Moody's Investors Service

99 Church Street
New York, New York 10007

April 24, 2007

By Electronic Mail

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Rules Regarding Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations (Release No. 34-55231; File No. S7-04-07)

Dear Ms. Morris:

Over the past several weeks Moody's has had several meetings with offices of the Securities and Exchange Commission ("SEC") on the above-captioned proposed rules (the "Proposed Rules") which implement the Credit Rating Agency Reform Act of 2006. In so doing, we have discussed the potential negative consequences of Proposed Rule 17g-6(a)(4) which under certain interpretations may be read to require an NRSRO to treat the ratings of other existing and future credit rating agencies interchangeably with its own. By way of demonstrating the impact, we have provided the Commission with the following research piece which empirically demonstrates the damaging result of compelling interchangeability of ratings.

We appreciate the opportunity to submit this document into the public record.

Sincerely,

Jeanne M Dering

Jeanne M. Dering

Executive Vice President

Global Regulatory Affairs & Compliance

A Case for Rating Agency Independence

Summary

- Moody's believes all its ratings, including ratings on structured pools of collateral securities, should be based on our own independently formed credit opinions. In contrast, some market participants argue that rating agencies should be compelled to use the ratings of all other agencies, including both current and all future rating agencies, interchangeably with their own when evaluating the credit risk of collateral securities. We believe such a proposal would negatively impact the credibility and reliability of our ratings and increase the risks to investors who rely on our ratings.

- Such a proposal would reduce the number of independent opinions in the marketplace, would contravene Congress' stated intention that the SEC should not interfere with the agencies' rating methodologies, and would require that rating agencies assign ratings that are inconsistent with their actual credit opinions. Rating agencies would also be put into the untenable position of having to choose which of two laws they would follow – an SEC regulation requiring agencies to rely on each others' ratings (even if their own opinions differ) or the general securities law principle that no one should intentionally deceive the market.

- Some market participants mistakenly believe that rating agencies agree on most transactions. One reason for this misconception is that many market participants focus on jointly rated Aaa securities. On securities that Moody's rates Aaa, other agencies also assign AAA ratings 98% of the time. However, when Moody's rates securities something other than Aaa, our ratings differ from other agencies' ratings almost half of the time, and the differences are nearly two rating grades on average – and often much larger.[1]

- Another reason for this misconception is that "rating shopping" has the effect of masking differences of opinion. Before finalizing a transaction, a deal's sponsor may ask multiple rating agencies whether a particular structure will achieve its targeted ratings. The sponsor then requests ratings from specific agencies, based largely upon their expected ratings and his beliefs about the relative influence of their opinions with investors.

- The benefit of independent opinions and the harm in compelling agencies to rely blindly on other agencies' ratings can be well illustrated by analyzing a sample of structured securities that were rated by other rating agencies but Moody's was not asked to rate because our ratings would have been lower.

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[1] For a list of supporting references, see Footnote 6.

- We examine forty-four residential mortgage-backed securitizations where Moody's and at least one other rating agency rated senior tranches. On these same securitizations, other rating agencies assigned single-A or BBB ratings to 113 junior tranches that Moody's was not asked to rate. If we had been asked to rate these securities, our ratings would have averaged 3 to 4 rating grades lower than those of the other agencies.[2]

- If, in these instances, Moody's had been required to use the ratings of other rating agencies on these securities without adjustment, we would have been compelled to rate structured pools containing these securities at substantially higher rating levels than our own credit analysis dictated.

- Interestingly, other agencies have recently indicated a difference of opinion of a similar magnitude with some of Moody's ratings.[3]

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[2] The differences in rating opinions across agencies observed for this sample are similar to those detailed in prior research on other samples. For more information, see Footnote 6 below.

[3] See, for example, "First Generation CPDO: Case Study on Performance and Ratings," Derivative Fitch, April 18th, 2007.

Introduction

In response to the SEC's proposed rulemaking on regulation of Nationally Recognized Statistical Rating Organizations (NRSROs), some market participants have expressed the view that rating agencies should be compelled to rely on ratings assigned by other current and future NRSROs, regardless of the resulting inability of the rating agencies to express their independent views. Such a proposal would imply that when evaluating the credit quality of a collateral pool backing a collateralized debt obligation (CDO), Moody's would have to rely directly on other NRSROs' ratings for any collateral that does not have a published Moody's rating.

In contrast, under Moody's current practices, a sponsor of a securitization can choose from among three methods by which Moody's can form an opinion about the risk profile of non-Moody's-rated collateral debt obligations:

1. Moody's can undertake a fundamental review or a quantitative analysis of the collateral to arrive at an unpublished credit estimate,
2. Moody's can review the sponsor's internal credit scoring system and "map" Moody's ratings to the sponsor's credit scores,[4] and
3. Moody's can incorporate the opinions of other rating agencies about the collateral, including adjustments to the ratings ("notching") where appropriate, to reflect where Moody's credit opinions diverge from those of other agencies.

Moody's provides the third option at the request of some collateral managers who prefer the efficiency of execution and certainty of results it provides in comparison to credit estimates. Moody's will employ this last option, however, only when Moody's has sufficient data to infer the average relationship between another agency's ratings and the ratings Moody's has derived internally or believes it would have assigned for a similar type of collateral based on existing ratings comparison analysis.[5]

If a rule were adopted requiring rating agencies to rely on other agencies' ratings, the SEC could certainly be viewed as "regulating the substance" of ratings, in contravention of one the Credit Rating Agency Reform Act's key mandates. Moreover, the information available to investors would be reduced by reducing the number of independent opinions in the market. Furthermore, the market's system of checks and balances that correct distortions that result from "rating shopping" would be undercut. Finally, we believe the quality of our ratings would decline, as we would be compelled to assign ratings to CDOs that would not reflect our actual opinion of the underlying collateral.

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[4] To provide a reliable mapping, Moody's would generally expect full access to the sponsor's credit management system and its performance, and we would re-map the sponsor's credit scores to Moody's ratings periodically. For a mapping to be reliable, however, Moody's needs to be confident the sponsor will not "adverse select" debt obligations for inclusion in CDOs that are riskier than those suggested by the mapping. For this reason, mapping is most commonly used for bank balance sheet CLOs, in which the very large size or a random selection process guards against the risk of adverse selection.

[5] In cases where the published ratings of a current or future NRSRO provide limited coverage of a given asset type, Moody's may be unable to offer the third alternative.

In the remainder of this document, we explain, using a recent data sample of residential mortgage-backed securitizations, why this issue is of great importance to the market. If Moody's had been compelled to accept other NRSROs' ratings at their assigned rating levels on CDO collateral, the resulting Moody's CDO ratings would have varied substantially from – and would have been much higher than – those reflecting our true credit opinions.

Rating Shopping Masks Large Differences in Opinion across the Agencies

For the purposes of this study, we looked at forty-four mortgage-backed securitizations, issued between August 2005 and January 2006. In all of these cases, Moody's was asked by the sponsor to rate senior tranches in these transactions. Moody's ratings were declined, however, for 113 tranches that were rated single A or BBB by our competitors. S&P rated all 113 of these tranches, and Fitch rated 60 of them.

Moody's ratings were declined on these junior tranches because our ratings would have been lower – and in some cases significantly lower – than the ratings published by the other agencies. Differences in rating opinions such as these are common across rating agencies. They arise due to differences in methodologies, the meanings of ratings, and views of the likely performance of various asset classes in general.

As shown in Table 1, the differences between the other agencies' ratings and the ratings Moody's would have assigned varied widely from case to case: our ratings would have been anywhere between 1 and 7 rating grades lower than the other agencies. On average, however, Moody's would have rated them 3 to 4 rating grades lower.[6] It should not be surprising that Moody's ratings would have been systematically lower: if Moody's ratings would have been the same as or higher than the other agencies' ratings, it is likely that we would also have been asked to rate the securities.

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6 These results are indicative of findings based on other data samples. Wide differences in ratings on jointly rated securities (other than those rated Aaa) are catalogued in the *Moody's Special Comment*, "Comparing Ratings on Jointly-Rated U.S. Structured Finance Securities: 2007 Update" (March 30, 2006) and in "Credit Ratings for Structured Products," National Economic Research Associates, (November 2003).

Academic research has further shown that rating differences are likely to be even more pronounced – though not directly observed – on securities that are not jointly rated and have been subjected to "rating shopping." See. Peretyatkin, V and W Perraudin, "EL and DP Approaches to Rating CDOs and the Scope for 'Ratings Shopping'" in M. K. Ong (ed), *Credit Ratings – Methodologies, Rationale and Default Risk, London: Risk Books* (2002).

Large systematic rating differences are documented for asset classes that have been subjected to rating shopping in the following *Moody's Special Reports*: "Moody's Study of Ratings of Non-Moody's-Rated RMBS" (April 18, 2002); Moody's Studies Ratings of Non-Moody's-Rated CMBS and Revises Notching Practices (January 22, 2002); and "Moody's Studies Ratings of Non -Moody's-Rated CDOs and Confirms Rating Estimate Approach" (March 22, 2002).

Table 1

Ratings Moody's Would Have Assigned If Asked *Versus* Those Assigned by S&P and Fitch
(On a Sample of Securities Rated A or BBB by S&P and Fitch between Aug '05 to Feb '06)

# of Rating Grades Moody's Would Have Rated Lower Than Competitor	# of Securities Rated by S&P	# of Securities Rated by Fitch
1	5	5
2	12	14
3	23	16
4	38	17
5	19	7
6	14	1
7	2	0
Memo Items:		
Total Number of Securities	113	60
Average Rating Grades Differences	3.9	3.2

If rating agencies were forced to rely on other agencies' ratings in rating CDOs, this would lead to incongruous outcomes in which agencies were compelled to evaluate the credit risk of collateral securities at very different rating levels than those supported by their own analysis. In the sample study shown above, this would result in the assignment of ratings for CDOs that were higher than those supported by Moody's own credit opinions about the collateral.

Why Do Collateral Managers Want to Include Collateral Not Rated by Moody's in Moody's-Rated CDOs?

Investors understand that rating opinions and approaches vary among agencies. They also understand that these differences can result in very different rating outcomes. As a result, it should not be surprising that bonds without a Moody's rating can often trade at wider credit spreads for their rating level than those that have a Moody's rating.

So why do collateral managers want to include collateral not rated by Moody's in a Moody's-rated CDO? Collateral that has not been rated by Moody's, and therefore may have a wider credit spread, is attractive to some collateral managers because it offers an arbitrage opportunity – the potential for larger cash flows to equity investors early in the life of a CDO. In fact, collateral managers have a pecuniary incentive to include in their CDOs those bonds with the widest possible credit spreads for a given rating level.[7] Their incentive would become even stronger if Moody's were forced to accept the collateral ratings of another rating agency – regardless of rating level – as its own, because the

[7] For this reason, when using another agency's ratings to evaluate collateral risk, rather than basing notching on the average rating gap, Moody's adjusts (i.e., notches) the other agency's rating down so that approximately 80% of the time, the adjusted rating would not be higher than the rating Moody's would likely have assigned to that type of security.

resulting CDO rating would in turn be higher than Moody's would otherwise assign, allowing for even greater arbitrage. In short, the mechanism Moody's has available to reflect our views on the lower credit quality of the collateral would be eliminated.

Impact on CDO Tranche Ratings Is Large

The effect of using other NRSROs' opinions rather than our own in a Moody's-rated CDO of mortgage-backed securities would likely be significant. Market participants that advocate making all NRSROs' ratings completely fungible have proposed compelling rating agencies to accept published ratings by other NRSROs on 15% or more of a collateral pool.

In this section, we illustrate the extent to which our ratings on tranches of CDOs backed by residential mortgage-backed securities would have been artificially high if such constraints had been imposed. In particular, we consider the case in which 15% of the CDO collateral is not rated by Moody's but is rated by other NRSROs. We assume that all the Moody's-rated collateral is rated Baa3, and all the collateral rated by other agencies (but not by Moody's) is rated BBB-, but we would have rated it Ba3 or three rating grades lower. This assumption is consistent with the average "rating shopping" outcome summarized in Table 1.

Table 2 summarizes these assumptions and other characteristics that might be expected for a CDO of mortgage collateral.

Table 2
Example Assumptions
CDO Model: Correlated Binomial
85% of the collateral is rated Baa3 by Moody's
15% of the collateral is rated BBB- by other agencies but Moody's would rate it Ba3
Number of Assets: 218
Moody's Asset Correlation Assumption: 20.50%
Weighted Average Life: 5.18 years
Weighted Average Coupon: 5.38%
Weighted Average Spread: 1.58%
Fixed/Floating Percentages: 23%/77%
Recovery Rate Assumption: 24.75%

Table 3 displays the ratings Moody's would assign based on its own opinion of the collateral; i.e., if Moody's had adjusted the other NRSROs' ratings down by three rating grades. The table also displays the ratings Moody's would have assigned if compelled to use other NRSRO ratings interchangeably with its own. Such a constraint would have caused our ratings to deviate from our opinion (to be "too high") by as much as two rating grades on four tranches and one rating grade on two tranches, with only one tranche's rating unaffected.

Table 3

Impact on CDO Ratings if Moody's Were Compelled to Rely Upon Other NRSRO Ratings on 15% of the Collateral Securities

Tranche	CDO Tranche Ratings if Moody's Relied Only On Its Own Credit Opinions	CDO Tranche Ratings if Moody's Required to Rely on Other NRSRO Opinions	Implied Differences in Ratings (# of rating notches)
A-1	Aaa	Aaa	0
A-2	Aa3	Aa1	2
B	A3	A1	2
C	Baa3	Baa1	2
D	Ba1	Baa3	1
E	Ba3	Ba1	2
F	Ba3	Ba2	1

Conclusions

In order to assign accurate, independent ratings on CDOs, NRSROs must have the autonomy to evaluate the CDO's collateral in those securitizations as justified by their own analytical standards and methodologies. Collateral managers have a strong incentive to add collateral not rated by Moody's to a Moody's-rated CDO if such collateral is rated more favorably by other NRSROs, but viewed as riskier by the market (as reflected in credit spreads) than the average spread for such rating level. If Moody's were compelled to accept as our own other NRSROs' ratings on collateral securities on up to 15% of the par value of the collateral, then our ratings would no longer reflect our own credit opinions. Moreover, the results of rating shopping, which are normally evident in market spreads, would be obscured to the market, hidden within the structure of the CDO.

While the example above is focused on the mortgage-backed CDO market, it is illustrative of a more general issue: rating opinions, approaches and methodologies among current and potentially future NRSROs can have very different meanings and conclusions. Forcing any NRSRO to blindly accept the approach or rating opinion of another current or future NRSRO could compel an NRSRO to publish an opinion that it does not believe and is not supported by its own analysis or methodology.