Moody's Investors Service

Testimony of Laura Levenstein

Senior Managing Director

Moody's Investors Service

Before the

United States House of Representatives

Committee on Financial Services

March 12, 2008

Hearing on Municipal Bond Markets

I. Introduction

Good afternoon Chairman Frank and members of the Committee. I am Laura Levenstein, and I am the Senior Managing Director at Moody's Investors Service ("**Moody's**") for the Global Public, Project and Infrastructure Finance Group. This Group comprises the departments specializing in all levels of public finance globally, as well as project and infrastructure financings. On behalf of my colleagues at Moody's, I would like to thank the Committee for inviting me to participate in today's hearing during which I will broadly discuss the unique attributes of the municipal credit market, Moody's rating system for that market and how it differs from our global rating system. I also will describe the evolution of the municipal market in recent years and the various changes we have been making to our rating system as a result of our ongoing dialogue with issuers, investors and other market participants.

The U.S. municipal bond market has long enabled states, municipalities and counties, as well as school districts and non-profit institutions like hospitals, to finance a range of important governmental activities as well as infrastructure and other public works projects. Moody's first began rating municipal securities in 1918 and we have maintained two separate bond rating systems for the past 90 or so years. Our U.S. municipal system includes ratings assigned to securities issued in the U.S. tax-exempt and taxable bond markets by state and local governments, non-profit organizations, and related entities.[1] Moody's global system includes ratings assigned to issuers and issuances of non-financial and financial institutions, sovereigns and sub-sovereign issuers outside the United States, and structured finance obligations.

These different rating systems grew out of and reflect the unique dynamics and needs of the municipal bond market and the participants in that market. There are two aspects of the market that historically have been particularly important:

- Municipal securities rated by Moody's have had relatively lower credit risk when compared to Moody's-rated corporate or structured finance obligations. While these issuers may experience financial distress, the municipal market has had limited default and loss experience. (Although it should be noted that the loss experience for non-rated municipal issuers has been higher than that for the rated universe.)
- Historically, investors in U.S. municipal securities have had a lower risk tolerance than investors in other types of securities. While the investor base has recently become more diversified, traditionally many municipal investors have tended to invest in municipal securities primarily as a reliable source of tax-exempt income

[1] Please see **Annex I** for Moody's municipal rating system and the definitions of each rating symbol.

and have sought to differentiate the most secure municipal securities within the overall universe of such debt obligations.

Nonetheless, Moody's recognizes that the municipal bond market has evolved, and with it we have taken steps to respond to the changing needs of investors and issuers. We at Moody's are committed to our narrow, but important, role in helping markets operate effectively and efficiently. In this regard, and as I will explain in greater detail below, we have recently decided to assign global ratings to municipal issuers upon request and welcome additional market feedback on measures that would improve the overall transparency and value of Moody's ratings systems.

I note at the outset that the information contained in my testimony is based on the securities that Moody's has rated in the municipal market. A large number of municipal bond issuances are not rated by Moody's and therefore our comments should not be construed as being applicable to the entire universe of municipal issuance.

II. Background on Moody's Investors Service

Credit rating agencies occupy a narrow but important niche in the investment information industry. Our role is to disseminate information about the relative creditworthiness of, among other things, financial obligations of corporations, banks, governmental entities, and structured finance transactions.[2]

Moody's[3] is the oldest bond rating agency in the world, having introduced ratings in 1909. Today, we are one of the world's most widely used sources for credit ratings, research and risk analysis. Our ratings and analysis track debt covering more than 100 sovereign nations, 12,000 corporate issuers, 29,000 public finance issuers, and 96,000 structured finance obligations. In addition, Moody's publishes credit opinions, transaction research, and commentary serving more than 9,300 customer accounts at 2,400 institutions around the globe.

Moody's credit ratings are forward-looking opinions that address just one characteristic of fixed income securities – their creditworthiness. Ratings are not statements of fact about past occurrences or guarantees of future performance and they do not constitute a recommendation to buy, sell, or hold a security. Ratings are designed exclusively for the purpose of ranking bonds according to their relative credit risk and do not take into consideration factors such as the direction of future market prices, an investor's investment objectives, or the investor's risk parameters.

Our long-term debt ratings are expressed according to a simple system of letters and numbers, on a scale that has 21 categories ranging from Aaa to C. Bonds with the lowest relative credit risk are rated at the Aaa level, those with a higher relative credit risk are rated at the Aa level, those with an even higher relative credit risk are rated at the

---

2 Please see **Annex II** for a brief description of the existing regulatory environment under which Moody's operates in the U.S.

3 As is a matter of the public record, Berkshire Hathaway is a shareholder of Moody's Corporation, our parent company.

A level, and so on down through the rating scale. A Moody's rating is not a "pass-fail" grade; rather, Moody's ratings are a relative ranking system.

Moody's credit ratings are widely and publicly available at no cost to investors and the general public. We publicly disseminate our credit ratings through press releases and also make them available on our website. They are made simultaneously available to all market participants regardless of whether or not they purchase products or services from Moody's. The public availability of ratings helps enhance the transparency and efficiency of financial markets, and allows the market and all users of ratings to assess independently the aggregate performance of our rating system.

A. Moody's U.S. Public Finance Group

Moody's began rating tax-exempt municipal debt in 1918. Today our Public Finance Group comprises approximately 100 analysts with diverse professional backgrounds. We publish ratings and research on bonds issued by states, counties, and school districts, as well as on bonds issued to finance not-for-profit healthcare, housing and higher education, public power, water and sewer systems, solid waste/resource recovery plants, airports, ports, mass transit, toll roads, and entertainment and tourism-related facilities. We also rate special financing structures, such as leases, land-secured transactions, state revolving funds, and other types of pooled financing.[4]

We assign our ratings in accordance with published analytical methodologies, which are available on our website, www.moodys.com, and we update our methodologies to remain current with evolving credit trends. We also publish numerous New Issue Reports and Update Reports per year, as well as in-depth analyses of high-profile issuers, rating methodologies, sector outlooks, and special comments.

III. Overview of the U.S. Municipal Finance Market

The municipal bond market has long been a critical arena for state and local governments to raise funds for major capital improvements, such as building roads, bridges, sewer systems and mass transit projects, to name a few. For tax purposes, municipal bonds are classified into two groups.

- *Tax-exempt* municipal bonds include governmental bonds issued to finance typical governmental functions of state or local governments. These functions include activities such as financing the construction or improvement of roads, sewer and water systems or government buildings. Tax-exempt bonds also include those which are issued to finance some non-governmental or quasi-governmental purposes, such as private higher educational institutions and not-for-profit institution. Like most debt obligations, these bonds function like promissory notes. The issuer of the bonds agrees to make scheduled interest payments, at a specified rate, for a fixed period of time, and return the principal at maturity. One attractive feature of tax-exempt bonds for investors is that the interest earned is free of federal income taxes and also may be

[4] References to the "municipal market" or "municipal bonds" do not encompass tax-exempt industrial development bonds issued by corporations or bonds technically issued by governmental entities but backed solely by corporate entities such as financial institutions.

free of state and/or local income taxes if the bond's purchaser is a resident of the issuing state.

- *Taxable* municipal bonds include both fully taxable municipal bonds and municipal bonds subject to the Alternative Minimum Tax.[5] This taxable segment of the market exists because certain activities that do not provide a significant benefit to the public at large are not federally subsidized. Investor-led housing, local sports facilities, and borrowing to replenish a municipality's underfunded pension plan are three types of bond issues for which the interest earned is subject to federal income tax. Taxable municipal bonds offer yields more comparable to those of other taxable sectors than to those of tax-exempt municipal bonds.[6]

(**Table 1** shows the overall size of the municipal market and the dollar amount of issuance in 2007 for both tax-exempt and taxable bonds.)

Table 1
U.S. Municipal Finance Market:
Selected Statistics 2007

	In dollars
Total outstanding	$2.6 trillion[7]
Total long term issuance in 2007	$429.7 billion[8]
Total tax-exempt issuance in 2007	$362.4 billion[9]
Total taxable issuance in 2007	$67.3 billion[10]

The municipal market can be differentiated from other credit securities markets in two important respects: the lower overall credit risk for municipal securities and the unique interests of municipal bond investors. We discuss both differences in turn.

---

[5] The Alternative Minimum Tax ("**AMT**") is a separate tax computation under the Internal Revenue Code, which, in effect, eliminates many deductions and credits and creates tax liability for an individual who would otherwise pay little or no tax. A potential investor might choose to purchase an AMT bond because the yields are higher, reflecting the risk that the interest earned on the bonds could become taxable to the investor at some point in time.

[6] The taxable municipal market has grown rapidly in recent years. According to Securities Industry and Financial Markets Association ("**SIFMA**"), in the last five years alone, over $90 billion in taxable municipals have been issued.

[7] SIFMA.

[8] Thomson Financial.

[9] Ibid.

[10] Ibid. Out of the total issuance of $67.3 billion, $29.3 billion in issuance represented taxable securities and $38 billion represented issuances of AMT bonds.

A. Lower Credit Risk for Municipal Securities

Overall, the credit risk of municipal securities is lower than that of corporate and other securities for a number of important reasons. Four of the principal reasons for this lower credit risk are discussed below.

1. *Municipal Issuers Provide Essential Services*

Municipalities typically are perpetual entities providing essential public services. They do not need to generate a return on equity but merely to break even or generate a small surplus in order to continue operating.

2. *Power to Levy Taxes or Tax-Like Charges*

Municipalities have the power to levy taxes or impose tax-like charges for those essential services. Also, municipalities can secure their bonds with a "general obligation" pledge, meaning that all of the municipality's revenue-producing powers are promised to be used to satisfy the debt, including the municipality's ability to levy taxes sufficient to pay such debt.

Further, if a default on general obligation debt occurs, bondholders can seek a *writ of mandamus*. The writ, ordered by a court, directs the appropriate governmental official to levy and collect taxes to pay debt service or to make required debt service payments using other available funds of the municipality. This ability to invoke *mandamus* provides a great degree of comfort that, in almost all circumstances, bondholders ultimately will recover 100% of the principal and interest owed.

3. *Distinctive Bankruptcy Laws*

There are unique laws that apply to bankruptcies of municipal entities – which contribute to the lower credit risk of these securities. While corporations can file for bankruptcy under Chapter 7 (liquidation) or Chapter 11 (capital structure reorganization), municipalities, when allowed by their governing state laws, would file for bankruptcy under Chapter 9. Bankruptcies of municipalities under Chapter 9 differ from corporate bankruptcies in several respects:

- Involuntary bankruptcy filings are not permitted;
- Chapter 9 provides only for an adjustment of the municipality's debts, not its liquidation; and
- The municipality's powers are not affected by the filing.

These differences in bankruptcy law allow a municipality to continue operating during a bankruptcy, giving it the ability to raise revenue and make payments on any defaulted debt.

4. *Third-Party Intervention*

Finally, a municipality in financial distress will typically never reach default because a higher level of government, e.g., the state, will generally step in to prevent defaults on outstanding obligations. Even though very few Moody's-

rated bonds have experienced payment defaults, numerous issuers have avoided defaulting on debt only because of intervention by a third party.[11]

Many other state and local government-related bond issuers share these low-risk characteristics, in part because they benefit from the implicit support of the state and local government authorities that create or sponsor them. For example, Moody's considers most water and sewer authorities and public university systems to be very strong credits, not only because they possess dependable revenue streams, but also because Moody's believes they are very likely to receive financial support from their sponsoring authorities in the event of distress.

Not all tax-exempt issuers share these inherently strong credit characteristics. Some tax-exempt issuers (such as not-for profit hospitals, issuers in public infrastructure project financings, and private universities) increasingly share "corporate-like" characteristics, such as exposure to true market competition and relatively less direct governmental subsidies and control.[12]

B. Unique Interests of Municipal Bond Investors

It has been our understanding that, historically, investors when purchasing municipal bonds have done so with different perspectives and risk appetites than investors in corporate bonds, and our rating systems have evolved to reflect those different needs. For example, unlike corporate bond investors, municipal investors generally have been more risk averse and have looked for tax-free alternative investment opportunities to US Treasuries. As a result, they have been less diversified in their investment portfolios, more concerned about the safety and liquidity of their investments, and in the case of individuals, often more dependent on debt service payments as a reliable source of income.

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

We note, however, that the attributes of the municipal investor community are changing and investors are becoming increasingly multi-disciplinary in their approach.

[11] It should be noted that in times of financial distress municipalities often can generate an internal solution to restore financial balance without involving a third party. However, there generally is a great deal of uncertainty with respect to the timing and content of the ultimate outcome.

[12] Nevertheless, there have been many instances of governmental intervention to support these types of issuers when they are in financial distress.

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

John Moody, the founder of Moody's Investors Service, first introduced a simple system for rating railroad bonds in 1909. This system was broadened a few years later to include all industrial bonds. When he later began rating state and local governments, he used a similar but distinct municipal rating system. The difference between the two rating systems was recognized explicitly in *Moody's Government and Municipal Manual* published in 1920,[13] and since that time we have continually published on it and talked to market participants about it.

Similar to the bond markets themselves, Moody's rating approach to municipal issuers (as well as issuers in other credit markets) has developed over time to address the unique needs of the investors and issuers. Investors in corporate or structured securities typically have looked to Moody's ratings for an opinion on whether a security or an issuer will meet its payment obligations.

Historically, this type of analysis has not been as helpful to municipal investors. If municipal bonds were rated using our global ratings system, the great majority of our ratings likely would fall between just two rating categories: Aaa and Aa. This would eliminate the primary value that municipal investors have historically sought from ratings – namely, the ability to differentiate among various municipal securities. We have been told by investors that eliminating that differentiation would make the market less transparent, more opaque, and presumably, less efficient both for investors and issuers.

Instead, Moody's distinguishes more finely among the various municipal securities and ranks one against the other on the basis of intrinsic financial strength. Because the risk and potential severity of loss is relatively low in the municipal market, Moody's municipal ratings principally focus on the risk that an issuer will face financial distress. In other words, we seek to measure an issuer's ability and willingness to service its debt without the need for third party intervention. This can be translated roughly into an estimate of its default probability without consideration of loss severity. This different calibration from the corporate market takes account of and reflects the unique interests and dynamics of the municipal bond market.

A. Key Analytical Factors and Rating Process for Municipal Ratings

Broadly speaking, Moody's ratings of securities issued by municipalities are based upon the analysis of the primary factors relating to municipal finance: economy, finances, debt, governance/management strategies, and structural features of the securities.

---

[13] Government and Municipal Manual of 1920: "…Municipal ratings 'are necessarily based on a broader and more general foundation than are the ratings supplied for the ordinary corporation or railroad issues. … Thus, under all ordinary conditions, it can be accepted as a fact that a municipal obligation of a well established and growing city or town is substantially secure insofar as the strength of the principal is concerned. Qualifications in rating, therefore, are limited, and the variations between one type of municipal bond an another are not very great."

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

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

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

V. Performance of Moody's-Rated Municipal Bonds

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

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

- Between 1970 and 2006, just 41 out of approximately 29,000 Moody's-rated municipal issuers defaulted. Twenty-two of these defaults occurred between 2001 and 2006.

- 16 of the defaults were for housing projects, 18 were for healthcare and other not-for-profit institutions, and seven related to local governments and related public sector issuers.
- Only one of the defaults among Moody's-rated municipal issuers involved an issuer of general obligation bonds, and this issuer recovered quickly and paid its obligations in full.

B. Greater Credit Risk in Unrated Municipal Market

As **Table 2** indicates, a significant number of municipal bond transactions are not rated. An issuer may elect not to obtain a rating for its debt for a number of reasons. In particular, if the transaction is small or the municipality is an infrequent issuer, the cost of public disclosure and other requirements to obtain a rating and access the public markets may make these options unattractive. Furthermore, access to public markets may not be necessary, since issuers in some circumstances may be able to place small deals directly with banks (i.e. bank-qualified deals) or with other private investors.

Table 2

Proportion of Rated Versus Unrated Market for Municipal Securities Issued in 2007[14]

	Dollar volume	Number of transactions
Rated long-term municipal bond issuances	93. 32%	62.46%
Un-rated long-term municipal bond issuances	6.68%	37.54%

There is evidence to suggest that, in general, issuers in the unrated municipal bond market may have higher levels of credit risk than rated issuers. While Moody's has not verified this data, *Income Securities Advisor,* an independent investment advisory and research firm, reported 1,311 defaults on unrated, tax-exempt bonds[15] during the period from 1980 through October 2004 – a significantly higher number of defaults than the number of defaults for Moody's-rated issuers.[16]

[14] Interactive Data Corporation and Bloomberg.

[15] The reported number of defaults of unrated bonds includes "technical defaults" (i.e. violations of covenants) as well as payment defaults, whereas Moody's studies capture defaults of rated securities only in the event of actual payment defaults. As noted, the data has not been verified by Moody's and we cannot assess it accuracy or validity.

[16] As noted earlier, only 41 out of approximately 29,000 Moody's-rated issuers of taxable or tax-exempt municipal bonds defaulted on payment obligations in the period 1970-2006.

VI. EVOLUTION OF MOODY'S MUNICIPAL BOND RATINGS REFLECT ONGOING DIALOGUE WITH MARKET PARTICIPANTS

In providing credit opinions to the municipal market over the past 90 years, Moody's has always maintained an active dialogue with municipal investors and issuers to understand what attributes would help make our municipal rating system most useful, and we have adjusted our rating system as the markets and the needs of investors and other market participants have evolved. While historically we observed that municipal bond investors have purchased such bonds with different perspectives and risk perspectives than investors in corporate bonds, in recent years we have seen municipal bonds increasingly traded by a wider range of multi-disciplinary investors. Over the course of the past few years, we have made several changes to our municipal ratings system and approaches to reflect this evolution in, and feedback from, the market.

- ***In 2001***, Moody's met with over 100 market participants to understand their views on the need for and value of globally consistent ratings.[17] The vast majority of participants surveyed indicated that they valued the municipal rating scale in its current form. Additionally, many market participants expressed concerns that any migration of municipal ratings to be consistent with the global rating scale would result in considerable compression of ratings in the Aa and Aaa range, thereby reducing the discriminating power of the rating and transparency in the market. However, a segment of the market indicated that they would value a greater ability to compare municipal credits to other securities in other markets.

- ***In 2002***, we published a default study which highlighted the limited default experience in the Moody's-rated market for public finance securities, and we noted that some taxable bonds were starting to be placed outside of the United States. To accommodate the latter trend, we began:

    1) offering entities issuing tax-backed or essential service revenue-backed taxable securities outside the U.S. the opportunity to request that a global rating be assigned; and

    2) providing broad guidance on how our municipal ratings would translate into our global ratings. In particular, we stated that it would be reasonable to conclude that nearly all Moody's-rated general obligation and essential service revenue bonds would be rated at or near the top of the global scale.[18]

- ***In 2006***, we published a *Request for Comment* asking market participants whether they would value greater transparency about the conversion of our municipal rating system to a global rating system. We received over 40 written responses and had telephone and in-person discussions with many other market participants. Generally, the majority indicated that they valued the distinctions the current rating system provides in terms of relative credit risk, but that they would endorse the expansion of assigning global ratings to taxable municipal bonds sold inside the U.S.

---

[17] "Moody's Municipal Default Study Highlights and Next Steps," Special Comment, June 2002.

[18] It is important to note, however, that the time period studied did not include a period of extreme financial distress such as the Great Depression.

- ***In 2007***, based on the above feedback and to further improve the transparency of our long-term municipal bond ratings, we:
    1) implemented a new analytical approach for mapping municipal ratings to global ratings, thereby enabling investors to compare municipal bonds to corporate bonds while maintaining the municipal scale that investors and issuers told us they valued;
    2) published a conversion chart that market participants could use to estimate a global rating from a municipal rating; and
    3) announced that, when requested by the issuers, we would assign a global rating to any of their taxable securities, regardless of whether the securities were issued within or outside the United States.[19]

Since publication of our report in March 2007, the market has continued to evolve. For example, recently, several of the largest municipal issuers, among the thousands we rate, have suggested that the municipal ratings system be eliminated altogether. We are very interested in learning more about the views of these and other issuers, as well as hearing from investors and other market participants. We are already re-evaluating our existing municipal ratings system and will be issuing a *Request for Comment* in which we will:

- propose assigning global ratings to any tax-exempt bond issuance, including previously issued securities as well as new issues, at the issuer's request beginning in May 2008;
- clarify that the conversion table we published in our March 2007 report can be applied to both tax-exempt and taxable municipal securities; and,
- ask whether market participants would prefer a simplified conversion table that would make it easier to estimate a global rating from a municipal rating.

During the *Request for Comment* period, we hope to gain a thorough understanding of issues important to market participants, including how issuers and investors are using municipal ratings today and how this has evolved over the past few years since 2006, when we last reached out formally to the market.

VII. MUNICIPAL BONDS WRAPPED BY FINANCIAL GUARANTEES

Both rated and unrated municipal bond issuers can choose whether or not to obtain credit enhancement for their bonds. Credit enhancement is available in different forms, such as guarantees, letters of credit and bond insurance. Consequently, the decision to purchase bond insurance rests solely with the municipal issuer, which weighs the costs and benefits of insuring its bond against its various other alternatives.[20]

---

[19] To put this demand for global ratings by municipal issuers into context, since we first began offering global ratings for taxable securities in 2002, only sixteen issuers have requested Moody's to assign a global scale rating to their bond issuances, while two issuers requested a global scale rating for their obligations under swap contracts.

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

Bond insurance is provided by a third-party insurance company, which in return for an insurance premium, agrees to insure the timely payment of interest and principal for the bonds for the entire term of the bonds. The issuer remains primarily responsible to pay amounts owing on the bonds as they come due. The bond insurer (also known as a "financial guarantor") becomes obliged to pay only if the issuer fails to make timely payments of interest or fails to repay the principal when it comes due. An insured bond is sometimes called a "wrapped bond" (*i.e.* a bond wrapped by insurance).

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

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

VIII. CONCLUSION

Moody's is strongly committed to meeting the needs of investors, issuers and other participants in the municipal bond market to assess the relative creditworthiness of securities in that market – a market that plays a vital role in meeting public needs.

Both issuers and investors in the municipal market have had characteristics that are different from those in other credit markets. Issuers – because of their unique powers and role as public entities and the laws that apply to them – have presented low credit risk. Although the characteristics of investors in this market have begun to change somewhat in recent years, historically investors purchasing municipal bonds have done so with different perspectives and risk appetites than investors in other areas of the credit market. Municipal bond investors traditionally have been, and we believe many municipal investors continue to be, highly risk averse and eager for a rating system that differentiates among various issuers' likelihood of experiencing financial stress.

Moody's is engaged in an ongoing dialogue with participants in this market and other markets we serve to ensure that our ratings meet the evolving needs of these participants. We have found a strong desire among participants in the U.S. public finance

markets for a credit rating system that is distinct from that used for rating corporate bonds. At the same time, we have continued to provide the market with enhanced tools to increase the transparency and comparability of ratings between these two markets. We review our practices in this market and make changes as necessary so that we can apply our analytical expertise in a way that can best meet the needs of investors, issuers and other market participants.

Annex I

Municipal Long-Term Rating Definitions

Aaa Issuers or issues rated Aaa demonstrate the strongest creditworthiness relative to other municipal or tax-exempt issuers or issues.

Aa Issuers or issues rated Aa demonstrate very strong creditworthiness relative to other US municipal or tax-exempt issuers or issues.

A Issuers or issues rated A present above-average creditworthiness relative to other US municipal or tax-exempt issuers or issues.

Baa Issuers or issues rated Baa represent average creditworthiness relative to other US municipal or tax-exempt issuers or issues.

Ba Issuers or issues rated Ba demonstrate below-average creditworthiness relative to other US municipal or tax-exempt issuers or issues.

B Issuers or issues rated B demonstrate weak creditworthiness relative to other US municipal or tax-exempt issuers or issues.

Caa Issuers or issues rated Caa demonstrate very weak creditworthiness relative to other US municipal or tax-exempt issuers or issues.

Ca Issuers or issues rated Ca demonstrate extremely weak creditworthiness relative to other US municipal or tax-exempt issuers or issues.

C Issuers or issues rated C demonstrate the weakest creditworthiness relative to other US municipal or tax-exempt issuers or issues.

Moody's applies numerical modifiers 1, 2, and 3 in each generic rating classification from Aa through Caa. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category.

Annex II

Regulatory framework in which Moody's operates

In September 2006, the Credit Rating Agency Reform Act ("**Reform Act**") was passed into law. It created a voluntary registration process for rating agencies willing to have their ratings used in federal securities laws by being designated as a nationally recognized statistical rating organization ("**NRSRO**"). The Reform Act also authorized the Securities and Exchange Commission ("**SEC**") to oversee such NRSROs. The objective of the Reform Act is "to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating agency industry"[21]. It aims to:

a) enhance accountability by providing the SEC with oversight authority to assess the continued credibility and reliability of an NRSRO;

b) promote competition through a clear process by which a rating agency can apply for and receive NRSRO designation; and

c) improve transparency by requiring registered NRSROs to make publicly available most of the information and documents submitted to the SEC in their applications.

In June 2007, the SEC published its rules to implement the Reform Act and ensure rigorous oversight of the credit rating industry and on September 24, 2007 Moody's became a registered NRSRO pursuant to the new Reform Act rules. The rules include the following:

- Registration Requirements (17g-1): Implements the registration requirements for NRSROs.
- Recordkeeping (Rule 17g-2): Ensures that an NRSRO makes and retains records to assist the SEC in monitoring, through its examination authority, an NRSRO's compliance with the provisions of the Statute.
- Financial Reporting (Rule 17g-3): Requires NRSROs to furnish the SEC with audited financial statements and associated schedules on an annual basis to allow the SEC to monitor the NRSRO's financial resources and assess its ability to support robust credit analysis activities.
- Protection of Material Non-Public information (Rule 17g-4): Requires an NRSRO to have procedures designed to prevent potential misuses of material non-public information.
- Managing Conflicts of Interest (Rule 17g-5): Requires an NRSRO to disclose and manage those conflicts of interest that arise in the normal course of engaging in the business of issuing credit ratings.
- Prohibition of Unfair, Coercive, or Abusive Practices (Rule 17g-6): Prohibits NRSROs from engaging in certain acts or practices relating to the issuance of credit ratings that the SEC has determined to be unfair, coercive, or abusive.

---

[21] Credit Rating Agency Reform Act of 2006, Preamble.

Last summer, using its new statutory authority, the SEC began examinations of the role of the rating agencies with respect to the subprime markets. The SEC's examination is focused on whether the rating agencies diverged from their stated methodologies and procedures for determining credit ratings in order to publish higher ratings. As stated by Chairman Cox,[22] a final report discussing the results of the examination is expected in the Summer of 2008.

[22] "The State of the United States Economy and Financial Markets": Written testimony of Chairman Christopher Cox, U.S. Securities and Exchange Commission, before the U.S. Senate Committee on Banking, Housing and Urban Affairs, February 14, 2008.