

# Alternatives for Structuring Liquidity for Asset-Backed Commercial Paper Programs: Conduit Issuer Ratings and Pure Liquidity Support

*A Moody's Investors Service Invitation to Comment*

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## SUMMARY

This Special Comment outlines an alternative approach for structuring liquidity back-stop lines supporting Asset-Backed Commercial Paper (ABCP) programs. The structure would permit certain types of ABCP issuers to achieve a **P-1** rating with the support of a pure liquidity line that has narrower avilment rights than is traditional in most markets around the world. In turn however, such conduits may be required to be enhanced to a relatively higher credit quality, measured on a stand-alone (ex. liquidity line) basis.

The approach is designed to result in expected loss rates of similarly rated securities that are roughly the same - regardless of whether the ABCP programs are supported by traditional liquidity lines or ones designed along the lines of the approach discussed below.

Moody's believes that this approach is consistent in spirit with the proposals being advanced by international regulatory authorities in the New Basel Capital Accord, its associated working papers and other documentation (collectively, the "Accord"). The Accord and related regulatory pronouncements, such as that recently announced by banking regulators in the U.S.<sup>1</sup> are clear in their assessment of capital based on ratings. Therefore the approach, which is based on ratings as well, offers some basis for working within current and proposed regulatory restrictions on ABCP liquidity facilities. The utility of the approach outlined in this Special Comment will be, for most market participants, contingent on the details of the Accord as finalized and implemented by national supervisory authorities around the world.

<sup>1</sup> See Federal Register / Vol. 66, No. 230 / Thursday, November 29, 2001 / Rules and Regulations



Accordingly, Moody's will continue to refine the details of this approach in parallel with the finalization of the Accord. As part of that process, Moody's encourages interested parties to submit comments to Moody's Structured Finance Group. Comments may be sent to the authors via email at [andrew.kriegler@moodys.com](mailto:andrew.kriegler@moodys.com), [sam.pilcer@moodys.com](mailto:sam.pilcer@moodys.com) or [jean.dornhofer@moodys.com](mailto:jean.dornhofer@moodys.com). As Moody's expects to issue an updated version of this document in mid-2002, comments are requested by June 1, 2002.

## **LIQUIDITY LINE COMPARISONS: CANADA, THE UNITED STATES AND EUROPE**

In the United States and Europe, liquidity facilities were originally created to bridge the timing mismatch presented by financing long term assets with short term ABCP. Over time, liquidity facilities evolved to absorb a range of other risks in addition to timing mismatch. This level of risk absorption or credit enhancement is sometimes necessary for the asset's purchase to be commensurate with an extremely low default probability associated with a **Prime-1** rating.

In transactions rated in Europe and the United States, liquidity banks are usually obligated to provide funding in three circumstances: (i) a market disruption; (ii) the lack of investor demand for the conduit's ABCP; and (iii) the breach of a performance trigger which forbids the pool from being further financed by ABCP (a "cease issuance" event). The only instance where the liquidity banks are not obligated to fund in these markets is when the issuer is insolvent.

The amount that the liquidity banks have to fund (commonly referred to as the "borrowing base") varies depending on the risk appetite of the liquidity banks. The borrowing base may partially support ABCP investors by providing funds in the amount of non-defaulted assets or may fully support ABCP investor by providing funds in the amount of ABCP. Liquidity banks who partially support transactions may elect to absorb a spectrum of risks, including but not limited to dilution, true sale, breaches of representations and warranties and cash co-mingling, as shown below.

As a result, the lines cover an array of credit and non-credit risks ranging from those that affect the general market all the way to risks that affect only a single conduit - or even a single program within a single conduit. For example, lines commonly cover the failure to roll an individual conduit's paper due to temporary market unavailability, credit risks of sellers of the assets (in particular, true sale failure), dilution of assets, breaches of representations and warranties, and cash co-mingling risk. At the extreme, fully-supported liquidity can insulate ABCP investors from all credit and liquidity risks of an associated pool of receivables.<sup>2</sup>

With conduit sponsors under competitive pressure to provide higher advance rates and quick execution, the availability of this type of liquidity has resulted in transactions usually being structured to provide a single class senior facility with a credit quality equivalent to a stand-alone rating of between **A** and **Baa**.

The degree of risk absorption differs somewhat between the United States and Europe and also varies by liquidity bank. In the European market for example, liquidity banks infrequently fully support transactions and are far less prone to absorb non-default risks such as dilution in partially supported transactions.

In contrast to international markets, the scope of Canadian ABCP liquidity lines has been limited to providing support in circumstances of a market disruption. This has resulted because of a strict interpretation of regulatory guidance by most market participants. While never issuing a formal definition of the term, the Office of the Superintendent of Financial Institutions ("OSFI", the Canadian banking and insurance regulator) has encouraged market disruption to be defined as general market disruption ("GMD"); a circumstance when not a single dollar of corporate or asset-backed commercial paper can be placed in the market - at any price. As a result, it has been left entirely to the structuring of the individual programs within conduits to cover the credit and non-credit risks arising in the course of various securitizations.

<sup>2</sup> Pilcer, Sam & Dierdorff, Mary: Understanding Structured Liquidity Facilities in Asset-Backed Commercial Paper Programs. Moody's Special Report, August 1997.

The market disruption limits have led many Canadian ABCP sponsors to have a greater focus on vanilla assets than do their counterparts in Europe and the United States and also to structure their programs to a higher stand-alone credit quality - up to **Aaa** in many cases. For example, Canadian securitization programs established to fund everything from home equity lines<sup>3</sup> to retail auto leases<sup>4</sup> have been created with both **Aaa** term tranches and either pari passu CP tranches or stand-alone but similarly structured and enhanced ABCP conduits.

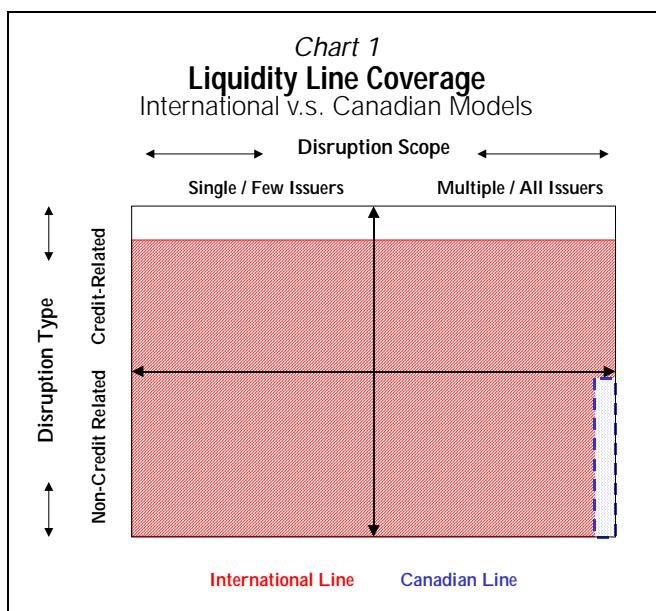
National regulators, either through the Basel Committee process or directly through related pronouncements such as issued by the Federal Deposit Insurance Corporation ("FDIC") in the United States,<sup>5</sup> are clear in proposing capital charges for liquidity lines. Moody's believes that regulators are also generally in agreement that the capital charge should be assigned based on the underlying rated exposure supported by the line.

At this point however, no regulator other than OSFI has so clearly made a distinction based on an absolute separation of liquidity and credit enhancement, a separation currently provided by the market disruption provision. However, the Accord does suggest that a liquidity line would not carry a capital charge if it was either unilaterally cancelable by the provider or if it was automatically cancelled upon credit deterioration.<sup>6</sup> Moody's believes that the basis for tying the Accord and OSFI's existing standards together can be made if a clear definition of credit deterioration is provided.

### GAPS IN THE CANADIAN LIQUIDITY STANDARD

The structure of Canadian ABCP lines can be traced to a 1994 guideline which clearly segregated the different classes of bank support: *first loss protection*, *credit enhancement* and *liquidity*; and attempted to ensure that each was supported by appropriate levels of capital. In particular, presaging actions by supervisors in other jurisdictions, OSFI has long tried to make certain that credit enhancement could not masquerade as liquidity support and minimize what they believed to be necessary capital charges as a result.

The lack of an objective and quantitative standard by which the use of a liquidity line could be shown to be for pure liquidity purposes - rather than for credit support - caused OSFI to take the most conservative view and adopt a GMD standard. Regrettably, while this accomplishes OSFI's goal of excluding credit risks from ABCP liquidity lines, it also precludes lines from providing support both for non-credit risks as well as in those circumstances where credit issues, while present, are not material.



3 Teicher, David: Genesis Trust PowerLine Line of Credit Receivables-Backed Notes, Series 2000-1 & Series 2000-2. Moody's New Issue Report, March, 2000.  
 4 Dill, Alexander & Fellows, Eric: HART: Class A-1 and A-2 Asset-Backed Notes, Series 2000-2. Moody's Pre-Sale Report, November, 2000.  
 5 Federal Register / Vol. 66, No. 230  
 6 Basel Committee on Banking Supervision: The New Basel Capital Accord. Paragraph 43. January, 2001.

There are many potential non-credit related disruptions that could cause an ABCP conduit to need to draw, if only briefly, on liquidity support. Examples can range from market concerns about the credit quality of a sponsoring institution to legal risks about the enforceability of collections on the primary asset class underlying the conduit. At the extreme, the payment system interruptions resulting from the physical destruction of facilities as occurred in New York on September 11, 2001 also represent a non-credit disruption.

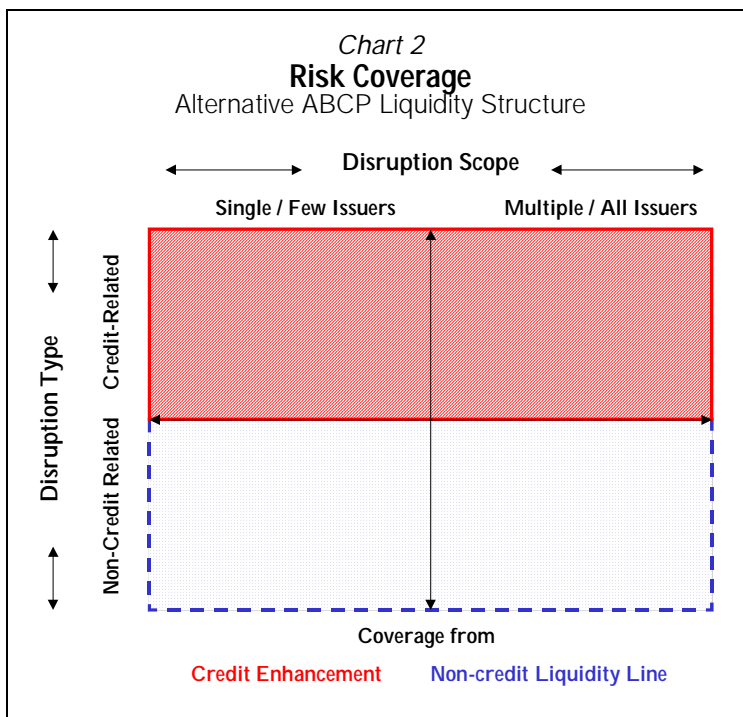
Several ABCP conduits in the United States drew down on their liquidity lines between Tuesday, September 11th and Friday, September 14th but the market did not grind completely to a halt.<sup>7</sup> As a result, had such a circumstance taken place in Canada, liquidity draws - even though they were clearly not related to the credit quality of the conduits - would not technically have been permitted under OSFI's general market disruption doctrine.

Moody's **Prime-1** rating means that ABCP investors will be paid in full and on time to a very high probability. The gaps that exist in Canadian style liquidity lines have led Moody's to conclude that it is unable to assign a **P-1** rating to any Canadian ABCP programs as currently described because the timeliness in repayment to ABCP investors is not assured in the absence of liquidity lines.

## RATING ABCP PROGRAMS BACKED BY NON-CREDIT LIQUIDITY SUPPORT

The concern with liquidity lines based on a GMD doctrine does not suggest that Moody's believes that the underlying philosophy of separating liquidity, credit enhancement and first loss protection is completely without merit. Rather, Moody's feels that it is entirely possible to structure transactions based upon such a model in certain circumstances - as long as care is taken to ensure that all of risks that would have been mitigated in a traditional ABCP structure are also covered in the alternative.

To explain how coverage of the credit, non-credit and timing risks in such an ABCP conduit could be accomplished, Moody's is introducing new methodology for this analysis. It includes a model that addresses the measurement of conduit-level credit risk through stand-alone ratings and provides for a comprehensive standard for the definition of non-credit liquidity lines.



## Issuer Ratings for ABCP Conduits

If the liquidity line supporting an ABCP conduit is not permitted to bear credit risk, sufficient credit enhancement or structural protections to reach the desired rating must be structured into the conduit itself, either on a transaction by transaction basis, or program-wide. That implies that conduit must be assessed and rated taking into

<sup>7</sup> Pilcer, Sam, Dornhofer, Jean & Maurice, Diane: September 11: ABCP Demonstrates Resiliency in the Face of Operational Meltdown. Moody's Special Report, December 2001.

account not only the credit strength of each of the programs within it but also the correlation of default between them.<sup>8</sup> As a result, the analysis will combine traditional ABS credit reviews with the type of correlation analysis performed as part of rating multi-sector collateralized debt obligations.<sup>9,10</sup> Moody's terms the result of that analysis a *Conduit Issuer Rating* ("CIR").

For traditional (i.e. non-structured) entities, issuer ratings are typically assigned when an organization desires an overall assessment of its long-term credit quality rather than an analysis of a specific debt obligation. In the case of ABCP conduits, the situation is analogous: the issuer rating will speak to the overall quality of the conduit while the short term ratings assigned to ABCP will combine that credit appraisal with an assessment of the timeliness provided by the liquidity line. Conduit issuer ratings will be assigned using Moody's long term rating scale using the expected loss approach.

In order to achieve a **P-1** rating, Moody's believes that a conduit backed by a non-credit liquidity line must hold an issuer rating of at least **Aa3**. This threshold is higher than the usual minimum long term **P-1** equivalent of **A2**. However, even without taking into effect the linkage between the conduit's issuer rating and availability of liquidity (see Non-Credit Liquidity Lines, below), Moody's believes that the more limited coverage afforded by a non-credit liquidity line warrants a higher threshold.

The higher default probability benchmark (**Aa3** versus **A2**) is derivative of ABCP investor's traditional desire to minimize the volatility associated with short term ratings and also reflects the severe circumstances surrounding the downgrade of a CIR. Indeed, given that the availability of access to the liquidity line is itself tied to maintaining a minimum CIR of **Aa3**, it is expected that conduits seeking to utilize this approach will be structured to the **Aaa** level.

Similarly, while the rating hurdle specifies that conduit sponsors and support providers<sup>11</sup> seeking to utilize this approach must be rated at least **P-1** (with long term ratings of at least **A1**), Moody's expects the majority of such conduits to feature sponsors and support providers with **Aa3** or higher ratings (see Rating Criteria, below).

<b>Non-credit Liquidity Ratings Thresholds</b>		
	<b>Minimum</b>	<b>Usual /Expected</b>
Conduit (Issuer) Rating	<b>Aa3</b>	<b>Aaa</b>
Sponsor / Supporter Ratings	<b>A1</b>	<b>Aa3</b>

As a practical matter, the assignment of a conduit issuer rating has the effect of rating the liquidity line that would be put in place to support it. While it remains to be seen how national supervisors will treat liquidity line ratings assigned on this basis, conduit issuer ratings would appear to be an appropriate input to the conversion factor and capital calculations proposed by the Accord.<sup>12,13</sup>

### **Non-credit Liquidity Lines**

Isolating an un-funded liquidity line from credit risk satisfies the goal of those regulators who wish to segregate as completely as possible the different classes of bank support to asset securitization programs. It does not, of course, close the coverage gaps in Canadian lines identified earlier. In particular, while credit risks can usually be dealt with by providing a combination of program-level and conduit-wide enhancement, non-credit risks can not.

In order to support the timeliness associated with a short-term rating, the coverage of a non-credit liquidity line must include coverage for all non-credit disruptions including those that affect only a single issuer. Rather than attempt to list all possible non credit-related disruptions, Moody's believes it is more appropriate to structure the line to be available to be drawn in all circumstances<sup>14</sup> - other than those caused by credit deterioration.

8 Although a second order effect, the default correlation between the asset pools, taken together, and the liquidity provider must also be considered.

9 Cotton, Christina & Fons, Jerome: *Moody's Approach To Jointly Supported Obligations*. Moody's Special Report, January, 1998.

10 Gluck, Jeremy & Remeza, Helen: *Moody's Approach to Rating Multisector CDOs*. Moody's Special Report, September, 2000.

11 In Canada, likely only the largest Canadian commercial banks.

12 Basel Committee on Banking Supervision: *The New Basel Capital Accord - Asset Securitisation Supplement*. Paragraphs 33 - 56. January, 2001.

13 Basel Committee on Banking Supervision: *Working Paper on the Treatment of Asset Securitizations*. Page 15. October, 2001

14 This does not preclude the inclusion in the liquidity documentation of reasonability tests to prevent issuers from drawing on the line simply as a funding arbitrage.

The determination of whether a credit deterioration has occurred can be measured by the change, if any, in the conduit's issuer rating. For a conduit to be rated **P-1**, Moody's would expect that the non-credit liquidity line would be available to be drawn in all circumstances as long as the conduit's issuer rating has not dropped below **Aa3**.

Moody's believes that the stability of a rating assigned to a conduit on such a basis will be approximately equal to the stability of a **P-1** assigned to any other class of issuer. This conclusion is based on the relative stability of **Aa3** and higher rated structured finance issues as compared to the stability of **P-1** rated securities generally.<sup>15</sup> In essence, we see that the major difference between the structure of a conduit using the proposed methodology and a traditional ABCP conduit is simply the location of the credit enhancement and structural protections.

<i>Table 2</i> Classic ABCP Structure
<b>'Baa' Conduit + Credit/Liquidity Combo =&gt; P-1</b>
Non-credit Liquidity Alternative
<b>'Aaa' Conduit + Non-credit Liquidity =&gt; P-1</b>

### **CREDIT QUALITY, LIQUIDITY AVAILABILITY & SHORT TERM RATING STABILITY**

The linkage of a conduit featuring stand-alone credit enhancement to a liquidity line that is available to fund in all circumstances, subject to a ratings maintenance test, covers the gaps that currently exists in the Canadian system and is potentially applicable in other jurisdictions. In particular, such an approach would allow in Moody's view, the ABCP issued by the conduit to achieve high short-term ratings.

Further, the use of a conduit's issuer rating in this way may satisfy, at least in principal, the need raised by some regulators for an objective and quantifiable measurement of the capital charge that will be assessed against liquidity lines.

Lastly, as noted above, Moody's believes that securities which feature **P-1** ratings assigned pursuant to this approach will be as stable as, and have expected loss profiles that are similar to all other equally rated securities.

However, Moody's conclusion that it is possible to use non-credit liquidity lines to support **P-1** rated ABCP programs does not mean that asset sellers, conduit sponsors and investors should minimize the differences between traditionally structured programs and those using non-credit liquidity. In particular, all market participants should consider the potential impact of the significant differences between programs structured to use the two types of liquidity.

- Event risk;
- Ratings criteria (hurdle conditions); and
- Monitoring requirements.

#### **Event Risk**

The approach acknowledges an explicit linkage between the availability of the liquidity line and the maintenance of the conduit's issuer rating at or above **Aa3**. Therefore, a decline in the stand-alone credit quality and the issuer rating of the conduit below the threshold level may, depending on the regulatory jurisdiction in which the conduit operates, cause the liquidity line to fall away entirely. The impact of such an event on the short term rating of the ABCP issued by the conduit would in the vast majority of cases be dramatic and cause a drop to **P-3** or **Not Prime**.

As noted earlier, Moody's believes that the observed ratings stability of highly rated securitizations means that securities which feature **P-1** ratings assigned pursuant to this approach will be as stable as, and have expected loss profiles that are similar to, all other equally rated securities. However, Moody's also acknowledges that programs structured in this manner are relatively more vulnerable to event risk - and its attendant sharp changes in credit quality - than are their traditional counterparts.

<sup>15</sup> Moody's Special Comment: Commercial Paper Defaults and Rating Transitions, 1972 - 2000. October 2000 & Moody's Special Report: Rating Changes in the U.S. Asset-Backed Securities Market: First Ever Transition Matrix Indicates Rating Stability... To Date. January 2001.

As a result, certain ABCP conduits, which primarily feature programs particularly exposed to event risks - such as those with uncertain credit quality that feature primarily external LOC's for enhancement, for example - may not be suitable for restructuring to use non-credit liquidity. In addition, Moody's will, in its review of conduits seeking to use the new approach, emphasize its assessment of event risks and the means proposed by sponsors to mitigate against them.

### **Ratings Criteria (Hurdle Conditions)**

The **Aa3** threshold rating level for conduits seeking to utilize non-credit liquidity support to achieve a **P-1** rating on ABCP is higher than the usual minimum long-term **P-1** equivalent of **A2**. However, the linkage between the conduit's issuer rating and availability of liquidity and more limited coverage afforded by a non-credit liquidity line both warrant a higher threshold. Given that a drop in a conduit's issuer rating below **Aa3** may cause its liquidity line to fall away, Moody's expects that most if not all such conduits will be structured to the **Aaa** level to maximize ratings stability.

Similarly, while the rating hurdle for conduit sponsors and support providers seeking to utilize this approach will be **A1**, Moody's expects the majority of such conduits to feature sponsors and support providers with **Aa3** or higher ratings.

Moody's understands that setting ratings hurdles at such levels may not make a switch to non-credit liquidity from traditional lines cost-effective. In particular, restructuring a conduit, which currently relies on some credit enhancement through the liquidity line, to achieve the expected conduit issuer rating of **Aaa** may not be reasonable. For example, "unwrapping" a transaction where liquidity banks have chosen to absorb cash co-mingling risk is possible but potentially involved. Similarly, there are cases such as covering breaches of representations and warranties in a sub-prime auto transaction, where an exhaustive review of the originator's underwriting practices, controls and audits would be necessary if liquidity was not going to absorb this risk.

Practically, in large portfolios where many pools have been purchased throughout the years, assignment of a CIR may be quite involved. Mapping a sample of pools from the portfolio may not be possible if the pools are not of a homogenous nature, which is frequently the case in the European market. As a result, the assignment of CIRs may initially be better suited to, for example, pools of highly rated ABS as opposed to existing pools of trade receivables. It may be difficult for a conduit portfolio composed of pools of trade receivables originated by sellers of **B1** credit quality to achieve the requisite CIR rating in view of cash co-mingling and servicer risk.

### **Review and Monitoring Requirements**

The issuer rating assigned to a conduit, whether assigned to facilitate the use of non-credit liquidity or for other reasons, is a fully monitored rating. The level of detail in the review process and in post-closing monitoring will be consistent with other complex term ABS transactions.

Moody's believes that the differences in application between traditional and non-credit liquidity likely means that the use of non-credit liquidity may be more limited than its traditional counterpart. In particular, although the approach is conceptually applicable across all assets, more practically its use will likely be directed towards conduits that focus on vanilla assets and those assets that are routinely enhanced or wrapped to **Aaa** in the term ABS markets.

## AN INVITATION TO COMMENT

Moody's believes that the methodology outlined in this comment is consistent with the existing body of structured finance ratings analysis and is also in keeping with the proposals being advanced by international regulatory authorities in the Accord. As the Accord continues to be refined with input from all market participants, Moody's believes that it is important to develop the concepts of non-credit liquidity in parallel with that process.

Moody's encourages interested parties to submit formal comments on this approach to the Structured Finance Group. In particular, Moody's is interested in the views of market participants on: (i) the applicability of Conduit Issuer Ratings and Non-credit Liquidity to the assets and programs they are associated with; and (ii) the impact of potential differences in ratings migration paths that may result from the use of non-credit liquidity.

Comments may be sent to the authors via email at [andrew.kriegler@moodys.com](mailto:andrew.kriegler@moodys.com), [sam.pilcer@moodys.com](mailto:sam.pilcer@moodys.com) or [jean.dornhofer@moodys.com](mailto:jean.dornhofer@moodys.com). As an updated version of this document is expected to be issued in mid-2002, comments are requested by June 1, 2002.

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