarantor*?
   d. Hemorrhaging assets from estate of insolvent bank owing to activation of "flip clauses" and to structured finance transactions retaining over-collateralization amounts?

e. Other?

10. **Are Moody's bank analysts and bank regulators regularly apprised of the "consequences of rating downgrade provisions?"**
    a. What do bank analysts and regulators think of "flip clauses?"

11. **Are structured finance notes accruing losses from *linkage* to swap counterparties that are being downgraded en masse?**
    a. Are widespread downgrades of structured finance notes worldwide warranted?
    b. What does ***linkage*** mean if downgrades of bank counterparties are not associated with structured finance downgrades?

12. **Why does Moody's indulge swap counterparties that are just waking up to the "consequences of rating downgrade provisions" at the expense of structured finance that benefit from the same provisions?**
    a. Bank counterparties were well-educated on the consequences of rating downgrade provisions by Moody's task force of 2004-2006 and publication of Hedge Framework.
    b. Bank counterparties freely entered into swap agreement after swap agreement with structured finance transactions.
    c. For other entities about whom a. & b. may also be said, e.g. institutional investors in structured finance or individuals unable to meet mortgages, banks have argued that no relief should be granted.

Paragraph 4
The ***LINKAGE Comment Request*** acknowledges six "***linkage factors***" including "the extent of ***inconsistencies*** with the ***de-linkage framework***" that may result in downgrades of seasoned structured finance notes but that do not upset the presumption of ***de-linkage*** in assigning new ratings of **Aaa(sf)**.

13. **Is Moody's inviting non-compliance for purposes of assigning an initial rating?**

14. **Is expected failure of a bank to carry-out *de-linkage* obligations a seventh "*linkage factor*?"**

Footnote 4 states that "due to the European sovereign and banking sectors distress, many structured finance transactions are no longer able to achieve the highest ratings."

15. **Is contagion from distress of the sovereign or banking sectors an eighth "*linkage factor*?"**
    a. Is possible "distress in sovereign and banking sectors" contemplated in upfront modeling of structured finance notes that "achieve the highest ratings," or is it another can kicked down the road?

16. **Should regulators credit structured finance notes held by banks as capital available for a crisis?**
    a. A banking/sovereign crisis in countries currently rated **Aaa** and **Aa** might prompt

wide downgrades of structured finance notes owing both to general contagion and to springing ***linkage*** to downgraded or defaulted banks.

Paragraph 5
The ***LINKAGE Comment Request*** operates by reference to four ***"linkage tables"*** which together constitute 13 dimensions.

17. Common-sense-wise – isn't the complexity of the *linkage tables* themselves and of the *LINKAGE Comment Request* as a whole saying something?
a. Who other than the authors of the ***LINKAGE Comment Request*** and this contributor can follow the tortuous apologia for preserving the assumption of ***de-linkage*** when assigning initial ratings of **Aaa(sf)** to structured finance notes?
b. As an example, please see footnote 7 on page 15.
c. Do the proposed ***de-linkage criteria*** converge with string theory?

Oops, more dimensions are bubbling up! The four ***linkage tables*** will not be employed rigidly as they do not cover every possible combination of ***linkage factors*** (six, eight, more?) "For some transactions, <u>***case-by-case modeling or adjustments***</u> may be appropriate."

This is the first of many "case-by-cases" in the ***LINKAGE Comment Request***. In fact, the ***LINKAGE Comment Request*** contemplates that it will be disregarded in most instances in favor of "case-by-case modeling."

18. Following is partial list of circumstances to be addressed by "case-by-case modeling."
a. RAC clause that reduces the effectiveness of *rating triggers* <u>***may***</u> result in an adjustment to the probability of becoming ***unhedged*** (footnote 8 page 15.)
b. Dynamic *rating triggers* (footnote 10 page 15.)
c. Counterparty has unilateral right to "transfer its rights and obligations to another entity without requiring the issuer's consent at the relevant time (footnote 12 page 16.)
d. A *guarantee* that covers "monetary obligations only and does not cover performance obligations (such as posting collateral)" may result in "less credit given to *rating triggers*." (footnote 13 page 16.)
e. "If there is no flip clause or there is material uncertainty regarding the validity in the relevant jurisdiction" case-by-case assessment" of both collateral sufficiency in event of counterparty default and "additional liquidity risk (by reason of a potential senior ranking termination payment)" (footnote 14 page 16.)
<u>**N.B. All transaction governed by U.S. law are subject to this case-by-case exception.**</u>
f. Moody's "determine(s) the transaction loss for other basis swaps on a case-by-case basis (footnote 2 page 17.)
g. "If a transaction is hedge by swaps provided by different counterparties and swap ***linkage*** applies with respect to no more than one of them, the ***linkage tables*** do not apply and we assess the impact of ***linkage*** on a case-by-case basis" (footnote 6 page 17.)
h. "If a swap provides arrear coverage or guarantee excess spread," Moody's "may adjust the loss category upwards.
(i) Does Moody's deem these types of swaps to be ***liquid***?

i. "If any payments under a swap are denominated in a currency other than GBP, USD or EUR (footnote 9 page 18) or any GBP, USD or EUR currency swaps > 10 years.
N.B. Applies to JPY, AUD, CAD, CHF, DKr, Skr all Emerging Market currencies, etc.
j. "If the transaction loss relating to a swap…provided by a single counterparty exceeds 30% - for example where a currency swaps 100% of the asset pool (footnote 10 page 18)
N.B. Most currency swaps are for 100% of asset pools
k. USD and EUR interest rate swaps > 7 years; GBP interest rate swaps > 6 years; and all other swaps regardless of WAL
N.B. An awful lot of interest rate swaps
l. Credit enhancement > 40% (footnote 2 page 18)
m. "If a transaction benefits from an unusually high or low amount of excess spread" or "if a transaction has no credit enhancement and no excess spread," Moody's determines "the resulting rating impact on a case-by-case basis" (footnote 3 page 18.)
n. "Where a tranche has a WAL that is materially longer or shorter than this (80% of the asset pool WALs)…we may adjust the tranche loss up or down on a case-by-case basis" (footnote 4 page 18.)
o. "For transactions in which losses are allocated differently" (rather than "all in the same manner), Moody's will "determine the tranche loss on a case-by-case basis."
p. For tranche sizes that are *materially different* to these (80%, 20% and 5%) we may adjust the rating impact up or down *as appropriate* on a case-by-case basis
N.B. Most tranches worldwide will differ from the three sizes of 80%, 20% and 5% depending on standard for "materially different" that is "appropriate" for adjusting "rating impact up or down."
q. Swap ***linkage*** can materially increase the default probability of the notes – that is, the probability of an issuer failing to make timely payments to note holders – and therefore influence the rating of the notes to a greater extent than may be indicated by the Step 4 Tables. It is unclear if increased "default probability of the notes" will be examined on a case-by-case basis or ignored altogether.
N.B. All structured finance transactions worldwide that are party to a derivative contract incur *swap linkage* that materially increases *the default probability of notes.*
r. Where a bank counterparty is "neither rated investment grade nor wholly owned by an investment grade entity or the swap is very likely to remain OTM (out-of-the-money for the issuer throughout its remaining life), we will assess the risk of this risk (i. any cash that the issuer would otherwise have used to make swap payments flows down the waterfall and is lost to the transaction; ii. the defaulted counterparty eventually exercises its rights to unilaterally transfer the swap to another counterparty; thereby curing the default and causing the aggregate amount of unpaid notes to fall payable to the issuer to the new counterparty as a lump sum; and the issuer is unable to pay this lump sum in a timely manner, such that it becomes a defaulting party and may be required to make a senior termination payment) on a case-by-case basis" (footnote 24, page 21.)
N.B. I'll jumpstart this case-by-case analysis - the situation won't occur. A new counterparty won't agree to replace in the first place if it expects to turn around and declare an ATE for non-payment of unpaid amounts.
s. Speaking of "case-by-case modeling", the ***LINKAGE Comment Request*** continually

cloaks analytical considerations in legal standards such as "reasonable" and "material" to describe quantitative analysis. (Footnote 6 page 17 is one of many instances.)

19. **How can intelligible comments be offered if each *de-linkage criterion* is subject to over-rule in favor of "case-by-case modeling?**
    a. Is "case-by-case modeling" more lenient from the point of view of bank counterparties than rating by reference to the four *linkage tables*?
    b. Who at Moody's vets "case-by-case" modeling?

20. **Ditto repeated references in *LINKAGE Comment Request* to legal standards such as "reasonable" and "material" to describe quantitative analysis.**
    a. E.g. footnote 6 page 17.

21. **Does "case-by-case modeling" invite bank lobbying for lenient treatment?**
    a. Does "case-by-case modeling" bolster bank counterparties in gaming Moody's by insisting on most lenient treatment that they or other counterparties have received?

22. **What will be the impact of "case-by-case" analysis at time of counterparty downgrade and non-compliance, given that each "case" represents the many structured finance transaction counterparty to a single downgraded bank?**
    a. Will Moody's face pressure to go easy on structured finance downgrades for the good of the financial system?

23. **What <u>adjustments</u> are being considered?**
    a. Will adjustments be made on a case-by-case basis?

24. **How can intelligible comments be offered regarding Moody's future assessments of critical *de-linkage criteria*?**
    a. Counterparty position to post collateral (footnote 4, page 15 and footnote 6, page 18.)
    b. "The collateral amount – and, in particular, the mark-to-market component – is being calculated by it (the bank) in a reasonable and realistic manner" (footnote 5, page 15.)
    c. A "reasonable prospect of a swap being out-of-the-money (footnote 6, page 15.)
    d. General assumption "that if a counterparty defaults, it will be possible to find a suitable rated entity that is willing to provide a replacement swap" and where assumption "not appropriate," "Moody's gives no value to any rating *triggers* and the probability of becoming ***unhedged*** equals the rating of the counterparty" (footnote 9 page 15.)

To refresh – by Paragraph 5, Moody's has responded to widespread downgrades of bank counterparties by proposing to revise ***de-linkage criteria*** so as to make them more lenient to bank counterparties. The ***de-linkage criteria*** acknowledge six ***linkage factors*** which will be ignored in issuing new ratings owing to ***de-linkage*** but which might cause downgrades of seasoned ratings if deemed ***linked*** to a downgraded counterparty. Any caveats? Well, if the six ***linkage factors*** en toto constitute a special situation (such special situations representing the vast majority of structured finance ratings,) "case-by-case" analysis or **<u>adjustments</u>** may be warranted.

Umm, ok, let's keep going.

Paragraph 6
The ***LINKAGE Comment Request*** expects "to be rating-neutral for most structured finance transactions" despite unilaterally stripping transactions of beneficial contractual provisions, sometimes retroactively via RAC. However, in "some" instances downgrades of "one-to-three" notches will occur, particularly for transactions with "large exposures to relatively lowly rated counterparties." Why is the multi-notch rating impact of ***linkage*** to a relatively lowly rate counterparty not contemplated in assigning initial structured finance ratings? Are banking analysts prohibited from taking rating actions that result in banks being "relatively lowly rated counterparties?"

25. **What ratings constitute "relatively lowly rated" for a bank counterparty?**
    a. **Baa**?

26. **Why do any structured finance transactions have swap counterparties that are "relatively lowly rated?"**
    a. The Hedge Framework is intended to avoid exactly this situation via *replacement/guarantee* provisions.
    b. Why haven't the "relatively lowly rated" bank counterparties *replaced* themselves or *obtained* guarantees?

27. **Will Moody's address swap risk in structured finance in a binary fashion – deem swap risk as *de-linked* for purposes of assigning new ratings of Aaa(sf) then cite *linkage* in downgrading seasoned notes by one-to-three notches?**
    a. Do three-notch downgrades concern the structured finance group?
    b. Do fundamental analysts discount structured finance ratings given their propensity for multi-notch downgrades?
    c. Should holders of structured finance notes be concerned by overnight risk of moving from ***de-linkage*** with no rating impact to ***linkage*** and rating downgrades of one-to-three-notches?

SWAP LINKAGE (Paragraphs 8-10)
Inconsistencies abound! Non-compliance with the ***de-linkage framework*** from the outset means that a structured finance transaction is ***linked*** to a counterparty from the get-go but ***de-linked*** for purposes of assigning an initial rating. On the other hand, full compliance with the ***de-linkage criteria*** is no guarantee of ongoing ***de-linkage*** for a structured finance transaction after receiving an initial rating. After all, the world is an uncertain place.

Paragraph 8
Moody's justifies its assumption of ***de-linkage*** for modeling new transactions even in some cases where the "swap does not substantially comply with the ***de-linkage framework***." In some cases, "the potential impact of being unhedged may be so small that ***linkage*** has no effect on the note ratings" – this is unlikely to be the case across an entire capital structured of rated notes. The buck, i.e. absorbing the losses that follow from being ***linked*** to a bank counterparty, stops

somewhere and should be considered in upfront modeling of structured finance notes.

In other cases, Moody's recognizes that the "the potential impact of being unhedged is material" but states that this may be ignored in rating a new transaction if "the counterparty is sufficiently highly rated." AIG was rated "**Aaa**" for a long period and obtained dispensations from complying with predecessors to the Hedge Framework.

28. **May a structured finance transaction with no ability to enter into a derivative hedge sell credit protection on a Aaa-rated reference entity with no rating impact for senior notes rated Aaa(sf)?**

Paragraph 9
Moody's warns that even full "compliance with the ***de-linkage framework*** at closing does not ensure that ***de-linkage*** will persist throughout the life of a transaction," although Moody's will assume persistent ***de-linkage*** in assigning new ratings of **Aaa(sf)**.

Paragraph 10
"Compliance with the ***de-linkage framework*** does not guarantee that the rating of the notes will not be affected by counterparty exposure. Although the ***de-linkage protections*** are strong, they are not bullet-proof."

In fact, the ***de-linkage protections*** of the existing Hedge Framework are bullet-ridden. "Counterparties do not always promptly *transfer* swaps (or obtain *guarantees*)" despite being contractually obligated to do so. Structured finance transactions may have difficulty finding *replacement* counterparties if upon waking up one day they find that their existing counterparty has defaulted, "thereby decreasing the likelihood that the collateral posted by the defaulted counterparty will be sufficient to pay for *replacement*."

The material probability that a structured finance transaction might become partially or fully ***unhedged*** invalidates the base assumption of the Hedge Framework, i.e. that a bank counterparty that is downgraded below a *transfer trigger* either will *replace/guarantee* 100% of its swaps with structured transactions or, alternatively, will never default.

29. **Why do rating agencies, underwriters and deal counsel continue to pretend that flip clauses are enforceable under U.S. bankruptcy law?**
    a. Does continued inclusion of flip clauses mislead investors?
    b. How does the inclusion of flip clauses promote transparency in the rating of structured products?
    c. Why do the rating agencies not take issue with each other's protocols in this regard?
30. **What is the systemic impact of all transactions to one insolvent bank counterparty making senior terminations and all transactions governed by same bankruptcy regime each being downgraded by several notches?**

RATING IMPACT OF SWAP LINKAGE (Paragraph 11 to end)
The ***Linkage Comment Request*** mentions that "conforming changes" will be incorporated into

the Hedge Framework. How expansive will the "conforming changes" be? Will collateral amounts or collateral types change?

How will Moody's assess at the time of counterparty default whether each affected structured finance transaction has "sufficient collateral?" Will this assessment be one-time only or an ongoing one for as long as transactions face the defaulted counterparty in question? Does Moody's assume that only one counterparty will be in default at any one time, or might multiple counterparties default in quick succession?

What remedy (other than downgrade) exists for structured finance transactions that are deemed to have insufficient collateral? Typically, do bankruptcy judges allow defaulted counterparties to top-up collateral where existing collateral is deemed to be insufficient by Moody's? How will Moody's assess the ratings of ***partially unhedged*** transactions, i.e. those with collateral proceeds that will pay for a partial swap but not a full one? Does facing a defaulted counterparty make life easier for a structured finance transaction? Do legal uncertainties and practical difficulties impact the resources of a transaction or its operations, e.g. the priority of payments? Might collateral be sufficient but inaccessible or sufficient with respect to the date a counterparty entered default but insufficient when an eligible bank agrees to *replace* the defaulted counterparty?

Why does Moody's wait until time of counterparty default to assess the rating impact for structured finance transactions that are partially or fully ***unhedged*** owing to collateral insufficiency or to some other reason? Does Moody's expect that counterparty default will be a rare event and that collateral insufficiency will be an even rarer event? Does Moody's believe that a bank rated below **A2**, i.e. **A3** or **Baa1** might not be downgraded to **Baa2** and then default before collateral is posted to a transaction? (Bank counterparties have at least 30 days to post collateral after being downgraded below a *collateral trigger*.)

More generally, is it best practice in assigning **Aaa(sf)** and **Aa(sf)** ratings to new structured finance issues for Moody's to defer rating adjustments until they cannot be ignored or at least until some future point when the transaction is seasoned, e.g. downgrade of a counterparty to below **A2**? Does Moody's take an equally relaxed approach to other components of assigning new ratings such as developing recovery assumptions for defaulted assets? (After all, some assets might never default.) How robust must underlying assumptions to be for Moody's to model a new transaction as incurring no losses from a major component such as an overarching derivative contract with a bank counterparty rated **A** or below?

Step 1. Probability of a Structured Finance Transaction Incurring Adverse Event(s) Attributable to *LINKAGE* to a Bank Counterparty (Determine for Each Transaction Worldwide)

A structured finance transaction that is party to a derivative contract is exposed to risk from events that are ***linked*** to credit deterioration of the corresponding bank counterparty. The wider financial system is ***linked*** to credit deterioration of a bank that is counterparty to many transactions that will be impacted simultaneously by the same adverse event(s).

A bank counterparty that implements the "***de-linkage criteria"*** (the Hedge Framework, the ***LINKAGE Comment Request*** or analogous protocols) in its derivative contract with a structured finance transaction agrees to perform costly obligations that benefit the transaction (albeit not so completely as to remove ***linkage***.)

The ***linkage*** of the wider financial system to the nexus of derivative risk between structured finance transactions and bank counterparties is magnified with each new transaction that enters into a derivative contract. Generic risk arising from ***linkage*** may morph into idiosyncratic risk that is highly concentrated within sectors of structured finance; individual bank counterparties; investor bases; currency markets into which swaps are being transacted; or domiciles governed by certain types of bankruptcy provisions.

The ***LINKAGE Comment Request*** ignores event risk in assigning new ratings to structured finance notes – the universal starting point is complete ***de-linkage*** of newly-rated notes from a bank counterparty.

Event risk associated with ***linkage*** of a structured finance transaction to a bank counterparty should be assessed for new ratings and for existing ones alike. ***De-linkage*** is best consigned to the category of structured finance constructs that have been repudiated by real world events – a category that is already teeming with RMBS, SIV, CDO brethren of the ***LINKAGE Comment Request.***

The ***LINKAGE Comment Request*** is silent on the implications for the wider financial system, where many structured finance transactions may be impacted simultaneously by the same adverse event(s) that arise from ***linkage*** to one bank counterparty.

The ***LINKAGE Comment Request*** is silent on the costs for a bank counterparty that discharges its obligations as specified in the ***de-linkage criteria.***

The ***LINKAGE Comment Request*** is silent on methods to aggregate data regarding ongoing implementation of ***de-linkage criteria.***

The ***LINKAGE Comment Request*** acknowledges a sole event that may ***link*** a structured finance transaction to its bank counterparty – that of suddenly becoming ***unhedged*** - but defers assessment of being ***unhedged*** until such time as ***de-linkage*** is no longer defensible.

Being ***unhedged*** (whether partially or fully) is bad for a structured finance transaction and, when the case for most/all transactions that are counterparty, i.e. ***linked***, to the same defaulted bank, bad for the financial system. Please see Step 1(A).

Paying a senior termination amount to a defaulted bank counterparty is bad for a structured finance transaction and, when the case for all transactions governed by the same bankruptcy law, bad for the financial system. Please see Step 1(B).

Incurring losses from other adverse events that are ***linked*** to the credit deterioration of a bank counterparty is bad for a structured finance transaction and, when the case for all transactions similarly affected, bad for the financial system. Please see Step 1(C).

The contractual provisions of ***de-linkage criteria*** store up significant costs and losses for bank counterparties. Moody's should apprise both its bank analysts and regulatory bodies on an ongoing basis of the ***de-linkage*** costs and losses for each bank that is counterparty to a structured finance transaction. Please see proposed Steps 1(D), (E) & (F).

Aggregate implementation of ***de-linkage criteria*** may magnify impacts of ***linkage*** by sector of structured finance, by individual bank counterparty, or by investor base, and introduce new risks apparent only from scrutiny of implementation worldwide. Please see proposed Step 1(G).

Below applies for each transaction with ability to enter into derivative contract (whether party to one or not at time of analysis), i.e. analysis of ***linkage*** begins with initial rating.

Step 1(A). Probability of a Structured Finance Transaction Becoming Partially or Fully Unhedged (Determine for Each Transaction Worldwide that is Counterparty to the Same Bank)

The probability of a transaction becoming partially or fully ***unhedged*** is foremost a function of the market to *replace* a credit-impaired bank as counterparty to a transaction or to *guarantee* the bank's obligations vis-à-vis the transaction. Absent a market to *replace/guarantee*, each transaction that is counterparty to a defaulted bank – even counterparties that hold collateral - will be partially to fully ***unhedged***.

Replacement is a rating agency construct with no analog in other swap markets. *Guarantee* is used widely throughout finance but the limited provisions of a guarantee typically omit much of the ***de-linkage criteria*** and leave a structured finance transaction ***linked*** to a downgraded bank counterparty.

Robust *replacement/guarantee* provisions, including *transfer triggers*, cannot accomplish ***de-linkage*** in the absence of suitably-rated banks bid to *replace* downgraded counterparties or to *guarantee* them. A bank that is rated above a *transfer trigger* is eligible to *replace/guarantee* but is unlikely to do so unless rated above a corresponding *collateral trigger* as well; otherwise collateral may be required from the outset of *replacement/guarantee*.

Sector downgrades leave fewer banks rated at or above *collateral triggers,* i.e. commercially interested in providing *replacement/guarantees*, and increase the number of banks rated below *transfer triggers,* i.e. seeking replacement/guarantee. *Replacement/guarantee* is a bidder's market for banks that remain rated at or above *collateral triggers* – they have leverage to price aggressively that part of a downgraded bank's portfolio that is compelling and to pass on the rest.

Swaps with structured finance transactions that are governed by bankruptcy law that upholds "flip clauses" may be an anathema to banks eligible to *replace/guarantee* a downgraded bank given the potential loss of un-netted mark-to-mark asset.

A downgraded bank counterparty is confronted with many challenges that may take precedence over replacing swaps with its structured finance transactions. On its own, a *transfer trigger* maybe so low that the bank counterparty is fatally impaired and can barely stay afloat, let alone *replace/guarantee* its swaps with structured finance transactions.

Per Moody's testimony and submissions to the U.S. House Financial Services Sub-Committee on Investigations regarding MF Global (MF Global 2), ratings are relative, not absolute. While investment grade, a **Baa** financial institution has a non-trivial risk of default. **Baa** transfer triggers may greatly reduce likelihood of *replacement/guarantee*.

Even under favorable conditions, a bank that is rated below a *transfer trigger* will incur an irreversible loss for each swap that it *replaces/guarantees* and will remain counterparty to swaps that it cannot *replace/guarantee*. The prospect of incurring irreversible losses may induce a downgraded bank to defer *replacement/guarantee*, particularly for those structured finance transactions that are governed by bankruptcy law unlikely to uphold "*flip clauses*."

A derivative contract specifies the legal standard of effort that a bank counterparty must use to *replace/guarantee* a swap with a structured finance transaction. (A bank typically has a grace period of at least 30 calendar days following downgrade below a *transfer trigger* before the standard of effort is applicable.) A derivative contract also specifies remedies available to a transaction whose bank counterparty does not expend the specified effort to *replace/guarantee*.

"Best efforts" obligate a bank to work tirelessly to effect *replacement* or obtain a *guarantee,* regardless of cost to do so. Should a downgraded bank balk at *replacing/guaranteeing* owing to unfavorable pricing from an eligible bank or banks, a structured finance transaction may declare a termination event that obligates the downgraded bank to effect *replacement* or obtain a *guarantee* immediately.

31. **Will "conforming changes" to Moody's *de-linkage criteria* preserve the Amended Termination Event?**
    a. Amended Termination Event obligates a bank counterparty rated below *transfer trigger* to accept live bid from eligible replacement counterparty regardless of how "commercially unreasonable."
    b. Amended Termination Event was critical element of Hedge Framework that was developed by Moody's task force to maximize instances of *replacement* occurring, i.e. fully ***de-link*** structured finance notes from bank counterparty.
    (i) Amended Termination Event was used in conjunction with obligation of bank counterparty to use "best efforts" to obtain *replacement/guarantee*.

"Reasonable efforts" is a much more relaxed standard: a bank may need only check market conditions perfunctorily and is not obligated to *replace/guarantee* under market conditions deemed "unreasonable," i.e. too expensive. Remedies for a structured finance transaction are typically limited to circumstances where three-to-five eligible banks are willing to bid to replace/guarantee and bids considered "commercially reasonable."

Replacement/guarantee bids are unlikely to be "commercially reasonable" under any circumstances; each structured finance transaction presents highly idiosyncratic risk to a *replacement* counterparty or *guarantor* as well as the obligation to implement costly ***de-linkage criteria.***

Moody's misinforms in press releases and methodologies that arranging *replacement* or obtaining a *guarantee* will be frictionless and costless from the point of view of both a structured finance transaction and a bank counterparty.

Moreover, Moody's does not believe its own PR. The ***LINKAGE Comment Request*** makes provision for cases where Moody's does "not expect a *transfer* (or *guarantee*) to be effected within a reasonable time following *trigger breach*. (Footnote 15, Grid Category C. Transfer Trigger (note 3), page 16.)

Under perfect circumstances, obtaining *replacement/guarantee* for 100% of the swaps with structured finance transaction in the portfolio of a downgrade bank is not achievable. In every day circumstances, i.e. those currently, obtaining *replacement/guarantee* for even a few transactions is proving impossible. ***Linkage*** must be the starting point in rating both new issues and existing ones.

Holding collateral will help a structured finance transaction re-hedge following default of a bank counterparty. However, default of a major bank is likely to be accompanied by stressed market conditions in which some eligible banks withdraw from the *replacement* market and remaining banks charge more to *replace*. In these circumstances, some structured finance transactions may re-hedge only partially and others not at all.

With banks flouting contractual obligations to *replace/guarantee* and lobbying for the unilateral ability to weaken provisions of ***de-linkage criteria,*** structured finance transactions are being stripped of protections that benefit rated notes. Rather than acknowledge the deficiencies of the existing ***de-linkage criteria*** by downgrading notes and introducing more stringent criteria, the ***LINKAGE Comment Request*** clears the way for banks to ratchet up ***linkage*** and for Moody's to continue awarding inflated ratings.

S&P and Fitch are doing the same. DBRS and Kroll have yet to be heard from.

Step 1. Probability of a Structured Finance Transaction from Incurring Adverse Event(s) Attributable to *LINKAGE* to a Bank Counterparty (Determine for Each Transaction Worldwide)

The Step 1 Table should be broken into Step 1 Tables (A)-(G) to reflect the range of event risks that a structured finance transaction may incur from ***linkage*** to a bank counterparty in addition to that of becoming ***unhedged***.

Step 1(A). Probability of a Structured Finance Transaction from Becoming Fully or Partially *Unhedged* (Determine for Each Transaction that is Counterparty to the Same Bank)

The probability of a transaction becoming partially or fully ***unhedged*** is foremost a function of whether a bank will *replace/guarantee* its obligations upon being downgraded below a *transfer trigger* and secondly a function of how fully a transaction with collateral can ***re-hedge*** on default of its counterparty.

"Where *replacement* cannot be assumed to occur following a counterparty default, probability of being ***unhedged*** equals that of rating of bank counterparty" (footnote 9 page 15.)

Replacement cannot be ***assumed*** to occur. Following are factors that might facilitate *replacement* in certain instances; i.e. lower the probability of being partially to fully ***unhedged*** to better than that of the "rating of bank counterparty."

1. Profit drives decision of a suitably rated bank to *replace/guarantee* a swap with a downgraded bank.
   a. Profit = *Replacement price – Replacement cost*
   (i) Replacement counterparty will book profit whether mark-to-market of swap is an asset or a liability.
   b. *Replacement price* is offered to downgrade counterparty or transaction with collateral
   (i) *Replacement* counterparty has great leverage in setting *replacement* price
   (ii) Leverage inverse with number of eligible counterparties also offering to *replace*
   c. *Replacement cost* is a function of:
   (i) *Replacement* bank's cost of funds
   (ii) Own credit rating
   (iii) Capacity to book more swaps
   (iv) Potential exposure of swap
   w. notional
   x. swap type, e.g. interest-rate swap, balance-guaranteed swap, cross-currency esoteric index, etc.
   y. maturity
   z. credit support to transaction characterized as swap, e.g. swaps that "provide arrears coverage or guaranteed excess spread" (footnote 8 page 18.)
   (v) Credit exposure to structured finance transaction
   w. structured finance sector
   x. governing law, e.g. "flip clause" enforceable is a credit negative
   y. note ratings/internal credit metrics
   z. repayment of "loan" if swap deeply "in-the-money" to *replacement* counterparty
   (vi) Cost of obligations to transaction under ***de-linkage criteria***
   w. obligations to post collateral and *replace/guarantee*
2. Profit to *replacement* bank = loss to swap desk of solvent counterparty being ***replaced***
   a. Swap desk of downgraded bank willing to accept irreversible losses from arranging replacement/guarantee?
   b. Lower *transfer trigger* allows swap desk to defer *replacement* until too late to do so?
   c. Moody's determination that a "relevant remedial action is not likely to be successfully performed following *trigger* breach" (footnote 3 page 15.)
   d. ***LINKAGE Comment Request*** incentivizes counterparty NOT to *replace*.
   (i) One-notch rating uplift from bank rating where "reasonable prospect of a swap being out-of-the-money (footnote 6 page 15)" decreases onus to *replace*?
3. Non-compliant ***de-linkage criteria*** don't obligate downgraded bank to *replace/guarantee*?
   a. The presence of a RAC clause that can reduce the effectiveness of *rating triggers* and

may result in an adjustment to the probability of being unhedged (footnote 8 page 15.)

b. A bank counterparty may "unilaterally transfer its rights and obligations to another entity without requiring issuer's consent at the relevant time." Risk of becoming *unhedged* may be greater than that of bank counterparty (footnote 12 page 16.)

c. "reasonable efforts" to replace rather than "best efforts."

d. transaction remedy = ISDA standard re: specified number of bids that are "commercially reasonable" rather than Hedge Framework Amended Termination Event & one "live" bid.

4. Stronger provisions
5. Profit to *replacement* bank less concern of estate of defaulted bank seeking to maximize recoveries?
6. Profit to *replacement* bank = partially ***unhedged*** transaction as collateral insufficient to fully *re-hedge*.
7. Post-*replacement* probability of transaction becoming partially or fully ***unhedged***.

   a. Post-*replacement* probability of being ***unhedged***.

   (i) *Replacement* counterparty does not implement ***"de-linkage criteria,"*** e.g. a transaction is fully ***linked*** to new counterparty.
8. Preference of swap desk of downgraded-but-still-solvent bank to obtain *guarantee?* (Having a swap *guaranteed* exposes structured finance transaction to higher probability of being ***unhedged*** than having the swap *replaced.*)

   a. Probability of being ***unhedged*** greater post-*guarantee* than post-*replacement* (footnote 13 page 16.)

   (i) *Guarantor* able to void guarantee if downgraded counterparty defaults and stops paying premiums – transaction remains ***linked*** to default risk of original counterparty.

   (ii) *Guarantee* does not cover performance obligations such as posting collateral - transaction remains ***linked*** to default risk of original counterparty.

   (iii) Credit risk of *guarantor*.
9. Collateral held by transaction where mark-to-market plus over-collateralization amount is an asset.

   a. Bank counterparty may not post collateral when require, per "Moody's assessment that a "counterparty is in a position to post when required" at some future date (footnote 4 page 15.)"
10. Multi-notch downgrades of banks exacerbates all of above in increasing probability of a transaction becoming ***unhedged***.

Step 1(B). Probability of a Structured Finance Transaction Paying a Senior Termination Amount (Determine for Each Transaction Domiciled in the Same Bankruptcy Regime)

1. Expand the three CIR designations of ***linkage*** ("High," "Medium" and "Low" depending on "flip clause" enforceability) into at least five categories.

   a. *"flip clause"* enforceable with **Aaa(sf)+++** probability

   b. *"flip clause"* enforceable with **A1(sf)------** probability

   c. *"flip clause"* probability of enforceability/repudiation = 50%

   d. *"flip clause"* repudiated with **A(sf)-----** probability

   e. *"flip clause"* repudiated with **Aaa(sf)+++** probability

Ultimately, however *"flip clause"* enforceability is binary and will be determined after a bank counterparty has defaulted. Upfront mis-estimates will result in rating adjustments to structured finance notes ***linked*** to the defaulted counterparty.

Step 1(C). Probability of a Structured Finance Transaction Incurring Other Event Risk(s) Attributable to *LINKAGE* to a Bank Counterparty (Determine for Each Transaction Worldwide)

Following Event Risks arise from ***linkage*** of a structured finance transaction to a bank counterparty but are ignored by Moody's in assigning an initial rating. Moreover, the ***LINKAGE Comment Request*** does address modeling treatment of event risk for seasoned notes linked to overarching derivative contracts with bank counterparties.

Each event risk is likely to be incurred by all structured finance transactions that are linked to the same bank counterparty.

1. ***Default of rated notes*** arising from failure of bank counterparty to pay scheduled swap payment.
   a. "*Swap **linkage** can materially increase the default probability of the notes* – that is the likelihood of an issuer failing to make timely payment to noteholders – and therefore influence the ratings of the notes to a greater extent than may be indicated by the Step 4 Tables" (footnote 4, page 19.)
   b. The influence of missed payments will be assessed only after they occur, i.e. after a transaction has incurred significant event risk.
2. ***Issuer Event of Default*** follows from default of rated notes
   a. Remedies for Issuer EoD vary by transaction.
   (i) Issuer may be directed to liquidate assets & re-pay notes and other obligors as specified by priority of payments. (Liquidation may follow automatically from Issuer default or may occur at direction of senior obligors such as noteholders.)
   (ii) Other remedies?
   b. The influence of liquidation or other remedies that follow an Issuer EoD will be assessed only after they occur, i.e. after a transaction has incurred significant event risk.
   N.B. Structured finance transaction typically have many Issuer EoDs that are omitted from rating new notes and monitoring existing ones – ignoring those attributable to ***linkage*** are part of a larger tendency that allows for ongoing rating inflation.
3. ***Moody's determination that a "relevant remedial action is not likely to be successfully performed following trigger breach" (*****footnote 3 page 15.)**
   a. Open-ended. Derivative contracts between structured finance transactions and bank counterparties and specify an array of obligations and remedies.
4. ***Legal and Operation Risk from Linkage to a Defaulted Bank***
   a. Dispute with estate of bankrupt counterparty regarding "mark-to-market" value of swap for purposes of determining a termination amount.
   b. Extended risk of litigation and uncertainty.
   (i) Lehman case is approaching the 4 year-point.
   c. Insufficiency of *replacement* payment (i.e. "market value component of termination amount" prompts estate of defaulted banks to look to structured finance transaction to make-up difference.
   (i) Prompted by mass losses with respect to all structured finance transactions

counterparty to defaulted bank.

(ii) Transaction is a distressed seeker of *replacement* – Metavante clock ticking – is indifferent to the loss incurred by defaulted bank when being *replaced*.

(iii) Metavante a corporation (i.e. not a structured finance transaction) and still had trouble with *replacement*.

5. ***Next Event Risk -***

Step 1(D). Probability That a Bank Counterparty Will Post Collateral Under Derivative Contracts with Structured Finance Transactions (Determine for Each Bank Counterparty and Report to Fundamental Analysts and Regulatory Bodies)

1. Probability of downgrade below *collateral trigger*.
2. Likelihood that bank counterparty will effect *replacement* or obtain a *guarantee* when rated below a *collateral trigger* and at or above a *transfer trigger*, i.e. not obligated to *replace/guarantee*.

   a. Very low probability.

   (i) Assume 100% probability of bank posting collateral for duration of rating below *collateral trigger* and at or above *transfer trigger*.
3. Likelihood that bank counterparty will effect *replacemen*t or obtain a *guarantee* when rated below a *transfer trigger*.

   a. Low probability - see Step 1(A) above.

   (i) Assume 80% of bank posting collateral for duration of derivative contract with transaction when rated at or below trigger.

   (ii) Swaps with highest mark-to-market liabilities/potential exposure most appealing to *replace/guarantee*?

   (iii) Swaps with highest mark-to-market liability/potential exposure least appealing to *replacement* counterparties/more expensive to *guarantee*?
4. Moody's assessment that counterparty is in "a position to post collateral" (footnote 4, page 15 and footnote 6, page 18.)

   a. Bad news all around for bank counterparty assessed as ***NOT*** to be in "a position to post collateral?"

   b. How does fundamental group view a bank counterparty that it has assessed as ***NOT*** to be in "a position to post collateral?"

   (i) More downgrades?
5. Moody's determination that a "relevant remedial action is not likely to be successfully performed following *trigger* breach" (footnote 3 page 15.)

   a. Do Moody's fundamental analysts and structured finance analysts get together and decide to give a bank counterparty a free pass to ignore obligations to take remedial action following *trigger* breach?

   b. Bank lets transactions declare ATE and pays transaction generic mark-to-market rather than absorb financing costs of posting collateral or losses from *replacement*?

   (i) Moody's good with this?

Step 1(E). Probability that Each Bank Counterparty Will Arrange *Replacement/Guarantee* for All Swaps with Structured Finance Transactions (Determine for Each Bank Counterparty and Report to Fundamental Analysts and Regulatory Bodies)

1. Bad news is *that replacement/guarantee* is expensive for bank to effect.

2. Good news is that *replacement* isn't happening at all, so no losses at least for downgraded but performing banks.
3. Estate of defaulted bank more likely to accept losses from obtaining replacement as more interested in maximizing recovery and less concerned with losses compared to mark-to-market?

Step 1(F). Probability of a Structured Finance Transaction Paying a *__Subordinated__* Termination Amount (Determine for Each Transaction Domiciled in the Same Bankruptcy Regime and Report to Fundamental Analysts and Regulatory Bodies)

1. Probability determined in conjunction with Step 1(B) probability and 1(E)?
2. Probability of "Flip clause" enforceability
   a. *"flip clause"* enforceable with **Aaa(sf)+++** probability
   b. *"flip clause"* enforceable with **A1(sf)** probability
   c. *"flip clause"* probability of enforceability/repudiation = 50%
   d. *"flip clause"* repudiated with **A(sf)-** probability
   e. *"flip clause"* repudiated with **Aaa(sf)+++** probability
3. Ultimately, *"flip clause"* enforceability is binary, i.e. enforceable or not.

Step 1(G). Compile Aggregate Data Regarding Implementation of *"De-Linkage Criteria"* Worldwide (Report to Fundamental Analysts and Regulatory Bodies)

1. Structured finance transactions party to derivative contracts with bank counterparties
   a. Sectors of structured finance
      (i) proportion of sector with derivative contracts
      (ii) most used indices in derivative contracts
      (iii) number of counterparties
   b. Aggregate par of rated notes
      (i) initial rating
      (ii) current rating
      (iii) downgrade attributable to ***linkage***
2. For each bank counterparty to structured finance transactions
   a. Number of derivative contracts
      (i) number of transaction counterparties
      (ii) notches between bank rating and rating triggers
         w. collateral triggers
         x. replacement/guarantee triggers
         y. Assessment of ability of bank to honor obligations tripped by rating triggers.
         z. Assessment of willingness of bank to honor obligations tripped by rating triggers, i.e. determine that a "relevant remedial action is not likely to be successfully performed following trigger breach," footnote 3 page15.
3. Bankruptcy law governing derivative contracts between structured finance transactions and bank counterparties.
   a. *"flip clause"* enforceable with **Aaa(sf)+** probability
   b. *"flip clause"* enforceable with **A1(sf)** probability
   c. *"flip clause"* probability of enforceability/repudiation = 50%
   d. *"flip clause"* repudiated with **A(sf)-** probability
   e. *"flip clause"* repudiated with **Aaa(sf)+++** probability

4. Indexes cited in derivative contracts between structured finance transactions and bank counterparties.

Appendix - Guidance Notes on Becoming Unhedged: Step 1 Table
Throughout this Appendix, Moody's makes reference to its "general assumptions" that allow it to assume ***de-linkage*** in rating new deals but which may obligate it to assume **linkage** at a later date when deals are seasoned. What is the confidence level associated with the "general assumptions?" Should the "general assumptions" be reviewed?

32. Are "general assumptions" consistent with Aaa(sf)++++ assumptions of *de-linkage* for rating new issues?
a. Will the "general assumptions" hold up in stressed markets likely to accompany default by a large bank?

Numbers refer to those in the referenced appendix (***LINKAGE Comment Request***, pps 15-16)

1. **a. *Has the implied rating for "probability of becoming unhedged" via "notching uplift" been cleared by Moody's committee on ratings and symbols or are the implied ratings a rough working tool for the structured finance group?***
   b. "Notching uplift" is not unitary but varies on several factors such as ability to *replace/guarantee* which varies by bankruptcy regime, by type of derivative contract by existing portfolio of swaps with structured finance transaction for each counterparty and by mark-to-market of each swap, among others.
   c. At what rating do "notching uplifts" become zero, i.e. the probability of being ***unhedged*** = that of the bank counterparty?
   (i) Baa, given that financial institutions face cliff risk per Moody's submissions and testimony to House Financial Services Committee in MF Global 2 hearings?
   (ii) Depends also on mark-to-market & bankruptcy domicile, i.e. incentives for bank counterparty to retain ***linkage*** (rather than *replace/guarantee*) after downgrades?
   (iii) Ca, no point in worrying about problems that might never happen?
2. Pass.
3. a. No replacement uplift where "flip clause" repudiated but uplift for collateral?
   b. Why does Moody's treat *collateral triggers* of **Baa1** and **Baa2** interchangeably, i.e. either contributes one notch uplift? Isn't **Baa1** *collateral trigger* (i.e. downgrade to **Baa2** or below) much better particularly given cliff risk facing all financial institutions? Won't all bank counterparties insist on **Baa2** and structured finance transactions be forced to go along? Will Moody's issue RAC for existing transaction to have their *collateral triggers* lowered to **Baa2** (i.e. **Baa3** or below)?
   c. How does Moody's determine that a "relevant remedial action is not likely to be successfully performed following trigger breach" and hence does not constitute ***de-linkage***? Is the determination made at time of initial rating or saved for some later date?
4. Continuing on 3.b. immediately above, why do uplifts of 1-notch uplift grow to 2 for **Baa1** or **Baa2** *collateral triggers* once breached?
   a. Romanettes follow footnote
   (i) Is a counterparty fulfilling a contractual obligation, i.e. posting collateral, a surprising event? If Moody's doesn't expect a counterparty to honor its CSA and believes that a structured finance transaction won't insist that the counterparty honor its ability to

post, shouldn't uplift be zero notches?

(ii) How does Moody's assess that a "counterparty is in a position to post when required?" Does Moody's publish lists of counterparties that are not in a position to post when required? Do the structured finance group and the banking group collaborate in determining the "position" of counterparties vis-à-vis their obligations to post collateral?

(iii) Ditto b but even more far-fetched. Assessment by Moody's that "counterparty is in a position to post" is not contemporaneous at time of assessment but with respect to some future date, i.e. "when required" and for unknown amount.

b. ***How can a commentator assess impact of Moody's future assessment of counterparty position to post collateral at a still-more future date?***

5. Moody's is not a party to a bi-lateral derivative contract between a structured finance transaction and a bank counterparty.

   a. Which party provides information to Moody's so that it may to judge whether collateral amounts are calculated in "reasonable and realistic manner?"

   b. How does Moody's evaluate upfront the ability of a transaction to enforce its rights to have a proper custodian for its collateral and for the bank counterparty mark-to-market is swap in a "reasonable and realistic?" Shouldn't doubts on this score be considered in upfront rating?

   c. How will Moody's determine that the mark-to-markets for each swap with a downgrade bank counterparty are being "calculated in a reasonable and realistic manner?" Does Moody's have a mark-to-market evaluation team?

   d. Is "reasonable" a legal concept or a stringent modeling one?

   e. Is "reasonable and realistic" consistent with Moody's upfront assumption of ***de-linkage*** with bank counterparty?

   f. If Moody's reviews are periodic, might the counterparty know this and rig its mark-to-markets for the day of review?

   g. Are bank mark-to-market teams comprised of personnel similar to those who rigged LIBOR?

   h. Is "two notch" adjustment to probability of being ***unhedged*** at time that deficiency becomes apparent a little late? Won't all transactions with deficient counterparty be affected, i.e. all experience two-notch downgrades out of the blue? What is systemic impact of Moody's suddenly downgrading by two notches all transactions with a certain counterparty that itself has been downgraded by at least a notch, i.e. hit a *collateral trigger.*

   i. How defensible is upfront assessment of ***de-linkage*** when counterparty downgrade reveals ***linkage*** and, potentially, multi-notch downgrades of transactions that have swap with the counterparty?

   j. ***Will a market value component of a termination payment equal the previous day's mark-to-market deemed by Moody's to be reasonable and realistic (except for the intervening day's change in market value)?***

6. What constitutes a "reasonable prospect of a swap being out-of-the-money?"

   a. Is "reasonable" a stringent **Aaa(sf)+++++** standard given the importance of ***linkage***?

   b. Does Moody's credit both "a reasonable prospect of a swap being out-of-the-money" and Credit Enhancement for a single transaction?

   c. Does an out-of-the-money swap eat into credit enhancement?

   d. How are the relative positions of an out-of-the-money swap (top of the priority of payments) and the more nebulous "credit enhancements" (below tranche being evaluated) combined for purposes of "uplift."

e. ***Might rating uplift where swap out of the money DECREASE onus on counterparty to replace itself?***

7. Given importance of *triggers* for *transfer* and for *collateralization*, why does Moody's penalize non-compliance by one only notch uplift?

   a. Why is Moody's inviting non-compliance with major ***de-linkage criteria*** such as rating criteria and peripheral ones, as well.

   (i) Is following intended to encourage compliance with ***de-linkage criteria?*** "Inconsistencies relating to *rating trigger* wording, the form of executed swap *guarantees* and automatic termination are addressed separately in notes 10, 11, 13 and 14 below. Further guidance on this note 7 is given in note 15 below."

   b. Is a structured finance transaction an active player in deciding which ***de-linkage criteria*** to include in its derivative contract and which to omit?

   (i) If so, does Moody's speak to transaction issuer to understand choices?

   (ii) If not, who drives the non-compliance-with ***de-linkage criteria*** bus? Bank counterparty? Underwriting bank?

8. **a.** How does Moody's assess upfront the likely impact of its own involvement in a swap transaction at a later date when it has just downgraded a bank counterparty and has been unilaterally asked by the downgraded counterparty to issue RAC so that the counterparty can evade honoring contractually-specified ***de-linkage criteria***?

   b. Isn't the ***LINKAGE Comment Request*** an example of Moody's giving a free pass to all bank counterparties to remain ***linked*** in practice with structured finance transactions, i.e. Moody's is happy to gut provisions of its own methodology?

   (i) What will change in the future?

   c. What will be the impact of "case-by-case" analysis at time of counterparty downgrade and non-compliance, given that each "case" represents one downgraded counterparty and many structured finance transactions?

   d. ***Why does Moody's rate transactions with offending, open-ended RAC provisions?***

9. **a.** On what basis does Moody's "generally assume that, if a counterparty defaults, it will be possible to find a suitably rated entity that is willing to provide a *replacement* swap (with or without rating triggers)?"

   b. Is Lehman the example?

   (i) If so, this gives too much weight to a minor participant in the market to face cashflow structured finance transactions under derivative contracts.

   (ii) ***Relying on Lehman as an example is akin to the RMBS group in the last decade having based U.S.-wide housing assumptions on New England experience of early 1980's.***

   c. Given the importance of *replacement* to ***de-linkage***, are "general assumptions" nearly good enough?

   d. Why would a *replacement* counterparty not incorporate existing *rating triggers* into its *replacement* derivative contract?

   (i) Is there a different standard for bank that serve as *replacement* counterparties and those that serve as counterparties to new transactions?

   (ii) How could ***de-linkage*** be ascribed to two transactions that each face the same bank counterparty, but where one has diluted protections post-*replacement* and the second enjoys the full ***de-linkage*** provisions?

(iii) Is Moody's again inviting non-conformance with the ***de-linkage criteria***?

e. What method does Moody's use to determine that the "general assumption" "is not appropriate?"

(i) Does Moody's publish findings regarding the conditions necessary for a defaulted counterparty to find *replacement* counterparties?

(ii) Why does Moody's still provide a notch uplift for swaps that are out-of-the-money for a structured finance transaction in domiciles where "*flip clause*" not clearly enforceable?

f. Will Moody's downgrade all transactions with all counterparties in domiciles where "general assumption" "is not appropriate?

(i) What will the systemic impact of these multi-notch downgrades?

10. What case-by-case criteria will Moody's use to assess whether *linkage* occurs with dynamic triggers.

a. Is "circular" or "self-referencing" a better descriptor than "dynamic" for rating triggers that change with the rating of the notes.

b. Does Moody's query issuers as to why they agree to "circular" or "self-referencing" rating triggers?

c. Do "circular" or "self-referencing" rating triggers introduce event risk into a deal?

d. Might "circular" or "self-referencing" rating triggers warrant a notching downlift?

11. How can Moody's ratings be "forward looking and speak to the full life of a transaction" yet assume ***de-linkage*** for upfront ratings?

a. The ***LINKAGE Comment Request*** is a document-long description of deficiencies in the ***de-linkage criteria*** which suggest that ***linkage*** should be assumed from initial rating.

b. What is forward looking about ignoring upfront risk that s counterparty will be downgraded below **A2**, at which time ***linkage*** is assumed and ratings of structured finance notes downgraded?

c. ***Is a more appropriate phrasing "forward-looking and speak to outcomes in which a swap counterparty is rated A2 or above but does not speak to the life of a transaction unless Moody's bank analysts promise that the counterparty will never be downgraded below A2 or default during life of the transaction?"***

12. When is the adjustment made? Upfront, i.e. consistent with analysis ratings that are "forward looking and speak to the life of a transaction" or at time of transfer?

a. Shouldn't ***linkage*** with notching downward occur from outset?

b. How does Moody's assess the likelihood of a competitor downgrading a bank counterparty?

13. Why does Moody's give full credit to *replacement or guarantee* equivalent occurring as intended but make allowance for deficient *guarantee* at time *transfer trigger* is breached?

a. Is this forward-looking?

b. Why does a *guarantee* deficient in such an important area as posting collateral qualify as a *guarantee* in the first place?

c. Do derivative contracts allow for deficient *guarantees* or do downgraded counterparties just honor or ignore contractual obligations to structured finance transactions as they please?

d. What other performance obligations are typically excluded from *guarantees*?

e. If a downgraded counterparty can obtain a *guarantee* for only some of its obligations at a reduced price or absorb full market loss for effect *replacement*, why would it *replace*?

f. Is Moody's yet again encouraging bank counterparties to not comply with the ***de-linkage criteria***?

14. **How does "mark-to-market" differ from "market value of a termination payment?" Does Moody's believe that the two are the same?**

a. Do *replacement* counterparties happily replace at "mid-market value" or do they charge as much as possible for their higher rating?

b. Even if markets don't move, would a fixed, generic "mark-to-market" be enough to fully re-hedge or is there a possibility that MANY structured finance transactions will be underhedged?

(i) Isn't there additional event risk that an interim payment will not be forthcoming to a counterparty?

(ii) What will be the waterfall impact of a missed derivative payment?

c. How will Moody's review on a "case-by-case" basis major points such as the enforceability of "*flip clauses*" in the context of "automatic termination."

d. ***Does Moody's believe that the irreversible action by a structured finance transaction to sell illiquid assets so as to cough up a potentially large termination payment is merely "liquidity risk?"***

(i) Do transactions typically have access to extra funding for such liquidity risk?"

(ii) Are *replacement* counterparties obligate to replace in accordance with the ***de-linkage criteria*** AND pay the termination amount paid by a transaction? Is the former not a "market value" issue and the latter a generic "mark-to-market that is likely to be much larger than market value?

(iii) How much more disingenuous can Moody's be regarding a major risk that will impact all transactions with a counterparty at one time?

e. What are the criteria that Moody's will use on a "case-by-case" basis for this major event risk?

15. Does Moody's believe that this footnote and accompanying grid are intelligible?

a. Why wait until counterparty downgraded below **A2?**

b. How far down the rabbit hole must we descend, Alice?

c. Grid Category B. Collateral Posting (notes 4 and 5) is particularly clear.

16. Moody's is dead wrong in asserting that "if the probability of becoming ***unhedged*** is equivalent to **Aaa**, swap linkage has no rating impact."

a. Structured finance notes rated **Aaa(sf)** are already full-up with **Aaa(sf)** expected losses. Piling the notes with more **Aaa(sf)** risk drops their rating to **Aa1** or lower (2***Aaa(sf)** expected loss no longer warrants **Aaa(sf)**.)

b. Which senior notes have a lower expected loss; **Aaa(sf)** senior notes issued by a transaction with no ability to enter into a derivative contract or same notes swapped into a second currency with **Aaa(sf)** probability of becoming ***unhedged***?

(i) Which of the two notes have more event risk?

(ii) Which of the two notes have more downgrade risk?

c. Does Moody's have internal system of **Aaa(sf)+**, **Aaa(sf) neutral** and **Aaa(sf)-** for use in assigning **Aaa(sf)** to new issues?

d. May a structured finance transaction with no need for a derivative hedge sell credit protection on a **Aaa**-rated reference entity with no rating impact for the senior notes that

are already full-up on derivative risk?
e. Treating **Aaa(sf)** rated notes as a dumpster for unlimited **Aaa** risk produced SIVs, CDOs of RMBS
(i) Hasn't Moody's learned anything?
f. Why is Moody's trying so hard to justify **Aaa(sf)** ratings for new issues?

Step 2/3 Table: Loss to Rated Tranches of a Structured Finance Transaction from Incurring Adverse Event(s) Attributable to *LINKAGE* to a Bank Counterparty (Determine for Each Transaction Worldwide)

Combine Steps 2 & 3 into a holistic assessment of the impact to each rated tranche from a transaction incurring adverse event(s) arising from overarching derivative contract with a bank counterparty.

Break Steps 2/3 into the following subsections which track the subsections of Step 1.

Step 2/3(A). Loss to a Structured Finance Transaction from Becoming Partially or Fully *Unhedged* (Determine for Each Transaction that is Counterparty to the Same Bank)
A transaction that is partially or fully ***unhedged*** is exposed to variation in cashflows available to pay rated notes owing to index mismatch between assets and liabilities. Exposure to mismatch of market indices between assets and notes will produce gains for transaction in some cases and losses in others.

1. Model transaction as ***unhedged***.
   a. Expected loss of each tranche will be determined by application of available cash according to transaction priority of payments.
   b. Transaction gains generally benefit equity first and then junior tranches.
   (i) No impact on senior notes which are paid fully in most scenarios and do not trap transaction gains from market exposure.
   c. Transaction losses risk harm all rated classes.
   (i) Additional expected losses for senior notes exceed the miniscule loss thresholds for **Aaa(sf)** and **Aa(sf)**.
2. Senior-most note expected losses map to **A(sf)** or lower.
3. Ratings of each tranche will reflect real-world risk that arises from exposure to market risk when partially or fully ***unhedged***.

Step 2/3(B). Loss to Each Structured Finance Transaction from Paying a Termination Amount (Determine for Each Transaction Domiciled in the Same Bankruptcy Regime)
Liquidating a transaction's assets to pay termination amount has irreversible impact on priority of payments and is not, as Moody's states, simply a "liquidity issue."

1. Model transaction as paying a termination amount.
   a. Expected loss of each tranche will be determined by application of remaining cash according to transaction priority of payments.
   b. Status of "flip clauses" under applicable bankruptcy law determines whether losses incurred by rated notes or bank counterparty.
   c. Where "flip clause" upheld with Aaa(sf)+ likelihood, expected losses of rated notes generally not impaired.

(i) See Table 2/3(C) 4.d. immediately below for possible exception.
d. Where "flip clause" repudiated, expected losses of all rated notes impaired.
(i) Additional expected losses for senior notes exceed the miniscule loss thresholds for **Aaa(sf)** and **Aa(sf)**.
2. Senior-most note expected losses map to **A(sf)** or lower.
a. Junior rate notes also likely to have lower ratings.
3. Ratings of each tranche will reflect real-world risk that arises from paying a termination amount to a bank counterparty.

Step 2/3(C). Loss to a Structured Finance Transaction from Incurring Other Adverse Event(s) Attributable to *LINKAGE* to a Bank Counterparty (Determine for Each Transaction Worldwide)

Model a transaction as incurring each of the following event risks arising from overarching derivative contract with defaulted bank counterparty.

1. ***Default of rated notes,*** i.e. failure of issuer to make timely payment to notes after bank counterparty fails to make scheduled swap payment.
a. Will likely occur for many-to-all transactions that face the defaulted counterparty.
b. Immediate loss = amount not paid noteholders in timely manner.
(i) Failure to make timely payment to notes may be with respect to interest only or interest and principal if cross-currency swap.
(ii) Missed payment may be entire amount owed or some lesser amount.
(iii) Missed payments under cross-currency swaps may have greater impact than missed payments under interest-rate swaps.
c. Given tiny loss thresholds for **Aaa(sf)**, **Aa(sf)** & **A(sf)**, comparatively small missed payment warrants multi-notch downgrade.
(i) Senior-most notes rated **A(sf)** or below.
2. ***Issuer Event of Default*** follows from default of rated notes
a. Will likely occur for many-to-all transactions that face the defaulted counterparty.
b. Remedies for Issuer EoD vary by transaction.
(i) Liquidate assets may be directed to liquidate assets & re-pay notes and other obligors as specified by priority of payments. (Liquidation may follow automatically from Issuer default or may occur at direction of senior obligors such as noteholders.)
w. Loss to transaction from distressed liquidation of assets.
x. Additional loss from write-off of swap termination amount if insolvent counterparty had not posted collateral.
y. If multiple counterparties, some counterparties may also be owed termination payments. These termination payments rank senior to rated notes.
(ii) Other remedies?
w. Other sources of loss?
c. Senior parties to transaction determine remedy for Issuer Event of Default.
(i) Senior notes may opt for liquidation if doing so minimizes losses.
(ii) Remaining counterparties may also have ability to declare termination events.
d. Loss levels well in excess of those indicated by initial ratings as currently modeled.
(i) junior notes may be wiped out
(ii) senior notes suffer non-trivial to large losses; capped at **A(sf)**.

3. ***Moody's determination that a "relevant remedial action is not likely to be successfully performed following trigger breach" (*****footnote 3 page 15.)**
4. ***Legal and Operation Risk from Linkage to a Defaulted Bank***
   a. Impact on priority of payments
      (i) reserving to pay senior notes
      (ii) legal uncertainties keep trustee from acting
      (iii) legal fees to represent transaction
   b. Dispute with estate of bankrupt counterparty regarding "mark-to-market" value of swap for purposes of determining a termination amount.
   c. Extended risk of litigation and uncertainty; Lehman case is taking 4 years.
   d. Insufficiency of *replacement* payment prompts court to look to structured finance transaction
5. ***Next Event Risk***

Step 2(D). Financing Costs for a Bank Posting Collateral Under Derivative Contracts with Structured Finance Transactions Counterparties. (Determine for Each Bank Counterparty and Report to Fundamental Analysts and Regulatory Bodies)

1. Staggered timeline for posting.
2. One-time downgrade to collateral trigger only = posting collateral for life of each structured finance transaction whose swap represents a mark-to-market liability.
3. Further downgrade to replacement trigger = replacing some but not all transactions and continuing to collateralize remainder.
4. Large subset of transactions remain with cp for life as cp doesn't effect replacement (particularly where flip clauses are not enforced?)
5. Insolvent banks lose full amount of collateral posted, i.e. mark-to-market & additional amounts, i.e. additional loss beyond that of existing mark-to-market liability. "Market Value" component of termination payment < mark-to-market (regardless of whether m-t-m is a liability or asset.

Challenge banks that argue they will post only for a short period before replacing themselves, i.e. replacement is 100% achievable.

Step 2(E). Assess Losses for a Bank Counterparty from Arranging *Replacement/Guarantee* for Some-to-All Swaps Structured Finance Transactions. (Determine for Each Bank Counterparty and Report to Fundamental Analysts and Regulatory Bodies)

1. 0.40% of notional; more for balance-guaranteed swaps & cross-currency?
2. One-time downgrade to collateral trigger only = posting collateral for life of each structured finance transaction whose swap represents a mark-to-market liability.
3. Further downgrade to replacement trigger

Step 2(F). Assess Losses for a Bank Counterparty Where Structured Finance Transactions Pays *Subordinated* Termination Amounts (Determine for Each Transaction Domiciled in the Same Bankruptcy Regime and Report to Fundamental Analysts and Regulatory Bodies)

1. Estimate mark-to-markets of swaps with structured finance transactions at time of subordination
   a. ***UNNETTED*** mark-to-market of each swap with a transaction that is in-the-money to

the bank.

(i) NOT third-party valuation (loss from subordination is in relation to mark-to-market of bank's books and records.)

b. Add potential change in m-t-m until next observation

2. Add Later recovery from transactions that are paid by replacement counterparty, i.e. "market-value" portion of termination payment

   a. Zero recovery where general assumption "that, if a counterparty defaults, it will be possible to find a suitably rated entity that is willing to provide a *replacement* swap" is found not to be appropriate in which case "the probability of becoming ***unhedged*** equals the rating of the counterparty" (footnote 9 page 15), i.e. no "market value portion of termination amount" paid to defaulted counterparty.

   (i) Large write-downs for many counterparties at once.

3. Write-down increasing larger proportion of estimates as bank downgraded.

   a. Estimates by bank rating

4. Non-U.S. counterparties write-down all mark-to-market assets as downgraded?

Step 2(G). Assess Systemic Implications from Implementation of *"De-Linkage Criteria"* Worldwide (Report to Fundamental Analysts and Regulatory Bodies)

Systemic issues with respect to individual counterparties? How many transactions affected? What potentially eligible counterparties are not participating in the market? Why? Failure of 1 Counterparties, 2 Counterparties?

Appendix - Guidance Notes on Becoming Unhedged: Step 2 Table

Throughout this Appendix, Moody's makes reference to its "General assumptions" that allow it to assume ***de-linkage*** in rating new deals but which may obligate it to assume ***linkage*** at a later date when deals are seasoned. What is the confidence level associated with the "general assumptions?" Should the "general assumptions" be reviewed?

The Appendix also refers to "case-by-case" analysis. How does Moody's ensure that "case-by-case" analysis is consistent? Does "case-by-case" analysis allow bank counterparties to game Moody's by insisting on most lenient treatment that they've received?

The Step 2 Table is comprehensive only with respect to basis swaps. Are basis swaps > 8 years liquid?

Are swaps not listed in Table 2, i.e. all but USD or EUR interest-rate swaps < 7 years and GBP interest-rate swap < 6 years subject to "case-by-case" modeling? Does Moody's determine WAL of swaps or some other party such as issuer, underwriter or bank counterparty?

Numbers refer to those in the referenced appendix (***LINKAGE Comment Request***, pps 17-18)

1. Pass.
2. More information, please, on "case-by-case" analysis of "other basis swaps."

   a. Does Moody', underwriter or bank counterparty designate an esoteric index as a "basis swap?"

   (i) Do bankers have a tendency to describe highly illiquid, esoteric derivatives as "basis swaps"?

b. Does Moody's publish lists of "basis swaps" as they appear in transactions?

3. Is Moody's defining WAL generously to help issuing inflated ratings? Longer WAL is associated with a higher loss tolerance for a specific rating pool.

   a. WAL of swap is much shorter than principal paying instruments such as rated notes or assets held by a transaction.

4. Pass
5. Multiple counterparties introduce multiple-squared event risk to a structured finance transaction. What is the "case-by-case" approach, in broad terms? More counterparties always mean more ***linkage*** and hence lower ratings than a single counterparty?

   a. How will remaining counterparties act if one counterparty that is insolvent receives senior termination payment?

   b. What are operational risks with multiple counterparties?

   c. ***Where a transaction has multiple counterparties, how does Moody's determine that linkage applies to only some counterparties?***

6. ***Linkage*** has real-world impact for transactions with "flip clauses" that may be repudiated when a swap is out-of-the-money to the transaction. The more out-of-the-money, the larger the negative impact of ***linkage*** on the ratings of the transaction's notes.

   a. Is Moody's comfortable in modeling all structured finance transactions governed by domiciles that are "flip clause" unfriendly as being ***de-linked*** from having to make senior termination payments?

   (i) What is the systemic impact of all transactions to one insolvent bank counterparty making senior terminations and all transactions governed by same bankruptcy regime each being downgraded by several notches?

   b. "Step 2 Table assumes a present market value close to zero," i.e. the transaction might fare equally well if ***unhedged***.

   (i) Is this the proper starting point for impact of ***linkage***? (Moody's starts by assuming ***de-linkage***; then ***linkage*** but no rating impact as a mark-to-market is perfectly neutral; then ***linkage*** with rating impact, then…?)

   (ii) Risk of being ***unhedged*** (as opposed to making termination payment) more pronounced as swap in-the-money to an issuer. Should this be the starting point of the table?

   (iii) What size adjustment is made to the loss category if a swap becomes "materially OTM for the issuer?"

   (iv) What is the OTM threshold for Moody's to deem a swap "materially OTM for the issuer."

   (v) Is "materially" a quantitative standard (sounds more like a legal one)?

   c. A swap may be out-of-the-money to an issuer from outset if the issuer borrowed money upfront from the swap counterparty. This practice was pervasive with cashflow CDOs, particularly CDOs of ABS.

   (i) How does Moody's evaluate the impact on the ratings of structured notes from additional ***event risk attributable to linkage*** when an issuer borrows money upfront from a bank counterparty?

   (ii) How does Moody's incorporate upfront borrowing due at top of waterfall with Credit Enhancement below a tranche?

   d. Notching credit for a swap being out-of-the-money to an issuer conflicts directly with crediting a tranche for subordination.

(i) Why does Moody's credit two features which are in opposition to each other, i.e. why is Moody's seeking to give notching uplifts at every opportunity when rating new deals? Shouldn't the methodology be rigorous given the implications of ***de-linkage***?

e. "If there is a collateral posting trigger above **Baa3**, we do not adjust the loss category by reason of the swap being or becoming ITM for the issuer – that exposure should be covered by collateral."

(i) Huh?

(ii) How does Moody's judge the likelihood of a swap "becoming ITM for the issuer?"

(iii) "A collateral trigger above **Baa3** may mean **Baa2**, more precisely a bank counterparty posts collateral to all swaps that are in-the-money to structured finance transaction upon **LOSS of Baa2**," i.e. being downgraded to **Baa3** or even **Ba1**. Isn't this *trigger* very low, given that in some cases "collateral is otherwise not expected to be posted."

(iv) Given Moody's submissions and testimony to House Financial Services Committee Hearings "MF Global 2," financial institutions rated **Baa3** or **Ba1** have substantial risk of default.

(v) How can structured finance notes be ***de-linked*** from a bank counterparty when, upon downgrade to **Baa3** or **Ba1**, it may not honor obligations to post collateral? Doesn't this outcome indicate substantial ***linkage*** from the outset for **ALL** transactions with the bank counterparty?

f. "However, if there is no collateral trigger above **Baa3** (or collateral is otherwise not expected to be posted) and the swap is or becomes ITM for the issuer, we may adjust the loss category upwards.

(i) At what time might the loss category be adjusted upwards? From the get-go at time of new issuance

(ii) What type of adjustment may be made?

(iii) Why does Moody's wait to make the adjustment?

(iv) What is the impact of "adjusting the loss category" upwards for **ALL** notes issued by structured finance transactions that face the counterparty in question?

7. Pass.
8. How ***MIGHT*** the loss category be adjusted upwards? What is rating impact?
   a. How do larger loss amounts jibe with ***de-linkage*** in rating new issues?
9. What is the "case-by-case" approach for most currencies of the world?
10. What is the "case-by-case" approach for the vast majority of the cross-currency swaps (i.e. swaps that cover 100% of the asset pool), particularly given that cross-currency swaps are the most volatile of swaps designated "liquid" by Moody's?
11. Decreasing WAL is accompanied by a lower expected loss threshold to preserve a rating. Decrease in notional of swap is often coterminous with pay-down of senior rated notes, i.e. ratio of swap notional to rated notes may be unchanged.
    a. Does Step 2 Table recognize shrinking expected loss hurdles?

Appendix - Guidance Notes on Becoming Unhedged: Step 3 Table

Credit enhancement is useful shorthand for synthetic transactions where losses may be written down, written back-up; adjusted, etc. and less useful for cashflow transactions with top-down priority of payments.

33. **Given the seniority of swap payments in the priority of payments for a cashflow structured finance transaction, aren't tranches more exposed to falling rocks from above than protected by cushions below such as "credit enhancement?**

34. **Losses must reside somewhere. Why give each tranche a chance to dodge the bullet rather than evaluate holistically for the entire transaction?**

One path-specific impact may be waterfall diversion to seniormost notes owing to failure of coverage tests; e.g. interest shortfalls may result in amounts being trapped to pay senior notes on future payment dates. If this rock were to fall on the second-most senior class, for instance one rated **Aa(sf),** does credit enhancement really help?

35. **Are two identically-rated transactions with identical capital structures and identical credit enhancement correctly rated if one cannot enter into a derivative contract and the second is party to a derivative contract?**
    a. Does the transaction that can enter into a derivative contract have more downgrade risk?
    b. Are both transactions ***de-linked*** from counterparty risk or only the transaction that cannot enter into a derivative contract truly ***de-linked***?

36. **Does Moody's already earmark credit enhancement to offset the impact of other risks to the ratings of senior notes?**
    a. Is credit enhancement unlimited so that Moody's can justifiably cite the same credit enhancement over and over again in discounting each new risk being added to a transaction.
    b. Is extra credit enhancement just lying around for senior notes to use if ***unhedged,*** obligated to pay a termination amount or incurring other event risk from ***linkage*** to a defaulted counterparty?

Is this the analog to adding more and **Aaa** risk to senior notes rated **Aaa(sf)**; after all unlimited risk is great as long as it's all **Aaa** (at least of time of initial rating.) Similarly, more and more risk may be added to a transaction as long as there's a fixed amount of credit enhancement and each risk is assessed on a stand-alone basis rather than in a holistic manner.

Once senior-most notes get full benefit of credit enhancement, isn't that enhancement fully used up for purposes of Moody's assigning an initial rating?

Does Moody's notch down credit enhancement where swap out-of-the-money, i.e. a mark-to-market liability, to a transaction?

Numbers refer to those in the referenced appendix (***LINKAGE Comment Request***, p 18)

1. Are the credit enhancement and reserves "benefiting the relevant tranche" already claimed by other Moody's rating criteria?
   a. How are credit enhancement and reserves divvied up in Moody's modeling when a transaction is deemed to be ***linked*** to a downgraded counterparty?
2. How broad a sub-set will these "case-by-cases" be? What benchmarks will Moody's use in its "case-by-case" analysis?
3. Ditto.
4. Don't expected loss hurdles also grow or decline as WAL increases or decreases?
5. Ditto 2 & 3 above.

Appendix - Guidance Notes on Becoming Unhedged: Step 4 Table
Numbers refer to those in the referenced appendix (***LINKAGE Comment Request***, pps 18-19)

1. "Where no ***linkage***-adjusted rating is given, it means the incremental expected loss associated with swap ***linkage*** has no rating impact."
   a. Why does upfront modeling assuming ***de-linkage*** ignore the incremental loss associated with swap ***linkage***?
   b. If a note rating without accounting for swap ***linkage*** = **Aa1+** and the note rating after accounting for swap linkage = **Aa1-**, does this mean that "the incremental expected loss associated with swap ***linkage*** has no rating impact?"
   c. Given tiny loss thresholds for ratings of **Aaa(sf)** and **Aa(sf)**, how small must "the incremental loss associated with swap ***linkage***" be to "have no rating impact?"
2. Tranche sizes of 80%, 20% & 5% compromise more than one capital structure, i.e. = 105%.
   a. What tranche sizes are materially different from these three amounts?
   b. New question – what is the "appropriate" up or down rating impact for materially different tranches sizes that will be evaluated on a case-by-case basis.
3. Why do the tables "denote if the ***linkage-adjusted*** ratings are weak or strong ratings within their bands" if Moody's does not "assign actual ratings with "+" or "**-**" indicators?"
   a. Does the system of non-public indicators aid transparency of structured finance ratings?
   b. Do the illuminati who acquire knowledge of "rating bands" and of unpublished rating modifiers such "+" & "-" wear garnet rings so as to identify themselves to each other?
4. So much to work with!
   a. "The ***actual*** rating of a tranche maybe influenced not only by the expected losses to noteholders but also by the likelihood of timely payment."
   (i) What is the ***non-actual*** rating of a tranche? Is that where the "+" and "**-**" come in?
   (ii) Is threat to "the likelihood of timely payment" an impact of ***linkage*** to a bank counterparty?
   (iii) Does this impact of ***linkage*** constitute event risk that should be incorporated into a rating from the get-go?
   b. "Swap ***linkage*** can materially increase the default probability of the notes – that is the likelihood of an issuer failing to make timely payment to noteholders – and therefore influence the ratings of the notes to a greater extent than may be indicated by the Step 4

Tables."

(i) Should there be a Step 5 Table to reflect the impact of ***linkage*** that influences the ratings of the notes to a greater degree than reflected in Table 4?

(ii) Does the likelihood of an issuer failing to make timely payment to noteholders constitute event risk not addressed in the ***LINKAGE Comment Request***?

(iii) What is the impact of senior notes experiencing an Event of Default, e.g. from failing to make timely payment to noteholders? Are sanctions unrelated to swap linkage activate by an Event of Default?

(iv) For multi-counterparty transactions, might ***linkage*** to one counterparty that is in default cause a payment default which in turn allows other counterparties to declare Additional Termination Events and claim senior termination payments?

Appendix A - Remaining Points on Counterparty Instrument Ratings

Moody's published the rating methodology "Moody's Approach to Counterparty Instrument Ratings" on February 23, 2012. Further comments follow.

Circularity of CIR, Bank Ratings, Structured Finance Ratings and CIR
De-linkage criteria assumes ***linkage*** to bank counterparty and CIR assumes ***linkage*** to bank counterparty as well. Where exactly is there complete ***de-linkage***? CIR methodology characterizes ***linkage*** to bank counterparty as "high," "medium" and "low" but not "none"!"

The CIR does mention an instance where de-linkage might be total for cases where a "swap excludes all termination payments," i.e. the swap contains "walk-away provisions."

1. **Are "walk-away provisions" enforceable?**

CIR ratings based on ratings of structured finance notes which in turn DEPEND on subordination via "flip clause", i.e. complete ***de-linkage*** from bank counterparty. Taking the other Escher staircase, CIR ratings also presume ***linkage*** to a bank counterparty, i.e. "flip clause" and subordination may not be upheld, in which case ratings of notes are ***linked*** to a bank counterparty and should be downgraded and, as CIR ratings are based on note ratings, CIR downgrade should follow. Rinse. Repeat.

What other Moody's ratings have the same feature as a CIR in that downgrade of the user of the CIR, i.e. the bank counterparty results in CIR downgrade as well?

2. **Where do the ratings of a CIR and corresponding bank counterparty converge?**
    a. **Baa2**?

Carve-out to CIR rating while Corresponding Bank Counterparty NOT in Default
"The ratings do not address potential losses in relation to any market risk associated with the transaction," i.e. *replacement* losses are excluded from definition.

Explicitly, "CIRs do not address losses that may be experienced by counterparties by reason of fluctuations in mark-to-market valuations, such as any market value loss as a result of a swap counterparty *replacing* itself."

3. **How large is a typical "market value loss as a result of a swap counterparty *replacing* itself.**

Carve-out to CIR rating while Corresponding Bank Counterparty NOT in Default
"CIRs relate to termination payments as well as scheduled payments."

However, "flip clause" defines away *termination* payments to a subordinated position which effectively writes the payment off. Net-net, a defaulted bank counterparties loses ALL mark-to-market assets with structured finance transactions on an UNNETTED basis.

The CIR covers the market value component" of a termination amount, but this too is defined away. Page 3, last right paragraph contradicts itself. The CIR "assumes the market value component of the SPV's *termination* payment will be paid in full…(assuming that *termination* and *replacement* occur at the same time)" in cases where "any premium payment received by the SPV from a replacement counterparty will be remitted to a defaulted counterparty – in full or ***partial payment of the termination payment*** owed by the SPV.

Why does Moody's attach importance to the tautology that a "premium payment from the new counterparty to cover the market value component of its termination payment to the defaulting counterparty?"

By dreaming up a new category of found money - *replacement premiums* - Moody's preserves the fiction that replacement is 100% achievable and avoids the task of redressing the manifest shortcomings of the ***de-linkage criteria***.

4. **Why does Moody's use "replacement payment," "replacement premium" and "premium payment interchangeably?"**
   a. All are wrong.
   b. We've talked about this in my August 8, 2011 SEC comment that may be linked from my June 11, 2012 letter to Mr. Michel Madelain included here as Appendix B. For instance, please see "profitable swap" page 33.

Solvent banks mark-to-market daily; losses are measured against previous day's mark-to-market. Mark-to-market for the same swap will be similar from bank to bank.

"Market value portion of a termination amount" is the price paid by a replacement counterparty to take over a swap from a defaulted counterparty regardless of theoretical "mark-to-market." The "market value portion of a termination amount" is deeply discounted by a new counterparty, i.e. reflects the relative position of the defaulted counterparty as distressed liquidator and new counterparty as white knight. The "market value portion of a termination amount" represents a partial recovery on a mark-to-market not the full mark-to-market itself.

5. **When does a generic mark-to-market of a swap diverge from the "market value component" of a termination payment upon *replacement*?**
   a. Do Moody's fundamental analysts believe that a bank amortizes the loss to "market value component of its termination payment from generic third-party "mid-market value" over time or in one gulp after replacement is effected?

6. **How can CIR measure termination payments if "flip clauses" enforceable and structured finance transaction incentivized to terminate immediately upon default of bank counterparty?**

CIR Not Aaa(sf) Standard – More Carve-Outs
Unpaid amounts ignored from payment promise for so long as it is not "legally certain that Section 2(a)(iii) is invalid in the relevant jurisdiction, non-payment by an SPV in reliance on Section 2(a)(iii) is not regarded as a default for the purposes of CIRs."

"We regard failure to pay unpaid amounts upon termination as default for the purpose of CIRs." However, the possibility of default of unpaid amount is not contemplated in initial rating. Unpaid amounts are substantial relative to a CIR denominator (when a CIR denominator is correctly defined – please see further below.

When is this CIR default – why, at the time of counterparty default, not before.

7. **What value is the CIR rating at time of default of corresponding bank counterparty?**

What Else is not Contemplated in Assigning a New CIR but Saved for Later?
Moody's monitors "any obligation to *replace* itself. Non-performance of this obligation would imply an increased *linkage* compared with the initial expectations." Why is this increased linkage not contemplated in upfront modeling?

8. **If no replacement occurs, i.e. "market value portion of a termination amount" equals zero, is the CIR rating intact? After all the defaulted bank received zero, i.e. the rated promise.**

CIR Gets Its Own Definition Wrong – EL Denominator *SHOULD BE* Carved-Up
The CIR rating methodology incorrectly defines the denominator for expected loss (footnote 5 page 8.)

Denominator should be expected payments ***(netted if netted in practice)*** made by a structured finance transaction under the derivative contract and not by a variant of the notional amount of the contract (e.g. "outstanding amount of notes," "reference to a fixed amortization schedule," or "reference to the amount of performing assets.")

For an interest-rate swap, expected payments may be 5% of notional, i.e. a CIR has rating inflation (via expected loss deflation) of 2000% right from the get-go.

Moreover, CIR ***linkage*** to rating of corresponding counterparty means that risk of termination cannot be ignored. The expected loss for a CIR should be determined by two weighted paths; one for scheduled payments, one for termination payment. Hurdle should also be weighted as path with termination payment will have a shorter WAL than path for scheduled payments. Moody's will also have to simulate termination payments.

Moody's may wish to refer to its methodologies for Derivative Product Companies (DPC) and Credit Derivative Product Companies (CDPC) to correctly define CIR expected loss. Both the DPC and CDPC methodologies were re-classified as structured finance methodologies in response to issues raised in the June 11, 2012 letter to Mr. Michel Madelain included here as Appendix B.

9. **Does CIR address obligation of structured finance transaction to return extra collateral after re-hedging or termination?**

a. Does CIR calculate a loss if transaction keeps extra collateral to pay for *replacement*, i.e. *replacement* costs more than theoretical mark-to-market?

Appendix B – June 11, 2012 Letter to Mr. Michel Madelain, President & COO of Moody's

William J. Harrington
51 5TH Avenue, 16A
New York, NY 10003
wjharrington@yahoo.com

June 11, 2012

VIA ELECTRONIC MAIL

Mr. Michel Madelain
President and Chief Operating Officer
Moody's Investors Service
7 World Trade Center
250 Greenwich Street
NY, NY 10007

Dear Mr. Madelain:

I am writing in my capacity as a former analyst at Moody's Investors Service (Moody's.)

My concern is that Moody's committees issue informed opinions.

Committees within Moody's U.S. Financial Institutions Group lack the competency to assess derivative risks either on technical grounds or in a common-sense manner. The same committees that evaluated MF Global are now evaluating larger U.S. financial institutions. (Please see second attachment "MF Global 2 – Questions for the Open Record – William J. Harrington.")

1. **What in-house analysis do Moody's committees use to assess derivative obligations and risks in determining bank ratings?**

2. **How do Moody's committees discount representations by bank management regarding derivative obligations and risks?**

Moody's Encourages Relentless Lobbying of its Committee Members. The U.S. financial industry has agitated vociferously to restrict the scale of looming downgrades. Senior-most finance executives publicly denigrate rating Moody's analysis that is driving the downgrades. Morgan Stanley senior management directly lobbies Moody's committee members for mild downgrades and canvasses them as to the rating impact of derivative transfers.

3. **How will Moody's committees vote independently given the relentless lobbying for them to vote in line with bank interests?**

4. **Why does Moody's allow committee members to be lobbied directly and repeatedly by issuers?**

5. **How do Moody's committees consider the views of end-users of bank ratings to balance the views of bank lobbying?**

Bank lobbying of Moody's is driven by the costs of derivative obligations that are triggered by rating downgrades. Individual banks have estimated the costs of posting collateral and terminating derivatives that are associated with various downgrades as being in the billions of dollars. The industry as a whole will have fewer derivative providers as downgraded financial institutions cease to meet credit criteria of derivative end-users.

Derivative obligations are zero-sum. When a bank successfully lobbies for mild-to-no downgrade and hence is not obligated to post additional collateral or to terminate derivatives with counterparties, the counterparties are concomitantly fully exposed to the bank's credit. These same counterparties (municipalities, sovereigns, supra-nationals, corporates, insurance companies, etc.) may in turn represent to Moody's that they will be fully protected should the bank in question deteriorate in credit.

Transferring derivatives from a bank holding company to an FDIC-insured bank affiliate is also zero-sum. Bank obligations under the transferred derivatives don't disappear; they are merely transferred to the FDIC as ultimate guarantor.

6. **How do Moody's committees assess the impact of a derivative portfolio on an FDIC-insured bank?**
   a. Is the derivative portfolio evaluated in light of its proportion to the bank's other activities?
   b. How do derivative obligations that are out-sized in relation to the other activities of the FDIC-insured bank impact the latter's rating?
   c. Is the FDIC queried on the extent of derivative risks that a given bank should assume?

7. **Should the ratings of a bank holding company and its FDIC-insured bank affiliate converge following transfer of derivatives from the former to the latter?**
   a. If transferring derivatives helps the rating of a bank holding company, shouldn't the transfer hurt the rating of the FDIC-bank affiliate (relative to that of the bank holding company?)

8. **Do Moody's committees keep the rating differences between a bank holding company and its FDIC-insured bank affiliate constant regardless of the latter's derivative risks, i.e. assume that FDIC support is open-ended and consign it to being so?**
   a. Is this decision more appropriately taken by the FDIC and U.S. taxpayer?

9. **By not closing the gap between the ratings of a bank holding company and its FDIC-insured affiliate where the latter has an outsized derivatives portfolio, is Moody's adding to systemic risk?**
   a. Counterparties of the FDIC-insured affiliate do not hold additional collateral, nor do they have the option to terminate trades.
   b. The FDIC-insured bank affiliate has carte blanche to write as much new derivatives business as it cares to.

10. **How many derivatives can be crammed into an FDIC-insured bank without invalidating its rating?**
    a. Do Moody's committees ask the question?
    b. Do Moody's committees hold the question to be primarily philosophical along the lines of "how many angels can dance on the head of a pin?"

Moody's Inability to Assess Derivatives Exists at the Highest Levels of Management
On August 8, 2011, you submitted a comment to the SEC (Mr. Michel Madelain of Moody's Investors Service Comments on SEC Proposed Rules for NRSROs.)

In the comment, you state that "MIS credit ratings speak only to credit risk." You also express "concern that the wording of the proposed attestation could inadvertently lead users of credit rating to believe that credit ratings address other types of risk, such as liquidity risk, market value risk or price volatility." (P16, *Annex – Technical Comments, 3. Disclosures Accompanying Credit Ratings, C. Attestation Requirement, II. Credit Ratings Speak Only to Credit Risk.*)

Moody's assigns counterparty ratings to Derivative Product Companies (DPCs) such as Merrill Lynch Derivative Products AG (MLDP) and Morgan Stanley Derivative Products Inc. (MSDP)

Below is an excerpt from Moody's announcement of February 17, 2012 "Moody's places rating of Morgan Stanley Derivative Products Inc., a termination derivative product company, on review for possible downgrade."

"DPCs are special purpose operating companies set up by leading financial institutions primarily to trade with non-affiliated counterparties in interest rate and currency swaps. Their counterparty ratings are based on factors such as bankruptcy remoteness, *non-consolidation with its sponsor in the event of the sponsor's bankruptcy, dynamic capital and collateral requirements, insulation from market risk via mirror trades with a sponsor-affiliated entity (prior to a trigger event)…"*

The counterparty ratings of DPCs also address the full exposure to market risk that exists AFTER a trigger event. The dynamic capital and collateral requirements described in the above excerpt are determined via simulations of possible market values, price risk and liquidity estimates for the derivatives portfolio.

In the case of a termination DPC such as MSDP, a major component of the rating addresses the ability to pay termination amounts to MSDP counterparties. These termination amounts are determined by marking-to-market the portfolios of each MSDP counterparty, i.e. they are solely a function of market value risk and price volatility.

In the case of continuation DPCs such as MLDP, the rating address the ability of MLDP to preserve sufficient liquidity to make indexed-linked payments under existing derivative portfolios while also negotiating to terminate them. As with termination DPCs, the termination amount of a continuation DPC takes the mark-to-market of a derivative portfolio as a starting point. A DPC also holds additional capital in recognition that market conditions (including liquidity) for a given derivative will impact its termination value.

11. How do Moody's committees assess the impact on a DPC sponsor such as Bank of America, N.A. or Morgan Stanley from its DPC incurring a "trigger event?"

More generally, Moody's ratings of fundamental entities such as financial institutions address the liquidity, market value and price volatility of derivative contracts both explicitly and implicitly. Posting collateral to counterparties combines the preceding as does terminating derivative portfolios.

Collateral and termination provisions generally privilege counterparties at the expense of debt holders. The expected losses of debt ratings thus are impacted by the liquidity risk, market value risk and price risk of an entity's derivative obligations.

12. Does Moody's agree that the credit risk of a derivative is determined by its market value which in turn is determined by liquidity and price volatility?

The Financial Institutions Group Has Long Declined to Learn About Derivative Risks
Committee members of the Financial Institutions Group did not accept invitations to learn more about the implications of DPC Trigger Events on the expected losses of their issuers. No one from the Financial Institutions Group attended a DPC committee post-2008 despite being invited to each committee for individual DPCs and for reviews of DPC methodology.

Intermediation Events relating to MLDP and Trigger Events relating to MSDP have implications for the expected losses of their respective sponsors Bank of America, N.A. and Morgan Stanley that are similar to those listed in the below email.

More broadly, the Financial Institutions Group would have deepened their understanding of derivative portfolios generally had they attended DPC committees in 2008-2010. The same issues regarding obligations to post collateral and terminate derivatives following downgrades that have been cited by bank lobbyists formed the entire basis of DPC committees and ratings.

Some of the below addressees participated in MF Global committees. Presumably, they will also participate in upcoming committees for U.S. financial institutions. (Moody's committees are not comprised of rotating guest panelists with secret identities but rather of the same few Moody's colleagues who meet with each other several times each day in meetings with issuers, investors, other Moody's groups and in committees. In all these meetings, including committees, management hierarchy is strictly enforced.)

__From:__ "Young, Robert" <Robert.Young@moodys.com>
__To:__ Bill Harrington <wjharrington@yahoo.com>; "Harrington, William" <William.Harrington@moodys.com>; "Frantz, Blaine" <Blaine.Frantz@moodys.com>
__Cc:__ "Nerby, Peter" <Peter.Nerby@moodys.com>;
__Sent:__ Saturday, March 15, 2008 8:34 PM
__Subject:__ RE: Trigger Event of BSFP (Aaa-Interest Rate DPC)

Thanks for your help Bill.
Bob

__From:__ Bill Harrington [mailto:wjharrington@yahoo.com]
__Sent:__ Sat 3/15/2008 6:56 PM
__To:__ Young, Robert; Harrington, William; Frantz, Blaine
__Cc:__ Nerby, Peter;
__Subject:__ RE: Trigger Event of BSFP (Aaa-Interest Rate DPC)

I looked through BSFP documents again & the basic points stand.

1) Contingent Manager (not a Bear entity) takes over BSFP immediately upon a Trigger Event. The Contingent Manager is responsible for BSFP only - it has no obligations to Bear.

2) BSFP already holds $415MM capital - it does not require Bear to hand it over.

3) Sometime over the next week (as early as Tuesday, as late as maybe following Tuesday), BSFP & Bear will terminate their book of trades. If BSFP is determined to owe money to Bear, it does not pay until two years later, unless all claims of BSFP counterparties are satisfied before that point. As I mentioned, the mark was roughly $2 billion in favor of Bear at last weekly reporting.

I am unavailable for rest of evening, have covered everything germane from Bear point of view. I wanted you to have this info prior to Monday morning's call.

I'll revert tomorrow to extent that I can.

"Young, Robert" <Robert.Young@moodys.com> wrote:

Do we have a schedule that shows the run-off of the trades, and is there any other way for them to extricate themselves from this? Can the trades be assigned (terminology?) elsewhere with Bear working with the assignee to settle any differences and release any trapped capital?

-----Original Message-----
From: Harrington, William
Sent: Saturday, March 15, 2008 4:40 PM
To: Frantz, Blaine; Young, Robert; 'Bill Harrington'

Subject: Trigger Event of BSFP (Aaa-Interest Rate DPC)

Blaine:

S&P downgrade of Bear's short-term rating to A-3 has caused a Trigger Event with respect to Bear Stearns Financial Products ("BSFP"), the Aaa-rated interest rate subsidiary whose primary business was providing interest rate hedges to muni's and RMBS transactions.

As a consequence of the Trigger BSFP is essentially jettisoned from Bear and goes into run-off mode with respect to its portfolio of trades. Any amounts owed Bear the parent are subordinate to making the counterparties whole.

From your point of view, the Trigger Event has two impacts.
1) BSFP keeps all of its capital, approximately $416MM, which was provided by Bear.
2) BSFP terminates al of its trades with Bear without paying any termination fee. That amount is approximately $2 billion, from the most recent report that I have.

Bear is not entitled to either amount, or any remainder, until all of BSFP's counterparties have been paid. As the majority of BSFP counterparties are continuation ones, i.e. they do not automatically terminate in a Trigger Event, there is no clear date when all payments owed them are satisfied, short of the maturity of the longest trade.

I don't have access to work email for the rest of the weekend, but you may email at home, above, with any follow-up questions.

WJH Experience in Moody's Derivatives Group 1999 - 2010

I joined Moody's Derivatives Group as a Vice President/Senior Analyst in June 1999 and retired as a Senior Vice President in July 2010. My responsibilities were entirely analytical and my main focus was the nexus in structured finance of derivative providers and their end users.

On Saturday, September 15, 2001, I joined Moody's colleagues in retrieving laptop computers from Moody's offices at 99 Church Street, two blocks from the World Trade Center. My apartment was the lone staging area. We gathered there in the morning and distributed laptops on the sidewalk in front of the Forbes Museum, cater-corner from my building, in late afternoon.

From 1999 to 2006, I was a lead analyst for Collateralized Debt Obligations (CDOs) and DPCs. DPC counterparties include municipalities, sovereigns, supra-nationals, corporations, insurance companies and, in limited cases, structured finance transactions.

In 2006, I concluded that the committee process for CDOs had been irredeemably compromised by Ray McDaniel's management team. I ceased working on CDOs and worked solely on DPCs and similar entities (CDPCs) both as lead analyst and as co-head of the team that rated structured finance operating companies.

In 2006, I co-authored Moody's "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions" (Hedge Framework.) I was the lone analyst to have worked continuously on the taskforce charged with developing a hedge contract protocol from its formation in 2004. Managers who remain at Moody's and who voted periodically in 2004-2006 to approve the taskforce's work include Mr. Michael Kanef, Mr. Frederic Drevon, Mr. Nicholas Weil and Ms. Yvonne Fu.

(In November 2010, after my retirement, Moody's affirmed the Hedge Framework in near original form. This was a serious mistake with damaging implications for the world financial system. In 2011, I alerted Moody's, other rating agencies, journalists, the European Banking Association, the SEC and U.S. bank regulators to problems with the Hedge Framework and the analogous hedge contract protocols of other rating agencies.

Mr. Jody Shenn of Bloomberg News reported some of my concerns in his May 23, 2012 article "Fitch wavers over plans to relax banks derivatives rules."

In short, Moody's Hedge Framework both bakes in losses for banks and awards inappropriately high ratings to asset-backed securities. Bank losses may be most pronounced for European banks and ratings may be most distorted for U.S. asset-backed securities.)

13. **How does the Financial Institutions Group assess the impact of "flip clauses" on institutions that are counterparties to structured finance transactions?**
    a. Where flip clause will likely be upheld with the result that a bank will lose the full mark-to-market of each derivative with each structured finance entity (i.e. not simply the much smaller netted mark-to-market)?
    N.B. This is another example of derivatives introducing market risk into the expected loss of a bank rating.

In 2009, I co-authored Moody's DPC methodology "Mitigating Voluntary Bankruptcy Risk of U.S.-Domiciled Termination Derivative Product Companies and Assessing the Effectiveness of Continuation Derivative Product Companies." This methodology was the driver for Moody's to place the Aa3 rating of Morgan Stanley Derivative Products Inc. on review for downgrade on February 17, 2012.

This methodology also prompted two 2009 downgrades of Merrill Lynch Derivative Products AG. Moody's Compliance Department sought (unsuccessfully) to overturn each of these downgrades. At the time of the downgrades, MLDP was negotiating to intermediate interest-rate swaps between AIG and some 50+ CDOs and other asset-backed securities – the downgrades made the intermediation more expensive from the point of view of AIG.

In June 2010, I declined an unsolicited offer from Mr. Mark LaMonte, Chief Credit Officer of Moody's Financial Institutions Group, to join his team. I resigned shortly thereafter.

I decided to leave Moody's after listening in disgust to testimony by Moody's executives in the spring of 2010 to the Financial Crisis Inquiry Commission and other investigative bodies. Little of this testimony struck me as truthful. Apparently, no Moody's executive cared to extend to country the common courtesy of better explaining Moody's role in helping ABS & CDO underwriters foment the 2008 financial crisis.

I found the April 23, 2010 testimony of Ms. Yuri Yoshizawa to the Senate Permanent Subcommittee on Investigations to be incredible. I had worked alongside Ms. Yoshizawa since 2000 and had reported to her or her managers since 2005. Her descriptions of the interactions between management of the Derivatives Group and lobbying underwriters bore no relation to my experiences.

I describe the general disbelief which followed Ms. Yoshizawa's testimony in an August 8, 2011 comment to the SEC (William J. Harrington Comment on SEC Proposed Rules for NRSROs.) My comment also discusses the breakdown in CDO committee and the interference by Moody's Compliance Department in MLDP committees cited above.

I will distribute this letter and other materials widely, as is my practice.

Sincerely yours,

William J. Harrington