Special Comment

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Responses to Frequently Asked Questions about Moody's Loss-Given-Default Assessments and Probability-of-Default Ratings

Summary Opinion

In January 2006, Moody's Investors Service published a Request for Comment on its Loss-Given-Default and Probability-of-Default Ratings for Non-Financial Speculative-Grade corporate Obligors (the Proposal). While we made modifications to the Proposal based on market feedback, the final methodology, which was recently published, is materially similar to the Proposal. This special comment provides responses to frequently asked questions we received on the Proposal; a separate comment will provide more detail about the specific questions we received on the Proposal, the frequency of the questions and our responses to the questions.

Moody's Investors Service
Global Credit Research

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BACKGROUND

General Information

Q1 What is Moody's doing?

Moody's is supplementing its current expected-loss (EL)-based security ratings and corporate family ratings (CFRs) with loss–given-default assessments (LGDA) on speculative-grade loans, bonds, and preferred stocks. We will also issue probability-of-default ratings (PDRs) on speculative-grade corporate families. The additional assessments/ratings will disaggregate expected loss into its two components: probability of default and loss-given-default.

Q2 Why is Moody's introducing these new assessments/ratings?

These new initiatives will increase the utility and transparency of our speculative grade ratings as it addresses broad market interest in disaggregating the PD and LGD components of our expected loss-based ratings. The new assessments/ratings framework will also provide greater consistency in distributing LGD across an issuer's capital structure and addresses the apparent conservatism in the existing bank loan ratings as suggested by empirical recovery analyses. In addition, this new initiative specifically addresses broad and growing market interest in disaggregating credit risk, which the Basel II regulatory framework has at least helped to reinforce.

Q3 Why are LGD and PD assessments/ratings not being applied to investment grade issuers?

We are applying PD ratings and LGD assessments only to speculative-grade issuers at this time. Loss given default has its greatest utility for companies at the highest risk of default. However, the methodology could add precision to notching practices for investment grade companies (for example, between a holding company and its operating subsidiaries) and will be considered after the speculative grade rollout.

BASIC DEFINITIONS

Q4 What is a loss–given-default assessment?

LGD assessments are opinions about expected losses given default on fixed income obligations. They are expressed as a percentage of principal and accrued interest at the resolution of the default.

Q5 What is a probability-of-default rating?

The PD rating speaks specifically to the likelihood of default of the issuer. It will be assigned only at the corporate family level and not to specific debt instruments. Purely a derivation from a company's CFR, PDs will rank order speculative-grade corporate families by their relative likelihood of default, irrespective of expected LGD rates on their defaulted instruments. PDs will also alert investors to situations in which two corporate families with the same CFR (and subsequently the same EL rates) have different probabilities of default and different average expected LGD rates across their liabilities.

Q6 How is the PD rating different from the expected loss credit rating?

While PD ratings will use the same rating scale as used for long-term securities and CFRs, they have significantly different meanings. The former will rank credits with respect to default risk while the latter ranks them with respect to expected credit loss, which is the product of default risk and loss in the event of default.

LGD APPROACH

General

Q7 How will the new PD ratings and LGD assessments be made and what symbols will be used?

As is the case presently, the CFR will serve as the benchmark rating. The primary drivers of LGD assessments are the family LGD and the configuration of obligations in the issuer's capital structure.

For issuers that are relatively far from default, we will assume a probability distribution of potential family LGD rates based on historical data. In most instances, the mean of this distribution will equal 50% with a standard deviation equal to 26%, reflecting the high degree of uncertainty associated with predicting family LGD rates. In some cases, we will assume a lower mean of 35% or a higher mean of 65%.

The analysts will construct a waterfall of the existing liabilities, and a model will be used to distribute that value across the waterfall. Using this construct, the model assigns the LGD assessments to the individual instruments. For issuers that are close to default (B2 or lower), the rating committee may apply a traditional valuation approach to estimate LGD (see discussion below). LGD assessments will be assigned to both individual debt securities and to the corporate family as a whole, and will be expressed through a new scale comprised of six ratings — LGD1 through LGD6.

PD ratings will be derived from the CFR rating and will be assigned only to issuers and not to specific debt instruments, using our long-term rating scale (i.e., Ba1 to C).

Assessing Enterprise-Wide Loss Given Default

Q8 Will the same enterprise-wide LGD approach be used for firms that are close to default?

The LGD model will be used across all speculative grade ratings. However, for firms in default or facing a significant probability of default, some of the uncertainty about expected liabilities at default and expected enterprise-wide LGD may be resolved. For such firms, typically those with a CFR rated B2 or lower, expected enterprise-wide LGD may be estimated by comparing expected enterprise value at default resolution using a typical valuation approach. However, for firms that are neither in default nor facing a significant probability of default, we do not plan to pursue a "fundamental" approach to valuing firms in distress.

Q9 Why wasn't a standard valuation approach used to determine an enterprise-wide LGD assessment for all speculative-grade firms?

We believe that family LGD rates for higher rated speculative grade issuers can best be modeled by distributing potential LGD rates in a way that is based on historical experience. We do not believe a fundamental valuation approach is accurate for firms that are a substantial distance from default given the high degree of uncertainty regarding a firm's enterprise value in a default scenario and uncertainty regarding the expected liability structure at default.

Q10 What situations warrant deviation from the 50% standard enterprise-wide LGD?

Firms with very little bank debt in their capital structure (a judgment to be determined by the rating committee) may be assigned an enterprise-wide LGD rate of 65% because such firms have historically experienced higher than average enterprise-wide loss rates. On the other hand, firms with only bank debt and/or regulated utilities have experienced lower than average enterprise-wide loss rates and, therefore, such firms may be assigned an enterprise-wide LGD rate equal to 35%. Please note that the 35% family LGD rate for 2nd liens may be used if the second lien credit facility is deemed to provide creditors with higher recovery prospects through such items as having customary and significant financial covenants and/or having a separate credit agreement.

Q11 Did Moody's consider the underlying reasons for default in determining the 50% average family level LGD assessment?

No. Because our historical research has not revealed any evidence that losses can be predicted on the basis of the principle cause of default, we did not consider the underlying reasons for default in determining the 50% average family level LGD assessment.

Q12 Will Moody's apply its existing notching practices when using a standard valuation approach?

No. The standard valuation approach may include additional known and probable liabilities in the capital structure and will estimate enterprise value through a standard valuation approach such as distressed EBITDA multiple. These inputs will then be applied to the general LGD model.

Q13 Why is the PD limited to a one notch differential from the CFR, if the family level LGD varies from the 50% average?

At typical LGD rates (i.e., 35%, 50% or 65%), the PD is limited to a one notch differential from the CFR based on the 4-year idealized loss table. The 4-year idealized loss tables, which are used by the structured finance group, maps PDs with CFRs, assuming a 50% LGD; the expected loss is a product of the PD and LGD. So, if the family level LGD varies from the 50% assumption, the PD must change accordingly.

Q14 How are intangible assets and unsecured tangible assets reflected in the enterprise-wide LGD assessment?

Analysts consider the amount and composition of intangibles and unsecured assets when determining deficiency claims and the value of security when prioritizing claims.

General Questions about the LGD Assessment

Q15 Will the LGD approach vary for different industries?

Generally no. Our research has not turned up evidence, for the most part, that loss can be predicted on the basis of industry. Exceptions are the regulated utilities and those companies with a bank-only or bank-light debt structure, where either a 35% or 65% enterprise-wide LGD rate may be applied as the situation demands as mentioned above.

Q16 Will the family-level LGD assessment change over time and through different business cycles?

The idealized default and loss rates are not meant to change with different business cycles. Further, LGD ratings are not expected to change as a company approaches default or goes through the different business cycles, unless there is a material change in the capital structure.

Q17 Will LGD assessments for specific debt instruments vary depending on who owns the security?

No. The LGD model does not differentiate among holders of debt, only among the relative classes and amounts of debt, which will be determined through the distribution of a company's loss given default in a waterfall analysis.

Q18 Why are asset values ignored in the LGD model?

Asset values are not considered, other than for assessing deficiency claims, because the LGD approach is anchored in the concept of distributing the estimated value of a firm at default (based on our empirical research of the 50% LGD mean) across a waterfall of existing liabilities. Again, the uncertainty in estimating firm value and liabilities at default obviates the benefit of doing a more refined analysis, especially at ratings above B2.

Q19 How does the LGD approach incorporate qualitative factors?

Qualitative factors such as financial policies and corporate governance will continue to be reflected only in a company's CFR.

Q20 Will the LGD approach result in changes to the existing CFR?

No. The CFR will still be determined through fundamental analysis. The LGD approach provides a more consistent method for notching specific debt instruments and will enable us to assign LGD assessments to specific debt instruments.

Q21 Will the LGD approach be used for issuers that only have one class of debt?

Yes. However, the ratings of the specific debt instrument may not necessarily be the same as the CFR. This will depend on the relative weight of other non-debt obligations, such as leases, pensions, and accounts payable.

Q22 What years were included in the study?

Our empirical data was based on default and loss studies from the early 1980's through 2005.

THE LGD MODEL

General

Q23 How will a company's liabilities at default be estimated?

In most cases, we will assume the company's current liability structure will be the one in place at the time of default. Non-debt liabilities that can be quantified with some certainty, such as trade credit, pension obligations and lease obligations, will be incorporated. Adjustments to the capital structure may also be made to reflect anticipated future debt retirements and issuance. Priority ranking of the liability structure will then be established. Please see below for discussion of revolving lines of credit.

Q24 Do covenants impact the LGD model?

Yes. Although covenants do not impact the collateral value of obligations, covenants (or the lack thereof) impact how deficiency claims are calculated for discrete asset collateral pledges

Q25 Why is Moody's assessing liability structures differently for fundamental credit analyses vs. LGD analyses?

The focus of the two analyses is different. Fundamental analysis determines credit risk and what could drive a company into distress, while LGD analysis assumes that a company is already in distress. Apart from balance sheet debt, which is the primary focus of the LGD analysis, our empirical research suggests that most of the off-balance sheet liabilities of a company are not that relevant in bankruptcy. Exceptions to this rule are pensions and leases, which are discussed below.

Q26 Will Moody's revise the LGD Model assumptions over time?

Yes. As a matter of practice, Moody's continually reassesses its methodologies and rating approaches to ensure high ratings quality. We will do so also with the LGD methodology and then modify our statistical assumptions and approach, if needed.

Treatment of Specific Instruments/Debt Classes

Q27 How will revolving credit facilities be incorporated into the model?

For Ba3 and higher rated companies, the revolver amount used in the LGD model is a "baseline borrowing" plus 50% of the undrawn facility amount, while for single B companies the percentage would increase to 75%. A "baseline borrowing" is defined as the "normalized" borrowing level, which could be an average historical utilization or near term projected borrowings. For Caa companies and lower, the facilities are input at an amount equal to the committed availability subject to the most restrictive covenants. Commodity-based industries defer to the lower of the above guidelines and the 4-year average of quarterly peak cyclical borrowings.

Q28 How are letters of credit treated in the LGD model?

In most cases, we will exclude letters of credit (LOC) in the LGD model unless exposure is probable. If the LOC supports an otherwise unsecured claim such as an environmental remediation claim, we will include the amount of the unsecured claim backed by the LOC as a secured claim, with the remainder treated as an unsecured claim.

Q29 How are obligations that are based on the value of a company's stock treated in the LGD model?

Obligations that are based on the value of a company's stock are excluded from the LGD model. Equity is deemed to be worthless or close to worthless in a distressed scenario.

Q30 Are securitizations included in a company's estimated liabilities at default?

No. Securitizations are ignored for the purpose of the LGD assessment since our research indicates that these facilities typically self liquidate prior to default.

Q31 How will under-collateralized secured obligations and second or third lien obligations be treated?

If secured claims have less than an "all assets" pledge, then we will determine through fundamental analysis how much of the secured claims need to be treated as a general unsecured claim (i.e., deficiency claim). We consider the debt to be fully collateralized when the stressed collateral value is sufficient to cover the debt. If secured claims carry an all-assets pledge, they are treated as the most senior claim, with no deficiency claim. A similar approach is used to value second or third lien debt collateral packages, treating the unsecured portions of these debts as general unsecured claims, ratable with other senior unsecured claims. After distinguishing secured from unsecured claims, through a review of the second/third lien credit agreements and the intercreditor agreement, rating committees will then determine which unsecured credit claims may benefit from subordination.

Q32 How are capital stock pledges treated in the LGD model?

We believe holding company obligations that are guaranteed by operating subsidiaries but secured only by a capital stock pledge are equivalent to an unsecured obligation of the operating subsidiary; similar obligations without guarantees are tantamount to subordinated debt.

Q33 How are trade payables treated with the new bankruptcy code?

Trade payables equal to 20 account payable days for material goods will be treated as administrative priority claims, with the balance considered a general senior unsecured claim. If volatility is not expected, the current balance of accounts payable is a reasonable proxy. If volatility is anticipated, rating committee's may elect to revise the payable balance based on average cyclical peaks and standard industry norms.

Q34 How will other obligations such as leases, underfunded defined benefit pension plan obligations, OPEB obligations, environmental obligations, or tax obligations be treated?

For both operating and capital leases, next year's disclosed minimum lease payments are treated as an unsecured obligation, as are underfunded pension obligations (amount derived from FiRST). We will generally exclude all other non debt like obligations because our research shows that the estimated recovery rates are not significant and do not impact the expected recovery rates for loans and bonds.

Q35 How will subordinated debt be treated?

When estimating and prioritizing a company's expected liabilities at default, we analyze the subordination clauses in the subordinated debt indentures. If not specified in the agreements, we would assume subordinated debt to be equal in rights to trade payables.

Q36 How will preferred stock and hybrid securities be treated?

Hybrid securities and preferred stock are input based on the underlying instrument (debt or preferred stock), irrespective of hybrid basket treatment.

Q37 How will IRB's be treated?

The full amount of IRB's will be treated as a general unsecured claim in the waterfall if the obligation is not backed by a bank letter of credit. If it is backed by a bank letter of credit, the full amount is considered a secured claim in the waterfall.

Treatment of Structural Considerations

Q38 Are the expected liabilities at default determined on a consolidated basis or separate legal entity basis?

We will continue to use the CFR framework where we apply a consolidated approach to determine the benchmark credit risk for the family, and then look to legal entity analysis to identify priority of claim within the family and for cases where the default risk and/or recovery profile may differ (e.g.; regulated industries; complex capital structures with divergent assets/business lines, international operations). We will also consider the flow of inter-company guarantees into the liability structure and determine whether such guarantees have been issued on a senior versus subordinated basis, and secured versus unsecured basis. For example, an upstream guarantee issued on a senior secured basis by an operating company to cover the debt of its parent holding company would rank that debt with senior secured debt at the operating company.

Q39 Are intercompany obligations included in a company's estimated liabilities at default?

Generally no. Intercompany obligations are ignored for the purpose of the LGD assessment since these obligations tend to have limited value in bankruptcy. However, if the intercompany notes serve as collateral for an unsecured obligation, then the unsecured obligation will be considered a secured obligation in the LGD model.

Q40 How are foreign obligations treated in the LGD model?

Foreign obligations will generally be treated the same as domestic obligations in the LGD model. However, if foreign trade accounts payable are separately identified, they will not be treated as an administrative claim in the LGD model as they are unlikely to be awarded priority claim status in a US bankruptcy.

Q41 How are guarantees of another entities debt treated in the LGD waterfall?

If the guarantee of a third-party debt is included in our fundamental analysis of a company's CFR, then the guaranteed obligation should be included in the LGD model. Otherwise, such obligations can be excluded from the LGD model.

Q42 How are joint venture obligations treated in the LGD model?

It depends on the ownership percentage, accounting treatment and specific terms and conditions. Joint ventures with less than 50% ownership, which are not on a company's balance sheet, should be excluded from the LGD model. If joint ventures are on the balance sheet, either because of FIN 46 with less than 50% ownership or because of more than 50% ownership, treatment in the LGD model will be at the rating committee's discretion focusing on the company's ability and willingness to support the joint ventures obligations in default.

Q43 How are unrestricted subsidiaries treated in the LGD model?

It depends on whether the unrestricted subsidiary has a separate CFR. If it has a separate CFR, debt of unrestricted subsidiaries is excluded from the LGD waterfall. If not, than treatment of the obligation in the LGD model will be at the rating committee's discretion focusing on the company's ability and willingness to support the subsidiaries obligations in default

RATINGS AND NOTCHING

Rating Issues

Q44 How will existing ratings be impacted?

It is important to highlight that the existing analytical approach to rating speculative grade companies will **NOT** change. As such we expect very little impact on the existing CFRs. What will change, however, is the notching around the CFR to arrive at the specific debt instrument rating. We anticipate that the adoption of the new notching framework will affect both the existing loan and bond ratings. Application of this methodology will likely lead to higher ratings on a large number of corporate loans, while bond rating changes are expected to be more balanced.

Q45 If there is no senior unsecured debt, can subordinated debt get the same rating as the CFR?

Possibly, but very unlikely. If a company has neither senior unsecured debt nor senior secured debt in its capital structure, then the senior subordinated notes could be rated the same as the CFR depending on the magnitude of other senior obligations such as pension liabilities, leases or trade payables.

Q46 Can a speculative grade company have an investment grade rating on individual securities?

Generally yes, subject to some rating "caps" discussed below (i.e., only possible for a company with a CFR of Ba3 or higher). To the extent there are other non-debt liabilities and unsecured obligations in the capital structure, the ability to rate secured bank debt above the CFR and into the investment grade category is possible. Rating unsecured obligations above the CFR is also possible if there is a significant amount of junior claims and no secured debt.

Q47 Will there be any ratings distinction between junior classes of debt?

There may be, depending on the relative proportion of different priority classes in a capital structure. Under the waterfall approach, secured debt is supported by unsecured obligations and effectively absorbs most of a company's value, while deeply junior obligations suffer to the point where there may not be a meaningful distinction between two classes. Deeply junior obligations may also have the same LGD assessments, as these are relatively broad buckets that each encompass a range of loss expectation.

Q48 How will shelf ratings be reflected in the LGD model?

For debt classes that have an existing rating, the same shelf rating will apply (i.e., senior unsecured debt rated B1 leads to senior unsecured shelf rated (P)B1). For unrated debt classes, we will input $1 into the model as "placeholder" and use the output as the rating (i.e.; if the model derives a B3 rating for $1 of subordinated debt, the shelf rating would be (P)B3).

Q49 Can a rating committee override the model's outcome?

No. The rating committee cannot alter the model's results. The model is simply a set of rules which we have established as our credit methodology to achieve greater consistency in our ratings. However, a rating committee retains considerable judgment, based on fundamental analysis, in determining an issuer's CFR, which remains the principle driver in the model. A rating committee may also revise the general LGD model assumptions in certain instances. The LGD approach also entails analyst discretion and rating committee discussion in determining the estimated liability structure, especially if it is a complex organization.

Notching Issues

Q50 Will ratings on individual secured obligations be "capped above or below" the CFR?

Yes. Because of the uncertainties about expected liabilities at default and various limitations in the priority waterfall approach, we have adopted a guideline limiting notches from the CFR. For CFR's of Caa2 or lower, ratings are limited to no more than four notches above the CFR. For CFR's of Caa1 or higher, they are limited to three notches. Two notches below the CFR is the likely effective cap for most companies, although in rare instances it may be three notches.

Timing and Implementation

Q51 How and when will Moody's implement the new LGD assessments?

The new ratings will be rolled out initially to non-financial corporate speculative-grade issuers in the U.S. on an industry-by-industry basis during September 2006. It will be followed by a rollout in Europe in early 2007 and selectively applied to other market segments over time, following requests for comment and appropriate modifications to reflect relevant market practices and bankruptcy laws.

Q52 Once Moody's starts implementing its LGD assessments, how will new deals be rated in sectors that have not yet been rolled out?

Once the final LGD methodology is published, all new deals will be rated in accordance with the published methodology regardless of whether the entire sector has been transitioned to the LGD methodology.

Q53 Will the LGD model be publicly available?

Yes. In the interest of full transparency, we expect that the LGD model will be posted on Moodys.com.

Q54 Is there a central repository for LGD related information?

Yes. General LGD related information such as the LGD model, LGD methodology and various LGD presentations are available on our website at www.moodys.com/LGD.

Q55 Will the LGD approach impact monitoring and turn-around time for new ratings and information requests?

Generally no. Consistent with our existing practice, we will regularly monitor ratings for events that may change our view on the credit profile of a company. Any shift in the capital structure or significant changes in non-debt obligations that might cause deviations from the adjusted liability structure will likely trigger the need for a ratings reassessment. Absent such changes, the LGD model will be updated annually. Although we do not expect the turn-around time for new ratings to change, rating committee members may request more details with respect to specific security provisions than in the past.

Business Issues

Q56 How will Moody's LGD approach impact pricing grids?

To the extent pricing grids are based on a company's CFR, we do not expect the LGD approach to have a significant impact. Those pricing grids based on a specific facility rating may have to be revised or "grandfathered" in connection with implementation of the LGD methodology.

Q57 How will Moody's LGD approach impact the pricing of bonds and loans?

We cannot speculate how the market will price bonds and loans upon implementation of the LGD methodology. However, as the market gravitates towards assessing the components of an instruments rating, rather than the overall rating, we believe the LGD approach will provide greater transparency as it bifurcates the two key components of an instruments rating: probability of default and loss given default. Ultimately, the pricing will depend on the relative importance of PD vs. LGD for the individual investor.

Q58 How will Moody's LGD approach impact CLOs and will Moody's change its approach to rating CLO's?

Please see Responses to Frequently Asked Questions about U.S. CLOs and Proposed Changes to Moody's U.S. Loan Rating Methodology issued by the structured finance group on March 29, 2006.

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