

## RATING METHODOLOGY

# Structured Settlement Securitizations Methodology

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This rating methodology replaces *Moody's Approach to Rating Transactions Backed by Structured Settlements* published in November 2018. The methodology's title and table of contents have been revised. We have also made limited editorial updates to improve readability, and we have added a footnote for further transparency on our approach to monitoring transactions. The updates do not change the substantive approach of the methodology.

### Scope

This methodology describes our approach to rating securities backed by cash flows from US structured settlements, which are scheduled future payments from litigation settlement agreements funded by annuity contracts. The methodology covers transactions backed by both major types of settlement agreements - "court-ordered" settlements and "non-court-ordered" settlements - which differ significantly in their legal risks. This methodology also covers our approach regarding lottery receivables (Appendix A) and tobacco legal settlement fee securitizations (Appendix B).

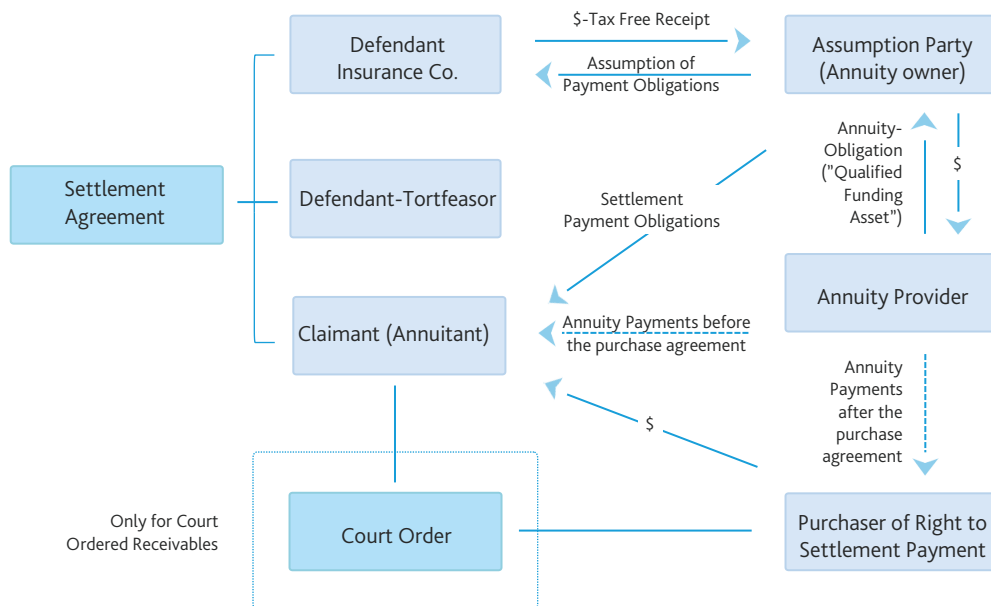
## Rating Approach

### Asset Overview

In a typical structured settlement, a plaintiff, a tort defendant, and the tort defendant's insurer ("defendant insurer") agree on a schedule of periodic payments for an extended period to pay a litigation settlement amount. The defendant insurer typically assigns its liability, the litigation settlement amount, to a third-party company ("assumption party") to fund the periodic payments to the plaintiff ("claimant"). The assumption party is usually a specially incorporated subsidiary of an annuity provider ("obligor" or "annuity provider"), whose purpose is limited to assuming payment obligations in exchange for lump-sum payments and to purchasing annuity contracts from its parent to fund the stream of future payments to the claimant. In a securitization of structured settlements, a company (the "purchaser," which is typically the sponsor of the securitization) purchases the rights to numerous streams of annuity payments from a variety of claimants, and then sells them to a special purpose vehicle which issues securities backed by those purchased future cash flows.

Federal legislation enacted in 2002 provides for a process by which a court approves the sale of a structured settlement from a claimant to a purchaser. Exhibit 1 below illustrates the relationships among the parties in a structured settlement and its sale to a purchaser. The court approval process reduces certain legal and servicing risks in securitizations backed by such structured settlements, compared to non-court-ordered structured settlements.

EXHIBIT 1  
**Diagram of a Structured Settlement and Its Sale to a Purchaser**



Source: Moody's Investors Service

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on [www.moodys.com](http://www.moodys.com) for the most updated credit rating action information and rating history.

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## Analysis Framework

Structured settlement securitizations have two major potential risks – payment diversion risk and annuity provider default risk. We describe in the following sections how we account for both in our analysis and modeling approach.

We use the results produced by a Monte Carlo simulation analysis as an input to our credit rating analysis. A rating committee may also consider other factors when assigning a rating, such as structural and legal risks and the expertise, experience, and stability of the parties in the transaction in underwriting and servicing. While the model output is an important factor, the rating committee's consideration of various qualitative and quantitative factors could lead it to assign a rating different from that indicated by the model output.

Our qualitative analysis focuses primarily on:

- » The extent of payment diversion risk (see “Payment Diversion Risk Analysis” section).
- » An assessment of the underwriting criteria (especially in non-court-ordered settlements, for which the risk of payment diversion can be material), the servicer's capacity to fulfill its duties, and whether the servicing arrangement adequately reduces the likelihood and extent of a servicing disruption (see “Analysis of Diversion Risks – Underwriting and Servicing”).
- » Evaluating the various parties' risk of bankruptcy and potential impact to the structured settlement and the securitization. This includes evaluating the potential bankruptcy of the claimant (see the “Bankruptcy of the Claimant” section), assumption party (see the “Bankruptcy of the Assumption Party” section), purchaser, securitization vehicle and annuity providers. (We also discuss our quantitative approach for the risks associated with the bankruptcy of annuity providers in the “Asset-level Analysis and Related Modeling” section).

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## Asset-level Analysis and Related Modeling

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### Payment Diversion Risk Analysis

Payment diversion risk exists because, even after the assignment of the right to annuity payments to the purchaser, the claimant remains the annuity contract's beneficiary and could request that the annuity provider divert payments from the purchaser to the claimant. This risk is more prominent in non-court-ordered settlement agreements. For court-ordered settlements, the court approval of the sale has largely mitigated this risk. Most transactions structured since 2002 have been court-ordered.

If the annuity provider follows the claimant's directions, either because the annuity provider was not a party to that agreement and was unaware of it (in transfers of pre-2002 settlements), or through administrative error, the purchaser (in our case, the servicer on behalf of the investors) would need to pursue legal action to attempt to recover the diverted payments and to prevent further diversions. The key risks to investors in pursuing such legal action are two-fold:

- » A court could rule the transfer of the settlement payments to the purchaser was unenforceable because of the anti-assignment provisions included in the settlement agreements.<sup>1</sup> In that case, the purchaser could seek damages from the claimant for the lost future payments.
- » Even assuming success in court diverting future payments back to investors, payments already diverted may be difficult to recover, especially from claimants in distressed financial condition.

However, we think these risks are mitigated by various factors, especially for court-ordered settlements. As explained below, we view diversion risk to be much lower in court-ordered settlements than in non-court-ordered settlements.

Payment diversion risk can be exacerbated by provisions included by the defendant's insurance company in the underlying litigation settlement agreement that prohibit the assignment of the settlement payments.<sup>2</sup> The purpose of including those "anti-assignment" provisions is to protect favorable tax treatment of the settlement agreement for the insurer. However, the existence of the provisions could increase the risk for a purchaser of the settlement payments, since claimants who divert annuity payments back to themselves could argue that the assignment to the purchaser was unenforceable, potentially interfering with the cash flows to the purchaser (and, ultimately, to investors).

#### Legal Risks Related to Payment Diversion

Purchasers of non-court-ordered structured settlement payments generally have strong legal positions in enforcing their purchase agreements despite the presence of the anti-assignment provisions, as explained later. When the sale of the scheduled settlement payments is done according to a court order, we consider it even less likely that the transfer to the purchaser of the rights to the cash flows would be successfully challenged, since the payment diversion risk is largely mitigated by the authority conveyed by the court order itself. In addition, since the annuity provider is a party to the court-supervision process,<sup>3</sup> it is unlikely that the annuity provider would follow a claimant's directive to divert payments in contravention of the court's order.

Despite the strong legal protections in structured settlement securitizations, the possibility remains that funds will be diverted away from the purchaser, either through fraud by the claimants or administrative error. We focus our assessment of that risk on evaluating how the purchaser's underwriting criteria and processes of claimants limits the likelihood of selecting claimants who might divert payments, and on the servicing and administrative abilities of the servicer.<sup>4</sup> In particular, we examine (1) the servicer's legal strategy and resources for recovering diverted payments, and (2) the servicer's ability to isolate payments from a purchaser's other funds (e.g., lock box arrangements) and to quickly track and pursue any delinquent payments.

<sup>1</sup> Section 130 of the Internal Revenue Code (IRC) allows the party accepting assignment of responsibility for future periodic payments to exclude the amount received from gross income to the extent the amount is used to purchase a "qualified funding asset." The assignment is termed a "qualified assignment." However, IRC, §130 also provides that periodic payments due under annuity contracts may not be "increased, decreased, accelerated or deferred." Insurers are concerned that a subsequent assignment of the settlement payments by the claimant could be viewed by the Internal Revenue Service as an acceleration of the payments, thereby disqualifying the transfer of responsibility to the assumption party from being treated as a "qualified assignment," with negative income tax consequences. To mitigate that risk, anti-assignment provisions are written into the settlement agreement.

<sup>2</sup> A relatively small percentage of annuity contracts do not prohibit the claimant from assigning its rights to receive the scheduled annuity payments to a third party, i.e., those annuities are "assignable" (a typical transaction may include a small percentage of assignable annuities contracts – up to 10% by net present value). Those assignable contracts have an even lower risk than non-assignable contracts that an assignment might be found to be unenforceable. However, in court-ordered transactions, where the unenforceability risk is already low, there is no practical difference in our analyses of assignable and non-assignable annuities.

<sup>3</sup> Transfer statutes typically require that at least 10 days prior to the court hearing of the case, an advance notice be provided to the obligor, the annuity provider and all other interested parties as a prerequisite to obtaining a court order. Such notice should include a copy of the settlement purchase agreement and other documentation describing the proposed sale of the scheduled payments. It should be noted that in the vast majority of cases, the obligors do not attend the court hearings; they would likely do so if they would like to object the sale.

<sup>4</sup> For more details, see the "Analysis of Diversion Risks - Underwriting and Servicing" section.

### General Mitigants to Diversion and Anti-Assignment Risks

For non-court-ordered settlements, an annuity provider likely would follow the claimant's directive since the annuity provider was not a party to the sale of the settlement cash flows and, in many cases, might be unaware of it. To stop any diversion of funds, the purchaser would initiate legal proceedings so that payments are held by the insurance company pending a final court judgment. If the purchaser is successful in its case against the claimant, the funds that are held would be delivered to the purchaser, and the claimant and annuity provider are estopped from future diversions. In theory, though, it is possible that the anti-assignment provisions in the settlement agreement might lead the court to view the agreement as unenforceable, and therefore make the court unwilling to order a stop to the diversion of funds.

However, we consider that unlikely. Purchasers of structured settlement payments generally have been highly successful in enforcing their purchase agreements, despite the presence of anti-assignment provisions. Their position is bolstered by several legal and equitable arguments, including the following:

- » The overwhelming majority of jurisdictions do not enforce anti-assignment clauses.<sup>5</sup> The trend in modern jurisprudence is against restrictions on the ability to transfer property rights. The case law that is closest on point supports this doctrine.<sup>6</sup>
- » Section 9-318 of the Uniform Commercial Code (UCC) renders ineffective a contract term that prohibits the assignment of an account in a general intangible for money due.<sup>7</sup>
- » Courts are nearly unanimous in holding that monetary obligations, as opposed to personal service contracts, can be assigned.
- » Claimants freely and expressly waive the restriction in the underlying settlement agreement when they sell their rights to settlement (annuity) payments to the purchaser.
- » Assignments by the claimant of structured payments do not appreciably increase the counterparty's (the defendant insurer's and the assumption party's) obligation to make payments. It only redirects the annuity cash flow to another party.
- » Even if the assignment were considered a breach of the underlying settlement agreement, the resulting litigation would involve a contract action, and the appropriate remedy would be damages, not invalidation of the assignment. A claimant generally would not be able to show damages. Moreover, it can be argued that the claimant would be unjustly enriched if it were to prevail by receiving payment twice – first by the purchaser in exchange for the annuity cash flow and second by reinstating its right to this cash flow.<sup>8</sup>

### Diversion Risk in Court-Ordered Transactions

In February 2002, the Victims of Terrorism Tax Relief Act of 2001 (the "Act") was signed into law. The Act included a section that addressed the sale of structured settlements, and it established a court process to approve such sales. The Act dramatically reduced the risk of diversions and the risk posed by anti-

<sup>5</sup> Many courts and state statutes distinguish between an assignment of the proceeds of the policy – the annuity payments – and the assignment of the policy itself, and hold only the latter to be unassignable.

<sup>6</sup> *Western United Assur. Co. v. Hayden et al.*, 64 F.3d 833 (3d Cir. 1995), is cited repeatedly in cases concerning assignments of annuity payments. In that case, the Third Circuit, applying Pennsylvania law, reversed the district court's ruling that annuity payments that had been assigned belonged to the claimant's bankruptcy estate. In so ruling, the appeals court noted that the annuitant was a direct contractual party to the settlement agreement with the tort defendant's insurer, and that her rights under the agreement could be assigned to a purchaser. The purchase agreement expressed the clear intent of the claimant to assign the payments under the annuity contract and settlement agreement.

<sup>7</sup> U.C.C. §9-318.

<sup>8</sup> Section 322(2)(b) of the Second Restatement of Contracts provides that an anti-assignment clause generally only gives the obligor a right to damages for breach of its terms rather than rendering the assignment ineffective.

assignment provisions. Since 2002, the vast majority of the securitized structured settlements have been backed by court-ordered receivables.

Under the Act, all subsequent structured settlement transfers must receive qualified court approval as defined by the Act, or the purchaser of the rights to the settlement would be subject to a 40% excise tax on the difference between the lump sum payment and the undiscounted payment stream. In most cases, a "qualified order" under the Act means a final order, judgment or decree concluding that the transfer is:

- » Not in breach of any federal or state law, order of any court or administrative authority.
- » In the best interest of the seller.
- » Issued under a state law of the state in which the claimant is domiciled, by a court of such state.<sup>9</sup>

In addition, in the court-ordered process, the annuity provider is a party to the procedures.

Being a party to the hearings and the settlement agreement makes the annuity provider much less likely to divert payments away from the purchaser at the request of the claimant, in violation of the court order. Moreover, even in situations in which payments are diverted, as long as the court order has been issued, it is highly unlikely a claimant could successfully claim the transfer to the purchaser was unenforceable, since a court has already overseen and approved the transfer process. Typically, the underwriter of the securitization hires an accounting firm to review a sample of the settlement files for proper documentation of the court order.

#### Analysis of Diversion Risks – Underwriting and Servicing

By selecting claimants whose credit and personal background suggest that they would be unlikely to divert payments, the purchaser's underwriting of settlement agreements can mitigate the risk that claimants will fraudulently divert settlement payments.<sup>10</sup> Therefore, we assess the extent to which the purchaser's underwriting criteria are likely to filter out risky claimants. Those criteria typically include some or all of the following:

- » An assessment of the claimant's financial status, including job and residence history – the more stable the claimant's financial condition, the less likely the claimant will resort to fraudulently diverting payments.
- » The claimant's educational background and degree of financial sophistication – the more financially sophisticated, the less likely the claimant can claim a failure to understand the implications of the settlement payments sale.
- » An assessment of the claimant's criminal record.
- » Verification of the claimant's ownership of the settlement payments.
- » An assessment of whether the settlement payments sale makes sense for the claimant and is therefore less likely to be challenged by the claimant.

The quality of the servicing in the transaction can also affect the risk to investors. We evaluate a number of factors regarding servicing, including:

<sup>9</sup> If there is no state law in the state that the claimant is domiciled, then the transfer can be done under the authority of a statute of the state in which the obligor or the annuity provider is domiciled by a court of such state.

<sup>10</sup> This risk is much more important in transactions backed by non-court-ordered settlements. In court-ordered settlements, servicing is mostly a back-office administrative matter. However, even in court-ordered settlement transfers, there is a small chance of diversion risk and fraud, which can be mitigated to some extent by high-quality servicing.

- » **The ability to quickly detect inappropriately diverted payments.** The effectiveness of the servicer's systems to flag future dates when large payments are due (when the risk of fraudulent diversion is the highest), and to contact the annuity provider prior to such a distribution so all annuity payments are made to the lock box. In addition, we evaluate the ability of the servicer to reconcile the payments received from the annuity providers with the amounts due and to follow up on delinquent payments with calls to the annuity providers to see if the payments have been diverted or delayed for some other reason.
- » **The ability to act on improperly diverted payments.** Despite efforts to prevent the improper diversion of payments, some may nevertheless occur, either through fraud on the part of the claimants or administrative error (e.g., payments sent to an incorrect address). We assess the strategy and ability of the servicer to mitigate the negative consequences to investors of such diversions by quickly obtaining court orders to stop future diversions of payments, to redirect payments to the purchaser, and to recover diverted payments that have already been made.
- » **The ability to accurately direct the payments received to the appropriate parties in the transaction.**

Given the importance of servicing in mitigating the risks to investors, we also evaluate the risk of servicing disruption. The servicing disruption risk tends to be low when servicing is provided by an experienced, stable, financially strong servicer, and/or the transaction provides for backup servicing arrangements that would likely lead to a smooth, quick transfer of servicing to another entity if needed. Typically, we would assign high ratings to structured settlement securities only if there is a low probability of servicing disruption.<sup>11</sup>

Given our evaluation of the strength of origination and servicing in a transaction, we estimate the expected losses from diverted payments and incorporate those losses into our cash flow analysis, as described in the "Cash Flow Model" section.

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### Annuity Provider Default Risk Analysis

An annuity provider default will reduce cash flows to the purchaser, and thus to the securitization. To analyze this risk, we use a Monte Carlo simulation analysis to examine the losses to investors,<sup>12</sup> if any, that may result from various potential combinations of defaults by the annuity providers. Those default combinations – and their timing – are chosen based on the probability of default implicit in the annuity providers' ratings<sup>13</sup> and on an assumed correlation of default among the providers due to systemic industry factors.

For each scenario, we also simulate the recovery rate on the defaulted settlements. With the life annuity industry being highly regulated and having significant state-level oversight, we expect that recoveries following a default would be substantial.<sup>14</sup> Therefore, in our transaction cash flow modeling, the key inputs related to the annuity providers' default are the probability that each annuity provider will default, the probability distribution of possible recovery rates, and the correlation of defaults among the providers.

<sup>11</sup> For more information on our views regarding operational risks such as potential servicing disruption, see our cross-sector methodology on counterparty risks in structured finance. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

<sup>12</sup> For more information on our simulation analysis, see the "Cash Flow Model" section.

<sup>13</sup> A credit estimate may be considered for an unrated annuity provider if the rating of the transaction is not deemed very sensitive to its creditworthiness. For more information, see our cross-sector methodology for using credit estimates. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

<sup>14</sup> Although the assumption party remains liable for the settlement payments after it purchases the annuity from the provider, it is typically an affiliate of the provider. As a result, we assume that if the provider defaults, the assumption party will as well.

Furthermore, we “haircut” the resulting cash flows by an assumed percentage to represent other types of losses, such as those that might result from successful challenges to the assignment of settlements to the purchaser.

### Probability of Default

Our Idealized Expected Default Rates table provides a guide for the various default rates that we expect in the long run on a large pool of securities with various combinations of ratings and maturities.<sup>15</sup> We use our Idealized Expected Default Rates to determine the probability of the provider's default on the annuity, based on the insurance company's Insurance Financial Strength Rating (IFSR), if available, and the annuity's term. For example, if the insurance company's IFSR were Aa3 and the annuity had a term of 10 years, the probability of default would be 0.4%. If an IFSR rating is not available, we will use the best alternative proxy, which we may, for example, derive from that entity's senior unsecured debt ratings. Alternatively, we may consider using a credit estimate or reference credit estimate.<sup>16</sup> Typically, in the structured settlement transactions that we rate, the largest providers are insurance companies rated by us.

However, a portion of the obligors in a typical pool consists of life insurance companies not rated by us. For those providers, we typically would assume the default probability would be consistent with that of a company with a high speculative-grade rating. We do so because the regulated nature of the industry provides substantial comfort, in our view, of at least some financial strength. For obligors that are not a life insurance company and are not rated by us (which occurs rarely), we would assume a low speculative-grade rating or, if such unrated obligor(s) comprised a material portion of the pool, we would obtain a credit estimate.

### Correlation

For obligor correlation, we assume that each individual company's default is correlated with all other obligors in the pool, reflecting that all the obligors in a typical pool are in the life insurance industry. This approach is consistent with the correlation approach we use to evaluate other pools of corporate credit. We generally employ single-industry correlation assumptions that range from 3% to 50%, depending on the industry, the nature of the obligation and the geographic dispersion of the obligors. We use a correlation assumption of 25% in analyzing the behavior of pools of life insurance company obligors in structured settlements. In arriving at the 25% correlation assumption, we considered the historically low observed correlation of default among life insurance companies, and that the securitized obligations are claims we view on par with insurance policies, rather than corporate debt obligations.

### Recovery Rates

We simulate recovery values for the structured settlements of defaulted obligors. For each of the obligors that default in a simulated scenario, we simulate a recovery value based on the type and ratings of the obligor. For annuities issued by investment-grade life insurance companies, we typically assume a triangular distribution<sup>17</sup> for recovery rates with a most likely outcome of 70%, a minimum of 55%, and a maximum of 75%. For non-investment-grade life insurance companies, we typically assume a most likely recovery rate of 50%, a minimum of 35% and a maximum recovery rate of 55%.

We model recovery rate assumptions for non-life insurance companies on a case-by-case basis and based on the following factors:

<sup>15</sup> For more information, see the discussion of Idealized Probabilities of Default and Expected Losses in *Rating Symbols and Definitions*. A link can be found in the “Moody's Related Publications” section.

<sup>16</sup> For more information, see our cross-sector methodology for using credit estimates. A link to a list of our sector and cross-sector methodologies can be found in the “Moody's Related Publications” section.

<sup>17</sup> A triangular distribution is defined by three parameters: the mode (i.e., the most likely outcome), the minimum possible value, and the maximum possible value. The probabilities in a triangular distribution increase linearly from the minimum to the mode and decline linearly from the mode to the maximum.



- » Annuities have relatively high legal standing in bankruptcy in most states. Under most states' bankruptcy laws, annuities are explicitly classified as the same level of priority as policyholders and/or insureds. However, even in those states that do not explicitly classify annuities with policyholders and/or insureds, we expect that state insurance commissioners would prioritize annuities with those other insurance liabilities in the event of a bankruptcy.
- » Life insurance companies operate under tight regulatory supervision, under which we would expect a company in financial difficulty to enter "rehabilitation" status before it approached insolvency, helping to preserve assets for distribution to creditors in a bankruptcy proceeding.
- » Historical data, which are limited, indicate very low net losses on structured settlements when the annuity provider has entered rehabilitation/receivership.<sup>18</sup>

Our lower recovery assumption for non-investment-grade life insurance companies is generally because these are relatively small companies that are not as well-diversified compared with the rated companies; as such, we consider the non-investment-grade life insurance companies susceptible to lower recovery rates upon default. We do not assume recoveries will be aided by state guarantee funds.

The recovery value reduces the cash flows from the simulated default date onward and is expressed as a percentage of the remaining payments. In addition, following a simulated default, we assume the recovery on each payment thereafter would be delayed. The duration of the delay is based on a triangular distribution of 12 months (most likely), 6 months (minimum) and 24 months (maximum).<sup>19</sup>

#### Annuity Provider Default Modeling

We model a variety of scenarios in which we simulate whether each obligor (annuity provider) defaults and simulate the recovery rate for each defaulted obligor. We also stress the cash flows to account for diversion risk (where the risk is material, i.e., in transactions backed by non-court-ordered settlements), and/or claimant bankruptcy (see "Additional Asset Analysis"). This is done by reducing the periodic aggregate payments of the total pool. We choose the particular diversion haircut based mainly on the historical performance of the originator and the seasoning of the pool. We choose the claimant bankruptcy haircut based on the diversification of the pool and the historical performance of the originator. The typical haircut we apply to account for bankruptcy risk is in the 1.0% to 3.0% range.

For each scenario, we determine whether each obligor defaults, and the timing of the default, in the following way:

- » For each annuity provider, we draw a correlated random variable based on a Gaussian distribution. We assume that pairwise correlations across all obligors are 25%.
- » This draw determines whether an obligor defaults in that scenario, and if so, in which period. To proceed, we use our idealized default rates. An obligor is assumed to default in the earliest period for which the idealized default probability for the rating of that obligor is greater than the draw.<sup>20</sup> If the draw is greater than the highest default probability given in the table for the rating of this obligor, the obligor does not default in that scenario.

<sup>18</sup> There are few cases in which insurance companies that had structured settlement obligations entered receivership. Data provided by the National Structured Settlements Trade Association indicate that over the 10-year period from 1982 to 1992, in an estimated 200,000 settlement annuities purchased to fund settlement agreements, losses upon default of the provider amounted to only 0.0015% of settlement annuities. For example, Executive Life of New York, which entered receivership in 1992, has not missed a payment on its settlement annuities to date.

<sup>19</sup> While there is likely to be some delay in realizing recoveries, the incremental impact on the liquidity needs of the typical transaction is negligible and immaterial.

<sup>20</sup> The idealized default rates show the cumulative default rates by year. For more information, see the discussion of Idealized Probabilities of Default and Expected Losses in *Rating Symbols and Definitions*. A link can be found in the "Moody's Related Publications" section.

For example, assume the annuity provider is rated Aa3, and the term of the settlement agreement is 10 years. Then, as indicated by our idealized default rates,<sup>21</sup> we would assume the default rate would be 0.4% over a 10-year term, 0.3% over an eight-year term, 0.2% over a six-year term, etc. Now suppose that in one particular scenario we drew a correlated random variable of 0.55 (i.e., 55%) for a particular provider. In that case, the provider would not default, since the idealized default probabilities are all less than the random draw (i.e., 55%) in all months of the life of the annuity.

Now consider another scenario in which all of the assumptions are the same except that the correlated random variable for the provider is .0025 (i.e., 0.25%). In that case, the annuity provider would default in year eight, since that is the earliest time for which the idealized default probability is greater than the correlated random variable (i.e., 0.25%).

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## Additional Asset Analysis

### Bankruptcy of the Claimant

When a claimant becomes bankrupt, the claimant's bankruptcy estate may assert that the scheduled payments are part of the claimant's bankruptcy estate, and therefore may decide to challenge the sale of the settlement to the purchaser. Such an event may delay cash flows to the trust and, if the bankruptcy estate's trustee is successful, may even reduce the payment to a transaction.

To analyze this risk, we assess whether the transfers of the annuity payments from the claimants to the purchaser are likely to be viewed by a bankruptcy court as a sale of the payments. Furthermore, as a backup position in case a bankruptcy court rules that the annuity payments were not sold, we evaluate whether the purchaser has a first perfected security interest in the settlement payments so it can enforce its security interest in the collateral once a claimant has filed for bankruptcy protection.

If the settlement payments have been sold, then the bankruptcy court should not include the settlement payments in the claimant's bankruptcy estate, nor delay the payment of the cash flows of receivables to the purchaser (and, ultimately, to investors) through the imposition of an automatic stay. In determining whether the asset transfer from the claimant to the purchaser was, in fact, a legal "true sale," the primary test is whether the risks and benefits of ownership have been transferred. Courts have confronted a number of fact-specific cases. Relevant facts for our analysis of structured settlement securitizations include, but are not limited to, the economics of the transaction and the unequivocal intent of the parties.

The risk posed by a challenge to the claimant's sale of the settlement payments is typically low in securitizations of structured settlements because pools are usually highly diversified among claimants; only if numerous claimants became bankrupt and their bankruptcy estates successfully challenged the sale status – both unlikely events – would there be a material effect on the transaction's cash flows. Additionally, for court-ordered transactions, we expect that the risk of a successful challenge by a claimant's bankruptcy estate trustee is minimal because the claimant's transfer of the scheduled payments was done through a court order. We would expect that a claimant's bankruptcy court would deem the transferred payments property of the purchaser and not property of the estate of such person under Section 541(a)(1) of the Bankruptcy Code.

We typically review a legal opinion obtained by the issuer in connection with the transaction stating that the transfer of the collateral to the issuer is a legal true sale, and the scheduled payments will not be part of the claimant's bankruptcy estate trust.

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<sup>21</sup> For more information, see the discussion of Idealized Probabilities of Default and Expected Losses in *Rating Symbols and Definitions*. A link can be found in the "Moody's Related Publications" section.

### Bankruptcy of the Assumption Party

The assumption party's bankruptcy may pose credit risk in a structured settlement transaction because the creditors of the assumption party may claim that the payments due from the annuity provider are the property of the assumption party. That claim could arise because, in most cases, the assumption party remains the stated owner of the settlement annuity contract, rather than the claimant or the trustee (as the ultimate assignee according to the court order). Thus, if the assumption party becomes bankrupt, the payment to the trust may be delayed or even stopped by the bankruptcy court. However, we think the risk is negligible.

A mitigant to assumption party default risk is that the corporate powers of the assumption party are usually limited to assuming settlement payment obligations and purchasing annuities to fund these obligations. By design, to conform to the Internal Revenue Service guidelines, this arrangement results in a matching of liabilities and assets on the balance sheet of the assumption party. Thus, there is a relatively low likelihood that the assumption party would become insolvent. In addition, the claimant typically is expressly named as a third-party beneficiary in the annuity contract, as the annuitant. As such, the claimant (and the trust in the claimant's place) can argue that it has a right to the annuity payments in the event of the assumption party's bankruptcy.

## Structural Analysis and Liability Modeling

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### Cash Flow Model

We use a cash flow model to analyze the risks to each class of notes within the sponsor's proposed capital structure. We simulate in a variety of scenarios the cash flows available to bondholders, including those from any credit enhancement available to offset shortfalls. For each scenario, we calculate an internal rate of return (IRR) that would be earned by investors. We calculate the average IRR across the simulations, and then compare it to the expected IRR to measure the reduction in IRR. We use these results to determine the model output using our benchmark IRR reduction for each rating category.

### Loss Benchmarks

In rating transactions backed by structured settlements, we use an IRR benchmark when assessing the model output. Modeled IRR reductions are associated with benchmark ratings in Moody's IRR Reduction Rates table,<sup>22</sup> which indicates the internal rate of return reduction interval associated with each given rating level.

## Other Considerations

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### Bankruptcy of the Purchaser

The purchaser's bankruptcy can also pose a risk to investors because creditors of the bankrupt purchaser could claim that the payments due from the annuity providers belong to the purchaser's bankruptcy estate. Thus, investors could lose the rights to the payments, or the cash flows to investors may become subject to an automatic stay and delayed through the bankruptcy filing.

We assess three key factors in our analysis of the purchaser's potential bankruptcy risk:

- » Have the receivables actually been sold from the purchaser to the issuing entity?

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<sup>22</sup> For more information, see the discussion of Internal Rate of Return (IRR) Reduction in *Rating Symbols and Definitions*. A link can be found in the "Moody's Related Publications" section.

- » Would the ultimate owner of the receivables (the securitization vehicle) be substantively consolidated with the purchaser in the event of the purchaser's bankruptcy?
- » Can the securitization trustee enforce its ownership or security interest in the receivables once the purchaser or issuing entity has filed for bankruptcy protection?

### True Sale

If the annuity payments truly have been sold from the purchaser to the issuing entity, then, in the event of the purchaser's bankruptcy, the bankruptcy court should not include the sold annuity payments in the bankruptcy estate nor delay the payment of the cash flows to investors (through the imposition of an automatic stay). In determining whether the transfer of the collateral was, in fact, a legal "true sale," the primary test is whether the risks and benefits of ownership have been transferred. Courts have confronted a number of fact-specific cases. Relevant facts for our analysis include, but are not limited to, the level of recourse retained, the economics of the transaction, and the unequivocal intent of the parties. We typically review a legal opinion from counsel hired by the sponsor in connection with the transaction stating that the transfer of the collateral to the trust is a legal true sale.

### Substantive Consolidation

Substantive consolidation is an extraordinary legal remedy in which the bankruptcy court views the bankrupt purchaser as being indistinguishable from the securitization trust, resulting in confusion about which assets should belong to which creditors. As a result, the assets of the securitization trust are consolidated with the assets of the purchaser and are subject to the automatic stay in bankruptcy.

We include in our analysis an assessment of the likelihood that the transaction might be subject to factors that have in the past led courts to order consolidation, including cases in which (1) the records of the companies were intertwined to the extent that they could not be separated; (2) arm's-length dealings between the two companies were not observed; or (3) boards of directors overlap. The risk of consolidation of corporate entities is mitigated when the affiliated companies are organized and managed separately, and all corporate formalities of separateness are observed in their ongoing governance. We typically review a legal opinion from counsel hired by the sponsor in connection with the transaction stating that the trust would not become consolidated into the purchaser upon the purchaser's bankruptcy.

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### Perfection of the Security Interest

Our analysis assesses whether the transaction's trustee can enforce its security interest in the annuity payments in the event of the claimant's or purchaser's bankruptcy. To enforce its interest, the trustee must "perfect" its security interest - that is, notify the world of the trust's interest in the asset - and ensure that no other party has a claim prior to that of the trustee. In other words, the trustee's interest in the annuity payments must be a "first priority perfected security interest."

If a bankruptcy court were to rule that the transfer of the payments to the issuing entity was not a true sale, a first priority perfected security interest serves as backup protection to the securitization trust's rights to the settlement cash flows in the event of the bankruptcy of the purchaser of the annuity payments.

The transfers of rights and their perfection, from the purchaser to the issuing entity and all the way to the trustee for the benefit of bondholders, are done according to the law of the state in which the entities reside. In most cases, the required transfers are physical transfers of the documents.

Article 9 of the UCC provides that structured settlement payment rights are categorized as "payment intangibles." Under the UCC Article 9, the purchaser's rights are automatically perfected upon the claimants' sales of scheduled settlement payments to it. Article 9 of the UCC has been adopted in the

majority of the states. In states where UCC Article 9 is not applicable, the perfection of the purchaser's rights is done by informing the obligor of the transfer of the scheduled settlement payments. In practice, even in states in which UCC Article 9 has been adopted, most purchasers inform the obligor about the transfer of the scheduled settlement payments.

We typically review a legal opinion from the sponsor's counsel stating that investors have a first priority perfected security interest in the annuity payments. In cases in which the sale of the scheduled settlement payments is done according to a court order, we consider it very difficult to successfully challenge the transfer and perfection of the purchaser's rights.

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## Bankruptcy of the Securitization Vehicle

Our analysis focuses on two main assessments of the potential for the securitization vehicle's bankruptcy:

- » The likelihood that a third-party creditor would be able to successfully petition the owner of the assets into an involuntary bankruptcy proceeding.
- » The likelihood that the owner of the assets would voluntarily seek the protection of the bankruptcy courts.

We refer to transactions in which the likelihood of either an involuntary or a voluntary bankruptcy is very low as "bankruptcy remote" transactions. To analyze the likelihood of an involuntary bankruptcy, we assess the characteristics that would mitigate the risk, such as if the owner of the assets had no assets other than the rights to the annuity payments, no other indebtedness beyond the securitization debt, limited activities that could give rise to contractual or other liabilities, and agreements with the sponsor and other contracting parties not to petition for the dissolution, liquidation, or bankruptcy of the securitization vehicle. Similarly, factors that would mitigate the risk of a voluntary bankruptcy would include (i) charter documents of the owner of the assets that require directors who are independent of the affiliated company and (ii) a unanimous vote of directors as a condition to filing a voluntary bankruptcy.

## Monitoring

In monitoring transactions backed by structured settlements and lottery receivables, we apply the key components of this methodology, except for those that become less relevant over time (e.g., underwriting standards) or remain unchanged (e.g., legal risks).

We review the periodic information received and analyze on a regular basis the amount by which the credit enhancement available to each tranche has increased or decreased, cumulative defaults of receivables, and whether the reserve account is fully funded. We view each of those indicators in the context of how closely payments have been in line with our original expectations.

In addition, we monitor the ratings of the top obligors of the receivables that are still part of the transaction. Material deterioration in the obligors' credit quality could impair the future cash flows to a transaction. We also assess any changes to the servicer's financial condition and its ability to continue to service the assets.

If defaults exceed typical historical levels, we would explore the reason for the increase, whether they are due to obligor defaults, diversions or servicing missteps. If, at any time, those or any other factors lead us to conclude that the current rating may no longer be consistent with the risk to investors, we are likely to

revise our quantitative and qualitative views and run the model with such adjusted views based on the updated asset pool.<sup>23</sup>

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<sup>23</sup> For example, in methodologies where models are used, modeling is not relevant when it is determined that (1) a transaction is still revolving and performance has not changed from expectations, or (2) all tranches are at the highest achievable ratings and performance is at or better than expected performance, or (3) key model inputs are viewed as not having materially changed to the extent it would change outputs since the previous time a model was run, or (4) no new relevant information is available such that a model cannot be run in order to inform the rating, or (5) our analysis is limited to asset coverage ratios for transactions with undercollateralized tranches, or (6) a transaction has few remaining performing assets.

## Appendix A: Securitizations Backed by Lottery Receivables

The purchase of a lottery receivable gives the issuer the right to receive payments due under lottery prize winnings from a state lottery commission. The transfer of lottery receivables is generally governed by state-specific transfer statutes and subject to court approval, resulting in legal protection against payment diversion risk similar to that of structured settlements.

The following requirements generally apply before a court issues a transfer order approving the sale of lottery prize payments by lottery winners:

1. The assignment must be in writing.
2. The purchaser must provide lottery winners with a written disclosure statement that includes:
  - payments being assigned, by amounts and payment dates
  - purchase price being paid
  - discount rate applied by the purchaser
  - amount of any origination or closing fees to be charged to the lottery winner
3. The purchaser must provide written notice of the proposed assignment and court hearing concerning the assignment to the applicable lottery commission's counsel prior to the date of any hearing.
4. Lottery winners must provide a sworn affidavit attesting:
  - they are of sound mind, in full command of their faculties and not acting under duress
  - they have been advised regarding the assignment by their own independent legal counsel

The payments on the lottery receivables are due from the state's lottery commission that conducted the lottery, and the respective lottery commission is the obligor under the respective lottery payments. The lottery payments to the winner and subsequently to the issuer are net of federal taxes, and if applicable, state taxes.

We model lottery receivables using a quantitative approach similar to the one we use for structured settlements, but with different assumptions. We assume (1) a probability of default for the lottery commission primarily linked to the lottery commission's investment policy, which is typically consistent with high-investment-grade securities; (2) a very low recovery rate in the event of the lottery obligor's default; (3) refund of tax withholdings on the lottery payments in the year after the withholding; and (4) a high correlation of default among the lottery obligors (typically 75%) and a lower correlation of default between the lottery obligors and the annuity obligors in the pool (typically 25%).

## Appendix B: Tobacco Legal Settlement Fee Securitizations

Tobacco legal settlement fee securitizations are backed by payment streams pursuant to fee payment agreements between tobacco manufacturers and the legal firms representing any of the public entities involved in a 1998 landmark settlement agreement. Like structured settlement securitizations, tobacco legal settlement fee securitizations are backed by payment obligations from rated entities (i.e., the tobacco companies).

For tobacco legal settlement fee securitizations, we analyze the cash flows and evaluate their sufficiency to repay the principal and any accrued interest by legal maturity. In addition, we consider qualitative factors, such as the transaction's leverage, expected repayment, legal risk and the probability of payment dilution.

We use a Monte Carlo simulation to project the transactions' cash flows. The main simulated parameters are the tobacco manufacturers' probabilities of default, which are a function of their respective ratings. Each Monte Carlo simulation consists of several thousand iterations. The primary model output of an iteration is the internal rate of return (IRR) to the bondholders.<sup>24</sup>

This approach will not be applied rigidly by us in all circumstances. Rating committees will, where appropriate, consider any other factors that they deem relevant to their analysis and this may lead the committee to assign a rating different from that indicated by the model output.

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<sup>24</sup> For more information, see the discussion of Internal Rate of Return (IRR) Reduction in *Rating Symbols and Definitions*. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section and in the "Loss Benchmarks" section.



## Moody's Related Publications

Credit ratings are primarily determined through the application of sector credit rating methodologies. Certain broad methodological considerations (described in one or more cross-sector rating methodologies) may also be relevant to the determination of credit ratings of issuers and instruments. A list of sector and cross-sector credit rating methodologies can be found [here](#).

For data summarizing the historical robustness and predictive power of credit ratings, please click [here](#).

For further information, please refer to *Rating Symbols and Definitions*, which includes a discussion of Internal Rate of Return Reduction, and which is available [here](#).

Report Number: 1209380

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