S. HRG. 110–931

THE ROLE AND IMPACT OF CREDIT RATING AGENCIES ON THE SUBPRIME CREDIT MARKETS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE CIRCUMSTANCES, THE INTEGRITY OF THE RATINGS PROCESS, THE OVERSIGHT OF THE SEC, AND WHETHER STATUTORY, REGULATORY, OR INDUSTRY CHANGES ARE ADVISABLE IN LIGHT OF SIGNIFICANT DOWNGRADES TO THE CREDIT RATINGS OF SECURITIES IN THE SUBPRIME MARKETS

WEDNESDAY, SEPTEMBER 26, 2007

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C O N T E N T S

WEDNESDAY, SEPTEMBER 26, 2007

WITNESSES

THE ROLE AND IMPACT OF CREDIT RATING AGENCIES ON THE SUBPRIME CREDIT MARKETS

WEDNESDAY, SEPTEMBER 26, 2007

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:34 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Jack Reed presiding.

OPENING STATEMENT OF SENATOR JACK REED

Senator REED. Let me call the hearing to order.

I want to thank Chairman Cox for joining us this morning. I particularly want to thank Chairman Dodd and Senator Shelby for their leadership on this issue. Both have expressed significant concerns about problems with the subprime market and have raised serious questions about the role that credit rating agencies have played in the current situation.

According to the FDIC, since the beginning of June 2007 the credit rating agencies have downgraded more than 2,400 tranches of residential mortgage-backed securities. The recent wave of downgrades have caused some investors to lose confidence in both the integrity and reliability of these ratings.

This hearing provides us with an opportunity to examine the role of the credit agencies in structured finance products and consider their impact on financial markets.

Back in April I chaired a Subcommittee hearing examining the role of securitization, where witnesses testified that problems in the subprime asset market area were confined to a small part of the market. Of course, since then we have learned that the fallout from the subprime turmoil was and is deeper and broader than we were led to believe. As a result, it seems that securitization not only distributes risk but that it can hide it as well.

Credit rating agencies play a critical role in capital markets. The agencies can enhance or reduce investor confidence depending on the information they provide. The increasing complexity of structured products like mortgage-backed securities and CDOs, collateralized debt obligations, and the perceived lack of transparency in this investor appears to have made investors more dependent on the rating agencies to perform quality analysis. In that sense, the agencies have become gatekeepers for the multibillion-dollar structured finance industry.

Furthermore, the credit rating agencies are the only market participants who make it their primary focus to evaluate and disseminate information and the importance of their central roles is further affirmed and supported by rules such as those that are used to determine pension investor guidelines and capital requirements for financial institutions. All of these factors indicate that the credit rating agencies have substantial responsibilities for providing timely and accurate information to other market participants.

With the complexity and volume of new types of securities being created, the rating agencies are uniquely situated in the process of structuring RMBS products through their close interaction with the issuers. These close relationships have led many to question the integrity of the process. Former SEC Chairman Arthur Levitt has said that the credit rating agencies' decreasing dependence on revenues from structured finance products creates a conflict of interest that undermines their ability to provide fully independent ratings assessments. They are, in his words, "playing both coach and referee in the debt game."

Finally, Lou Ranieri, the pioneer of MBS, suggested in 2006 that the mortgage-backed security sector was "unfettered in its enthusiasm" and "unchecked by today's regulatory framework."

He further stated that "We have a quasi-gatekeeper in the rating services and in the end the SEC is the regulatory of the capital market. It is the one who can touch this stuff and make a difference."

So I am eager here about the SEC's activity in this area.

Last year, under the leadership of Senator Shelby, Congress passed the Credit Rating Agency Reform Act that gave SEC more regulatory and oversight authority over credit rating agencies. In June 2007, the Commission adopted implementing rules. These rules require a Nationally Recognized Statistical Rating Organization, an NRSRO, to disclose a general description of its procedures and methodologies for determining credit ratings. We are interested in learning how the recently adopted rules will help address investor concerns.

Of course, we want to hear from the credit rating agencies about why there were so many downgrades of RMBS in such a short period of time. We want to know what did they fail to anticipate and what have they learned from recent events? How are they updating their models to account for changes in the market and the complexity of structured products.

I hope everyone here today recognizes the seriousness of this issue. We have been down this road before. After Enron we addressed the relationships among corporate managers, auditors, and analysts. I worry whether there may have been lessons learned with respect to the importance of independent objective analysis in those cases which were not recalled in this particular situation.

So steps need to be taken and all options are on the table. Ultimately our goal is to strike the right balance between voluntary and regulatory actions and, in doing so, to enhance and restore investor confidence in the capital markets.

Before I call on Chairman Cox, I would like to recognize Senator Shelby, the ranking member, and other members of the Committee for their statements.

Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Until the highly publicized failures to warn investors about the impending bankruptcies at Enron, WorldCom, and other large companies, credit rating agencies operated under the regulatory radar screen for decades in spite of their important role in capital markets.

In recent months, widespread attention has been devoted to downgrades of credit ratings on structured financial products, particularly subprime residential mortgage-backed securities. Numerous reasons have been offered for why the rating agencies got it wrong. Some have suggested the rating agencies awarded high ratings to curry favor with the large investment banks. Others have criticized the rating agencies for playing an active role in structuring these complex deals, which presents a number of conflict of interest concerns.

The purpose of this hearing is to explore these and other questions.

In the 109th Congress, as Chairman Reed mentioned, the Banking Committee conducted a comprehensive review of the market in which the rating agencies operate. This investigation revealed an extremely concentrated and anti-competitive industry. Two of the most profitable public countries in the U.S. operated what has been called a partner monopoly, each controlling approximately 40 percent of the industry's revenues and issuing 99 percent of corporate debt ratings. This virtual absence of competition was repeatedly cited as a major factor leading to ratings of inferior quality and practices deemed to be abusive and anti-competitive. The business model of the debt issuers paying for their own ratings also led some to question whether the rating agencies could effectively manage the inherent conflicts of interest.

The Committee's examination, culminated in the passage of the Credit Rating Agency Reform Act of 2006, as Chairman Reed alluded to. The Act is not quite a year old so it is premature to judge its impact. Moreover, SEC regulations implementing the Act have only been in place for a few months.

The centerpiece of the Act replaced the opaque SEC staff licensing system with a more transparent and open registration system that will result, we hope, in a greater number of Nationally Recognized Statistical Rating Organizations, or NRSROs.

The Act also provided the SEC with broad authority to supervise the rating agencies. The Commission may examine registered rating agencies for compliance with the rules passed pursuant to the Act, such as the management of conflicts of interest, adherence to disclosed procedures and methodologies for determining ratings and recordkeeping requirements. I look forward to hearing about the examinations currently underway, the first such exams conducted pursuant to the Act.

In light of recent difficulties, I would also like to know if the Commission has all the authority, Chairman Cox, it needs to conduct vigorous oversight of the rating agencies. I understand this is a very complex analytical discipline. The process of rating structured financial instruments can be confusing and very difficult to comprehend.

What is not difficult to comprehend, however, is the fact that some specific ratings were just plain, plain wrong and the subsequent downgrading actions by the rating agencies have had a serious impact on a significant sector of our financial system.

It is my hope that we will be able to use today's hearings to explore what a rating is, what it is not, how it is determined, and what leads an agency to change its rating. Finally, we will want to hear what went wrong. If there have been lessons learned, what are they? And what can be done to make sure it does not happen again?

I would like to thank all of the participants appearing here today, especially Chairman Cox. Welcome again to this hearing. You spend a lot of time.

Thank you, Mr. Chairman.

Senator REED. Thank you, Senator Shelby.

Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman.

I want to thank you and Senator Dodd and Senator Shelby for holding this timely hearing, and thank Chairman Cox for being here.

I guess we can look at the subprime crisis in two ways, or in two parts really. First, how do we deal with the present problem, the 2 million homeowners who are likely to go into foreclosure? I believe that involves two things: one, finding people who can do workouts for the people on the edge of foreclosure. There is no one around so for so many of these people. Senators Casey, Brown, and I have put $100 million in the transportation appropriation to do that but we need more.

Second, money for financing of these new refinancings. And there we are looking, some of us anyway, FHA reform has passed this Committee. That will affect a smaller number of homes. But getting Fannie Mae and Freddie Mac involved one way or the other will make a great sense.

We also have to look at how to prevent this crisis from occurring again, how to prevent the poor people who were taken advantage of from being taken advantage of again. To that end some of us, I have proposed dealing with the mortgage brokers, the unlicensed mortgage brokers, who many of them are fine people and many of them are rapacious people who deserve future regulation, and punishment in a certain sense, although probably there is no law to do it for what they have done. That deals with the individual borrower, where the crisis started.

But there is also the problem of how, with so many of these mortgages that were done on a bad basis, that were almost impossible to be repaid, that investors just scooped them up. And there we have the look, No. 1, at that credit rating agencies because you cannot expect an individual investor to know the details of these complex regulations, these complex packages whether they be mortgages or derivatives or anything else. We really depend more and more, as society gets more complicated we depend more and more on credit rating agencies.

And the fundamental question here is what went wrong? What went wrong? I met with the head of one of the agencies and they were telling me nothing went wrong. I will tell all of the representatives of companies that I have worked with and defended in the past, they are good New York companies, to say nothing went wrong, that is not going to fly. It defies common sense.

These were not AAA rated packages, just shown by what has happened now. But the point is they were not AAA rated because many of the mortgages in them were not repayable to begin with.

Now maybe the agencies will say it was not our job to do that. But that, too, defies what we think a credit rating agency should do.

And so I think we have to explore this. This is one of the untold chapters so far in the subprime story, how the risks associated with subprime mortgages were underestimated and then swept under the rug by eager investors. And that is why this hearing is so important.

One of our witnesses spoke about the potential distorted incentives that result from the fact that most—at the Joint Economic Committee we had a hearing on this. One of our witnesses spoke about the potential distorted incentives that result from the fact that most rating agencies are paid by the companies they rate rather than by investors who use the ratings. Chairman Reed pointed out, I think very aptly, that the last crisis we had in terms of accounting problems there was the same problem. The accountants were paid by the people who were getting the ratings from them.

And so the question is is this a conflict of interest? First the rating agencies market their rating services to the issuers who, of course, want better ratings. Could this be creating a tendency to inflate ratings in the marketplace?

And second, rating agencies typically get paid after the issuer decides to accept the rating. Well, on its face, that one just seems ripe for potential conflicts of interest.

So when the rating agency has done a thorough objective job of rating a security, the issuer can pull its business if it does not like the rating. Up until the 1970's, it was pointed out at our Joint Economic Committee hearing, all of the original credit rating agencies were funded by investors. It is the investors that care the most about the independence of the credit rating analysis, the integrity of the evaluation of credit quality, and the timely review of ratings.

In the 1970's, a switch in payment structure took place and today the bulk of the major rating agencies, rating related income now comes from fees charged by issuers. So the question looms, should the structure be changed? Or should there be two types of agencies out there, one that is paid for by investors and one that is paid for by the issuer?

Are there conflicts of interest in the other model, the investor related model? And do those conflicts of interest outweigh the conflicts of interest we potentially have seen here? We should discuss whether we should promote the entry of serious viable investor funded rating agencies to compete against rating agencies that are purely paid by the issuers or to provide incentives for today's rating agencies to go back to their roots and have investors pay for the ratings.

I do not know the answer to that question. I have not made up my mind. But it is certainly worth exploring, both to see if we should move to a new model, and also to help us shine a light on what went wrong in the past.

I look forward to the witness's testimony.

Thank you, Mr. Chairman.

Senator REED. Thank you, Senator Schumer.

Senator Sununu.

STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you very much, Mr. Chairman.

I think, insofar as the credit rating agencies are concerned, their role in rating these securities is signaling the markets as to what the level of risk inherent in the securities is. The markets use that to price the risk.

What we have seen really over the past 18 months, changes in the financial services markets, indicates that in many areas of financial services the pricing for risk was inaccurate, that there was not an appropriate premium placed on risk. Not just in mortgage-backed securities but in other areas of the market as well. We have seen the financial services industry and financial instruments respond to that.

What we want to do today is to get a better understanding of how the rating services priced or estimated risk in these securities, whether they looked at the securities clearly, effectively, indifferently in the way that a rating agency should and to better understand what the impacts of re-rating, downgrading, or upgrading those securities has been. And to find out whether the legislation we passed last year will help address whatever problems may have existed in the rating agencies themselves.

That was, I think, good legislation. I think it has been broadly supported as laying the groundwork for better assessing performance of credit rating agencies and also encouraging greater competition among credit rating agencies. And those that misprice risk or misgrade securities should be punished in the marketplace.

However, I think it is important that we look at this, the problems here, with an understanding of what the larger fundamental economic problem is. And that is a collapse of the housing industry in the real estate market. Housing inventories are now at a 10 month supply. It is very likely that those inventories will go even higher as the sales situation in the housing market further deteriorates. And that, in turn, is at least in part what is driving foreclosures, reduction in price sales, loss of equity and creating an untenable financial situation for hundreds of thousands if not millions of consumers.

So we want to make sure we do not do anything, even as we take all of these steps, we do not want to do anything that ultimately will restrict consumer credit where credit should be made available and we do not want to discourage the securitization of mortgages because that is very important to making credit available to those that are trying to purchase a home or refinance a home. And we certainly do not want to discourage the ability of those who hold mortgages to go to the homeowner and work out a modification and write down part of that mortage so that someone can stay in their home.

And bad legislation, bad regulation, could possibly do any one or all three of those things. Again, in an environment where it is much more likely than not that we are moving from 10 months of inventory to 12 months of inventory to 14 months of inventory over the next six to 9 months, I think we need to be very thoughtful and cautious in making any changes to the regulatory structure so that we do the right thing for all of those that are in the most difficult of situations with regard to their homes.

Thank you, Mr. Chairman.

Senator REED. Thank you, Senator Sununu.

Senator Casey.

STATEMENT OF SENATOR ROBERT P. CASEY

Senator CASEY. Mr. Chairman, thank you very much and I appreciate the opportunity to participate in this hearing.

Chairman Cox, we appreciate your presence here and your testimony, which we will hear.

I have just a brief statement. First of all, with regard to what brings us here, which is the crisis that is in the subprime problem we have across the country. I think the evidence now is irrefutable that this is a real and substantial problem for families. But as we know now, it has had an impact on credit and other financial measures across the world. So this is a major challenge. Part of this challenge is examining the role played by and the impact that our credit rating agencies have.

I have to say in a personal way I have had some experience dealing with rating agencies as the Auditor General and State Treasurer of Pennsylvania. But in particular, when I was the State Treasurer, I remember waiting with great anticipation about whether or not a rating agency would give an investment grade rating to our tuition account program which I was in charge of and I had said I would make reforms to. And I could not, as a public official, reform or reintroduce that tuition account program that so many families depend upon without having the seal of approval, so to speak, of a rating agency.

So I realize that as a public official, and I know I speak for probably lots of public officials and agencies, the importance we place upon that rating in terms of determining whether we can market or certify or at least point on a positive note to a program. So it is critically important and I realize the role that those agencies play in our system.

But I think this question raises—or I should say this crisis raises some real questions about conflict of interest. It raises questions that we also encountered, I think our country encountered, in the lead up to the enactment of Sarbanes-Oxley. Like what happens when an entity is doing consulting services for entities that are involved with or seek ratings from that same entity?

There are a lot of questions and we will be asking those today. But I think even, Senator Shelby mentioned the fact that the Credit Rating Agency Act is only a 2006 act. So we should not be precipitous in our judgments.

But I think that when an act is in place, even for a year, I think it bears scrutiny and examination, especially in light of this crisis. So we want to make sure, Chairman Cox, that you have the resources that you need and also the authority that you need. We may determine that the authority is substantial and adequate but we want to make sure that that is among the many questions that we ask of you today and ask the panel that will follow you.

Thank you very much.

Senator REED. Thank you very much, Senator Casey.

Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you. I do not have a statement and look forward to Chairman Cox's testimony, as well as our witnesses on the second panel.

Thank you.

Senator REED. Thank you very much.

Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Mr. Chairman, thank you. Senator Shelby, thank you. Chairman Cox and other witnesses, it is good to see you again, Chris. Thank you for joining us to offer your insights.

The Federal Reserve Bank of Cleveland this week held a conference in Pittsburgh on how to reclaim vacant properties. But the big question on the minds of the hundreds of local officials and others attending was where to find the money to tear these properties down. It is not just a house here and there. Whole neighborhoods in my State and the States many of you represent have been devastated. In many areas the only workout left is at the business end of a bulldozer.

Chairman Schumer held a hearing earlier this year that focused on one neighborhood in Cleveland. One of the witnesses had a chart showing the loans of Argent Mortgage, a top lender. The purported value of these properties was two or three times the real value of these homes. On paper, the loan-to-value ratio for these loans might have been consistently 90 percent. But in the real world the ratio was 150 or 180 percent or even higher. More than a quarter of the loans Argent made over the last 4 years have already resulted in foreclosure.

The current crisis is not simply the invisible hand at work. A lot of very visible hands peddled these loans to the people of Cleveland and elsewhere. I doubt that Adam Smith anticipated a financial product that was mass marketed and designed to fail on a slow fuse. Yet at every hearing on this topic we have heard that nobody was at fault. Not the brokers, not the lenders, not the issuers, apparently not the rating agencies. Evidently, we are witnessing the immaculate deception.

I am sorry but, as Senator Schumer said, I do not buy that. Everyone is at fault. And everyone includes Congress. Congress needs to act quickly to enact the type of borrower protections contained in the legislation that Senators Schumer and Dodd have introduced. We also need to figure out how to get the financial markets to provide faster punishment for bad actors through pricing or plain lack of access to capital. It is not enough that these companies only go bankrupt because by that point they have left a trail of destruction in their path.

The benefit of structured finance is the dispersion of risk. But today responsibility is dispersed, as well. We need to figure out to maintain responsibility through both legal and economic means.

I appreciate the ideas that some of today's witnesses have suggested. It seems to me we can and we should try to refine the data that goes into rating products so that each actor is scrutinized on an ongoing basis with those available details.

It may be, as our witnesses will testify, that it takes some time to decide whether an overall trend is in place. But it should take much less time to determine the outliers like Argent Mortgage and price them out of business.

We can talk clinically about credit enhancement steps, such as the over-collateralization of security, but there is nothing excess about that collateral to the homeowner who lives in it. We must be much more careful in what we do.

Thank you, Mr. Chairman.

Senator REED. Thank you very much, Senator Brown.

Senator Bunning.

OPENING STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

First of all, I would like to welcome Chairman Cox, who is my good friend.

As easy as it would be to blame one bad actor in the housing markets, that is not the case. Numerous groups contributed to the mess, though some contributed more than others.

At the top of the list is the Fed and its former chairman and now author, Alan Greenspan. This hearing is not about the Fed or its role in the housing bust, but understanding Greenspan's Fed monetary policy is key to understanding what happened next.

In 2000, Mr. Greenspan kept raising interest rates in the face of a slowdown, driving the market and the economy into a recession. In order to undo the problem created by tight money, he then went too far the other direction, taking rates as low as 1 percent. That easy money encouraged excessive risk-taking.

Even though Mr. Greenspan knew it would lead to problems, he did nothing about it. With mortgage rates dropping to all-time lows housing became hot and people rushed in. Things were going great until about 2005, when rising interest rates and housing prices appreciation overcame the abilities of borrowers to afford the house they wanted.

But instead of accepting that the good times were coming to an end, borrowers and lenders looked for ways to keep the party going. What they found was a breakdown in responsibility and common sense by regulators, lenders, investors, brokers, and borrowers.

By 2005 everyone believed they had figured out the way to take the risk out of the lending to home buyers, even those with poor credit. How was this miracle pulled off? By packaging loans into bonds that were given a gold star by the rating agencies and sold to investors seeking higher returns. The banks, rating agencies, and everyone else in the middle got a nice fee and washed their hands of the loans.

Let me be clear that everyone involved in the process shares the blame for today's mess, including the borrowers. But we are here to talk about the rating agencies and their roles.

As I just mentioned, the rating agencies sat right in the middle of the scheme and enabled the whole thing to happen. Their ratings created a sense of security and gave investors the green light to buy mortgage-backed bonds. But oddly enough, I find myself in agreement with Chairman Greenspan when he said last week that the rating agencies did not know what they were doing. The rating agencies simply got it wrong.

In fact, downgrading of mortgage-backed securities have already surpassed the level from the last housing downturn and are almost certain to increase further. That kind of mistake matters when your decisions are relied on by the entire market.

Important questions need to be answered. Why and how were the rating agencies so wrong? Why did the marketplace rely on them so heavily? How much risky lending did the generous ratings enable? Can their ratings be relied on in the future?

Even the rating agencies will admit that their business models represent a conflict of interest. They get paid a substantial fee by the person wanting to get rated, who then uses that rating as a reason to buy their product. That is like a movie studio paying a critic to review a movie and then using a quote from his review in the commercials.

Senator Shelby was right when he led this Committee to pass the Credit Rating Agency Reform Act last year. Under that act, we are finally going to get a look at how the agencies operate and how they try to manage their conflict of interest. More importantly, the public is going to get information that is accurate.

Chairman Cox, your Commission has just finished the rules and registered the first seven agencies. The information you learn from them will help us determine whether further regulation is needed or whether the market will be able to take their ratings for what they are worth in the future.

Thank you, Mr. Chairman.

Senator REED. Thank you, Senator Bunning.

Senator Menendez.

OPENING STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman.

Well, here we are, 6 months after our first hearing to examine the subprime crisis, and we are still seeing the effects of the fallout. As far as I am concerned, unfortunately, the storm is not over. In fact, in some respects it still seems to be picking up wind.

Home sales dropped yet again last month and yesterday one of the Nation's largest homebuilders reported its worst ever quarterly earnings. This means much more than a ripple effect on our markets. It means Americans are still losing their homes.

We still have to get to the bottom of the crisis and, as far as I am concerned 6 months into this, time is running out.

Today we have a chance to examine one piece of the subprime puzzle. It is only one piece, however. I will reiterate a point I have made before at some other hearings, we have to look carefully at everyone who has had a hand in this chain from the point a loan is signed by the borrower until it is sold on the secondary market.

The cracks in the system cannot be patched up with a few tweaks here and there, and I am convinced that the market cannot fix this alone. Until we have uncovered all of the root causes of what led to the tsunami in this market, it remains ripe for more turmoil.

As a member of this Committee over the past few months, I have heard all of the players duck their responsibility and point the finger at anyone but themselves. This has become a game of hot potato and it has to stop.

If you ask me, everyone is responsible and should be held accountable. The fact is these loans had a real impact on real lives. We are not just talking about lower annual earnings or stock prices that have dropped. We are talking about people whose dreams have been shattered. We are talking about homes being taken away. We are talking about disintegration for some of what is, in essence, the American dream.

And yet no one, no one, is willing to step up and say what hand they had in the process. So while I do not believe this is just about placing fault I think we cannot lose sight of the larger picture, and that is that we still have not gotten to all of the root causes of this fallout. I hope the Committee will not seek to presume that the marketplace is going to take care of all of this. I hope that that will not be the view of the committee and that, in fact, we must act.

Finally, while the credit rating agencies may not be at the center of this chain, they are still a link. The question is, in my mind, which I hope we will explore today—I certainly intend to do—is how much did the credit rating agencies affect the process and the end result? Did they provide less than accurate information? Did they react too slowly to changes in the market? And above all, did they become enablers of the now crisis? Did they do so by compromising ratings by potential conflicts of interest?

I am not quite sure how you go about doing the rating and then going ahead and advising how to package it so you get the best ratings possible. I am not quite sure that that is really in the interest of other than those who wanted to package these products and get the best possible ratings. I am surely not convinced that that was appropriate by any stretch of the imagination.

So I am looking forward to that testimony to hear how it was proper to have the very essence of what would be a conflict be pursued as a normal course of business.

Thank you, Mr. Chairman.

Senator REED. Thank you, Senator Menendez.

Senator Allard.

OPENING STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman.

First of all, I would like to thank you for holding this hearing. Earlier this year we held a Securities Subcommittee hearing to learn more about the role of securitization in the subprime markets, so we had a very interesting discussion. Credit rating agencies came up a number of times at that hearing so this will be a good opportunity, I believe, for the Committee members to follow up on many of those matters that were raised during our Securities Subcommittee meeting.

Credit rating agencies or Nationally Recognized Statistical Rating Organizations play an important role in our financial markets. Confidence in those ratings has been shaken following a number of downgrades of residential mortgage-backed securities. In fact, just in July and August, Standard & Poor's issued 1,544 downgrades of residential mortgage-backed securities.

The downgrades and lack of confidence have dramatic consequences. Besides the direct consequences in the financial market, the situation has curtailed securitization, which has made it more difficult for families to buy a home.

Now former Federal Reserve Chairman Alan Greenspan has been quoted a number of times. I will give a more complete quote to the Committee. He issued a sharp rebuke in a newspaper article earlier this week. He said he believes that the volume of structured finance products will decrease. He said, and I quote "People believed they—" meaning the credit agencies "—knew what they were doing, and they do not" said Greenspan. "And then, quoted again, "What kept them in place is a belief on the part of those who invested in that was that they were properly priced. Now everyone knows that they were not and they know they cannot really be properly priced. "That is one of the things I want to follow up in my question is that last statement.

In a foreshadowing of these concerns, Congress enacted the Credit Rating Agency Reform Act of 2006. Unfortunately, the law is still being implemented. But I am hopeful that once it is in place it will foster a stronger more robust system with better accountability in order to prevent this situation from recurring.

At today's hearing we will hear about a number of concerns, some that have already been mentioned by my colleagues here on the Committee. But I again would like to highlight that what I see as a potential Achilles' heel of this entire system is that credit ratings are not paid for the work of researching, analyzing, and creating a rating. Rather they are paid for the actual rating. It does not matter how much work they did or did not do that went into determining the rating. It is if the client does not like the final rating, they can walk away without paying a dime.

The analogy that I can think of is if you are an accountant and you are doing the tax forms for somebody and you do not come up with the right tax balance, you would not expect them not to pay the accountant. I think if you want credit ratings to be accountable, I think you base it on the time and research and effort that goes into the program, not on the results and whether you like the results or not. So I think we need to check into that more closely during this hearing.

I find this startling, especially when you put into other housing market context. For example, just like credit ratings, a number of entities rely on appraisals. Lenders use the appraisal in underwriting homes. Buyers use the appraisal in making their decisions, and so forth. To give the appraisal integrity, we value the objectivity of the appraiser. He or she is paid for the professional service of appraising a home, not just a specific number at the end of the process.

Similarly, what if home inspectors were not paid for conducting the inspection but only for delivering the desired report on the end? So there are numerous examples that we can use where this is not a desirable business practice.

So I am hopeful that the FCC will be closely examining this issue as part of its ongoing work. We have a good lineup of witnesses, I know, that have a great deal to say. And I look forward to their testimony.

Thank you, Mr. Chairman.

Senator REED. Thank you, Senator Allard.

Senator Martinez.

OPENING STATEMENT OF SENATOR MEL MARTINEZ

Senator MARTINEZ. Mr. Chairman, thank you very much. I will be very brief.

I just wanted to say that I agree with my colleague from New Jersey that there is an awful lot of people or entities involved in this process. The outcomes are horrible.

We saw a tremendous wave of home ownership, particularly among minority families, first-time home buyers, that are now facing the flip side of that coin as they face the potential for foreclosure.

During the good times it is very difficult to focus on the problems that exist within the industry and the problems have existed and have been obvious. It is very difficult to convince anyone that there is broker abuse when the good times are rolling. It is equally difficult to convince anyone that RESPA, the Real Estate Settlements and Procedures Act, is deeply flawed and must be reformed, earnestly performed. Not during the good times, no one wants to think about that. We still have to look at that. It is part of the ongoing review that we should be doing as to all things that need to look in the whole industry.

The Government-Sponsored Enterprises have a weak regulator. We have known that. These are enormous entities with the credit backing, presumed credit backing, of the U.S. Government. They can be tremendously at risk. Yet we have a weak regulator providing the oversight for these GSEs. We have got to have GSE reform. They may be part of the solution to the problems we currently face, but GSE reform also must be a part of it.

So along with that I also believe that the rating agencies are part of the process and part of the circle of all that we need to examine and look at. I look forward to hearing the testimony of the witnesses. I will not prejudge whether, in fact, the current crisis is one that can be solved by us here in the Congress acting. It may be that, difficult as it is, we do not have the power to reverse the excesses of the past years.

But I do look forward to hearing the testimony from the witnesses today and probing into this important area of what it is we have to review, which includes the rating agencies as well.

Thank you for the hearing, Mr. Chairman and Ranking Member Shelby, we look forward to the testimony from the witnesses.

Senator REED. Thank you very much, Senator Martinez.

Chairman Cox, thank you for joining us today and we all await your testimony. Thank you.

STATEMENT OF CHRISTOPHER D. COX, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Chairman COX. Thank you very much, Chairman Reed, Senator Shelby, and members of the Committee.

I am pleased to be here today to discuss the important the Securities and Exchange Commission is doing concerning credit rating agencies.

When Congress gave the Commission statutory authority in the Credit Rating Agency Reform Act of 2006 to oversee credit rating agencies registered with the Commission, you explicitly found that Commission oversight would serve the interests of investor protection. And that it would foster competition, accountability and transparency in the industry.

The rating agency act grants the Commission broad authority to examine all books and records of an NRSRO. This broad examination authority permits the Commission to examine every NRSRO on a periodic basis for compliance with the Commission's new rules governing rating agencies that we put into effect since the enactment of the law, including rules addressing conflicts of interest and rules prohibiting unfair, coercive or abusive practices.

The law makes it clear that the commission's otherwise broad authority does not extend to the regulation of the substance of the credit ratings or the procedures and methodologies that a ratings agency uses to determine its credit ratings. In striking this balance, the legislation gives the Commission responsibility for promoting competition in the credit ratings industry and for policing ratings agency activities, including in particular conflicts of interest, as has been mentioned by virtually every Senator speaking this morning.

At the same time, the law declares that it is not our role to second-guess the quality of their ratings.

The rating agency act is still just months old and it set out an aggressive schedule for implementation. The Commission is ahead of that schedule. The SEC proposed six new rules on February 2nd of this year, just 4 months after the law was signed. We adopted the final rules on May 23rd, months ahead of the June 26th—pardon me, more than a month ahead of the June 26th statutory deadline. And earlier this week the Commission issued orders granting registration under the rating agency act to seven credit rating agencies. Each of these applications was swiftly reviewed, evaluated, and determined within the 90-day timeframe specified by the act. As a result these seven new registered credit rating agencies are now subject to both the provisions of the act and the Commission's final rules implementing it.

In recent months, the credit rating agencies have been heavily criticized for their ratings of structured finance products, especially subprime residential mortgage-backed securities. Critics have faulted the rating agencies for assigning ratings that were too high and for failing to lower those ratings sooner, as the performance of the underlying assets deteriorated.

There has also been criticism that the agencies have failed to maintain appropriate independence from the issuers and underwriters of those securities.

For their part, the rating agencies generally have stated that the incidence of mortgage delinquencies in 2006 far exceeded their original credit loss expectations. That was particularly so, they said, for subprime mortgages. They have also point out that in the past their expectations have turned out to be more conservative than the actual loss experience. They have noted several factors that seemed to have caused the unexpected losses this time around, including fraud in the mortgage origination process, deterioration in loan underwriting standards, and lending standards that became more restrictive very quickly, which in turn made it ever more difficult for over-leveraged borrowers to refinance.

As of today, the SEC has not formed a firm view on any of these purported reasons that have been advanced by the credit rating agencies for what has happened. But we are carefully looking into each of them in the context of an overarching examination the Commission has begun with respect to these rating agencies that are active in rating residential mortgage-backed securities.

This examination, which is being conducted on a nonpublic basis, was commenced in response to the recent events at the mortgage markets. In particular, the Commission is examining whether the ratings agencies were unduly influenced by issuers and underwriters to publish a higher rating. This examination is also focusing on the NRSROs followed their stated procedures for managing conflict of interest that are inherent in the business of determining credit ratings for residential mortgage-backed securities. In this regard, the examination will seek to determine whether the rating agencies' role in the process of bringing RMBS to market compromised their impartiality.

In addition to the Commission's examination that I have just described, the President has requested that the President's Working Group on Financial Markets examine the role of credit rating agencies in lending practices, how their ratings were used, and how the repackaging and selling of assets—the securitization process—has changed the mortgage industry. As a member of the President's Working Group, the SEC is taking a leading role in this study.

The Commission is also a member of the Credit Rating Agency Task Force created by the International Organization of Securities Commissions. In that connection, we recently chaired an IOSCO meeting at which the rating agencies that are most active in rating residential mortgage-backed securities made presentations to the SEC and the securities regulators of several countries, focused on their role in developing structured finance products.

Mr. Chairman, I appreciate the opportunity to provide this Committee with this update on the Commission's oversight of credit rating agencies, and I look forward to answering your questions.

Senator REED. Thank you very much, Chairman Cox and let me begin.

You make the point that you do not feel the statute gives you the authority to examine the substance of the credit ratings or the procedures and methodologies. Would you want that authority, given the situation we have seen in the marketplace?

Chairman COX. No, Mr. Chairman, at this juncture it is my judgment that you and the Congress have struck a sound balance. We have a great deal of authority that we are on the very front end of exercising. It may be that more needs to be done in this area. We may learn that as a result of our examinations now under way.

But it is very easy to see in the abstract what would become of competition, what would become of the market, what would become of the substance of the ratings themselves if they just disintegrated into following a Government regulation on how to do it. There would be no innovation. There would be no potential for improvement. Or at least there would be a real collar on that because we would have determined a priori here is right away.

Particularly, as Senator Schumer pointed out, in a market that is becoming more complex we have got to recognize that the statistical models that are used, the stress tests that are applied, are constantly being reevaluated and updated, and so there has got to be room for that.

Still whether or not ultimately the business practices, the resources that are being applied, and the outputs are all within the range that Congress in the law and the SEC in practice consider reasonable, I think do fall within the statutory authority that you have given us.

Senator REED. Mr. Chairman, among your responsibilities, and you listed how aggressively you have been pursuing them, which is to try to prevent self-dealing and conflict of interest which I think is appropriate, but it seems to me, too, you have to have an interest in—as the statute describes—that these agencies are consistently producing credit ratings with integrity.

How do you accomplish that unless you are able to go in and look at the substance of their procedures and methodologies?

Chairman COX. As I say, I think that you and the Congress have struck the proper balance here because——

Senator REED. We should restrike the balance which I think, at least in terms of discussion, that is on the table.

Chairman COX. Yes, of course.

In implementing the law and adopting our rules earlier this year and fleshing this out we came to the tentative conclusion, similarly, that we have ample authority to disgorge information from the credit ratings agencies, to make it public in appropriate circumstances so that the market can judge and better understand what the methodologies look like, so that rather than putting a collar on innovation we have a lot more hot white light focused on how this is done. That will affect the pricing of the services offered by the ratings agencies because we will have, in the marketplace, a better idea of what they are worth.

It will also affect the way that people use the ratings. I am sure we will hear soon a full throated defense from the rating agencies of what they have done, in part because they think people are trying to use the ratings for purposes for which they were originally not intended. The more disclosure, the more transparency there is here, the better the market is going to be able to deal with that.

Senator REED. Given the scope of your responsibilities, do you have a plan for regular examination of these credit rating agencies?

And would that examination involve both the Office of Compliance and Inspection and the Division of Market Regulation?

Chairman COX. The very short answer to that question is absolutely, yes. The further answer is that we are in the midst, as I described, of just such an examination right off the bat with the law fresh on the books.

Senator REED. What are your instructions to these examiners? What are they looking for?

Chairman COX. First, they are focused on the bread-and-butter of what the statute requires of these agencies. We want to look at their resources. The threshold questions that we also consider at the time, which is very recent, 48 hours ago, when we issued an order to register initially these seven agencies. Are you a fly-by-night operation or are you serious? Do you have the resources that are necessary to do a thorough job of this? What kinds of people do you have? What kinds of backgrounds and experience do they have? What is your management structure and so on? What are your financial resources?

Next we move on to conflicts of interest. Those are inherent in the business, as has been described here. How do you manage those? What are your procedures? We have, in our rules, stated ab initio that several things are just flat prohibited. We, of course, examine against those and make sure that those rules are being followed, that associations between the credit ratings agencies and those whose products they are rating are either nonexistent or within the rule.

And then last, we take a look at—although not last in importance—we take a look at unfair and abusive practices. This stems from the competitive, the pro-competitive charter that you have given the SEC.

We will find, I think, over time, whether or not each of our authorities in those three main areas can be embroidered sufficiently to give us all of the power that I think you want us to have.

Senator REED. The possibility exists, given that scheme, that if they are reasonably capitalized and their operations are funded at an adequate level, and there are no overt conflicts of interest, et cetera, but they are consistently wrong in their ratings, they would still pass your test.

Chairman COX. I think that is theoretically correct. One wonders, however, if we are doing a much better job of providing transparency, how long that would last in the marketplace. How much can you charge for being wrong every time?

Senator REED. Thank you very much, Mr. Chairman.

Senator Shelby.

Senator SHELBY. Thank you.

Chairman Cox, it is my understanding that the SEC never intended or expected that the National Recognized Statistical Rating Organization concept would become so widely relied upon. Given all of the problems we have seen over the years in the rating industry, conflicts of interest, a lack of competition, questionable ratings quality, abusive practices and so on, is it appropriate to reconsider the regulatory reliance on NRSRO ratings?

Or let me ask it this way: if you were to create a new system today would you design it differently? And if so, how so? Obviously, the system is flawed.

Chairman COX. The answer to the first question is yes. And the answer to the second question is almost certainly somewhat different because we would have so much benefit of hindsight.

The reason I say yes so readily to the first question is that we are already doing that within the SEC. We are examining our own rules to take a look at whether or not the express mention and reliance upon the NRSRO concept in our own rules is appropriate and what its consequences are.

This all started out in 1975. It has been an accretion of small steps. But it has included the Congress making express mention of it in the 1934 act. And so I think all of us in the Congress and in the SEC would do well to consider whether or not post-enactment of this landmark legislation, in a world where we expect there to be more competition and more transparency, whether all of that was really taken into account in the first instance dating back to 1975 when we first introduced this concept for purposes of our net capital rule.

Senator SHELBY. I appreciate that. We all, I believe, realize that there is something gone wrong here in the rating agencies.

Chairman Cox, would you support the forfeiture of an NRSRO status, either for all securities or a class of securities, by rating agencies that fail to satisfy minimum accuracy standards? There is some bad stuff out there.

Chairman COX. That is a difficult question to answer the way you put it because our authority to revoke registration or to limit it derives directly from the statutory language as it is written. So if you are asking me whether we would use our authority in that way, given the current statute I think it would be very difficult.

If you are asking me whether I would urge the Congress to amend the statute to give us more clear authority to do what you have suggested, I would say that the answer to that question awaits a little more induction. We need to learn a little bit more than presently we know on the front end of these examinations.

Senator SHELBY. Professor Lawrence White of New York University, who will testify on the next panel, says—and I quote—"Capital markets have no way of knowing or discovering whether there are better, more efficient, and effective ways of assessing the creditworthiness of bond issuers."

Do you agree with Professor White that there is no more test for the rating agencies? Do they lose market share for bad performance? Do inaccurate ratings cost the rating agencies business? Will a more competitive ratings market, which we envision, create more significant ramifications for inaccurate ratings?

In other words, if people come out with inaccurate ratings—and they have, Enron, WorldCom, the subprime debacle—are they really punished for that? The market punishes most people when they are wrong. It seems like the rating agencies are getting by and who is getting punished are the people who bought these homes, for the most part.

Chairman COX. Without question one of the major premises of credit rating agency legislation that Congress has just put in place is that competition is a remedy to these problems. We are now at the beginning of opening up that space to more competition.

As a footnote, we should observe that anybody can rate bonds but not anyone can be an NRSRO. So using this process we will see whether or not the space really does open up. And given that we might move from an oligopoly to a more full throated competitive market, whether or not the transparency that comes along with that—because that is another leg that the legislation stands on—also provides discipline, including price discipline in the marketplace.

Senator SHELBY. There is no substitute for transparency and competition, is it not?

Chairman COX. Certainly when we are talking about pricing and risk allocation and so on, that is absolutely right.

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

Senator REED. Thank you, Senator.

Senator Casey.

Senator CASEY. Thank you, Mr. Chairman. Chairman Cox, thank you for your testimony and your service.

I was struck by the juxtaposition of two parts of your testimony just for purposes of my first question. The question really focuses on I guess the threshold determination that the SEC makes when it seeks to commence an examination of the kind we are talking about here with regard to the rating agencies.

The juxtaposition I am focused on is on page two of your testimony, you talk about the criticisms of the rating agencies. Your testimony says in part critics have faulted the rating agencies for initially assigning rates to those securities that were too high. That is one criticism, rates that are too high. Second criticism, failing to adjust those ratings sooner as the performance of the underlying assets deteriorated. That is the second criticism. And the third that you site, the third criticism, maintaining appropriate independence—or for not maintaining appropriate independence from issuers.

Two paragraphs down you tell us what the Commission will examine. You say, in particular the Commission will examine whether the rating agencies were unduly influenced by issuers and underwriters—which seems to connect to that third criticism. And then second, you say the examination will focus on whether or not the rating agencies followed their procedures for managing conflicts of interest. And it goes from here.

I guess I have two questions. One is in this case or in any case how is that threshold determination made as to what you will examine based upon a body of criticism or a body of public information or even other information that the SEC has?

Chairman COX. The broader canvas of the various criticisms that have been made provides the backdrop for what we do. But the statute tells us, and our rules that we have adopted in furtherance of the statute, tells us precisely in which direction to head. That is why we have a focus on managerial, financial resources, on the competition piece, unfair and abusive practices and on conflicts of interest.

Senator CASEY. So it is the SEC's opinion that when you talk about—in terms of what the critics have said—that either faulting the rating agencies for assigning too high a rate or not adjusting midstream, you think both of those lie outside of the statutory authority that you——

Chairman COX. No, I think it is clearly within the statutory authority to the extent that the reasons that we are examining are the cause. If conflicts of interest, for example, result in the credit ratings agency being too cozy with the person paying and with, therefore, the issuer or the underwriter of the security to be rated, and that is the reason for the pathology, the particular problem, such as too good a rating to start with and not a quick enough adjustment, then we would be right down the center lane of what you have authorized us to go after.

Senator CASEY. I wanted to ask you about the process. Once you make a determination about what you will examine based upon your statutory or other regulatory authority, what does the process entail from that point? How many people are you deploying on this? And what is the process? What is the timeline? If you can take us through how this process would work.

Chairman COX. Certainly. One reason that we were able to beat the deadlines that you put in the statute was, watching the legislative process, we had fair notice that this might actually be signed into law. You had consulted with us during the legislative process. So from a budget standpoint, I was able to prepare budgets and submit them to the Hill and to OMB and the President that contemplate doing this work.

Certainly for the next fiscal year we are in good shape, no surprises here. This is a big priority and we are putting people from the Division of Market Regulation, from the Office of Economic Analysis and the Office of Compliance, Inspections and Examinations on the job.

I should also add that we are locating many of those people not in Washington but in New York, which is the locus of a lot of this activity.

Senator CASEY. My time is running out but maybe I will submit a question in writing for the record that speaks to this balance that I know we have got to strike, and it is a difficult balance. But I am wondering whether or not—we are out of time but I will just put it in for the record—that whether or not at the end of your examination, even if you are concerned about and compliant with striking the right balance, whether or not the SEC can recommend to these rating agencies that even on the question of the ratings themselves or changing or altering those ratings midstream, whether or not that is not an appropriate role for the SEC to play to make recommendations based upon expertise that you could retain or may have residing within the Commission.

I will sketch that question out and send it to you.

Thank you very much.

Chairman COX. Thank you, Senator.

Senator REED. Thank you very much, Senator Casey.

Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman.

Senator Reed and Senator Shelby both mentioned the concern about getting the ratings wrong, the degree to which inaccuracies in ratings done by the rating agencies should cost market share, the degree to which if you are getting the ratings wrong there should be some punishment, some discipline exercised in the marketplace. But all of that presumes that we have good information to determine whether or not they got the ratings right or wrong in the first place.

And I think that is an issue that really has not been explored to any large degree in all of these discussions. I have the testimony here and there are some numbers about default rates and upgrades and downgrades but very little comparative information. And we are actually in a position where performance can be measured fairly accurately. Because these are ratings designed to give an indication of the likelihood of default. Over time you can determine whether, in fact, the securities went into default or companies, if it is an equity, went into default. We can actually measure performance.

It would seem to me that it is relatively easy to calculate accuracy and performance over time, to disclose that information and then to naturally compare it. Compare one agency to another. It is I think great, as was indicated here, that we have seen the approval of seven agencies and people have talked about the need for greater competition in this area. But we would want competition to be based on performance. But again, competition based on performance requires that you have accurate performance statistics out there.

My question is to what extent does either the SEC or market participants have access to historical default rates, accuracy for these securities or others rated by the agencies? And is that made available in a way that we can compare performance from one organization to another over time?

Chairman COX. That has not been the case in the past. It is now and will be the case in the future as a result of legislation, as a result of our rules. This is a very important change. Giving the marketplace this better information will, I think, provide a great more useful information than people have ever had before, which will in turn affect the way that ratings are used, the way that rating services themselves are priced, and certainly the way that the assets that are rated are priced and the risk is assessed.

Senator SUNUNU. Will data reflecting accuracy and performance be made available across different types of securities, asset-back securities, debt instruments, and equities, as well?

Chairman COX. The ratings performance information is, I believe, going to be provided in a way that will make it susceptible to a good deal of intermediation by analysts. So that not only what you describe but perhaps a lot more granularity might be possible.

Senator SUNUNU. Who is going to determine the format of presentation, the statistics and data that will be made available for all companies? In other words, is the SEC facilitating this? Or is it happening through the rating agencies themselves or through a cooperative effort facilitated by a third party?

Chairman COX. First, the form NRSRO that is provided under our new rules by the rating agencies provides a format—it is a forum—for this information. Second, what becomes of that information as people manipulate it and add it, subtract it, divide it, and so one is up to the marketplace.

This is, however, an area that I should add, we are going to look at and see whether or not we cannot constantly find ways to cause the information to be reported in the first place so that is more useful to investors. Not only is this the case with respect to the way the information is divided up when it comes to us, but also the technology that is used to report it. We have an overarching initiative to use computer data tags to attach to the information so that it can be much more easily manipulated than presently any SEC report can.

Senator SUNUNU. Is data regarding the rating agencies' accuracy for the 2006 class of subprime asset-backed securities available now for all of the agencies that rated those securities?

Chairman COX. I believe as a result of registration that is the case, but let me inquire and make sure.

[Pause.]

The additional information I can provide, with staff help, is that the firms are now making information publicly available. But if there is a failure here we will step in and make sure that it becomes available.

Senator SUNUNU. I will interpret that to mean not quite yet but we all hope it is forthcoming. And I appreciate your willingness to help. I think that is very important information to have as part of the record of this hearing and I look forward to seeing it.

Thank you, Mr. Chairman.

Senator REED. Thank you very much.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Welcome, Chairman Cox. We appreciate your appearance here today.

On an aside, I had submitted questions from your July appearance and have not received them yet. And I hope we can get answers soon.

Chairman COX. Senator, just to give you some insight into our Commission process, I finished with those answers some time ago but they go through a Commission-wide process. I will make sure that, with your public urging here, that you have those ASAP.

Senator MENENDEZ. Thank you, I appreciate that.

Mr. Chairman, here we are here 6 years after Enron, long after we knew the vulnerabilities that existed surrounding credit rating agencies. But it seems that we are, in some respects, still at square one. Don't you think that we are behind the curve here?

I know you just came to the Commission 2 years ago and we just passed a law last year. But there were other powers the SEC had before this bill.

Chairman COX. In fact, Senator, the powers that we have and had then extend to areas that I think are not the center of the action here. Obviously, we have got anti-fraud authority. We had some very minor opportunities to get to the real meat of this with respect to those, not all, firms who were registered as investment advisers because we could examine their books and records qua investment adviser.

But not until this legislation did the SEC have the authority to inspect and examine credit rating agencies as credit rating agencies.

Senator MENENDEZ. I look at the report that the Commission issued in January of 2003 as required by Sarbanes-Oxley, and it is interesting to note on its final page, amongst the three major areas: potential conflicts of interest were listed. There were three different categories within that context.

That is 2003. And here we are in 2007 still talking about potential conflicts of interest.

Let me ask you this: do you——

Chairman COX. Senator, as you know, the conflict of interest piece is a centerpiece of the Credit Rating Agency Act and our rules now. And so that is very sturdy authority than presently we have. So the registrations that brought these are firms within our rules as of 48 hours ago give us authority that we just did not have before.

Senator MENENDEZ. I am only pointing out that in 2003 the Commission said that this was a challenge.

Chairman COX. Yes, we were aware of the problem.

Senator MENENDEZ. Four years later either it did not seek powers to look at it beyond it, and the Congress did not act before then. And so we have actually had warning signs for some time.

Let me ask you this. It seems to me that credit rating agencies are playing both coach and referee in the debt game. They not only rate these instruments but they also offer the issuer help in constructing the product in order to obtain a certain rating. For some agencies these structured finance deals have accounted for more than 40 percent of their total revenues. Isn't that a problem?

Chairman COX. It is certainly potentially a problem. If is one of the reason that we are examining and it is one of the very points that we are examining against.

Senator MENENDEZ. Let me ask you this: don't we need more oversight? Do you believe that you presently have the authority to set standards, monitor and evaluate compliance, discipline rating agencies for violations including, in the most egregious cases, revocation of the SEC recognition? Do you believe you have those powers today?

Chairman COX. Yes, we do.

Senator MENENDEZ. In that respect, isn't one of the things we should be looking at here is more transparency, the disclosure of any services a ratings agency has provided to the company in connection with the issuance or rating of debt, including any consulting on the structuring of the transaction and the amount of fees related to those services that were paid to the rating agency? Wouldn't that be something that would be desirable?

Chairman COX. Indeed, providing such services in addition to ratings would fall within the category of identified conflicts of interest. Our current rules require the agency to self-identify those conflicts of interest, and beyond that to identify the procedures that it has put in place to mitigate those conflicts.

Senator MENENDEZ. So finally, what is your timeline, Mr. Chairman? What do you see as the timeframe in which the Commission will act so that we can all understand what we expect of these credit rating agencies so we do not find ourselves in a future debacle of this sort?

Chairman COX. The examinations are already underway. And so we are talking almost certainly months, not any longer period of time. But even during the pendency of the examinations, we are going to be learning things in real time. And so I would be very pleased to maintain a dialog with this Committee about lessons learned on an ongoing basis.

Senator MENENDEZ. I appreciate that. I think it would be helpful for us to know so that we do not wait an inordinate period of time if here is something that we can would respond to.

Thank you.

Senator REED. Thank you.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

I agree that we need to get more information to the investors and I appreciate your answer in that regard. I just want to make sure that they have good information.

If we are talking about subprime loans, doesn't that indicate that there is some risk there?

Chairman COX. Indeed.

Senator ALLARD. Is there a way of the investor knowing what portion of the portfolio that they may be investing in is subprime?

Chairman COX. Almost certainly the disclosures that would—certainly, if these are publicly registered debt instruments.

Senator ALLARD. How does a company that has subprime loans, how do they get some of the higher ratings that we saw say 2 or 3 years ago?

Chairman COX. I think that is very dependant on the facts and circumstances. As you know, there are a variety of complex instruments that have been and are being designed repackage these securities. Diversification of the risk, a combination of one type of underlying asset with another, tranching, all of these are ways to segment and allocate risk.

Senator ALLARD. Does the consumer, when they buy a security, do they understand—as a general rule, do they understand those factors that go into——

Chairman COX. I am sorry, who is the "they" in this example?

Senator ALLARD. This would be your purchaser of stock or investor. Let's say the investor.

Chairman COX. One certainly would hope and expect so. But I think, looking back, it is also empirically true that everyone here ended up with something that they did not want or expect. And that certainly includes the investors.

But the rating agencies themselves underestimated the default probabilities and they underestimated the loss that could occur in the event of default and overly relied, I think they have tacitly admitted, on historical data that was different from what actually happened in this case.

The investors, perforce, who relied in part on that, on those ratings, were surprised and surely not all of them knew beforehand that this is what they were getting into.

Senator ALLARD. One aspect that I would bring up is the valuation of the home. One of the problems we have had in these home failures is that we found that the appraiser—which is regulated by the State if they are regulated at all, or in some aspects maybe even their reputation is locally determined. And sometimes whether a bank uses an appraiser or not depends on whether they facilitate that loan being made or not.

One of the key links is the actual appraisal of the home. Is there a way of knowing and identifying whether certain areas of the country have a greater problem with appraiser values than other parts of the country? And can that be plugged in to the evaluation? Do you see that as a problem?

You understand, I mean, when it is overappraised, your risk is higher.

Chairman COX. I would imagine, because this is a subject that is inherently understandable and knowable, that if such data do not already exist, they could be readily compiled. And that further, putting together better information on the input side would almost certainly help is you aggregate the risk information. Senator Martinez earlier mentioned the possibility of RESPA reform as a way to improve the inputs.

Senator ALLARD. I am not sure that can be readily compiled. I am trying to figure out how you can compile that. It can be a variable. It can be a pretty extreme variable, I think depending on maybe how these markets work out locally. I think it may be——

Chairman COX. It may not be readily compilable by you or by me right now with what is available. But it just strikes me that if this were a priority that things could be arranged so that it would be subject to ready compilation.

Senator ALLARD. The reason I ask is I do want to see us get the information to the investor so they know what kind of risk that they are taking. One aspect of it is the actual appraisal of the property, the home itself. It seems to me like that would be very difficult to assess and put together and I see a lot a variation happening by region of the country and perhaps even from one time period to another time period depending on what the dynamics might be in a market in a certain locale.

Thank you, Mr. Chairman. I see my time has expired.

Senator REED. Thank you, Senator Allard.

Senator Martinez.

Senator MARTINEZ. Thank you very much, Mr. Chairman.

Chairman Cox, thank you for being here and it is very fine work that you are doing.

I noticed in your testimony that you mentioned that the President has requested the President's Working Group on Financial Markets examine the role of credit rating agencies. As a member of that Presidential working group, the SEC has been taking a lead role in that study. Can you tell us a little more about what you are specifically focusing on in that aspect of your work?

Chairman COX. Yes, the role of rating agencies in the process of bringing these securities to market, the overall economic impact, and of course, each of the members of the President's Working Group has a different perspective on this and we have different information. So when we put our resources together from the Fed, from the Treasury, from the SEC, and from the CFTC, we have a much better picture. And our staff are working on aggregating all of that information.

Senator MARTINEZ. From the SEC perspective, what is your focus as you participate in this analysis?

Chairman COX. We will be able, certainly, by order of magnitude more, post our orders earlier this week, to contribute real-time information as a result of what we are learning in our examinations.

Senator MARTINEZ. Thank you, sir. That is all I have.

Senator REED. Thank you, Senator Martinez.

Chairman Cox, thank you for your testimony and for your service at the Commission. I am sure we will be involved in this issue going forward and we seek your advice and your counsel. Please do that.

Chairman COX. Thank you very much, Mr. Chairman. The SEC looks very much forward to working with you on this issue.

Senator REED. Thank you.

I would now like to call forward the second panel.

Let me thank all of our witnesses on the second panel for joining us today. I would like to introduce them and then call upon them individually for their statements.

All of your statements will be made part of the record so you may summarize. In fact, we encourage summaries. I would ask you all to try to abide by the 5-minute timeline, so that we could engage in questioning after your comments.

Mr. John Coffee is the Adolf A. Berle Professor of Law at Columbia University Law School and Director of its Center on Corporate Governance. He is a Fellow at the American Academy of Arts and Sciences, and internationally recognized authority on securities. He has testified before several Congressional Committees, including the Senate Banking Committee. It is good to see you back, Professor Coffee. We always welcome your presence and your testimony. We greatly appreciate his contributions, particularly to the drafting of the Sarbanes-Oxley Act, and particularly Title V. Thank you, Professor Coffee.

Ms. Vickie A. Tillman is Executive Vice President of Standard & Poor's Rating Services. Prior to assuming her current position in 1999, Ms. Tillman was Executive Managing Director of Standard & Poor's Structured Finance Ratings where she had worldwide operational and financial responsibility for directing rating activity for all S&P structured finance ratings services. Thank you, Ms. Tillman.

Mr. Lawrence J. White, Dr. Lawrence J. White, is the Arthur E. Imperatore Professor of Economics at New York University's Stern School of Business and Deputy Chair of the Economics Department at Stern. From 1986 to 1989 he served as a board member of the Federal Home Loan Bank Board and from 1982 to 1983 he served as Director of the Economic Policy Office and the Antitrust Division at the United States Department of Justice. He is currently the General Editor of the Review of Industrial Organization and Secretary-Treasurer of the Western Economic Association International.

Mr. Michael Kanef is a Group Managing Director at Moody's Investor Services, where he has worked since 1997. He is the head of the Asset Finance Group, which is responsible for ratings on residential mortgage-backed securities, term asset-backed securities, and asset-backed commercial paper issued in the United States, Canada, and Latin America.

Thank you all for your presence here today. We look forward to your testimony.

Professor Coffee, please.

STATEMENT OF JOHN C. COFFEE, ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA UNIVERSITY SCHOOL OF LAW

Mr. COFFEE. Chairman Reed, Ranking Member Shelby, members of the Committee, thank you for inviting me.

Because you have shown in your questions that this is a very informed panel, I am going to delete about five pages of background information and get right to the core of my testimony.

I want to make three proposals. But it summarizes what I say in my written testimony to say that the current market for debt ratings is one in which there is very little penalty for inaccuracy. It is one in which there are strong incentives for optimism and grade inflation. There is very little reason to downgrade a rating that you have already made. You do that only under pain of great embarrassment.

The result is we have a market in which there is a tendency toward rating inflation and toward stale ratings. I am not suggesting that there were demons here. I am going to paint a picture of the gatekeeper in this market who is under great pressure and who is vulnerable to that pressure. And I think the proposals have got to look at how to create countervailing pressure to make this market more sensitive to the need for greater accuracy.

What is causing this? I give a given number of reasons. But one distinctive factor in this market is behaving very differently in its rating of corporate bonds versus its rating of structured finance products. I think that is because structured finance gives new power to the investment banks. They are assembling large pools of securitized assets. They are repeat players. And they can remove their business if they do not get what they like. They have much more power than the traditional corporation, which was only 0.01 percent of the agency's business.

Let me document this. The data that the agencies themselves are producing show a huge disparity. Moody's data—and I congratulate Moody's on presenting this data—Moody's data shows that for its minimum investment grade rating, Baa, over a 5-year cumulative default period ending in 2005 corporate bonds that received the minimum investment grade had only a 2.2 percent default rate. The collateralized debt obligations, CDOs, had a default rate of 24 percent. They both got the same rating. That is a ratio of over 10 to one.

Now Moody's tells me, quite properly, that maybe 2005 was aberrational and they suggested we look at 2006. On that basis the ratings changed slightly. The corporate debt credit default rate for Baa was 2.1 percent and the defaults rate for CDOs was 17 percent.

I do not care whether you look at the 24 percent default rate or the 17 percent default rate, this was a default rate on securities labeled investment grade. And that means to each Senator who is here that there were public pension funds in your jurisdiction, there were also other institutional buyers, universities, hospitals, charities, who are thinly staffed and rely on, live or die on—perhaps improperly, perhaps too casually—whether or not the securities had an investment grade rating. That is all they are checking before they buy. The market may efficiently price these, but there are unsophisticated debt purchasers who are taking more risk than they intend because they are buying investment grade ratings that have a default rate that would be extreme for a junk bond. That is the current problem.

What can we do? I will also give you one other fact. These gatekeepers are subject to great pressure. Moody's has told the Wall Street Journal, which quoted this just a month ago, that when they downgraded debt ratings in July of 2007 this year they experienced a market reaction. Their market share in residential real estate-backed CDOs went from 75 percent to 25 percent. That means there is extreme pressure on this kind of gatekeeper and it is going to keep them from downgrading properly and it gives you stale ratings.

What should be done? I want to make three quick suggestions. One, picking up on what has already been suggested, I think the SEC should compute the default rates using its own criteria, not letting the agencies do it themselves because they will all use different criteria. It should publish this on a computer screen on a real-time basis so for each asset class and for each investment grade we will see ratings that the SEC has verified.

What am I trying to do? I am trying to establish a competition based on quality and accuracy. I am trying to create a reputational penalty and embarrassment cost because that is the only sanction we can really use easily.

Second, I would suggest, as Senator Shelby already has suggested, that NRSRO status should be forfeitable for extreme inaccuracy. If the debt rating should be 3 percent default rate and you have a 20 percent default rate, I would suggest that at some level, whether it is 6 percent, 10 percent, or 12 percent, being outside that boundary could cost you your NRSRO status. You forfeit it until you get it back.

The last point in just 5 seconds, the real hope in this field might be the entry of new competitors who are based on a subscription-funded system, not an issuer-funded system. They face an obstacle. They cannot get data from issuers. Corporate issuers do not want to deal with people they have not hired. They like their friendly allies. I would protect the new competitors who can play a useful watchdog role by extending Regulation FD, Regulation Fair Disclosure, so that if a company gave any data to an NRSRO rating agency, it would have to give the same data to all other NRSRO rating agencies. That is the way to protect the independence of the process and protect the objective new input. None of these are costly or intrusive.

I will leave you on that note.

Senator REED. Thank you, very much, Professor Coffee.

Mr. Kanef.

STATEMENT OF MICHAEL KANEF, MANAGING DIRECTOR OF THE ASSET FINANCE GROUP, MOODY'S FINANCIAL SERVICES

Mr. KANEF. Good morning, Chairman Reed, Ranking Member Shelby, and members of the Committee.

I am pleased to be here on behalf of my colleagues at Moody's Investors Service to speak about the role rating agencies play in the financial markets and to discuss some of the steps that we believe rating agencies and other market participants can take to enhance the effectiveness and usefulness of credit ratings.

Moody's plays an important but narrow role in the investment information industry. We offer reasoned independent forward looking opinions about relative credit risk. Our ratings do not address market price or the many other factors beyond credit risk that are part of the investment decisionmaking process and they are not recommendations to buy or sell securities.

Let me briefly assess the subprime mortgage market which has been part of the broader residential mortgage market for many years. While subprime mortgages originated between 2002 and 2005 have generally continued to perform at or above expectations, the performance of mortgages originated in 2006 has been influenced by what we believe are an unprecedented confluence of factors.

These include three key factors. First, increasingly aggressive mortgage underwriting standards in 2006 and numerous sources also indicate that there have been instances of misrepresentations made by mortgage brokers, appraisers, and others.

Second, the weakest home price environment on a national level since the 1960's.

And third, a rapid reversal in mortgage lending standards which first accommodated and then quickly stranded overstretched borrowers needing to refinance.

Moody's response to these increased risks can be categorized into three broad sets of action. First, beginning in 2003, Moody's began warning the market about the risks from the deterioration in origination standards and inflated housing prices. And we published frequently and pointedly on these issues from 2003 onward.

Second, we tightened our ratings criteria, steadily increasing our loss expectations for subprime loans and the credit protection we looked for in bonds they backed by about 30 percent between 2003 and 2006. While Moody's anticipated the trend of weakening conditions in the subprime market, neither we nor most other market participants anticipated the magnitude and speed of the deterioration in mortgage quality by certain originators or the rapid transition to a restrictive lending environment.

Third, we took prompt and deliberate action on specific securities as soon as the data warranted it. We undertook the first rating actions in November of 2006 and took further actions in December 2006 and April and July 2007, and will continue to take rating action as appropriate.

In addition, we are undertaking substantial initiatives to further enhance the quality of our analysis and the credibility of our ratings. These include enhancing our analytical methodologies, continuing to invest in our analytical capabilities, supporting market education about what ratings actually measure in order to discourage improper reliance on them, and developing new tools to measure potential volatility in securities prices which could relieve stress on the existing rating system by potentially curtailing the misuse of credit ratings for other purposes.

We also continue to maintain strong policies and procedures to manage any potential conflict of interest in our business. Among other safeguards: at Moody's ratings are determined by committees, not individual analysts. Analyst compensation is related to overall analyst and overall company performance and is not tied to fees from the issuers an analyst rates. And our methodologies are publicly available on our website. And finally, a separate surveillance team reviews the performance of each mortgage-backed transaction that we rate and that surveillance is a monthly basis.

Finally, beyond the internal measures that we undertake at Moody's, we also believe that there are reforms involving the broader market that would enhance the subprime lending and securitization process. These include the Federal licensing of mortgage brokers, tightening due diligence standards to make sure all loans comply with law, and strengthening and enforcing representations and warranties.

We are eager to work with Congress and other participants on these and other measures that could further bolster the quality and usefulness of our ratings and enhance the transparency and effectiveness of the global credit markets.

Thank you. I will be happy to answer your questions.

Senator REED. Thank you very much.

Ms. Tillman, please.

STATEMENT OF VICKIE A. TILLMAN, EXECUTIVE VICE PRESIDENT FOR CREDIT MARKET SERVICES, STANDARD & POOR'S

Ms. TILLMAN. Mr. Chairman, members of the Committee, good morning.

I am Vickie Tillman. I head the rating activities at Standard & Poor's.

Recently, there has been much public discussion around credit rating agencies and problems in the subprime market and I appreciate the opportunity to clarify S&P's role in the financial markets, to discuss our record of offering opinions about creditworthiness, and to assure you of our ongoing efforts to improve.

While ratings are not guarantees, S&P's record of evaluating the credit quality of RMBS transactions is excellent. As the chart on page six of my prepared testimony demonstrates, we have been rating RMBS for over 30 years. During that period of time, the percentage of defaults of transactions rated AAA is 0.04 percent. Even our lowest investment grade rating, BBB, has a historical default rate of only slightly over 1 percent.

That said, we at S&P have learned some hard lessons from the recent difficulties in the subprime area. More than ever we recognize that it is up to us to take steps so that our ratings are not only analytically sound but that the market and the public fully understand what credit ratings are and what they are not. Our reputation is our business and when it comes into question we listen, we learn, and we improve.

Credit ratings speak to one topic and one topic only, the likelihood that rated securities will default. When we rate securities, we are not saying that they are guaranteed to repay, but the opposite, that some of them will likely default. Even our highest rating, AAA, is not a promise to performance but an evaluation of the risk of default.

Recognizing what a rating constitutes is critical, given the recent market turmoil has not been the result of widespread defaults on rated securities but rather the tightening of liquidity and to a significant fall in market prices. These are issues our ratings are not meant to and do not address.

I want to spend a minute now on how and why ratings change. While ratings may not be as volatile as market prices, they are not static either. Our view of a transaction can and does evolve as facts develop, often in a way that is difficult to foresee. Changes in ratings reflect these developments. This has been the case with a number of recent residential mortgage-backed transactions involving subprime collateral. In these transactions a number of the behavioral patterns emerging are unprecedented and directly at odds with historical data.

At S&P we have been expressing in publications our growing concerns about the performance of these loans and the potential impact on these rated securities for the last 2 years. I have quoted a number of them in these publications and in the written testimony.

We have also taken action including downgrading RMBS transactions more quickly than ever before and updating our analysis in terms of increased risk. Moreover, we continue to work to enhance our analytical processes by tightening our criteria and increasing the frequency of our reviews, modifying our analytical models, completing a recent acquisition that will help further enhance our analytics and our models, and analyzing areas in which we can do more, such as a way to enhance the quantity and the quality of the data that is available to us.

We also take affirmative steps to guard against conflicts of interest that may arise out of the fact that we, like most other major rating agencies, use an issuer pay model. As the Committee knows, this issue was thoroughly debated by Congress during the consideration of the 2006 act. A number of independent commentators, including the head of the SEC's Division of Market Reg, apparently agree that any potential conflict of interest can be managed.

At S&P our policies and procedures include the fact that analysts are neither compensated based upon the number of deals that they rate, nor involved in the negotiation of fees. These controls and others are set forth in a code of conduct modeled after the IOSCO code. Every employee receives training on this code and must attest to its compliance.

Equally important, S&P has not and will not issue higher ratings so as to garner more business. From 1994 through 2006, upgrades on U.S. RMBS ratings outpaced downgrades by a multiple factor. This pattern would not exist if S&P deliberately issued high ratings to please issuers. Nor would we have our excellent track record of predicting the likelihood of RMBS defaults if our ratings were the subject of undue influence.

Finally, Mr. Chairman, I would note that the issuer pay models helps bring greater transparency to the markets as it allows all investors to have real-time access to our ratings. Unlike under a subscription model, the issuer pay models allow for broader market scrutiny of ratings every day.

Others have questioned S&P structured transactions that we rate. Again, my written statement responds to this point in detail but let me make our position clear. S&P does not tell issuers what they should or should not do. While we may discuss aspects of proposed transactions and our analysis, we do not compromise our criteria. Nor could we, as we make our basis criteria publicly available and deviations from it would be readily discoverable.

Since my time is running very quick, let me end by reiterating our commitment to do all that we can to make our analytics the best in the world. Let me also assure you again of our desire to continue to work with the Committee as it explores developments affecting the subprime market.

Thank you, and I would be happy to answer any questions you may have.

Senator REED. Thank you very much.

Dr. White.

STATEMENT OF LAWRENCE J. WHITE, ARTHUR E. IMPERATORE PROFESSOR OF ECONOMICS, LEONARD N. STERN SCHOOL OF BUSINESS, NEW YORK UNIVERSITY

Mr. WHITE. Thank you.

Mr. Chairman, Ranking Member Shelby, members of the Committee, my name is Lawrence J. White. I am a Professor of Economics at the NYU Stern School of Business. I thank you for the opportunity to testify this morning. I am pleased to be here. I am going to summarize my statement, which in its full length is available to you.

As you have already heard this morning, there is a lot of blame to go around. I will not repeat the parties, we basically know who they are. The bond rating firms are among them.

What I want to do is summarize how we got to where we are, provide some context, and make a plea to the Committee, to the Congress. Let's see what the new legislation can do before we enact—before you enact new legislation.

How did we get here? Back in 1975 the Securities and Exchange Commission wanted to establish capital requirements for broker dealers, and it wanted to base those capital requirements on bond ratings, just as bank and insurance regulators had done in earlier decades. But whose ratings should be used for these purposes? To its credit, the Securities and Exchange Commission recognized the problem of the bogus rating agency that might hand out AAA ratings to everyone, or DDD ratings to everyone. And so it created the NRSRO category.

Unfortunately, the NRSRO category became a protective ring around the incumbent bond rating industry. It protected incumbents and restricted entry. As recently as early 2003 there were only three NRSROs. And the whole process for administering the NRSRO regime was exceedingly opaque. Until the Enron hearings in early 2002, NRSRO was one of the best-kept secrets in Washington. Even today it is certainly not a household phrase.

The importance of the NRSRO designation can not and should not be understated. Regulated financial institutions across the financial sector were and still are required to heed the ratings of the NRSROs in deciding what bonds they can and cannot hold in their portfolios. In essence, the financial regulators have been delegating to third parties, the NRSROs, safety judgments about what is or is not appropriate for financial institutions' portfolios.

Because financial institutions are forced to heed the NRSROs ratings, the bond markets in general must heed those ratings even if they were to believe that the NRSRO ratings otherwise have no value.

Senator Shelby earlier mentioned my earlier statements and I will repeat them again. There has been no clean market test of whether the NRSROs really are providing value to the financial markets under the until very recent regime.

However, we do have the new legislation that is just 1 year old. The implementing registrations are just 3 months old. The new law was intended, is intended, to bring down the entry barriers in the bond rating business, open up entry, create more competition, more alternatives, let different business models be out there, and let the financial market participants make their decisions as to whose ratings are to be trusted and whose are not to be trusted.

I would have preferred to have gone farther and to have gotten rid of the NRSRO category entirely, but I think the legislation provides a good start in the right direction.

Accordingly, I urge the Committee to not enact new legislation. First, it would be extremely difficult, if not impossible, for legislation to prevent the kinds of mistakes that I believe the bond rating firms have made in the recent past. And efforts to do so really run great risks of stultifying the industry, of distorting the industry, and creating new barriers to entry.

Second, as I just stated, the new legislation should be given an opportunity to work. We need to see what new competition, real competition, among rating companies with the different opportunities, different models, different ideas, what that can do. The financial markets, if given the opportunities, I think can make good choices.

And the financial regulators should be given the opportunity to rethink this delegation question in light of the new market opportunities for bond rating firms with more bond rating firms out there.

So let's see what the recent legislation can do before new legislation concerning this industry is considered.

Thank you again for the opportunity to testify today, and I will be happy to answer questions from the Committee.

Senator REED. Thank you very much, Dr. White.

Thank you all for your excellent testimony.

Let me ask a question to both Mr. Kanef and Ms. Tillman. I will begin with Ms. Tillman first.

You indicate and you take very seriously there is a code of conduct in your firm, and the same with your firm. Do you believe that independent of whatever we do that, that code of conduct should be strengthened in areas, for example post-employment? When someone leaves your firm and goes directly to a client of yours it raises the specter—and frankly, that should be obvious.

Second, we have been told in regard to these particular difficult products, structured finance, that the rating agencies were not only rating them but they were also helping structure them or advising the client as to what they could do, which raises I think an inherent conflict. Should those functions be totally separate or clearly disclosed or something in terms of what you can do today short of new legislation?

Ms. TILLMAN. In terms of the first question about employment, I mean theoretically, I mean I do not necessarily think that that is either right or wrong in terms of whether somebody should be restricted.

From a cost-benefit analysis, being that I do manage the ratings business, it may, in fact, have an unintended consequence of allowing us to hire the kind of skilled people that we need if they know that their career paths are going to be limited by where they could next.

Senator REED. I think the assumption would be for a suitable period of time, as is imposed upon——

Ms. TILLMAN. Right. So in general, it is not something that, you know, I think could not work. But again, I have not thought through what the implications would be relative to the business.

In terms of your second question, relative to structuring debt, we do not structure debt, structure the transactions.

If I can be given a few minutes to sort of explain what our role is relative to this. First of all, I would like to make a point clear, that our criteria is absolutely transparent to all of those in the marketplace. They understand it. they see it. The models that we use internally to look at the stress testing or look at the probability defaults around the loans that are packaged in these, these are readily available in the marketplace, as well.

So there is a lot of understanding around what kind of loan characteristics, what kind of stressing we do in the marketplace.

So as the originator originates the loan, the investment banker works with the originator to package the loan. They already have an idea of what kind of loans they are looking for, relative to the way Standard & Poor's looks at the almost 70 different characteristics, if you will, on every loan that is put in a pool.

Once that is packaged, I think there seems to be a point that needs to be made, that this is actually a very sophisticated investment community. Most of these bonds, if not a majority of them, are sold to institutional investors or had been sold to hedge funds who have their own staffs that not only look at ratings, which again is only speaking to credit risk. But the ratings does not speak to suitability of the investment, the pricing of the investment. They have their own firms there, their own people that run their models. Or they use our models as a benchmark and run their own proprietary models before they will make a decision as to whether that is an appropriate investment for a particular risk appetite.

So they go through that process and they present to Standard & Poor's a package of pooled securities——

Senator REED. Let me just get to the point, because my time is limited.

Ms. TILLMAN. I am sorry.

Senator REED. So there is no collaboration between Standard & Poor's and the issuer, in terms of how the product is structured? That you simply take what they present you, evaluate it, and give a rating?

Ms. TILLMAN. We have a great dialog. We have an open dialog with the investment bankers. They need to understand what our criteria is. We need to understand better what their structure is. And if we tell them that it does not fit with our criteria, what we do is tell them why it does not fit with our criteria——

Senator REED. And how to make it fit.

Ms. TILLMAN. No, sir. We do not tell them how to make it better. That is up to them to make the determination as to whether they want to change the structure, change the pool, change the over-collateralization.

Senator REED. I appreciate that. I do not want to be abrupt but I want Mr. Kanef to get a chance and I have another question.

I think, at least on the surface, there is a suggestion here that there is something going on more than simply being presented a group of loans or a product, here is our rating, take it or leave it. There is this dialog.

Mr. Kanef.

Mr. KANEF. Thank you, Mr. Chairman.

With respect to the first part of your question, I think the British actually may call it gardening leave, a period of time before you can go to a client. Certainly, I think Moody's would be willing to consider such a thing, as well as other potential changes to our code if the SEC or yourselves were to feel that there were some aspects of that code that were not sufficient. Certainly, we would be willing to consider the things that you might suggest.

With respect to your second question, as with S&P, our methodologies and models are publicly available and the parties that are participants with respect to the structuring of the deals, the investment bankers and their clients, are very sophisticated.

The process actually plays two important roles, from our perspective. The first is we gain additional information from the issuers and the investment bankers about their transactions that we may not have otherwise known. We also are able to provide them with feedback as to the way in which our publicly available methodologies, which are very broad, apply to a specific set of facts and circumstances.

I guess the last point I would make—I know you are running short on time—is that this process is really very similar to the process that occurs on the corporate side, as well. For example, a corporation might come to Moody's, that Moody's rates, and say I would like to take out a loan for $4 billion. Would that have an impact on the rating of my company? And that sort of dialog happens across the rating spectrum, not just in structured finance.

Senator REED. Thank you.

We will have the second round because of the—I do not know about the quality of the questions, but the quality of the answers.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Professor Coffee, Professor White, I want to just personally thank you for your incisive and unvarnished observations regarding this whole ratings business which is obviously flawed and conflicted in many, many ways.

A recent article by an American Enterprise Institute Visiting Scholar, Charles W. Calomiris, and a Drexel University Finance Professor, Joseph Mason—you might know them—says, and I will quote "Unlike typical market actors, rating agencies are more likely to be insulated from the standard market penalty for being wrong, that is the loss of business. Issuers must have ratings—" as you have pointed out "—even if investors such as banks, insurance companies, and pension funds do not find them accurate. That fact reflects unique power that the Government—" Dr. White alluded to "—the Government has conferred on rating agencies to act, in a sense, as regulators."

Do you agree, Professor Coffee?

Mr. COFFEE. I think both Professor White and I agree that what the NRSRO rating agency is doing is two things. It is providing information and it is providing licensing power. The issuer needs that rating, even if the market rating is inaccurate.

Senator SHELBY. They are delegating the job, in a way, are they not? They are delegating their job.

Dr. White.

Mr. WHITE. That is thoroughly the phrase that I think is correct, delegating to third parties the assessment of the safety, of the portfolio, of their regulated institutions.

Senator SHELBY. Do both of you professors agree that credit rating agencies have power that no other gatekeeper possesses and an NRSRO can sell its services to issuers even if the market distrusts the accuracy of its ratings because it is, in effect, licensing the issuer to sell its debt to certain regulated investors?

Mr. COFFEE. I have said that and I still agree with that.

Senator SHELBY. Do you agree with that?

Mr. WHITE. Accountants may well have—auditing firms may well have similar powers. You said unique. I am not sure this is completely unique. But the power to issue that kind of license. I think Professor Partnoy, Frank Partnoy, has used that phrase of licensing.

Senator SHELBY. Something is wrong in the rating agencies, you both would agree?

Mr. WHITE. Yes.

Senator SHELBY. Mr. Kanef, a former Managing Director at Moody's, Mr. Mark Adelson—I am sure you know him—recently told, and this has been mentioned here already, told the Wall Street Journal that investment banks would take their business to another rating agency if they could not get the rating they needed. He said, and I quote "It was always about shopping around for higher ratings" although, he says, euphemisms were used for this process such as "best execution" or "maximizing value."

Given the highly lucrative nature of this sector, it has been reported that 40 percent of Moody's total revenues last year came from structured finance alone, it seems natural that the banks would have some leverage over rating agencies eager to profit from these deals.

Could you comment on that?

Mr. KANEF. Thank you, Senator.

As an initial point, I would reiterate something that we mentioned just previously, which is that our methodologies for rating all of these assets are publicly available. They are available on our website free of charge. And they are widely distributed. So that most parties who have a desire can read the way in which we would be rating a transaction.

Senator SHELBY. Is that the methodology where you are talking about structured instruments?

Mr. KANEF. Yes, that is correct, sir.

Senator SHELBY. And is that basically, and you correct me if I am wrong in my questioning, where you put some so-called better mortgages in a structure with some that are probably less desirable a rating, and then you tie them all together and you come up with some methodology and say in our judgment this is now investment grade ratings?

I know this is a simplification, but isn't that what you do?

Mr. KANEF. Yes, I guess it is fair to say that what we do is explain to market participants and to regulators and others the desire to read the pieces, the way in which we will apply analysis to derive a rating in structured finance. So that would be a review of the pool of assets and a review of the legal structure.

If I could just make one more statement with respect to rating shopping, which is the issue that I think you raised second, Moody's ratings are driven primarily by the desire of the purchasers of securities. We call it a demand/pull model where the purchasers of the securities are the ones that are requesting the rating. The investment bankers and the issuers that we deal with only work with Moody's and the other rating agencies that they choose to work with because of the pull from the investors.

If the investors lose faith in the rating agencies themselves, that demand goes away and the desire for the ratings goes away.

Moody's has not been shy about stepping away from markets in structured finance where we have not been comfortable with the risk that we saw. So for example——

Senator SHELBY. Were you comfortable when you issued the rating, though?

Mr. KANEF. I misspoke, Senator. What I mean to say is there are whole markets that we have not rated at all, not from inception. So for example, the ABCP market, which is the Asset-Backed Commercial Paper market, in Canada, which we felt had a structural flaw in it——

Senator SHELBY. Let's talk about the ones in the U.S. that you have rated and profited by rating and then you become uncomfortable later when you see that a lot of those mortgages are non-performing; is that correct?

Mr. KANEF. Yes, sir. The ratings are not static statements of opinion. The ratings are made at inception as a forward-looking opinion of the credit risk inherent in a transaction and in the securities issued pursuant to that transaction. As in any forward-looking opinion, as the facts that the opinion was based upon change, the rating changes as well.

In fact, we view our role as participants in the market to provide current up-to-date rating opinion to the market. So when we see changes in the market, either changes in economic situations or changes in performance, that were not initially anticipated, we change the ratings to communicate that to the market.

Senator SHELBY. Does it ever bother you in any way that the people that you rate these for pay you for rating them? I mean that is an obvious conflict to a lot of people that study ethics.

Mr. KANEF. We acknowledge at Moody's that there is a conflict——

Senator SHELBY. There should be a better way, should it not? In other words, there has got to be a better method of not paying you to rate bonds and you profit from it and then people now are holding the bag, so to speak, and will so in the future.

My last question to you, because I hope I will be around for another round but I am not sure. And I have some questions for the record.

Did it bother you when you were looking at these structured mortgages, so to speak, so many subprime, that a lot of these mortgage rates would be reset in 2 years, more than likely upward rather than downward, they generally always are? And that payments consequently to an individual borrower would go up?

Now having realized that a lot of people pay very little, if anything, down on these mortgages, having realized or should have realized that the credit of a lot of these people was kind of spotty to begin with, does it not defy common sense to think that a lot of these mortgages would not go into default, if not before they were reset, but certainly after they were reset? Because a lot of these people are working folks all over America that I think people have taken advantage of.

Does that bother you at all? Did it bother you when you were rating these things?

Mr. KANEF. Mr. Chairman, do I have time to answer that question? I apologize, Senator. I am just looking at the clock. I do not know if I am permitted.

Senator REED. You are permitted.

Mr. KANEF. Thank you, sir.

Senator SHELBY. Are you apologizing to the people that have been victimized or are you apologizing for taking the time?

Mr. KANEF. I am apologizing for taking the time right now. But I would like to answer both of your questions, sir.

The first question you raised was one with respect to the conflicts of interest in the issuer pay model, which is the model whereby the issuer who is seeking the rating pays for the rating.

Moody's acknowledges that there are conflicts in this model and we have several procedures and processes in place which we believe insulate the ratings process from those conflicts. I know that the SEC has newly provided ability to review that and comment upon the degree to which we have been successful in limiting those conflicts of interest.

The basis of that is the committee's decision is not an individual's decision. So although there will be a lead analyst that interacts with an issuer, there is a committee of five to eight people who make the determination with respect to what a rating is. And the pay for analysts is not tied to the individual number of deals that an analyst rates. It is tied to the quality of the work that that analyst performs.

Senator SHELBY. But the more deals you handle and the more issuers, the more money you get paid; is that right?

Mr. KANEF. That is fair, but we are a global institution and——

Senator SHELBY. That does not mean that you do not get paid for what you do.

Mr. KANEF. That is fair.

Senator SHELBY. And you do not benefit from your conflicts of interest.

Mr. KANEF. The other point that I would make is that the other models that have been suggested, including the investor pay model, also have conflicts of interest. So for example, if you are paid by an investor, the investor may wish for you to provide a lower rating which would enable them to receive a higher yield on the security issued.

In addition, if an investor pay model is adopted, the benefit of the public good of the rating, the fact that the rating is made publicly available to regulators, to governments, to other investors, would not necessarily remain in place.

So there are issues with the other forms of payment for ratings, as well as the existing one.

Senator SHELBY. My time is up but it seems to me that money is trumping ethics in this area of ratings.

Thank you, Mr. Chairman.

Senator REED. Thank you, Senator Shelby.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

I want to ask both Ms. Tillman and Mr. Kanef a question I asked your companies in April of this past year when we had a hearing. Do you think you have any responsibility or are in any way to be held accountable for the mortgage market meltdown? A simple yes or no would do.

Ms. TILLMAN. I am not sure it is a simple yes or no, but certainly we have stated publicly that the assumptions that we used in the 2006 originated deals did not meet the expectations. They far exceeded, in terms of early payment loss, what happened. I think one thing we do recognize is that while we have used historical information to make predictions of the future, that we have to find better ways of doing it.

So we certainly understand that some things did not work in our analysis and we are looking into what the root causes are and what we can do to improve that.

Senator MENENDEZ. But not meeting expectations is not the same thing as saying you performed in every way as you should have.

Ms. TILLMAN. I think in terms of the process and the procedures that we followed, we did follow. We gave an independent assessment of what the probability of default was and the risk.

Senator MENENDEZ. Mr. Kanef.

Mr. KANEF. I think that with the information that we had at the time that we made these ratings, we provided our best opinion to the market of the credit risk inherent in these securities.

Senator MENENDEZ. So the answer is no.

Let me ask you this then, you have both discussed changes that you have made either to your methodologies or additional data that you are collecting to make more informed decisions about ratings. If you do not think you had any responsibility—any responsibility—to contributing to the subprime crisis, then why is there a need for change now? Could some of these changes have affected a different outcome?

Mr. KANEF. Senator, the rating process is a continually improving one. As we learn new information about the market and about the type of information that we have received, we adjust our rating process and we continually strive to improve our methodologies. In that way we try to ensure that on a going-forward basis all of the information that we have is incorporated in the ratings that we provide.

Ms. TILLMAN. I would just agree with Mr. Kanef and say that ratings are not static and ratings can be for 7 years, the term of maturity over a longer period of time, and things change. One of the things that is important to understand is that we rate in terms—the initial rating is for the expectation of how we think things are going to happen.

On the surveillance side, we actually get live information of is this performing the way our expectations, in fact, expected? So it is actual behavior as opposed to what we assumed might have happened.

As those things change, we look into what are the challenges associated with it or what are the assumptions that we made that are causing these things to perform differently.

Senator MENENDEZ. Ratings certainly are not static. That is for sure. On August 21st Standard & Poor's, in a single day, in a single day, cut its rating on two sets of AAA bonds to a CCC rating. And Moody's also drastically downgraded in late August.

That was not a slight shift in a rating. Those were pretty massive changes, just like scratching the surface off of a bar of gold to find out it is only lead.

I hope when you talk to us about static that that type of action is not the action that you subscribed to in the market not being static and that your reviews are not static.

My main concern, which I still do not get the sense that the rating agencies see themselves as having any responsibility here, I still do not get that. I did not get it in April, I do not get it today.

How many other gold-plated blocks of lead are out there? Are you expecting any more downgrades of this magnitude in the coming months?

Ms. TILLMAN. To comment, I do not know which security that you are referring to. But if it was one called a SIV-Lite, the structure of those deals are such that if the value of the collateral exponentially changes within a month, then it hits a trigger and therefore causes the deal to unwind very rapidly. We call it a credit cliff, if you will. So if it does not meet the value requirements as expected—and we have not seen that happen ever.

That has got to be one of the first time, and I have been in the business for 30 years, that we have seen the value of the collateral within a bond change so quickly within 1 month.

So if that is the one you are thinking about, the way they are structured actually has embedded in it a trigger that requires the SIV or the SIV-Lite, which is a structured investment vehicle, to unwind.

Senator MENENDEZ. But you did not look ahead to look at the value of that——

Ms. TILLMAN. Absolutely, we looked at——

Senator MENENDEZ. So you went from AAA to CCC and so your judgment sometime had to be pretty faulty.

Ms. TILLMAN. Well, what I am saying is we have never seen the value really unwind and deplete as much as it did in a 1-month period. So we do stress it. We do stress it in terms of what happens in the event of this and what happens in the event of that.

Senator MENENDEZ. Let me just follow, if I may——

Ms. TILLMAN. In terms of responsibility——

Senator MENENDEZ. I have only got a minute left. So let me follow up where Senator Shelby left off, because I think he made some excellent points, and I agree with them.

If, Mr. Kanef, you have 40 percent of your Moody's total revenue last year from structured finance deals, and I listened to your answers to these questions, Ms. Tillman, you said we do not tell them what to do. We have a dialog. And Mr. Kanef, you said we have a feedback.

Clearly, someone comes to you and in this dialog, in this feedback, I assume that there are conversations going on to say well, if you did this or if the entity comes to you and says what if we did this, then you would say we would do X, in terms of rating. Is that a fair assumption?

Mr. KANEF. Yes sir, I believe it is.

Senator MENENDEZ. So then the dialog and the feedback goes into a process in which the entity is molding how they are going to present to you in order to achieve a certain rating, a higher rate hopefully for their purposes. Is that not a fair statement?

Mr. KANEF. I think, Senator, that that is a fair statement. I believe that the question is not to what extent that we are responding to an issuer's request for feedback on a proposed structure, but what happens to that rating overall over time. Again, the demand/pull model that we operate in means that if our ratings are not right over a long period of time we will not be in business.

I would suggest to you that we have seen very significant adverse economic situations relating to the subprime market this year. But for the period from the end of 2001, 2002, 2003, 2004 and into 2005, in fact, the subprime RMBS ratings that Moody's had produced performed significantly better than the expectations that we had.

In fact, even in 2006—and we acknowledge that the economic situation, the liquidity situation, and the information that we had provided all worked together to cause a very difficult situation for those bonds——

Senator MENENDEZ. Mr. Kanef, it does not take a rocket science—and I will stop here, Mr. Chairman.

It does not take a rocket scientist to figure out that if I have no document loans, if I have no down payments, if I have ARMs that clearly within the income scheme are not going to allow me to be able to meet the future, that that security-backed instrument is weak in its potential.

And so I assume that that is part of what you do in your analysis. And yes, maybe your analysis changes over time. But it is the initial analysis that drives the marketplace, certainly at the beginning where the hedge funds decided to go and spend a lot of money and then fuel the whole process, even though the instruments that were being used were clearly weak in terms of its security and its underpinnings.

I just do not understand why we make it so complicated. It seems to me it is pretty simple. It just seems to me that some people missed it along the way. And why they missed it is the heart of the problem.

Thank you, Mr. Chairman.

Senator REED. Thank you, Senator Menendez.

I propose several more questions, if my colleagues would want to stay, that is fine. We will make this brief.

Professor Coffee, I was listing to Chairman Cox and he seemed to suggest that he would be amenable to posting information about performance of the rating agencies. You suggested in your testimony that the SEC could calculate a 5-year cumulative default rate, put it out there, and do it in a way to give the market another benchmark for their decisions.

Mr. COFFEE. This is not a radical proposal. Essentially, I am saying that sunlight is the best disinfectant. I would like to take credit for that line, but I think Justice Brandeis said it first.

What I want the SEC to do, however, is to compute the default rate because each rating agency will use different methodology and each will be more favorable to it.

If you just had one screen where we saw the default rates on structured finance and a small pension fund out in your own State could look at that screen and realize that these seven new agencies were rating this below investment grade and the old agencies were rating it an investment grade, they would have some pause for concern.

And the default rate really is the output. All I am saying is that the proof is in the pudding. And I would like to focus us on the output data, what the default rates are, and less on the input data, how many hours did you spend agonizing over this problem?

Senator REED. Given your review of the legislation that Senator Shelby authored, they have the authority to do this today?

Mr. COFFEE. I thought we had a very interesting sentence of dialog in which that question was asked by Senator Shelby of Chairman Cox. Chairman Cox said, quite properly in my judgment, that it is highly ambiguous.

The statute is framed in terms of basically input data. What were your processes? What were your methodologies? You might have great processes, but if you consistently get it wrong, I think you should forfeit your status as a NRSRO.

It is like an umpire who might have great training, but he cannot tell the difference between a strike and something that is five feet wide of the plate. That is where I think we should act.

Senator REED. I noticed, in my quick review of the statute, is that the agency, the Commission has the authority to actually revoke the status if there is not managerial and financial resources producing consistent ratings over time.

Mr. COFFEE. That does focus on the input data. It is very hard for the agency to prove that you did not have a good staff or you did not work hard. I would just say if you are consistently wrong, that is a basis for forfeiting your status.

Senator REED. So that might be a change, Professor White, that you would at least consider?

Mr. WHITE. Certainly in the old regime I was consistently advocating a focus on output rather than inputs. In the new regime, if Jack is right that it is going to take new legislation, I worry that who knows where new legislation—with respect to the bond rating firms and I am only focusing on the bond rating firms—would go.

I think the markets will, with more NRSROs out there, with more choices, more alternatives, more opportunity to decide what business model, investor pay, issuer pay, I do not know who else might pay, let the markets figure this out.

In the old machine, they could not. They were forced to heed the NRSROs. That kind of forced participation, restrictive entry, naturally we would expect to see poor results. We would expect to see high prices, high profits, sluggish behavior. And I think we saw that sort of thing.

I want to see what a new more competitive regime can offer.

Senator REED. Mr. Kanef and Ms. Tillman, again thank you all for your excellent testimony.

One of the issues that was raised, I think by Professor Coffee, is the notion that for corporate debentures, corporate debt, it is a pretty straightforward analysis. You look at the company's sheet. As you mentioned, a company could come to you and say if we borrow $5 million what are you going to do? That is a pretty straightforward transaction.

In these new instruments, highly complicated, in fact people that I respect suggest that it is very difficult to understand even if you devote a lot of time and attention. Should there be red flags, i.e. a AAA on a corporate debt of Mobil Oil, in the mind of a pension fund, was the same as a AAA in one of these esoteric mortgage funds?

Were you safe in making that sort of its all the same? Because frankly, there are hedge funds and private equity people that are buying this stuff. But there are also a lot of managers of county pension systems and people like former Treasurer of Pennsylvania Senator Casey buying this. And they, I would assume, rely almost exclusively on well, if it is AAA it is the same stuff. I am buying Mobil debentures at AAA and I am buying whatever life mortgage company of the world CDOs.

Was that not—looking back was that something that should have been much more clearly designated in your ratings?

Ms. TILLMAN. I cannot speak to Moody's statistics on what Professor Coffee has outlined. But in the same timeframe that Professor Coffee was talking about Moody's statistics, our statistics relative to lowest investment grade BBB, in terms of its default rate was probably around 2 or 2.5 percent. In that same timeframe our corporate ratings default rate were around 2.5 to 3 percent. So in terms of what we are looking at, we did not really see these huge distinctions around the default rates of a corporate bond versus a default rate of a structured bond.

In fact, if you look—and by the way, all the transition and default studies that we do are publicly available and have been publicly available for a very long time. They do go by sector. You can look at a corporate bond default. You can look at an ABS, you can look at RBS. We will continue to make sure that those are publicly available.

But if you look at the default rates relative to structured debt versus corporate debt, actually structured debt has been, since 1978, actually performed better than corporate debt.

So again I am not—so I will let Mr. Kanef respond to the rest of it.

Senator REED. But that structured debt, particularly the residential structured debt, a lot of that was guaranteed mortgage-backed securities by Fannie and Freddie and others.

Ms. TILLMAN. No, we actually do not rate those.

Senator REED. You do not rate those at all?

Ms. TILLMAN. No. We rate the non-agency debt.

Senator REED. I want to make sure we are doing apples and apples.

Mr. KANEF. Mr. Chairman, could I respond as well, please?

Senator REED. Yes, you may. Please.

Mr. KANEF. As a preliminary matter, our transition studies, the studies of what ratings move up or down to, as well as our rating default studies, are also publicly available, as is the data that underlies those studies. So we make both of those things available to the public, as well. So certainly we are all for sunshine and disclosure.

With respect to the total structured finance universe, the same item that Ms. Tillman was speaking to, Moody's has a similar result. That is if you look at all of the investment grade structured finance issuance and you compare that to all of the corporate investment grade issuance over I think pretty much a 15 year time period going back from the present, you find that the overall default rates for the total investment grade buckets are very, very similar. So that there are differences based on specific product in specific time period. But over a longer term you find that, in fact, the performance is very similar.

Senator REED. Professor Coffee, do you have a comment?

Mr. COFFEE. I do not have any stake in this debate between Moody's and Standard & Poor's.

All I would suggest is if the institutional investor out there who does not have its own staff could see the default rates disclosed on one SEC screen and could see a 17 percent default rate, I do not think they would buy that security at any price

Senator REED. Let me ask another question about methodology, because you have said your methodology is fully available on the Web, you can see it. Did anyone ever come to you and say your methodology is all screwed up with respect to these exotic mortgages?

For example, I am told that for a long period of time some of the NRSROs were not including the debt-to-income of the borrowers in their models. Which, to me, is an interesting point which now has been reincorporated. So to what extent does this public exposure of methodologies actually result in any changes or feedback?

Mr. KANEF. I guess, Senator, I appreciate you raising that point because this is something that has been widely reported in the press and it is just not a true statement of fact. For the record, I would like to correct that.

Senator REED. No, that is your role.

Mr. KANEF. For the subprime RMBS transactions that we rated in 2006, for over 99 percent of those transactions we received DTI or debt-to-income and we, in fact, considered that in our valuation. So I very much appreciate the opportunity to change that.

With respect to your question, though, if I could respond, we actually do receive a significant amount of feedback on our methodologies, some positive, some negative. We try to incorporate that which we feel helps move the process forward.

Senator REED. Let me ask another question with respect to methodology. Do you similarly publish the methodology of your surveillance activities, the frequency of your reviews, the information, the specifics? And how detailed is this? If this is general, an equation that says we take these five factors into consideration, that might be very difficult to match up with a specific investment that an investment fund has made or a pension fund has made.

Mr. KANEF. Senator, we do publish, and we have published, methodologies of our surveillance process. It is always a balance between exactly what to include in that methodology for publication to ensure that people actually get to read through it. I do not know exactly—I guess I can only say that we do make that available and we are certainly willing to discuss questions that market participants have about that.

Senator REED. Let me ask a final question, because you have been very patient. That is, a lot of the criticism has been directed against the rating agencies but also against the issuers because of the incredible complexity of these instruments, with several different tranches including—was there any public transparency on the actual instruments you were rating?

Ms. TILLMAN. Absolutely. I think that is one of the main things that we make available is why the different tranches are rated a specific way. That goes into the transparency in terms of what we provide.

The other thing I would like to add, and I believe Moody's does the same thing but I will let Mr. Kanef speak to himself. We have investor counsels, we have issuer counsels, we have counsels, we speak to the investment community. And sometimes when they are—in terms of what our methodologies so there can be a discussion. Again this is away from any transaction so that we have a dialog and get input from the community in terms of what it is that we are doing.

In fact, when we are thinking of a major criteria change relative to specific types of bonds, we have put out an RFP to the community to get input from them, to see what their—and it is not just to the investment bankers, it is to a larger broader community that extends beyond that in terms of what do you think about the way we are thinking.

Because we cannot operate really insular around a lot of the stuff that we are doing. And so that process in itself takes on and really is an open dialog around they are more than happy to tell us that we are crazy around what our thoughts are. They do not hold back. But that dialog, in itself, does take place as well.

Senator REED. I want to thank you. I think this could go longer. The issue is complex and multifaceted. But you have been extraordinarily patient and we thank you for your attendance and your testimony.

The record will remain open for an additional week. There may be following on questions from my colleagues. If you have additional information that you would like to send us, please do so.

At this time, I would adjourn the hearing.

[Whereupon, at 12:04 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

TESTIMONY
OF
CHRISTOPHER COX, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING CREDIT RATING AGENCIES

BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

SEPTEMBER 26, 2007

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

TESTIMONY CONCERNING CREDIT RATING AGENCIES

CHRISTOPHER COX
CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

Before the U.S. Senate Committee on Banking, Housing and Urban Affairs

September 26, 2007

Chairman Dodd, Senator Shelby, and Members of the Committee:

I am pleased to be here today to discuss the important work the Securities and Exchange Commission is doing concerning credit rating agencies. In giving the Commission statutory authority in the Credit Rating Agency Reform Act of 2006 (Rating Agency Act) to oversee credit rating agencies registered with the Commission as nationally recognized statistical rating organizations ("NRSROs"), Congress explicitly found that Commission oversight would serve the interest of investor protection by fostering competition, accountability, and transparency in the industry.

The Rating Agency Act grants the Commission broad authority to examine all books and records of an NRSRO. This broad examination authority permits the Commission to examine an NRSRO on a periodic basis for compliance with substantive Commission rules applicable to NRSROs, including rules addressing conflicts of interest and rules prohibiting certain unfair, coercive, or abusive practices. Although the Commission was granted authority to regulate an NRSRO as such, the Act expressly stated that the Commission has no authority to regulate the "substance of the credit ratings or the procedures and methodologies" by which any NRSRO determines credit ratings. In striking this balance, the legislation recognizes an appropriate role for the Commission in promoting competition and policing NRSRO activities such as conflicts of interest, and at the same time declares that it is not our role to second-guess the quality of the rating agencies' ratings.

The Rating Agency Act is still only months old, and it set out an aggressive schedule for implementation. The Commission is ahead of that schedule. The Commission proposed six new rules on February 2, 2007, just four months after the law was signed, and adopted final rules on May 23, 2007, more than a month ahead of the June 26, 2007 statutory deadline. And earlier this week, the Commission issued orders granting registration as NRSROs under the Rating Agency Act to seven credit rating agencies. Each of these applications was swiftly reviewed, evaluated, and determined within the 90-day timeframe specified by the Act. These seven credit rating agencies now are subject to both the provisions of the Act and the Commission's final rules implementing it.

Recent Events Regarding Residential Mortgage-Backed Securities

In recent months, the credit rating agencies have been heavily criticized regarding the accuracy of their ratings of certain structured finance products, especially subprime residential mortgage-backed securities (RMBS). Critics have faulted the rating agencies for initially assigning ratings to those securities that were too high; for failing to adjust those ratings sooner as the performance of the underlying assets deteriorated; and for not maintaining appropriate independence from the issuers and underwriters of those securities.

For their part, the rating agencies generally have stated that incidence of mortgage delinquencies in 2006 far exceeded their original credit loss expectations, particularly for subprime mortgages. In the past, their expectations had been more conservative than the actual loss experience. They have noted several factors that seem to have caused the unexpected losses: fraud in the mortgage origination process; deterioration in loan underwriting standards; and finally, lending standards quickly became more restrictive thereby making it more difficult for over-leveraged borrowers to re-finance.

We have as yet formed no firm views on any of the reasons put forth by the credit rating agencies, but we are carefully looking into each of them in the context of an examination the Commission has begun with respect to NRSROs active in rating RMBS. This examination – which is being conducted on a non-public basis – was commenced in response to the recent events in the mortgage markets. In particular, the Commission is examining whether these NRSROs were unduly influenced by issuers and underwriters of RMBS to diverge from their stated methodologies and procedures for determining credit ratings in order to publish a higher rating. The examination is also focusing on whether the NRSROs followed their stated procedures for managing conflicts of interest inherent in the business of determining credit ratings for RMBS. In this regard, the examination will seek to determine whether the NRSROs' role in the process of bringing RMBS to market impaired their ability to be impartial.

In addition to the Commission's examination of NRSROs, the President has requested that the President's Working Group on Financial Markets examine the role of credit rating agencies in lending practices, how their ratings are used, and how securitization – the repackaging and selling of assets – has changed the mortgage industry and related business practices. As a member of the President's Working Group, the Commission is taking a leading role in this study.

The Commission is also a member of the credit rating agency task force created by the International Organization of Securities Commissions ("IOSCO") and we recently hosted an IOSCO meeting at which the credit rating agencies most active in rating residential mortgage-backed securities made presentations with respect to their role in developing structured finance products, and how they manage the conflicts of interest that arise in providing rating services.

The History and Role of Credit Rating Agencies in the Financial Markets

In considering recent events, it is useful to review the history of credit rating agencies and their role in the financial markets. Credit ratings have been used to distinguish among grades of debt creditworthiness since early last century. But it was only beginning in 1975 that the SEC began to make explicit reference to credit ratings in its rules, using credit ratings by market-recognized rating agencies to distinguish among grades of creditworthiness for various purposes under the federal securities laws. The Commission originally adopted the term "NRSRO" in 1975 solely for determining capital charges on different grades of debt securities under the Commission's net capital rule for broker-dealers. Over time, however, the NRSRO concept was incorporated into a number of additional SEC rules and regulations, including rules issued under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. Congress, too, began to use the NRSRO concept in legislation, as have other regulatory bodies, including banking regulators both at home and abroad.

Despite the fact that the NRSRO concept was used by the SEC for regulatory purposes prior to the enactment of the Rating Agency Act, no legislation had yet given the Commission statutory regulatory authority over credit ratings agencies as such. Before the Rating Agency Act was enacted, the Commission staff identified credit rating agencies as NRSROs through the no-action letter process. In that process, the staff would review information and documents submitted by the credit rating agency, including how broadly its credit ratings were used in the securities markets, to determine whether the agency had achieved broad market acceptance for its ratings. If in the staff's view that acceptance had been achieved, the staff would issue a letter stating that it would not recommend enforcement action against broker-dealers who used the agency's credit ratings for purposes of complying with the Commission's net capital rule.

The SEC staff previously identified 11 firms as NRSROs under this process. However, several NRSROs subsequently consolidated so that five of the credit rating agencies that were identified under the no-action letter process remained in business at the time that the Rating Agency Act was enacted: A.M. Best Company, Inc.; DBRS Limited; Fitch, Inc; Moody's Investors Service, Inc.; the Standard & Poor's Division of the McGraw Hill Companies, Inc. Two additional NRSROs were identified between the passage of the Rating Agency Act and its implementation: Japan Credit Rating Agency, Ltd.; and Rating and Investment Information, Inc.

The Credit Rating Agency Reform Act of 2006

The Rating Agency Act replaced the no-action letter process with a program of Commission oversight of credit rating agencies that elect to register as NRSROs. Under the Rating Agency Act, a credit rating agency seeking to be registered as an NRSRO must apply for registration with the Commission, make public in its application certain information to help persons assess its credibility, and implement procedures to manage the handling of material nonpublic information and conflicts of interest. Consistent with the statutory mandate, the Commission's implementing rules require disclosure of an

NRSRO's conflicts of interest, and proscribe certain conflicts of interest. Key provisions of the Rating Agency Act and the new Commission rules are summarized below.

Disclosure Requirements and Performance Measurement Statistics

The Rating Agency Act and its implementing rules require an NRSRO to disclose in its public filings with the SEC a general description of its procedures and methodologies for determining credit ratings. In addition, an NRSRO must make public certain performance measurement statistics including historical downgrade and default rates within each of its credit rating categories over the short, medium, and long terms. These statistics are intended to serve as important indicators of the performance of an NRSRO in terms of its ability to assess the creditworthiness of issuers and obligors. Finally, as described in the Commission's adopting release in June 2007 regarding the NRSRO rules, the Commission is studying whether it would be appropriate to require additional types of performance statistics to be disclosed as an alternative, or in addition, to historical default and downgrade rates, such as a credit rating downgrade that occurs long after a significant drop in the value of the securities being rated. We believe that the disclosure requirements of the Rating Agency Act, as implemented now and in the future through our rulemaking, will assist users of credit ratings in assessing the reliability of an NRSRO's ratings over time, and will increase transparency with respect to the accuracy of an NRSRO's ratings.

Conflicts of Interest and Prohibited Practices

The Rating Agency Act requires an NRSRO to disclose the conflicts of interest that are inherent in its business of determining credit ratings and to establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of its business, to address and manage the conflicts of interest. The Rating Agency Act also provided the Commission with authority to prohibit or require the management and disclosure of conflicts of interest relating to the issuance of credit ratings by an NRSRO. Pursuant to this authority, the Commission adopted rules that prohibit an NRSRO from having certain conflicts of interest if it has not complied with the requirements in the Rating Agency Act to disclose and manage them. One of the conflicts in this category is receiving compensation from an issuer or underwriter to rate securities issued or underwritten by the entity. The Commission's rules also prohibit an NRSRO from having certain other conflicts in all circumstances. One of the conflicts in this category is receiving compensation for determining a credit rating where the person paying for the credit rating provided the NRSRO with net revenue in the most recently ended fiscal year that equaled or exceeded 10% of the NRSRO's total net revenue.

Finally, the SEC rules, among other things, also address the handling of material non-public information by an NRSRO and prohibit certain unfair, coercive, or abusive practices by the NRSROs – including modifying or threatening to modify a credit rating or otherwise departing from systematic procedures and methodologies in determining credit ratings, based on whether the obligor, or an affiliate of the obligor, purchases the credit rating or any other service or product of the NRSRO or any person associated with the NRSRO.

Books and Records, Financial Reports, and Examination

In addition to significant disclosure requirements and conflict of interest provisions, the Rating Agency Act and the Commission's implementing rules also require an NRSRO to make and keep certain books and records, including documentation of its established procedures and methodologies used by the NRSRO to determine credit ratings. These recordkeeping rules will allow Commission examiners to review whether an NRSRO is following its stated procedures and methodologies and otherwise complying with the Rating Agency Act. NRSROs also are required to keep external and internal communications received and sent by the NRSRO or its employees that relate to initiating, determining, maintaining, changing or withdrawing a credit rating.

The Rating Agency Act and implementing rules also require NRSROs to furnish to the Commission, on a confidential basis, certain financial reports, on an annual basis, including audited financial statements. In addition to the audited financial statements, the rules also require NRSROs to furnish separate unaudited financial reports that will assist the Commission in carrying out its statutory responsibilities under the Rating Agency Act.

The Rating Agency Act provides that all records of an NRSRO are subject to such reasonable periodic, special, or other examination by representatives of the Commission as the Commission deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in the furtherance of the purposes of the Securities Exchange Act of 1934.

Prohibition on Regulating Rating Procedures

Finally, in implementing this statute, the Commission is ever mindful of the explicit intent of Congress that we not substitute the Commission's judgment for that of the rating agencies.

I appreciate the opportunity to provide the Committee with this update on the Commission's oversight of the credit rating agencies. I would be happy to answer any questions you might have.

Testimony of Professor John C. Coffee, Jr.

Adolf A. Berle Professor of Law
Columbia University Law School

Before the Senate Banking Committee
On September 26, 2007

"THE ROLE AND IMPACT OF CREDIT RATING AGENCIES ON THE SUBPRIME CREDIT MARKETS"

Chairman Reed, Ranking Member Shelby, and Fellow Senators:

I am pleased and honored to be invited to testify here today and will get to the point without delay.

I. Introduction

Let me begin with a basic generalization: When a debacle occurs in the financial markets—whether it be the crisis triggered by the failure of Enron and WorldCom in 2002, the contemporary mortgage meltdown, or earlier problems in the junk bond market—one can usually identify a "gatekeeper" in whom investors have lost confidence. By the term "gatekeeper," I mean those professionals on whom investors necessarily depend to provide certification and verification services: auditors, securities analysts, credit rating agencies, investment banking firms and sometimes corporate attorneys. These professionals develop "reputational capital" over many years and many clients that leads investors to rely on them, in part because investors know that the gatekeeper will suffer a serious reputational injury if it is associated with a fraud or unexpected insolvency. Because this injury should be greater than any amount the issuer can pay the gatekeeper to acquiesce in fraud, it should deter the gatekeeper from involvement in fraud.[1] From this perspective, "reputational capital" is in effect "pledged" by the gatekeeper in support of the issuer's statements. But when the market learns that the gatekeeper failed to uncover fraud or related problems (or that it blinked at them), the resulting loss of confidence, both in the gatekeeper and the market's mechanisms generally, can produce a sharp decline in stock market values, a liquidity crisis as buyers flee the market, or even, in an extreme case, a panic. Recent market developments suggest that there has been such an erosion in investor trust and confidence.

Thus, when accounting irregularities and financial statement restatements soared in the period between 1998 and 2002, and eventually culminated in the Enron and WorldCom insolvencies, investors lost confidence in audited financial statements, and stock market prices collapsed. As a result, Congress enacted the Sarbanes-Oxley Act to eliminate conflicts of interest and restore confidence in the auditing profession. Controversial as that statute may have been, it basically worked.

Today, attention has shifted to the performance of a different gatekeeper: the credit-rating agency. Functionally, it plays much the same role for debt purchasers that auditors and securities analysts perform for equity investors. Structured finance particularly relies on the credit-rating agency because investors have no ability to evaluate on their own the securitized pools of financial assets that structured finance creates. That is, while a sophisticated debt purchaser might be able to evaluate the creditworthiness of the bonds of a major corporation by examining the corporation's financial statements, the debt purchaser has no corresponding ability to assess the risk level of a mortgage pool backing an issue of collateralized debt obligations ("CDOs") and so must rely on a "gatekeeper"—here, the credit rating agency.

The market for mortgage-backed securities is particularly dependent on gatekeepers. The day is long past when bankers behaved like Jimmy Stewart in "It's A Wonderful Life" and made mortgage loans based on their evaluation of the character and integrity of the borrower. The connection has been irrevocably severed between making the loan and bearing responsibility for its performance. Instead, the lending institution has become simply an "originator"; its loans are aggregated, along with those of many other financial institutions, into large pools of financial assets that investment banks market to institutional debt purchasers. Obviously, there is an incentive for the "originator" to transfer its more risky loans to the securitization pool, rather than keeping them on its own books. To counteract this tendency and because the debt purchaser cannot individually evaluate the strength of the loans in the pool, the debt purchaser must rely on the credit rating agency (and, probably to a lesser extent, the investment bank syndicating the mortgage-backed debt).

The evaluation of structured finance products is obviously more difficult than simply evaluating a public corporation's creditworthiness—and thus it is also more profitable for the rating agency to rate these often complex and exotic products. The structured finance market has grown exponentially over the last decade, and this in turn has vastly increased the revenues of the principal rating agencies. No serious person can doubt that the growth of the structured finance industry has been socially desirable because it has expanded housing opportunities. But for precisely this reason, the performance of the gatekeepers central to this market is also a matter for public and Congressional concern. Until recently, the market for debt ratings seemed to be working smoothly, but it has always had some unique characteristics.

II. An Overview of the Debt Ratings Market

Let me stress four characteristics of this market:

(a) Market Concentration. The debt rating market has always been highly concentrated, with only three major players (Moody's, Standard & Poor's, and Fitch). This concentration is partly attributable to the facts that (a) reputational capital is not easily acquired and (b) the SEC long discouraged new entrants into this market. Although the Credit Rating Agency Reform Act of 2006 will encourage new entrants, it does not follow that this market will soon become competitive. Barriers to entry remain. Debt purchasers fear new, "fly-by-night" rating agencies and will prefer to rely on the established players. Absent real competition, conscious parallelism can become the norm and thus the dominant players may acquiesce to client pressures for liberal grading.

(b) Conflicts of Interest. At first glance, credit rating agencies are better insulated from client pressures than most other gatekeepers. Because they rate thousands of clients, no one client is material to their revenues. Even more importantly, little prospect exists that the individual rater can be "captured" by the client. In contrast, the audit partner of a major accounting firm is far more vulnerable because the partner may serve only one (or a few) clients and the partner's future career depends on whether he or she can hold the principal client. Thus, David Duncan, the Arthur Andersen audit partner for Enron, had more reason to be loyal to Enron than to Arthur Andersen. Lose the client, and your career is eclipsed. But this is not true in the case of credit rating agencies. There, the actual rater has not a single client, but maybe thirty or forty. In addition, the individual rater is a relatively low ranking employee, is paid far less than a partner of a law or accounting firm, and typically possesses less individual discretion; critical decisions tend to be made at the committee level. The prospect of client capture thus seems more remote.

But this insulation has its limits. The major change that destabilized rating agencies appears to have been the rise of structured finance. Not only are the process and criteria for rating a securitized pool of financial assets opaque, but major investment banks that assemble these pools bring them to the rating agency for advance negotiation over the rating before they are marketed. The process can become one of extended negotiation, because if an investment grade rating is initially denied, the investment bank can seek to supplement and/or improve the quality of the asset pool. This is a qualitatively different process than the evaluation of the financial statements of a corporate issuer, whose financial statements cannot be changed or improved in response to criticism in the short run. As a consequence, the rating agency is no longer facing an atomized market of clients who each come to it only intermittently (and thus lack market power), but instead large repeat clients who have the ability to take their business elsewhere. Today, structured finance accounts for a major share of some rating agencies' total revenues; equally important, these amounts are paid by a small number of investment banks that know how to exploit their leverage—and get the rating just over the line and into the promised land of investment grade.

(c) Stale Ratings and Tardy Downgrades. In principle, the debt market wants current, updated ratings. Yet, rating agencies have been notoriously slow to adjust their ratings downward. For example, Enron was not downgraded until just four days before it filed for bankruptcy,[2] well after its problems were a matter of public knowledge. The mortgage meltdown intensified this last July, when Moody's downgraded several billion dollars worth of mortgage-backed collateralized debt obligations ("CDOs"). The general view is that these downgrades were long overdue (in part, as discussed later, because of the high default rates on CDOs). Why then are rating agencies slow to downgrade? A rating agency earns no additional revenues from downgrading outstanding securities, but it does risk offending powerful clients—the issuer, its investment bank, and the institutional investors that hold the rated securities in their portfolio. No one is made happier by a downgrading, and many are outraged (as was clear this July). Thus, downgradings tend to be delayed and may be motivated mainly by the fear that investment grade-rated debt securities might imminently default. In this respect, ratings downgrades are often less prophecies of the future than slightly premature obituaries for terminally ill bonds.

(d) The Prospect of Retaliation. A final factor that may compromise some rating agencies is the ease with which business can be moved from one rating agency to another. In contrast, firing an auditor is difficult because SEC rules require full disclosure of the circumstances surrounding the termination and permit the auditor to comment. Also, when the auditor is fired, there is great uncertainty about what the incoming auditor will do; perhaps, it will be even tougher, and certainly, it has leverage over the client. Precisely because issuers usually hire multiple rating agencies, they can drop one with less visibility or adverse consequences. In any event, the evidence clearly shows that there is a market penalty for downgrading one's ratings. Moody's has reported that since it downgraded a series of structured finance offerings in July, 2007, its market share in the relevant market for mortgage-backed securitizations has dropped from 75% to 25%.[3] In short, business in the market for ratings is mobile, retaliation is relatively costless, and hence the gatekeeper can become compromised, particularly with regard to structured finance products.

If the rating agency is subject to more pressure in the case of structured finance offerings than in the case of corporate bond offerings, this diagnosis leads to a testable prediction: default rates should be higher on structured finance products than on corporate bond offerings for securities having the same ratings grade. Currently, the evidence appears to corroborate this prediction that debt ratings are more likely to be inflated on structured finance products than on corporate bonds. Looking at the default rate on Moody's lowest investment grade rating (Baa), two financial economists recently reported that the five year cumulative default rate on corporate bonds receiving a Baa rating from Moody's between 1983 and 2005 was only 2.2%, but the same five year cumulative default rate for CDO's receiving the same Baa rating from Moody's between 1993 and 2005 was 24%—more than ten times higher.[4] Moody's informs me that they consider the default or impairment rate for 2005 to be aberrational for several reasons,[5] and they have advised me that the comparable five-year cumulative default rates ending in 2006 (as opposed to 2005) were 2.1% for corporate bonds and 17% for CDOs. But even on their preferred comparative basis, the ratio is still over 8 to 1 (as opposed to over 10 to 1).

Even as so modified, the most plausible interpretation of this disparity is that ratings were inflated on CDOs (at least more so than on the corporate bonds), probably because only the issuers of the former had sufficient leverage with the rating agency. This hypothesis is not presented as established fact or as a permanent tendency, but it is exactly the type of issue that the SEC should focus on in its investigation: what were the default rates for individual underwriters' offerings? Until rebutted, the most reasonable inference is that the underwriters that did the most business with a rating agency had a higher rate of default on their offerings.

III. What Can Be Done?

If the gatekeeper has been compromised, what reforms would make sense? A variety of options are possible, but first it is important to recognize what will not work.

Free market theoreticians may argue that nothing need be done because the market will restabilize on its own. But this is a market uniquely prone to failure—and not simply because of the usual problem about conflicts of interest. In other markets, a professional whose advice was demonstrably inaccurate would lose business. But this does not necessarily hold true in the market for debt ratings, because the service providers in this market are not simply providing information through their ratings. They are also conferring a governmentally-delegated permission to buy upon institutional investors that are legally restricted to purchasing securities rated investment grade.[6] This is the real significance of the SEC's Nationally Recognized Statistical Rating Organization (or "NRSRO") designation, because only a rating agency with this designation can render debt securities eligible for purchase by many investors.[7] Put bluntly, an NRSRO can sell its services to issuers, even if the market distrusts the accuracy of its ratings, because it is in effect licensing the issuer to sell its debt to certain regulated investors. This is a power that no other gatekeeper possesses. But such a market in which the gatekeeper is dispensing permission as much as providing information is more likely to produce inflated ratings, because there is less of a penalty for inaccuracy.

More generally, another feature of this market is that not one constituency unambiguously favors objective information over optimistically biased information. To be sure, debt purchasers want the truth at the outset <u>before they purchase</u>. But once they have placed the issuer's bonds in their portfolios, institutions are unhappy with any downgrading of the issuer's debt. Because debt securities trade in the secondary market far less frequently than do equity securities, it also follows that the constituency of prospective buyers (who do want the objective truth) is far smaller than the constituency of debt holders (who may not).

Given these problems, what forces can counteract this inherent tendency for optimism? The most obvious candidates are litigation and bureaucratic regulation, but as next discussed, neither option is promising.

A professional who makes inaccurate judgments is often subject to legal liability on any of a number of grounds. Yet, litigation against the credit rating agencies looks more feasible in theory than in practice. The plaintiffs' bar will assert that a debt rating is a statement subject to Rule 10b-5 and that recklessness satisfies the obligation to show scienter under that rule. Still, to date, plaintiffs have never been able to hold a rating agency liable. Even in Enron, where the rating agencies reduced Enron's debt to below investment grade only four days before its bankruptcy, the agencies escaped liability on both securities fraud and malpractice grounds.[8] Their defense has long been that their ratings constitute First Amendment-protected speech, much like newspaper's editorials.[9] The rating agencies have even invoked, with some success, press shield laws to protect them from having to respond to subpoenas.[10] In 2003, the Second Circuit refused to uphold this extension of the press shield law to one rating agency,[11] but it did so on a narrow ground. Finding that Fitch only rated the debt of issuers that hired it, the Second Circuit decided that Fitch was not a true journalist. However, the Second Circuit also noted that Fitch's practice of rating only its own clients "contrasts noticeably with Standard & Poor's practice ... of rating nearly all public debt issuances regardless of whether it was hired to do so or not."[12] The implication then is that S&P and Moody's would qualify for protection under these statutes.

Even if the rating agencies' First Amendment theory seems overbroad, they probably receive even more effective insulation from the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which requires a plaintiff to plead with particularity facts giving rise to a strong inference of fraud. The relationship between rating agencies and their investment bank clients is far from transparent, but discovery is not available under the PSLRA until its high pleading standard is first satisfied. As a practical matter, plaintiffs have a fighting chance in court only if they can obtain extra-judicial access to documents or emails that show that the rating agency had contemporaneous doubts or concerns that were not revealed in its rating. Even then, the failure to downgrade a rating may not be actionable at all, because in the words of Basic v. Levinson, silence is not actionable absent a duty to disclose.[13] My assessment is not that plaintiffs can never win, but that the barriers to victory are so high that private litigation is not an effective disciplining force.

Finally, even if litigation against rating agencies were more feasible, this might only aggravate, rather than cure, the problems of this market. The case for a ceiling on liability is probably stronger in the case of rating agencies than in the case of auditors. Rating agencies each rate thousands of securities for a relatively modest fee and thus would face potential liability in the trillions on all the debt offerings that they have rated. Without a ceiling, they might face extinction if they were liable under simply a recklessness standard.

If litigation then seems unpromising, tough bureaucratic regulation could arguably be the best alternative. Former SEC Chairman Arthur Levitt has called in a recent Wall Street Journal Op-Ed piece for closer SEC oversight, the elimination of conflicts of interest, and possibly the creation of an agency similar to the Public Company Accounting Oversight Board ("PCAOB") to monitor the rating agencies.[14] Potentially, these reforms seem desirable, but they are not easy to implement. Although conflicts of interest are critical, it is far from clear that they can simply be eliminated. The fundamental conflict is that the issuer hires the rating agency to rate its debt (just as the issuer also hires the auditor to audit its financial statements). It is not easy to move to a different system. To be sure, until the early 1970s, the rating agencies were paid by their subscribers, not the issuer. But they barely broke even under this system. More generally, the deeper problem with subscription-funded ratings is that there is no way to tax the free rider. A first user of a rating can pass the rating information along to its friends and allies, possibly in return for reciprocal favors. Thus, Pension Fund A could subscribe to Moody's and Pension Fund B could subscribe to Standard & Poor's, and they could exchange the information they receive from both, meaning that both agencies would not receive the full market value of the information that they produce. The same problem makes it infeasible to have investors pay auditors for their services. As discussed below, it is possible that subscriber-paid credit rating agencies could enter this field (and some have), but they are likely to play more of a watchdog role than to serve as one of the principle raters. Subscription-funded ratings is a niche market at best.

Bureaucratic regulation faces other problems. It does not seem within the effective capacity of the SEC, or any more specialized agency, to define what an investment grade rating should mean or the process by which it is determined. Such efforts would only produce a telephone book-length code of regulations, which skilled corporate lawyers could easily outflank. Here again, rating agencies are different than auditors. The PCAOB as a reform worked well because there already was a pre-existing methodology governing how audits should be conducted. The Sarbanes-Oxley Act simply re-assigned the responsibility for monitoring compliance from a private body, the American Institute of Certified Public Accountants (or, "AICPA"), to a public body, the PCAOB. In contrast, no recognized methodology exists for assigning debt ratings. Indeed, Moody's and S&P differ in their approach. S&P is known to be more quantitative and rule bound; Moody's, more qualitative and subjective, leaving most decisions to a committee. Absent any professional consensus, it seems premature to expect either the SEC or a specialized agency to adopt rules governing what an investment grade rating should mean.

The SEC could, of course, do many things, but to date, its focus has not shifted from its traditional concern that competition will produce laxity. In June, it issued a massive release to implement the Credit Rating Agency Reform Act of 2006.[15] As in the past, its primary concern appears to be the danger of fly-by-night rating agencies and the proverbial race to the bottom. Even if this concern is justified, it overlooks the danger that the established rating agencies may also have become compromised. If so, more detailed record-keeping and greater procedural formality, as the SEC contemplates in its new release, will not have much useful impact.

What then could work? I will make three proposals, all premised on the idea that the least intrusive remedies are the best:

Proposal One: Disclose Default Rates On Each Rating Grade For Each Product. One of the more effective regulatory initiatives directed at consumers requires automobile manufacturers to disclose estimated gas mileage (both for urban and highway driving) on the window stickers of new automobiles. Correspondingly, the SEC could calculate the five year cumulative default rates on different classes of financial products for each rating agency and disclose this data on one centralized web site. Admittedly, Moody's already discloses such information on its own web site, but others do not, and it is the comparison that is critical.

Today, it is doubtful that most debt purchasers were aware that the five year cumulative default rates on CDOs rated investment grade by Moody's recently ranged between 17% and 24% (as discussed above). Moreover, Moody's is generally thought to be the most conservative and cautious of the rating agencies. In any event, if the SEC were to maintain one centralized web site, it could employ common criteria to compute default rates and display reliable comparative data on every rating agency registered with the SEC under the 2006 legislation. This would assist the market to understand the different approaches of different raters (and it would thereby encourage rating agencies to compete to establish a reputation for quality). It would also compel the SEC to focus on the relative success of different raters, instead of simply monitoring the procedural steps each followed. As next discussed, rating accuracy, not the procedural due care of the rater, is both the critical focus and the only data that has objective meaning.

Proposal Two: Forfeiture of NRSRO Status. In principle, rating agencies should compete in terms of their relative accuracy. But the market does not appear to penalize inaccuracy very heavily, and corporate issuers may prefer the rater with the most optimistic bias. The best response to this problem is to make the rating agency's status as an NRSRO depend upon maintaining an acceptable level of accuracy. As noted earlier, Moody's cumulative five year default rate for CDOs that it rated Baa (or its minimum investment grade) was between eight and ten times higher than its default rate for corporate bonds that it similarly rated Baa. The SEC should define a maximum default rate for each letter grade rating and should measure compliance with this standard separately for corporate bonds and structured finance products. For example, the SEC might specify an 8% default rate for Moody's Baa rating and a tighter 3% default rate for its AA ratings. If the credit rating agency's default rate for any particular rating or product exceeded these parameters over a defined period, it should forfeit the ability to serve as an NRSRO for the given rating or product as to which it was demonstrably inaccurate. Thus, institutional investors could still receive and consider the agency's rating, but they would be unable to rely on such a rating for purposes of determining the legality of an investment by them. The duration of this suspension as an NRSRO should continue until the particular agency's five-year default rate fell back to within the acceptable parameters for that rating. Ideally, a new rating agency should not obtain NRSRO status until it could demonstrate that it had a default rate within these acceptable parameters.

This proposal would not bar a rating agency from continuing to issue ratings during any period in which it was disqualified as an NRSRO, but such ratings would be useful only for their informative value, not their legal impact. The goal here is to sever the link between providing information and conferring legal protection, with the latter being made dependent on the rater's level of accuracy. The net result should be to create an incentive for more conservative ratings that might counterbalance the current incentives for grade inflation.

In reality, this proposal creates a reputational penalty that would be painful, but not fatal. Conceivably, it could happen that all the major ratings agencies might forfeit their NRSRO status (for at least some ratings or some products), but even this very unlikely event would still cause no disaster. Their institutional clients would be required to fall back on their own analyses to satisfy their obligations as a prudent trustee. Moreover, in light of the 2006 legislation, which should result in a number of new NRSROs, it is increasingly unlikely that all credit rating agencies would fail the reasonable accuracy criteria mandated by the SEC.

Ultimately, the SEC has a choice; it can look to procedural criteria: such as the number of hours spent determining a rating, the educational qualifications of the rater's staff, or the number of institutions that claim to rely on the particular rater. Or, it can look to the objective results: did the agency's ratings accurately predict the risk levels of the securities over an extended period? The first option will produce voluminous records of dubious value. The second option makes more sense.

<u>Proposal Three: A Transparency Rule: Encourage the Growth of Subscription-Based Rating Agencies By Giving Them Access to the Same Data Made Available By the Issuer to Any Other Rating Agency</u>. As noted earlier, the major rating agencies are paid by the issuer to rate its securities. In contrast to this dominant issuer-paid format, some new rating agencies are seeking to establish themselves as subscription-funded rating agencies. The latter seldom receive access to the same material, non-public data that the issuer-paid traditional agencies receive. Although I doubt that subscription-funded agencies will displace the traditional rating agencies, subscription-funded rating agencies are less conflicted, and they could play an important watchdog role. But such

new entrants face barriers, as issuers may not wish to deal with them or disclose sensitive information. Indeed, the issuer may withhold access to non-public information for precisely the same reason that public companies use to withhold data from securities analysts who were skeptical of them: to punish them. Thus, some have sensibly proposed that an equivalent of Regulation Fair Disclosure ("Reg FD") should be adopted to require "equivalent disclosure" to all NRSROs of any information that is given by an issuer to any NRSRO.[16] Such disclosure would be conditioned on the recipient NRSRO's undertaking to maintain the confidentiality of the disclosed information. The key goals of this proposal are both to assure rater independence and objectivity and to promote greater competition.

IV. Conclusion

For competition to work in this special context, it must be facilitated. These proposals are intended to work toward that goal in common: (1) an SEC clearinghouse that would compute default data by rating grade and product for each rating agency; (2) the forfeiture of NRSRO status by agencies that fail to satisfy minimum accuracy standards; and (3) a Reg FD restriction on "selective disclosure" to assist new entrants in gaining access to issuer information and to assure rater independence.

The alternative course is that the SEC will persist in its prior antipathy to new entrants in this market and/or will assume the role of a traditional bank examiner, overseeing the rating agencies. This would accomplish little, but would generate much wasted motion and require a bureaucracy of some size. As an overseer, the SEC would predictably focus its attention on new entrants, but recent events suggest that no rating agency should be above suspicion. All should be held accountable and this requires that objective criteria be applied evenly to all.

Endnotes

[1] For a fuller discussion of this concept of "reputational intermediaries" who develop and pledge their reputational capital to make their opinions and certifications credible, see John C. Coffee, Jr., GATEKEEPERS: The Professions and Corporate Governance (Oxford University Press 2006) at 2-3.

[2] Id. at 18-19; see also Claire Hill, Rating Agencies Behaving Badly: The Case of Enron, 35 Conn. L. Rev. 1145 (2003).

[3] See Aaron Lucchetti, "Ratings Firms' Practices Get Rated," The Wall Street Journal, September 7, 2007, C1 at C2.

[4] See Charles Calomiris and Joseph Mason, "Reclaim Power from the Ratings Agencies," Financial Times, August 24, 2007 at 11.

[5] They believe that 2005 statistics "were driven mostly by the poor performance of 1997-1999 vintage high yield corporate bond obligations." Also, "many of the impairments that had occurred in earlier years were cured in 2006 and were therefore removed from the statistics." (Email dated September 20, 2007 to the author from Richard Cantor of Moody's). It is open to some debate whether the curing of a default really should remove it from the statistics, and the 1997-1999 CDOs were at the height of the real estate bubble when investment bankers were packaging risky portfolios of mortgage loans (and investors were relying on credit rating agencies to protect them).

[6] For the best statement of this critique, see Frank Partnoy, The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit-Rating Agencies, 77 Wash. U. L. Q. 619 (1999).

[7] This term, which has been used by the SEC since the mid-1970s, is now defined in Section 3(a)(62) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(62). This author discusses the long debate over the NRSRO designation, and its use as a "regulatory license," in Coffee, supra note 1, at 288 to 302. While this author is skeptical about the value of the NRSRO designation, it is unlikely to be discarded in the immediate wake of the 2006 legislation that codified it.

[8] See In re Enron Corp. Sec., Derivative & ERISA Litig., 2005 U.S. Dist. LEXIS 4494 (S.D. Tex. Feb. 16, 2005).

[9] See, e.g., Jefferson County Sch. Dist. No. R-1 v. Moody's Investor's Servs., 175 F.3d 848, 856 (10th Cir. 1999) (Moody's negative evaluation is a "protected expression of opinion" subject only to an actual malice standard); County of Orange v. McGraw Hill Cos., 245 B.R. 151, 157 (C.D. Cal. 1999) ("The First Amendment protects S&P's preparation and publication of its ratings.").

[10] See In re Pan Am Corp., 161 B.R. 577, 580-82 (S.D.N.Y. 1993); In re Scott Paper Co. Sec. Litig., 145 F.R.D. 366, 369-70 (E.D. Pa. 1992).

[11] In re Fitch, Inc., 330 F.3d 104 (2d Cir. 2003).

[12] Id. at 110.

[13] 485 U.S. 224, at 239 n. 17 (1988).

[14] See Arthur Levitt, Jr., "Conflicts and the Credit Crunch," The Wall Street Journal, September 7, 2007 at A-15.

[15] See Securities Exchange Act Release No. 34-55857 (June 5, 2007) ("Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations").

[16] This idea originates with Multiple Markets, which has already advanced this idea in correspondence with Congressional committees.

Moody's Investors Service

Testimony of Michael Kanef
Group Managing Director
Moody's Investors Service

Before the
United States Senate
Committee on Banking, Housing and
Urban Affairs

September 26, 2007

I. Introduction

Good morning Chairman Reed, Ranking Member Shelby and members of the Committee. I am Michael Kanef, and I am the head of the Asset Backed Finance Rating Group at Moody's Investors Service ("Moody's"). My group is responsible for ratings of Residential Mortgage Backed Securities ("RMBS"), Term Asset Backed Securities ("ABS") and Asset Backed Commercial Paper ("ABCP") issued in the United States, Canada and Latin America. On behalf of my colleagues, let me thank the Committee on Banking, Housing and Urban Affairs for the opportunity to participate in today's panel on the role and impact of credit rating agencies on the subprime credit markets.

In my statement, I will provide a brief overview of the role of credit rating agencies in the structured finance market. In doing so, I will touch on the Credit Rating Agency Reform Act of 2006 and the Securities and Exchange Commission's rules implementing the Act. I will then describe Moody's rating and monitoring process for residential mortgage-backed securities and highlight some of the policies and procedures that help us ensure that our rating opinions are produced according to the highest standards of independence, objectivity and integrity.

I will then comment on the recent deterioration in the subprime mortgage sector, which has been caused by an unusual confluence of three factors -- increasingly aggressive mortgage loan underwriting practices, declining home price appreciation, and the sudden unavailability of refinancing alternatives for mortgage-holders. I will review the various courses of action that Moody's has taken over the past four years in response to this weakening situation. Finally, I will describe some additional steps that Moody's believes that rating agencies as well as other market participants can take to help provide greater transparency in the structured finance market and bolster confidence in the overall financial markets.

I note at the outset that the observations and information contained herein are largely based on data and experience related to the subprime mortgage securitizations that Moody's has rated, and not on the broader subprime mortgage market, some of which was securitized and rated by other rating agencies, some of which was securitized but not rated, and some of which was not securitized.

II. Background About Moody's

Rating agencies occupy a narrow but important niche in the investment information industry. Our role is to disseminate up-to date information about the relative creditworthiness of, among other things, financial obligations of corporations, banks, governmental entities, and pools of assets collected in securitized or "structured finance" transactions.

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

Moody's credit ratings are forward-looking opinions that address just one characteristic of fixed income securities – the likelihood that debt will be repaid in accordance with the terms of the security. They reflect an assessment of both the probability that a debt instrument will default and the amount of loss the debt-holder will incur in the event of default. In assigning our credit opinions, Moody's analysts adhere to published rating methodologies, which we believe promote transparency and consistency on our global ratings.

Our ratings are expressed according to a simple system of letters and numbers, on a scale that has 21 categories ranging from Aaa to C. The lowest expected credit loss is at the Aaa level, with a higher expected loss rate at the Aa level, an even higher expected loss rate at the A level, and so on down through the rating scale. Moody's rating system is not a "pass-fail" system; rather, it is a probabilistic system in which the forecasted probability and magnitude of credit losses rises as the rating level declines.

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

While Moody's ratings have done a good job predicting the relative credit risk of debt securities and debt issuers, as validated by various performance metrics including published rating accuracy ratios and default studies, they are not statements of fact about past occurrences or guarantees of future performance. Furthermore, ratings are not investment recommendations. The likelihood that debt will be repaid is just one element, and in many cases not the most material element, in an investor's decision-making process for buying credit-sensitive securities. Credit ratings do not address many other factors in the investment decision process, including the price, term, likelihood of prepayment, liquidity risk or relative valuation of particular securities.

Moody's has always been clear and consistent in telling the market that our ratings should not be used for any purpose other than as a gauge of default probability and expected credit loss. We have discouraged market participants from using our ratings as indicators of price, as measures of liquidity, or as recommendations to buy or sell securities. Although some market participants may have used our ratings for such purposes, they are not designed to address any risk other than credit risk and should not be used for any other purpose.

III. The Credit Rating Agency Reform Act of 2006

In September 2006, the Credit Rating Agency Reform Act ("**Reform Act**") was passed into law. It created a voluntary registration process for rating agencies willing to have their ratings used in federal securities laws by being designated as a nationally recognized statistical rating organization ("**NRSRO**"). The Reform Act also authorized the Securities and Exchange Commission ("**SEC**") to oversee such NRSROs. The objective of the Reform Act is "to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating agency industry"[1]. It aims to:

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

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

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

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

- Registration Requirements (17g-1): Implements the registration requirements for NRSROs.
- Recordkeeping (Rule 17g-2): Ensures that an NRSRO makes and retains records to assist the SEC in monitoring, through its examination authority, an NRSRO's compliance with the provisions of the Statute.
- Financial Reporting (Rule 17g-3): Requires NRSROs to furnish the SEC with audited financial statements and associated schedules on an annual basis to allow the SEC to monitor the NRSRO's financial resources and assess its ability to support robust credit analysis activities.
- Protection of Material Non-Public information (Rule 17g-4): Requires an NRSRO to have procedures designed to prevent potential misuses of material non-public information.

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1 Credit Rating Agency Reform Act of 2006, Preamble.

- Managing Conflicts of Interest (Rule 17g-5): Requires an NRSRO to disclose and manage those conflicts of interest that arise in the normal course of engaging in the business of issuing credit ratings.
- Prohibition of Unfair, Coercive, or Abusive Practices (Rule 17g-6): Prohibits NRSROs from engaging in certain acts or practices relating to the issuance of credit ratings that the SEC has determined to be unfair, coercive, or abusive.

IV. Role of Credit Rating Agencies in the Structured Finance Market

The use of securitization as a financing tool has grown rapidly both in the U.S. and abroad since its inception approximately 30 years ago. Today, it is an important source of funding for financial institutions and corporations. Securitization is essentially the packaging of a collection of assets into a fixed income "security" that can then be sold to investors. The underlying group of assets is also called the "pool" or "collateral." A securitization does not simply transform a loan pool into a single security: it leads to the creation of two (or more) bonds.[2] One of the bonds may be deemed nearly risk-free from default and rated Aaa, but the others are often quite risky because the payments generated by the underlying pool are first used to make required payments to the Aaa-rated bond investors before making funds available to the holders of the other securities.

Residential mortgage-backed securities are bonds whose principal and interest payments are made from the mortgage payments received on thousands of mortgage loans. In considering the role of rating agencies in this market, it is important to recognize that we are one of many players with historically well-defined roles in the market.[3] Moody's comes into the residential mortgage securitization process well after a mortgage loan has been made to a homeowner by a lender and identified to be sold and

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2 For a more detailed discussion of the securitization process and the various participants in that process, please refer to Annex 1.

3 In particular, we do not conduct any "due diligence" on these loans as that role is currently conducted by two separate parties at separate time periods during the loan origination and securitization process: first, the lender or originator of the loan conducts due diligence at the time when it is extending the mortgage loan to the borrower; and second, the investment banker arranging the structured finance vehicle conducts due diligence and ensures that the loans in a particular pool meet underwriting standards. Please see Annex 1 for more detail.

pooled into a residential mortgage-backed security by an originator and / or an investment bank. We do not participate in the origination of the loan; we do not receive or review individual loan files for due diligence; and we do not structure the security. Rather, we provide a public opinion (based on both qualitative and quantitative information) that speaks to one aspect of the securitization, specifically the credit risk associated with the securities that are issued by securitization structures.

Consequently, our role in the structured finance market is fundamentally the same as the role Moody's has played over the last hundred years in the corporate bond market. As discussed in greater detail below, the rating processes are, in fact, very similar in the two sectors. Ratings are assigned by committees when securities are first issued and then monitored over the life of those securities. Upward or downward rating adjustments result from deviations in performance from the expectations held at the time of the initial rating – expectations regarding the performance of the underlying asset pool in the case of securitizations and expectations regarding the realized business or financial plan in the case of corporations. Moody's ratings performance reports – posted on our website, www.moodys.com – indicate a high degree of consistency between structured finance and corporate ratings.[4]

a) Moody's Analytical Approach

Our analytical methodologies, which are published and freely available on our website, consider both quantitative and qualitative factors. Specifically, in rating a mortgage-backed securitization, Moody's estimates the amount of cumulative losses that the underlying pool of mortgage loans is expected to incur over the lifetime of the loans (that is, until all the loans in the pool are either paid off, including via refinancing, or default). Because each pool of loans is different, Moody's cumulative loss estimate, or "expected loss," will differ from pool to pool.

[4] These publications include a wide variety of metrics, including a measure of the accuracy of ratings as predictors of the relative risk of credit losses. See, for example, the follow Moody's *Special Comments*, "Default and Recovery Rates of Corporate Bond Issuers, 1920-2005" (January 2007), "The Performance of Moody's Corporate Bond Ratings: March 2007 Quarterly Update" (April 2007), "Default & Loss Rates of Structured Finance Securities: 1993-2006" (April 2007), and "The Performance of Structured Finance Ratings: Full-Year 2006 Report" (May 2007).

In arriving at the cumulative loss estimate, Moody's considers both quantitative and qualitative factors. We analyze between 40 and 60 specific credit characteristics for each loan in a pool,[5] which help us assess potential future performance of the loans under a large number of different projected future economic scenarios. For example, the quantitative data we analyze includes, among other characteristics:

- credit bureau scores, which provide information about borrowers' loan repayment histories;
- the amount of equity that borrowers have or do not have in their homes;
- how fully the borrowers documented their income and assets;
- whether the borrower intends to occupy or rent out the property; and
- whether the loan is for purchase of a home or for refinancing an existing mortgage loan.

We also consider the more qualitative factors of the asset pool, past performance of similar loans made by that lender and how good the servicer has been at loan collection, billing, record-keeping and dealing with delinquent loans. We then analyze the structure of the transaction and the level of loss protection allocated to each "tranche," or class of bonds issued by the structure. Finally, based on all of this information, a Moody's rating committee determines the credit rating of each tranche. However, it should be noted that the quality of our opinions is directly tied to the quality of the information we receive from the originators and the investment banks. Regardless of the quantity of data we assess, if the data we receive is faulty – e.g., as a result of misrepresentation – the quality of our rating opinions will be jeopardized.

It is important to note that, in the course of rating a transaction, we do not see individual loan files or information identifying borrowers or specific properties. Rather, we receive only the aforementioned credit characteristics provided by the originator or the investment bank. The originators of the loans and underwriters of the securities also make representations and warranties to the trust for the benefit of investors in every

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[5] We do not receive any personal information that identifies the borrower or the property.

transaction. While these representations and warranties will vary somewhat from transaction to transaction, they typically stipulate that, prior to the closing date, all requirements of federal, state or local laws regarding the origination of the loans have been satisfied, including those requirements relating to: usury, truth in lending, real estate settlement procedures, predatory and abusive lending, consumer credit protection, equal credit opportunity, and fair housing or disclosure. It should be noted that the accuracy of information disclosed by originators and underwriters in connection with each transaction is subject to federal securities laws and regulations requiring accurate disclosure. Underwriters, as well as legal advisers and accountants who participate in that disclosure, may be subject to civil and criminal penalties in the event of misrepresentations. Consequently, Moody's has historically relied on these representations and warranties and we would not rate a security unless the originator or the investment bank had made representations and warranties such as those discussed above.

Moody's monitors its ratings on all securitization tranches on a monthly basis, and, as appropriate, considers the need for a ratings change. Monitoring is performed by a separate team of surveillance analysts who are not involved in the original rating of the securities, and who report to the chief credit officer of the Asset Finance Ratings Group. We generally receive updated loan performance statistics on a monthly basis for every collateral pool for each transaction we have rated. We assess this information using quantititative models and flag potential rating "outliers" – securities whose underlying collateral performance indicates that the outstanding rating may no longer be consistent with the current estimated risk of loss on the security. Once a specific rating is flagged, a Moody's surveillance analyst will further investigate and discuss the status of the transaction with senior members of the team who together determine whether a rating change should be considered.

Moody's does not take wholesale rating actions based on market speculation. Rather, our analysts carefully and deliberately consider the data that we receive on a transaction-by-transaction basis, and we conduct the monitoring process judiciously to make sure that such relevant information is appropriately considered. If based on the analyst's review it is deemed appropriate to consider adjusting the rating, the analyst will call a rating committee and follow Moody's procedures for conducting a rating committee.[6] These procedures include: ensuring that the committee is comprised of individuals who have relevant expertise, presenting the facts and circumstances of the particular security to the committee, debating the various issues, and voting on the rating outcome on a majority basis, with the most senior member of the committee voting last.

b) Discussions With Issuers

In rating any structured security (or, for that matter, any corporate security) we may hold analytical discussions with issuers or their advisors. These discussions do not transform rating agencies into investment bankers, consultants or advisors. Instead, they serve the dual purpose of: (a) helping us better understand the particular facts of the transaction as proposed by the issuer; and (b) clarifying to the issuer the rating implications of our methodologies for that transaction.[7]

In circumstances where there is considerable performance history for the particular asset being securitized and where the structure has been used previously, our published methodologies may provide sufficient transparency on our analytical approach to obviate the need for detailed "back-and-forth" discussions.

In contrast, we have more general conversations with issuers who are securitizing new asset classes or are utilizing novel structures that are different from those we have discussed in our published methodologies (revealing the limitations of a "one-size-fits-all" approach). As part of this dialogue, an investment bank underwriting a mortgage-backed security, for example, provides the composition of a pool of mortgages and the details of a particular structure and asks for the rating implications in light of our existing, published methodologies. What the investment bank does in response to our feedback – whether they decide to seek a rating of the structure presented, modify the structure as

6 "Moody's Investors Service Ratings Policy: Core Principles for the Conduct of Rating Committees," Ratings Practice, April 2006.

7 Similar discussions frequently take place with corporations contemplating changes in financial structures and business strategies (e.g., the potential rating implication of a share buy-back program on a corporate issuer's senior unsecured debt obligations), or with new corporate issuers to whom Moody's has not previously assigned a rating.

they see fit, or not seek a Moody's rating at all – is determined entirely by the investment bank and the originator.

Moody's does not provide consulting services as part of this process and receives no incremental or additional payments for holding these discussions. We believe that these discussions help enhance overall market transparency and stability in that both issuers and investors have a better understanding of our analytical thinking and the ratings that result.

Moody's does not structure, create, design or market securitization products. We do not have the expertise to recommend one proposed structure over another, and we do not do so. Investment bankers structure specific securities and tranches to fit the needs of particular issuers and investors. We are not privy to many of the discussions that consider the features of a securitization (many of which are non-credit related), and we do not know who the ultimate investors in the transaction will be.

c) Managing Conflicts of Interest

The issuer-pays business model used by Moody's, like most alternative models (e.g., the investor-pays model), gives rise to potential conflicts of interest. Issuer fees were introduced over three decades ago, and since that time we believe we have successfully managed related conflicts of interest and provided the market with objective, independent and unbiased credit opinions. To foster and demonstrate objectivity, Moody's has adopted and publicly disclosed important fundamental principles for managing Moody's ratings process.[8] For example, among other steps:

- Rating decisions are taken by a rating committee and not by an individual rating analyst;
- Analysts participating in a committee are required to be fully independent from the companies they rate – they are prohibited from holding discussions regarding fees with and owning securities in institutions that they rate (except through holdings in diversified mutual funds);

[8] See, "Moody's Investors Service Code of Professional Conduct".

- Analysts are neither evaluated on the basis of, nor compensated for, the revenue associated with the entities they rate; compensation of analysts consists of a base salary and an annual bonus;[9]
- Rating actions reflect judicious consideration of all circumstances we view as relevant to an issuer's creditworthiness;
- Moody's will take a rating action that it deems appropriate regardless of the potential effect of the action on Moody's or an issuer;
- Moody's does not create investment products, or buy, sell, or recommend securities to users of our ratings and research;[10]
- Once a rating is assigned, a separate surveillance team, which is independent of the rating team, takes responsibility for the ongoing monitoring of that rating. The surveillance team reviews the performance of each structured finance security, makes recommendations about adjustments to the ratings and, as appropriate, convenes rating committees to adjust ratings; and
- Our rating methodologies are publicly available on our website, allowing the market to ensure that we consistently adhere to them in every rating we issue.

The integrity and objectivity of our rating processes is of utmost importance to us. Our continued reputation for objective and independent ratings is essential to our role in the marketplace.

d) Performance of Moody's Structured Finance Ratings

The predictive content of Moody's ratings has consistently been demonstrated. Our annual default studies demonstrate that both our corporate and structured finance ratings have been reliable predictors of default over many years and across many economic cycles. Over the past 15 years, investment-grade structured finance securities have had somewhat lower credit losses on average than investment-grade corporate

[9] The annual bonuses of analysts are based on Moody's overall financial performance and the qualitative performance of the individual analyst.

[10] Moody's parent company, Moody's Corporation, invests excess cash in highly-rated short-term debt securities. All investment decisions are made at the parent company level.

securities. This strong overall performance of structured securities led many market participants to increasingly perceive the sector to be "safer" than the corporate sector.

Moody's rating accuracy on mortgage-backed securities has been similar to its rating accuracy on other structured finance products, and, over long time horizons, comparable to the accuracy of Moody's corporate bond ratings. However, since sectoral shocks cannot always be predicted in advance, default rates by rating category have varied widely from year to year across regions and industries within the corporate sector, as well as within various structured finance sectors. As in most sectors, the RMBS sector has seen years in which its securities have experienced lower credit losses than other similarly rated securities and other years when they have proven more risky.

V. The Recent Weakness in the Subprime Mortgage Securitization Market

Subprime mortgages have been part of the broader residential mortgage market for many years, and as a group, have performed differently at various stages of the credit cycle. For instance, to date the majority of subprime mortgages originated between 2002 and 2005 have performed at or better than subprime loans performed in prior periods. Many subprime mortgages underlying the securitizations issued in 2006, however, are experiencing higher levels of serious delinquencies than the mortgages that backed securitizations issued between 2002 and 2005. Put differently, more borrowers are becoming seriously delinquent on 2006 subprime loans than borrowers on loans originated between 2002 and 2005. The poor performance of 2006 subprime loans initially followed a pattern that is not uncommon in a residential housing "credit cycle". However, a number of extraordinary factors have made the current turn in this cycle much more dramatic than in past slowdowns.

During periods of growth in the housing and mortgage markets, increased borrowing demand allows existing mortgage lenders to expand their business and new lenders to enter the market. Eventually, these trends create overcapacity in the mortgage lending market as borrowing demand slows or falls. As the lending market cools (e.g., when interest rates rise, home price increases abate, or the economy slows), competition among lenders for the reduced pool of borrowers heats up and lenders may lower credit standards (i.e., make riskier loans) in order to maintain origination volume. The riskier loans are more likely to become delinquent and potentially default.

Lending behavior in the subprime mortgage market over the past few years and until recently had followed this pattern. Through 2005 and 2006, in an effort to maintain or increase loan volume, some lenders introduced alternative mortgage products that made it easier for borrowers to obtain a loan. Such loans include:

- Loans made for the full (or close to the full) purchase price of the home, allowing borrowers to have no equity in the home;
- Loans with less rigorous documentation, such as those allowing borrowers to state their income without verification and asset information instead of providing documented proof;
- Loans that expose borrowers to sudden payment increases; and
- Longer-tenure loans, which have lower monthly payments that are spread out over a longer period of time (40 years and longer).

Often, the loans made had a combination of these features. In situations commonly referred to as "risk layering," for example, a borrower could get a low initial payment, without documenting other income or assets, and put no money down. Consequently, while the $640 billion of subprime mortgages originated in 2006 still comprised a relatively small portion of the nearly $3 trillion of residential mortgages originated during that same year, the subprime sector was steadily becoming a larger proportion of the overall mortgage origination by dollar volume (see ***Figure 1***).

Figure 1			
	Total Mortgage origination ($billions)	Total Subprime origination ($billions)	Percent of Subprime Orgination of Total Orignation
2002	3,038	421	14%
2003	4,370	539	12%
2004	3,046	560	18%
2005	3,201	625	20%
2006	2,886	640	22%

This trend toward riskier loan originations was exacerbated by a confluence of circumstances that has played into the unusually poor performance of subprime mortgages originated in 2006. Moody's has identified three factors that are especially relevant:

- **Aggressive underwriting standards,** including risk layering in the mortgage origination process has been a contributor to the housing bubble and subsequent deterioration in mortgage payment performance. In addition, many market participants have suggested that fraud, such as misrepresentations made by mortgage brokers, appraisers and the borrowers themselves, has also played a significant role and exacerbated the problem. Numerous sources have indicated that home values, borrowers' incomes as well as other information may have been overstated and the intended use of the home was often misstated (i.e., as a primary residence rather than an investment property);

- **Decline in home prices on a national basis** has been the most important factor in the decline in subprime mortgage loan credit performance. July 2007 marked the twelfth consecutive month of home price decline on a year-over-year basis.[11] This is the longest period of declining home prices on a national basis since 1969, and declining home prices have reduced borrowers' equity in their homes and constrained their refinancing opportunities. The borrowers most affected by the housing downturn

[11] As of the date of the submission of this testimony, the August 2007 data was not yet available.

have been those who because of the timing of their purchase did not realize benefit from the price appreciation that had occurred in prior years; and

- **A rapid reversal in mortgage lending standards**, in which mortgage lending standards moved from very loose to very restrictive. This first accommodated and then quickly stranded overstretched borrowers needing to refinance in the future.

As the residential mortgage market has shifted from an environment of aggressive lending, low interest rates, and rapid home price appreciation in 2004, 2005, and early 2006, to one of tighter lending standards, higher costs of borrowing and a weak housing market, the collateral performance of the 2006 vintage of subprime residential mortgage-backed securities (RMBS) has deteriorated. Data indicate that from the beginning of 2002 through the second quarter of 2005, loan defaults within six months of origination ranged from 0.63% to 1.32%, with an average of 0.90%. However, since that time, such early loan defaults have exhibited a sharply rising trend with each successive quarterly cohort, roughly tripling from 1.31% for the securitizations issued in the third quarter of 2005 to over 3.50% for those issued in the fourth quarter of 2006.[12]

These loan defaults will likely continue to increase in the months ahead, as loans reset to higher interest rates in 2007 and 2008. Moody's believes that loan modifications,[13] when used judiciously, can mitigate losses on mortgage loans and increase the likelihood that the securitized bonds backed by the mortgages will be paid.

In an effort to gauge the potential impact that loan modifications might have in reducing losses on defaulted loans, Moody's recently conducted a survey of the modification practices of sixteen subprime mortgage servicers (who together constitute roughly 80% of the total subprime servicing market). The survey results, which were

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12 The data provided is based on the information that Moody's presently has on the performance of these loans and is subject to change as the loans mature.

13 Loan modifications are typically aimed at providing borrowers an opportunity to make good on their loan obligations and may include interest rate reductions, loan term extensions, payment deferrals, and forgiveness of payments, penalties or principal. Because these modifications are aimed at reducing or postponing borrowers' payments, they are particularly useful in mortgage environments such as the current subprime market, where delinquencies are increasing. To determine whether a loan modification is the best course of action, servicers will generally have to review the borrower's current financial situation and re-qualify the loan.

published in September 2007,[14] suggest that, on average, subprime servicers have only recently begun to address modifications as it relates to interest rate resets. Specifically, the survey showed that most servicers had only modified approximately 1% of their serviced loans that experienced a reset in the months of January, April and July 2007. Based on this data, it appears that the number of modifications that will be performed in the future by subprime servicers on loans facing reset may be much lower than what may be needed to significantly mitigate losses in subprime pools backing rated securitizations. This may exert downward pressure on our ratings.

VI. Moody's Response to the Deteriorating Subprime Market

As mentioned earlier, the 2002 – 2005 vintages have continued to perform at or above expectations and our rating changes, shown below in ***Figure 2***, indicate that the deterioration in subprime mortgages seems relatively isolated in the 2006 vintage.

Figure 2
Downgrade / Upgrade Percentage By Vintage
(By Rated Original Balance)

	Prime		Alt-A		Subprime		Total RMBS	
Vintage	Downgrade	Upgrade	Downgrade	Upgrade	Downgrade	Upgrade	Downgrade	Upgrade
2002	-	1.9%	0.4%	1.0%	2.3%	2.0%	1.1%	1.8%
2003	-	1.2%	0.1%	1.0%	1.1%	2.7%	0.6%	1.9%
2004	-	0.9%	-	-	0.3%	0.2%	0.2%	0.3%
2005	-	0.1%	-	-	0.5%	0.3%	0.2%	0.1%
2006	-	-	-	0.1%	5.4%	-	2.5%	0.1%
2002 - 2006	-	0.8%	-	0.2%	2.1%	0.6%	1.0%	0.5%

Having said that, during the period from 2002 – 2006, Moody's observed an increase in the risk profile of subprime mortgage portfolios that we were asked to review prior to assigning ratings. Our response to these increased risks can be categorized into three broad sets of actions:

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[14] Moody's Subprime Mortgage Servicer Survey on Loan Modifications," September 21, 2007, Moody's Special Report

1) **<u>We began warning the market starting in 2003</u>**

We provided early warnings to the market, commenting frequently and pointedly over an extended period on the deterioration in origination standards and inflated housing prices. We published frequent reports on these issues starting in July 2003 and throughout 2004, 2005 and 2006.[15] In January 2007, we published a special report highlighting the rising defaults on the 2006 vintage subprime mortgages.[16]

2) **<u>We tightened our ratings criteria</u>**

In response to the increase in the riskiness of loans made during the last few years and the changing economic environment, Moody's steadily increased its loss expectations and subsequent levels of credit protection on pools of subprime loans. Our loss expectations and enhancement levels rose by about 30% over the 2003 to 2006 time period, and as a result, bonds issued in 2006 and rated by Moody's had more credit protection than bonds issued in earlier years.

Moody's observed the trend of weakening conditions in the subprime market and adjusted our rating standards to address the increased risk. Along with most other market participants, however, we did not anticipate the magnitude and speed of the deterioration in mortgage quality (particularly for certain originators) or the rapid transition to restrictive lending.

3) **<u>We took rating actions as soon as the data warranted it</u>**

As illustrated by ***Figure 3***, the earliest loan delinquency data for the 2006 mortgage loan vintage was largely in line with the performance observed during 2000 and 2001, at the time of the last U.S. real estate recession. Thus, the loan delinquency data we had in January 2007 was generally consistent with the higher loss expectations that we had already anticipated. As soon as the more significant collateral deterioration in the 2006 vintage became evident in May and June 2007, we took prompt and deliberate action on those transactions with significantly heightened risk.

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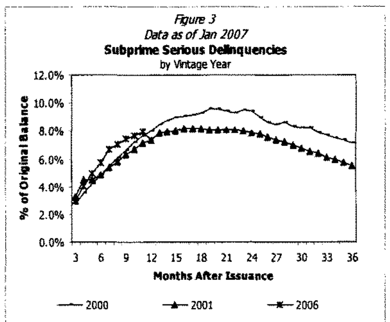
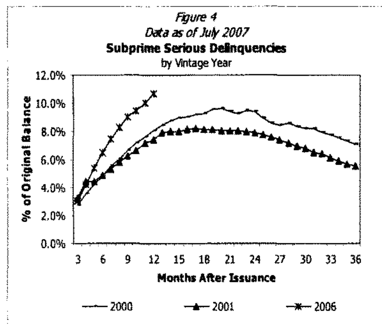
15 Please see Annex II for a grid which identifies our various publications on the issue.

16 Early Defaults Rise in Mortgage Securitization, Moody's Special Report, January 18, 2007.

Figure 4 shows the significantly higher loan delinquencies in the 2006 vintage, as of July 2007. For example, at 10 months of seasoning, 8.6% of the underlying loans in the 2006 vintage were seriously delinquent, nearly twice the level of delinquencies of the 2001 vintage 10 months after closing.





Moody's first rating actions (downgrades and reviews for downgrades) on securities backed by 2006 vintage subprime loans took place in November 2006. Further rating actions occurred in December and our first comprehensive set of rating actions (on second lien mortgage transactions) took place in April 2007, with a second set of actions (on first lien mortgage transactions) in July 2007. To date, we have downgraded about $25 billion, or roughly 5 percent of the $460 billion of subprime mortgage-backed securities we rated in 2006 (see ***Figure 5***). (To put the 2006 vintage rating actions in broader perspective, please see Figure 2 which shows that, to date, Moody's downgrades for the combined 2002 – 2006 time period amounts to 2.1% by dollar volume in the subprime RMBS sector, and 1% by dollar volume for all of RMBS.)

Figure 5

	By Number of Tranches			By Dollar Volume ($mil)		
	Total Number of Tranches Rated	Number On Review/ Downgraded	% Impacted	Rated Dollar Volume	Dollar Volume Impacted	% Impacted
First Lien Transactions						
Aaa	2,118	0	0.0%	$345,578	$0	0.0%
Aa	1,262	0	0.0%	$40,843	$0	0.0%
A	1,291	10	0.8%	$21,190	$185	0.9%
Baa	1,299	244	18.8%	$14,897	$3,161	21.2%
Ba	447	181	40.5%	$4,450	$1,910	42.9%
Total	6,417	435	6.8%	$426,959	$5,257	1.2%
Second Lien Transactions						
Aaa	184	86	46.7%	$25,561	$12,716	49.7%
Aa	180	157	87.2%	$3,479	$3,087	88.7%
A	184	175	95.1%	$1,851	$1,785	96.4%
Baa	211	207	98.1%	$1,462	$1,450	99.2%
Ba	99	99	100.0%	$670	$670	100.0%
Total	858	724	84.4%	$33,023	$19,708	59.7%
First and Second Lien Transactions						
Aaa	2,302	86	3.7%	371,139	12,716	3.4%
Aa	1,442	157	10.9%	44,322	3,087	7.0%
A	1,475	185	12.5%	23,040	1,970	8.6%
Baa	1,510	451	29.9%	16,360	4,611	28.2%
Ba	546	280	51.3%	5,120	2,581	50.4%
Total	7,275	1,159	15.9%	$459,982	$24,965	5.4%

We did not take these rating actions sooner because, until we had actual performance information to distinguish between individual mortgage pools, the only rating actions that we could realistically have taken would have been on the entire $460 billion of Moody's-rated 2006 subprime RMBS securities. Such sweeping action would have failed to distinguish among

- first and second lien mortgages;[17] and

[17] These are loans secured by a second priority mortgage lien on residential real estate. When closed simultaneously with the first-lien mortgage loan, they are known as "piggyback" loans. The holder of a second lien mortgage is only entitled to recoveries on the underlying property after the first lien holder has been paid in full.

- collateral from mortgage originators who made better-quality loans in 2006 (such as Wells Fargo Bank and Option One) and those who made lower quality loans (such as New Century Financial Corporation).

Instead, we began publishing narrative commentary expressing our concerns about expected loan deterioration while we collected performance data on specific pools to validate our assessment of overall market conditions and differentiate performance among various individual mortgage pools.

By basing our actions on performance information rather than negative market sentiment, our rating actions have currently been limited to a fraction of Moody's-rated subprime RMBS securities. The timing of our actions allowed us to identify specific problematic mortgage securities and originators and, at least as importantly, enabled us to avoid potential rating reversals on billions of dollars of securities that are currently performing within expectation.

We opted for the approach described above to avoid applying general concerns about risks in the mortgage market to specific securities where asset quality continued to provide protection consistent with original rating levels. We will continue employing our careful and deliberate approach by closely monitoring market developments and taking rating actions when sufficient information becomes available.

VII. Actions to Enhance Ratings Quality and Usefulness

A variety of factors contributed to the deterioration of the subprime mortgage market over the past several months. Today, it is clear that a constant erosion of underwriting standards between 2003 and 2006 – including misrepresentations by mortgage brokers, appraisers and borrowers – was a major contributor to the housing bubble and subsequent correction. Many lenders and brokers who were charged with upholding lending standards stopped playing that role effectively – until early this year when many lenders went out of business and those that remained quickly tightened lending standards, further exacerbating defaults from borrowers unable to refinance.

As the higher than expected levels of delinquencies on the 2006 subprime loans started becoming apparent, the resulting volatility in the capital markets was further exacerbated by the short positions taken by some hedge funds on securities and indices and the lack of transparency regarding who holds many of these structured finance products.

We believe that addressing the problems in the subprime market will require action on the part of many market participants, and we are eager to work with the Congress, regulators and other market participants to this end. In this same spirit, we have undertaken substantial internal initiatives at Moody's that have begun, and will continue, to enhance the quality of our analysis and the credibility of our credit ratings. These internal initiatives include:

- **Enhancements to our analytical methodologies.** We have made a number of refinements to our methodology for rating subprime securities – as we do periodically with all our methodologies – to further improve our ratings process and to respond to the unprecedented market changes that have occurred in the overall performance of subprime securitizations. These changes have included, among others:

  - Increasing our delinquency and loss expectations as well as the resulting credit enhancements we look for to support our various rating levels, for both currently outstanding and future subprime transactions;

  - Expanding the mortgage loan data we request from the issuer to include depth and breadth of borrower's credit history, presence of escrow for taxes and insurance and presence and level of cash reserves;

  We will continue to refine our methodologies to respond to changing market dynamics. As in the past, we will continue to publicly post draft versions of important revisions to methodologies and models and actively encourage constructive comments from market participants before we implement the changes.

- **Continued investments in analytical capabilities.** We plan to continue investments in and analysis of historical performance data as well as future scenario analysis to improve the predictive power of our models for RMBS securities. We will also explore ways to more quickly decide when ratings actions are warranted in the case of unexpected deterioration in collateral performance underlying individual securitizations.

- **Changes to the credit policy function.** We have already taken steps to enhance the credibility of our ratings by further separating the Credit Policy function from management of Moody's ratings business, establishing a direct communication responsibility for the Chairman of Credit Policy to the Board of Directors of Moody's Corporation. Reinforcing the oversight role, credit officers from within the rating departments will have a reporting line to the Chairman of Credit Policy to ensure proper sharing of information and standards across sectors. Finally, we recently reorganized our operating businesses to formalize the existing separation between the ratings business and other products and services offered by Moody's Corporation.

- **Additional market education.** While capital market participants are often highly sensitive to Moody's ratings and rating actions, some may have misunderstood the meaning of, or misused either intentionally or unintentionally, our ratings. This is despite Moody's frequent publications and extensive distribution of information on these topics.[18] Additional market education about what our ratings

[18] For examples, see our publications: "Understanding Moody's Corporate Bond Ratings and Rating Process," May 2002; "Comments from Moody's Investors Service on the European Commission Services' New Capital Adequacy Directive: Recognition and Supervision of ECAIs," January 2003; "Measuring the Performance of Corporate Bond Ratings" April 2003; "Moody's Investors Service Response to the Director General Internal Market Services' Working Document on the Implementation of the European Parliament and Council Directive 2003/6/EC on Insider Dealing and Market Manipulation," April 2003; "Moody's Investors Service Comments on the Securities and Exchange's Concept Release on Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws," July 2003; "Are Corporate Bond Ratings Procyclical?" October 2003; "Statement of Raymond McDaniel at the 29th Annual Meeting of the International Organization of Securities Commissions" October 2003; "Statement of John Rutherfurd at the 30th Annual Meeting of the International Organization of Securities Commissions" April 2005; "Moody's Investors Service Comments on the Securities and Exchange Commission's Rule Proposal on the Definition of Nationally Recognized Statistical Rating Organization," June 9, 2005; "Moody's Investors Service Code of Professional Conduct," June 2005; "Response of Moody's Investors Service to The Committee of European

do and do not measure will assist those who misunderstand the meaning of a credit rating and ensure more appropriate use of our credit ratings.

- **Development of new tools beyond credit ratings.** Moody's designs and manages its ratings to speak to expected credit losses. We are currently attempting to develop additional financial tools that measure fundamental values and potential volatility in securities prices. Such tools, regardless of who develops them, could fill currently unmet market needs and relieve stress on the existing rating system by potentially curtailing misuse of ratings for other purposes. However, since they do not exist today, we do not know if we will be successful in developing them or if the market will be interested in – and benefit from – using them.

In addition to these changes to our practices at Moody's, we believe reforms involving the broader market and its participants would enhance the usefulness and effectiveness of the credit rating opinions we provide. We believe measures that address potential fraud and increase transparency would be particularly beneficial. While there is no sure way for an outside observer of the lending process to detect fraud or to enforce transparency, there are steps we believe would help:

- **Licensing or other oversight of mortgage brokers**, who unlike most other financial professionals responsible for selling investment products, are not required to register with any federal regulatory authority. Procedures that might be considered include background checks, finger printing, minimum standards of competency, and a mechanism to address customer complaints.
- **Greater disclosure** of additional information by borrowers and lenders.
- **Tightening due diligence standards for underwriters** and requiring a higher level of verification performed by an independent third party such as an accountant or trustee.

Banking Supervisors' Consultation Paper on the Recognition of External Credit Assessment Institutions," September 2005.

- **Stronger representations and warranties** from originators and issuers on the loans included in a securitization pool. A third party, such as the trustee, the master servicer or a credit risk manager, should have the responsibility and the appropriate incentives to monitor and to enforce those representations and warranties.
- **Increased disclosure from issuers and servicers on the individual loans in a pool.** Standardized reporting of loan level information, both prior to closing and throughout the life of the transaction, should be provided to all transaction participants requesting it.
- **Increasing transparency.** Many funds that currently invest in structured products are not required to disclose these investments, thereby obscuring where different interrelated assets are held. Such opacity can create confusion and fear in the markets, which in turn can lead to a crisis of confidence. (Investors will abstain from taking risks that they are not confident they can dimension.) We are eager to work with the Congress, regulators and other interested market participants to enhance transparency in the area of "who holds what."

VIII. <u>Conclusion</u>

Moody's is deeply committed to providing the most independent, objective and accurate credit assessments available in the global markets. We appreciate the anxiety and frustration that has resulted from the unprecedented market conditions that have occurred in the subprime mortgage market this year. Moody's has worked hard to respond quickly, accurately and sensibly to rapidly changing market conditions, and we continue to refine our practices to improve our performance in the future, based on what we have observed from this confluence of events. We welcome the opportunity to work with the Congress and the SEC on measures that could further bolster the quality and usefulness of our ratings and restore confidence in the global financial markets. We are also eager to work with other market participants on broader market-based reforms and solutions that would enhance the transparency and effectiveness of the global credit markets.

I hope that this testimony has been useful, and I would be pleased to address your questions.

Annex I: **The Process of Securitizing Subprime Mortgages**

To understand the process of securitizing subprime mortgages, it is important to understand the roles played by the various market participants:

- Mortgage originators, or lenders – entities that make the loans, such as banks or mortgage finance companies. Typically lenders make a loan decision based on four key factors: a borrower's current income in relation to the size of the mortgage loan; a borrower's credit history (including their FICO score); the appraised value of the house that secures the mortgage; and the size of the down payment for the loan. Originators are one of the two parties who historically have been responsible for conducting due diligence on the loans pooled together for securitization.
- Subprime borrowers – borrowers who have weaker credit histories (e.g., average FICO scores of 610), incur loan-to-value ratios of 80-100%, and have income to loan payment ratios of 45-50%.
- Investment bankers – generally investment banks or other banks that structure the securitizations and sell the bonds that are issued to investors. Investment banks are the second party who historically have been responsible for conducting due diligence on the loans pooled together for securitization.
- Trustees – entities that are responsible for administering the securitizations.
- Servicers – entities that collect all payments on the subprime mortgage loans from the borrowers.
- Investors – entities that purchase the bonds that are backed by the assets and their related cash flows. In the securitization market, these entities are typically sophisticated institutional investors who generally make their investment decisions based on their own analysis, with ratings being one of many factors they consider.

Steps to Structure Mortgage-Backed Securities

The securitization process generally begins approximately three or more months after a borrower has closed on his mortgage transaction. It is at this point in time that the lending institution decides to securitize. It is important to note that some lenders may choose to retain the loans they have made on their balance sheet or sell them into the whole loan market, and as such a certain percent of mortgages are never securitized. Once the lender decides to securitize, however, there are numerous steps involved in securitizing a mortgage-backed security from lender origination to investor purchase.

First, a large number of subprime residential mortgage loans (typically thousands) are identified for securitization by the mortgage originator. This originator relies on an arranger like a bank or investment bank to assess the risk of the loan portfolio, conduct due diligence by sampling loan files, with or without the help of a due diligence firm, and "kick out" any loans which do not conform to the underwriting standards. The originator creates a trust, limited liability company or corporation,[19] which is the securitization issuer. The originator then sells all of its legal right to receive monthly payments on the subprime mortgages to the trust, receiving cash in return which is then used to originate new loans, thereby keeping the market liquid. The trust thereby becomes the "owner" or "holder" of the loans. Finally, the trust issues and sells bonds to investors – in separate tranches that have varying degrees of risk and payouts. The bonds obligate the trust to make monthly payments to the bond investors, which it does using the monthly loan payments it receives from borrowers on their mortgages.

Loss Protection for Mortgage-Backed Securities

Securitizations of all kinds, including those of subprime mortgage loans, use various features to protect bondholders from losses. The more loss protection (also referred to as "credit enhancement") a bond has in relation to its "expected loss", the higher the likelihood that the investors holding that bond will receive the interest and principal promised to them. Some common types of loss protection are:

[19] For ease of reference, we will refer to these types of new entities as the "trust".

- A guarantee from a creditworthy entity, like an insurance company, or a bank that covers all or a certain portion of the losses above a certain level;
- "Overcollateralization", which is the amount by which the aggregate amount of mortgage loans exceeds the aggregate amount of bonds issued;
- "Subordination", which means that instead of all bonds in the securitization sharing losses equally, losses are borne by bonds sequentially in reverse order of seniority; and
- "Excess spread", which refers to the application of any excess amount of interest collected on the loans over the amount of interest payable on (and fees and expenses payable with respect to) the bonds to cover loan losses.

Example of How Loss Protection Works

Figure 6 represents a simple subprime securitization transaction, where four classes, or "tranches," of bonds totaling $90 are issued and are backed by loans totaling $100. In this structure, losses would first be applied to reduce the "$10 net worth," or overcollateralization. Only when the losses exceed the overcollaterization amount would the bond balances be affected. Losses would be applied to the bond tranches in reverse order of seniority, such that losses are not allocated to a given tranche until the balances of all tranches that have a lower priority have been reduced, or written down, to zero.

Figure 6

Simplified Balance Sheet for a Typical Subpri

Assets (Loans)	Liabilities (Bonds) + Net Worth
	$65 Senior Bond
	$10 Mezzanine Bond #1
	$10 Mezzanine Bond #2
	$5 Subordinated Bond
$100 Mortgages	$10 Net Worth ("Overcollateralization")

For example, if the losses on the pool of mortgages were $20, as shown in ***Figure 7***, then the outstanding balance of the mortgage loan pool would fall to $80. At this point, the overcollaterization amount would be reduced, or "written down" from $10 to zero, and the remaining $10 of losses would result in losses for both the $5 subordinated bond and the $10 mezzanine bond #2. The principal amount of the $5 subordinated bond would be written down to zero, and then the $10 balance of mezzanine bond #2 would be reduced by the remaining $5 of losses to a balance of $5. Losses are not allocated to a given tranche until the balances of all tranches that have a lower seniority have been written down to zero.

Figure 7

Securitization After Incurring $20 of Losses

Assets (Loans)	Liabilities (Bonds) + Net Worth
	$65 Senior Bond
	$10 Mezzanine Bond #1
	$5 Mezzanine Bond #2
	$0 Subordinated Bond
$80 Mortgages	$0 Net Worth ("Overcollateralization")

Consequently, the likelihood that an investor in a particular tranche will receive both the principal and interest due on the bond depends not only on the quality of the loans in the securitization, but also on the amount of loss protection provided. The higher the seniority of a bond issued in a securitization, the greater protection it will have against losses, making it more likely to be repaid in full – meaning it is "less risky." Conversely, the lower the seniority of a bond, the less protection it will have against losses, making it less likely to be repaid in full.

When Moody's issues credit ratings for subprime bonds like those in this example, the tranches generally receive progressively lower ratings as the seniority of the tranches gets lower. Each progressively more subordinate bond has less loss protection because each has fewer bonds that can provide a cushion to absorb losses in case of defaults on some of the loans in the pool. Furthermore, because losses on subprime loans are generally expected to be much higher than losses on "prime" loans, a greater amount of loss protection is needed in a subprime securitization for a given tranche to receive the same rating as a similar tranche of a prime securitization.

Annex II:

Early Warnings: Sample of Moody's Publications Discussing the Deterioration of the Subprime Mortgage Sector

Title	Publication Date	Trends, Moody's View and/or Actions
		2003
Second Lien Mortgages - Issuance Volume Set for Another Record-Breaking Year in 2003	July 3, 2003	- *"The credit performance of second lien mortgage-backed securities has been strong over the past five years; however, as price appreciation slows down and interest rates rise Moody's believes that there could be more volatility in the credit performance of this product and will maintain credit enhancement levels accordingly."* (Page 1)
		2004
2003 Review and 2004 Outlook: Home Equity ABS	January 20, 2004	- *"Moody's expects relatively high defaults and losses for these mortgage types and has set credit enhancement levels to offset the risks."* (Page 5) - *"Potentially indicating deteriorating credit quality, the percentage of full documentation loans in subprime transactions continues to decline as borrowers choose more expensive low and no doc alternatives to minimize the time and scrutiny taken by lenders to underwrite new loans."* (Page 6) - *"Not only are borrowers susceptible to payment shock in a rising interest rate environment, but at the end of the IO period borrowers will again suffer payment shock with the introduction of principal in their monthly payment. Because of the shorter amortization period, that principal amount will also be significantly higher."* (Page 6)
Moody's Approach to Rating Initial Period, Interest-Only Mortgages in Prime RMBS	May 5, 2004	- *"But a first look at the effects of an IO feature on loan pools reveals expected loss severity, and therefore cumulative loss levels, that are 10% to 20% higher than those for an equivalent non-IO loan."* (Page 1)
		2005
2004 Review & 2005 Outlook: Home Equity ABS	January 18, 2005	- *"Because these loans are generally underwritten based on lower initial monthly payments, many subprime borrowers may not be able to withstand the payment shock once their loans reset into their fully indexed/amortizing schedule. The resulting higher default probability, which may be exacerbated with slowing home price appreciation, could have a very negative effect on home equity performance in the future."* (Page 3) - *"The increase in reduced documentation in the subprime sector is particularly worrisome because for*

		borrowers with weaker credit profiles the need for establishing repayment capability with stronger asset and income documentation becomes even more important." (page 6) - *"Moody's increases credit enhancement on such loans to account for the lower borrower equity and the higher borrower leverage"* (page 6)
The Importance of Representations and Warranties in RMBS Transactions	Jan 14, 2005	- *"Moody's believes that representations and warranties against the inclusion of certain loans in securitized transactions provide a small but important protection against losses."* (Page 1) - *"For those securitizers that don't meet standards, Moody's would seek additional credit enhancement, or financial backing from another company, or acceptable third-party verification of compliance with the standard R&Ws."* (Page 2)
An Update to Moody's Analysis of Payment Shock Risk in Sub-Prime Hybrid ARM Products	May 16, 2005	- *"Moody's adjusts the loss coverage levels up or down by up to 15% for mortgage loans that utilize product features resulting in higher or lower levels of payment increase relative to the benchmark loan."* (Page 1)
Moody's Increases Overcollateralization Floor In Subprime Mortgage Transactions	Jul 12, 2005	- *"To increase the level of protection for investors in Moody's-rated residential mortgage-backed securities (RMBS), Moody's Investors Service has revised its overcollateralization floor for subprime mortgage transactions that include a mix of asset types, such as manufactured housing loans."* (Page 1)
		2006
2005 Review & 2006 Outlook: Home Equity ABS	January 24, 2006	- *"Full documentation levels fell by almost 10 percent on average per transaction from the beginning of 2004 to the end of 2005. Therefore, in 2005 not only did we see a proliferation of riskier "affordability" products, but also a gradual weakening of underwriting standards."* (Page 5) - *"Moody's loss expectations on the interest-only mortgages are about 15%-25% higher than that of fully amortizing mortgages."* (Page 6) - *"In Moody's view, credit risk for this product is approximately 5% higher than the standard 30 year fully amortizing product, all other credit parameters being equal."* (Page 6) - *"Moody's considers hybrid ARM loans to be riskier than equivalent fixed- rate loans primarily because of the risk of payment shock associated with adjustable-rate products."* (Page 6)
The Blurring Lines between Traditional Alternative-A and Traditional Subprime US Residential Mortgage	Oct 31, 2006	- *"In today's economic environment which includes declining US residential mortgage loan origination volume, originators are exploring various ways to stay competitive. We are seeing originators who historically specialized in either prime or subprime moving into*

Markets		*each other's markets to maintain or increase their origination volume."* (Page 1)
Moody's Approach to Coding Subprime Residential Mortgage Documentation Programs: Updated Methodology	Nov 28, 2006	- *"The subprime residential mortgage-backed securities (RMBS) market is experiencing a decrease in the percentage of loans with full income documentation ("full income doc")."* (Page 1) - *"Less than full documentation, or in other words, reduced documentation ("reduced doc") programs can add to the credit risk of a loan as the borrower's financial capabilities are not fully revealed and may result in a loan that may be beyond the borrower's means."* (Page 1)

TESTIMONY OF VICKIE A. TILLMAN,
EXECUTIVE VICE PRESIDENT,
STANDARD & POOR'S CREDIT MARKET SERVICES,
BEFORE THE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

SEPTEMBER 26, 2007

Mr. Chairman, Members of the Committee, good morning. I am Vickie A. Tillman, Executive Vice President of Standard & Poor's ("S&P") Credit Market Services, and head of Ratings Services, our nationally recognized statistical rating organization ("NRSRO"). I appreciate the opportunity to appear before you today. I especially appreciate your invitation because I believe it is important to clarify the role of rating agencies such as S&P in the financial markets, the rigor S&P applies in fulfilling that role, and our overall record of delivering unbiased opinions on creditworthiness. To that end, I also welcome the opportunity to address some questions that have been raised about how we have served the market in the midst of unprecedented conditions in the subprime mortgage market and the credit crunch and pressure on the economy that have followed.

I want to assure you at the start of my testimony that we have learned hard lessons from the recent difficulties in the subprime mortgage area. While we fully agree with Secretary Paulson's observation last week that "the subprime mortgage market improved access to credit and homeownership for millions of Americans," it appears that abuses may have occurred in the origination process. We support Congress' efforts to investigate those abuses and to prevent their recurrence. For our part, we are taking steps to ensure that our ratings — and the assumptions that underlie them — are analytically sound in light of shifting circumstances. As I am sure you know, and as my testimony will set forth in some detail, S&P began downgrading some of its ratings in this area towards the end of last year and had warned of deterioration in the subprime sector long before that. Nonetheless, we are fully aware that, for all our reliance on our analysis of historically rooted data that sometimes went as far back as the Great Depression, some of that data has proved no longer to be as useful or reliable as it has historically been. Additionally, the collapse of the housing market itself has been both more severe and more precipitous than we had anticipated. As I will describe in more detail later, we have taken a number of steps in response to enhance our analytics and process and continue to look for ways in which to do still more.

Our reputation and our track record are the core of our business, and when they come into question, we listen and learn. We take our work seriously, very seriously, and at no time in our history more than now, as I speak to you.

In my testimony I would like to address four broad topics:

- First, the nature of S&P's ratings and their role in the capital markets;
- Second, S&P's approach to rating residential mortgage-backed securities ("RMBS"), including mortgage securities backed by subprime mortgage loans;
- Third, a number of the questions that have been raised in the press and elsewhere related to ratings, including:
    - Questions as to whether payment of fees by issuers presents a conflict of interest that could compromise analytical independence;
    - Questions as to whether S&P is somehow involved in "structuring" RMBS and other structured finance transactions;
    - Questions about the appropriateness of our ratings because securities backed by subprime collateral sometimes receive 'AAA' ratings; and
    - Questions about whether S&P has acted too slowly in responding to the deterioration of the subprime mortgage market.

- Fourth, steps we have taken in light of the Credit Rating Agency Reform Act passed by this body in 2006.

Ratings and Their Role In The Capital Markets

I would like to begin today by discussing the nature of our credit ratings, as it appears from numerous press reports that this matter is sometimes misunderstood. At their core, S&P's credit ratings represent our opinion of the likelihood that a particular obligor or financial obligation will timely repay owed principal and interest. Put another way, we assess the likelihood, and in some situations the consequences, of default — nothing more or less.

When we issue a rating on a particular security we are expressing our view that the security shares similar credit characteristics to those securities that have, in the past, represented a particular range of credit risk. A bond that we rate as 'BBB' has received the lowest of our so-called "investment grade" ratings; one rated 'BB' has received the highest non-investment grade rating. "Investment grade" securities are those securities that certain regulated investors may legally purchase. On S&P's ratings scale, such securities are those rated at the 'BBB' level or higher. Since we began rating RMBS in the late 1970's, only 1.09% of those securities rated by us 'BBB' have ever defaulted. For 'BBs' this number is 2.11%. Thus, when we rate securities, we are *not* saying that they are "guaranteed" to repay but the opposite: that some of them *will* likely default. Even our highest rating — 'AAA' — is not a guarantee or promise of performance. 'AAAs' do default and have defaulted, although rarely.

Another misconception about ratings relates to their purpose and use. Ratings speak to one topic and one topic only — credit risk. As we have repeatedly made clear in public statements, including statements to the SEC, testimony before Congress, and innumerable press releases, ratings do *not* speak to the likely market performance of a security. Thus, ratings clearly do not address:

- Whether investors should "buy", "sell" or "hold" rated securities;
- Whether any particular rated securities are suitable investments for a particular investor or group of investors;
- Whether the expected return of a particular investment is adequate compensation for the risk;
- Whether a rated security is in line with the investor's risk appetite;
- Whether the price of the security is appropriate or even commensurate with its credit risk; or
- Whether factors other than credit risk should influence that market price, and to what extent.

I want to be clear. Ratings matter; as the individual who oversees S&P's ratings business I would be the last person to suggest to you that they do not. But in the current climate, it is especially important to bear in mind just what it is we do and that other developments also affect market perceptions and behavior. The current credit crunch is very real, but we certainly have not witnessed widespread defaults of mortgage-backed securities. This dynamic and its relationship to the nature of ratings was recently recognized by one of Europe's top regulators, Mr. Eddy Wymeersch, Chairman of the Committee of European Securities Regulators and also Chairman of Belgium's Banking and Financial Commission. According to Mr. Wymeersch:

> "[t]he press and general opinion is saying it's the fault of the credit rating agencies . . . Sorry, the ratings are just about the probability of default. Nothing more. Now we have a liquidity crisis and not a solvency crisis."

Though they may move more slowly than market prices, ratings are not designed to be static. Our view of an RMBS transaction evolves as facts and circumstances develop, often in ways that are difficult to foresee. We issue ratings and, as new information becomes available with the passage of time, we either affirm those ratings — *i.e.*, leave them unchanged — upgrade them, downgrade them, or put them on CreditWatch, which is a warning to the market that the rating is subject to change after a pending review. To make such decisions, we perform surveillance on our ratings. I will discuss our surveillance process in greater detail a little later on, but the three important points here are:

- That we have a team and process in place whose responsibility it is to monitor developments and bring about ratings changes to reflect those developments as appropriate;
- Changes in RMBS ratings are not based on speculation or market sentiment; and
- Such changes are often based upon events which were not predictable.

To cite only a few recent examples on this last point, the level of early payment default trends in recent subprime loans is unprecedented; so is the fact that, while individuals who purchased homes have generally paid their mortgages before paying off their credit cards, that now appears no longer to be true to the extent it once was; so is the reality that, while individuals who live in homes they purchase historically repay the mortgages on these homes more regularly than those who live elsewhere, that long-standing pattern now appears of questionable validity in a striking number of cases. These are ahistorical behavioral modes, ones of particular import at a time of a substantial fall in real estate prices, and ones that, together with other factors, required downgrading some RMBS ratings even though no substantial amount of pool losses have occurred.

I said earlier that we have made repeated statements about the nature and role of ratings. To the extent those efforts have failed to communicate sufficiently clearly about that topic, we view this hearing, and this process overall, as an opportunity to begin to rectify that. We recognize that we bear primary responsibility for getting the message out. We are making, and will continue to make, every effort to do so.

S&P's Rating of Securities Backed By Mortgage Loans, Including Subprime Loans

Our ratings of residential mortgage-backed securities, particularly RMBS backed by pools containing subprime mortgage assets, have recently received a significant amount of attention. S&P has been rating RMBS for thirty years and has developed industry-leading processes and models for evaluating the creditworthiness of these transactions. As a result, S&P has an excellent track record of assessing RMBS credit quality. For example, S&P's cumulative U.S. RMBS default rate by original rating class (through September 15, 2007) is as follows:

Initial Rating	% of Default
AAA	0.04
AA	0.24
A	0.33
BBB	1.09
BB	2.11
B	3.34

Default statistics are the critical measure of ratings analytics because, as I explained earlier, at their core ratings speak to the likelihood of timely repayment, not other market factors, such as supply and demand, that may go into the pricing of securities. Moreover, these default numbers for our RMBS ratings are lower, in some cases materially lower, than the long-term default rates for similar ratings issued on corporate bonds.

While evaluating the credit characteristics of the underlying mortgage pool is part of our RMBS ratings process, S&P does not rate the underlying mortgage loans made to homeowners or evaluate whether making those loans was a good idea in the first place. Originators make loans and verify information provided by borrowers. They also appraise homes and make underwriting decisions. In turn, issuers and arrangers of mortgage-backed securities bundle those loans and perform due diligence. They similarly set transaction structures, identify potential buyers for the securities, and underwrite those securities. For the system to function properly, S&P relies, as it must, on these participants to fulfill their roles and obligations to verify and validate information before they pass it on to others, including S&P. Our role in the process is reaching an opinion as to how much cash we believe the underlying loans are likely to generate towards paying off the securities eventually issued by the pool. That is the relevant issue for assessing the creditworthiness of those securities.

As a practical matter, S&P's analysis of an RMBS transaction breaks down into the following categories:

The LEVELS® Model The first step in our analysis is evaluating the overall creditworthiness of a pool of mortgage loans by conducting loan level analysis using our Loan Evaluation and Estimate of Loss System (LEVELS®) Model. This model is built on, and reflects, our analytical assumptions and criteria. S&P's criteria do not dictate the terms of the mortgage loans; those terms are set by the originator in the underwriting process. S&P collects up to seventy different types of inputs, including, but not limited to: the amount of equity a borrower has in the home; the loan type; the extent of income verification; whether the borrower occupies the home; and the purpose of the loan. This analysis allows us to quantify multiple risk factors, or the layered risk, and allows us to assess the increased default probability that is associated with each factor. Based on the individual loan characteristics, the LEVELS® model calculates probabilities of default and loss realized upon default. The assumptions and analysis embedded in the LEVELS® model are under regular review and are updated as appropriate to reflect our current thinking about rating residential mortgages.

As part of our commitment to transparency, S&P makes its LEVELS® model available to investors who wish to license it. The vast majority of those involved in issuing RMBS have access to LEVELS® and use it regularly. We also publicly announce any changes to our LEVELS® model in a timely manner. In other words, our basic criteria is out there every day, subject to criticism and comment.

The SPIRE® Model Another important aspect of our rating process is assessing the availability of cash flow, which comes from the monthly payments generated by the mortgage loans, to timely pay principal and interest. To do this, we use our Standard & Poor's Interest Rate Evaluator (SPIRE®) Model. The model uses the S&P mortgage default and loss assumptions (generated by the LEVELS® model) as well as interest rate assumptions. Like the LEVELS® model, our SPIRE® model reflects our analysis and assumptions and is regularly reviewed and updated as warranted.

Also like our LEVELS® model, our SPIRE® model is publicly available, used extensively by market participants, and subject to market comment and review every day.

Review of Originator and Servicer Operational Procedures S&P also reviews the practices, polices, and procedures of the originators and servicers primarily to gain comfort with the ongoing orderly performance of the transaction. For an originator, the topics we review include, but are not limited to: loan production practices; loan underwriting; and quality control practices and findings. S&P may adjust its credit support calculation based on the underwriting employed at origination.

Review of Legal Documents S&P also reviews, with the assistance of internal and external counsel, the legal documents of the securities to be issued, and, where appropriate, opinions of third-party counsel that address transfer of the assets and insolvency of the transferor, as well as security interest and other legal or structural issues. S&P reviews the underlying documentation in order to understand the payment and servicing structure of the transaction.

Credit Enhancement Any description of our ratings of RMBS would be incomplete without discussing the critical concept of credit enhancement. Credit enhancement is the protection (*i.e.*, additional assets or funds) needed to cover losses in deteriorating economic conditions, sometimes referred to as "stress". Sufficient credit enhancement allows securities backed by a pool of subprime collateral to receive what might otherwise be considered high ratings. One form of credit enhancement, although there are several, would occur if the pool has more in collateral than it issues in securities, thereby creating a cushion in the pool. We refer to this form of credit enhancement as "overcollaterization," and it is a key component in our ratings analysis. It provides protection against defaults in the underlying securities. That is, if the pool ends up experiencing losses, it should still generate enough cash from which to pay the holders of the securities. I will discuss credit enhancement in more detail later in my testimony.

The Rating Committee After reviewing the relevant information about a transaction, including information related to credit enhancement, the lead analyst then takes the transaction to a rating committee. As with all S&P ratings, structured finance ratings are assigned by committee. Committees are comprised of S&P personnel who bring to bear particular credit experience and/or structured finance expertise relevant to the rating. The qualitative judgments of committee members at all stages of the process are an integral part of the rating process as they provide for consideration of asset and transaction specific factors, as well as changes in the market and environment. Personnel responsible for fee negotiations and other business-related activities are not permitted to vote in ratings committees and vice versa.

Notification and Dissemination Once a rating is determined by the rating committee, S&P notifies the issuer and disseminates the rating to the public for free by, among other ways, posting it on our Web site, www.standardandpoors.com. Along with the rating, we frequently publish a short narrative rationale authored by the lead analyst. The purpose of this rationale is to inform the public of the basis for S&P's analysis and enhance transparency to the marketplace.

Surveillance After a rating has been issued, S&P monitors or "surveils" the rating to review developments that could alter the original rating. The surveillance process seeks to identify those issues that should be reviewed for either an upgrade or a downgrade because of asset pool performance that may differ from original assumptions. The surveillance function also monitors the credit quality of entities that may be supporting parties to the transaction, such as liquidity providers. Analysts review performance data periodically during the course of the transaction, and as appropriate present that analysis to a rating committee for review of whether to take a rating action. The rating committee then decides whether the rating change is warranted. For changes to public ratings, a press release is normally disseminated.

S&P's Commitment to Constant Improvement

While our ratings process is the product of three decades of analytical experience and excellence, we are always looking for ways to enhance that process and our analytics. This is a hallmark S&P principle and is especially true when, as with recent subprime loans, developments indicate that historically-rooted behavioral patterns that have served as solid foundations for analysis may lack their prior value.

By now there is no doubt that subprime loans made from late 2005 through at least early 2007 are behaving very differently from loans in prior periods, even when the loans share the same basic credit characteristics. For example, for years a primary indicator of a borrower's credit has been so-called FICO credit scores. FICO scores are provided by another independent market participant and are an industry standard. In recent loans, we are seeing borrowers with high FICO scores behaving in a manner consistent with how materially lower FICO borrowers have historically behaved. Similarly, as I observed earlier, there are a number of other ahistorical anomalies that make more problematic applying a number of historically-rooted assumptions about the behavior of borrowers. At the same time, these behaviorial shifts appear *not* to be occurring in loans generated in 2004 and most of 2005, which include many of the same type of subprime characteristics present in the more recent loans. We are still gathering data to analyze the causes for these inconsistent market dynamics.

In response to these developments, and as part of our constant commitment to enhancing our analytical processes, S&P has already initiated a number of steps:

- We have significantly heightened the stress levels at which we rate and surveil transactions to account for deteriorating performance as evidenced by data we have received. We have also increased the frequency of our review of rated transactions;
- We are modifying (and will soon be releasing) our LEVELS® model to incorporate these new stress levels and other changes recently made to our ratings assumptions, as announced in our July 10, 2007 press release;
- We recently acquired IMAKE consulting and ABSXchange. These services have long provided data, analytics and modeling software to the structured finance community and we feel they will further enhance our in-depth surveillance process;
- We have also undertaken a survey of originators and their practices, particularly with respect to issues of data integrity. We are in the process of compiling the results of this survey and will publish those results when finalized; and

- We have hired a Chief Compliance Officer to augment our internal control procedures.

In addition to these steps, we continue to look at areas in which we can further enhance our analysis and processes. Some of the areas include:

- Our policies and procedures to protect against conflicts of interest;
- The quantity and quality of data available to us; and
- Modification of our analytics to reflect changing credit behaviors.

S&P's Response To Various Questions

Some have raised questions about ratings and the ratings process in recent months in light of the turmoil in the subprime mortgage market. As I have previously said, we are well aware that certain historically-rooted assumptions we made in determining which RMBS ratings to issue do not, in retrospect, appear to have remained as relevant as they previously have been. Whether that is because of factors unique to the period immediately prior to and after 2006 or whether we must change those assumptions on a long-term basis is a subject of robust and continuing examination and re-examination at S&P.

At the same time, some of the questions recently put to S&P reflect a fundamental misunderstanding of what ratings are or are based on inaccurate or, in some cases, incomplete information. Let me now address those questions.

The "Issuer Pays" Model Does Not Compromise the Independence and Objectivity of Our Ratings

A number of commentators have asked whether payment of fees by issuers and/or their representatives presents a conflict of interest that compromises the independence and objectivity of ratings. Skeptics question whether, in pursuit of fees, S&P and other major rating agencies may give higher ratings than they otherwise would. Not only is this not true at S&P, but this line of questioning ignores the significant benefits of the "issuer pays" model to the market.

S&P currently makes all of its public ratings available to the market free of charge in real time. When a rating is assigned or changed, the announcement is made on our Web sites — www.sandp.com and www.ratingsdirect.com — and a press release is provided to news outlets and other media. Today there are approximately 9 million current and historical ratings available on RatingsDirect. In addition, as many as 1.3 million active ratings are available for free on www.sandp.com. The benefits to the market are obvious: any and all interested market participants can access the same information at the same time. It creates a level playing field and a common basis for analyzing risk. It also leads to higher quality ratings as our analysis is subject to market scrutiny and reaction every day from every corner of the capital markets.

This type of free, public disclosure and transparency is only possible under the "issuer pays" model. Developing and maintaining models and hiring experienced and skilled analytical talent is costly. Without payment by issuers, those costs would have to be covered by subscription fees, an approach with several insurmountable problems. A subscription model would severely limit the transparency and broad (and free) dissemination of ratings, as access would necessarily be expensive and exclusive to subscribers. Not only would this result in less, not more, information in the market, but it would also take away an important check on ratings quality — the constant scrutiny of a broad market. Moreover, because subscription fees would necessarily be significant (given the breadth of our ratings coverage and the depth of our analysis), many investors, including the vast majority of individual investors, simply would not be able to afford access to ratings information. The likely result would be one of two equally harmful outcomes: either (i) these investors would have no meaningful access to ratings information; or (ii) a ratings black market would develop in which S&P's intellectual property — its ratings analysis — would be misused or resold in a manner all too consistent with the pervasive misuse of other intellectual property and with the same destructive impact.

As noted, some have questioned whether the "issuer pays" model has led S&P and others to issue higher, or less rigorously analyzed, ratings so as to garner more business. First and foremost, there is no evidence — none at all — to support this contention with respect to S&P. This is not surprising since it would be clearly against S&P's self-interest as well as its cornerstone principles.

Indeed, what evidence there is on the subject shows the opposite.

1. Consider, for instance, the performance of our RMBS ratings. As reflected in the chart below, in every year from 1994 through 2006, upgrades of U.S. RMBS ratings significantly outpaced downgrades by multiple factors — about 7:1 on average. The ratio was even higher from 2001-2006. That is to say, after S&P initially provided its ratings in this area, actual performance of the rated transactions led to upgrades far more often than downgrades as time passed.

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
% of Ratings Upgraded	6.81	2.54	1.38	2.54	2.20	2.78	10.08	10.21	9.24	12.82	10.74	7.91	3.79
% of Ratings Downgraded	2.21	1.70	1.18	1.25	1.28	0.54	1.93	1.05	0.98	0.85	0.45	0.64	1.04

If, as some claim, S&P deliberately issued high ratings to please those who paid for them, one would expect that the initial (allegedly inflated) ratings would require downward adjustment to reflect actual performance. Similarly, one would expect default rates on our RMBS ratings to be higher — indeed, materially higher — than the statistics I cited earlier. But, over the years, the opposite has emphatically been the case.

2. Similarly, if S&P put revenue ahead of analytical rigor, we would not refuse to rate, as we have, transactions that do not meet our criteria. A recent highly publicized example occurred in Canada where significant amounts of asset-backed commercial paper became illiquid. The paper had not met S&P's minimum criteria and so we did not rate it. These are not the actions of an agency that would rate every deal that reaches our door.

3. The primacy of our reputation has been recognized by independent sources. A report prepared by two Federal Reserve Board economists found "no evidence" that rating agencies acted in the interest of issuers due to a conflict of interest. After detailed study, the report concluded that "rating agencies appear to be relatively responsive to reputation concerns and so protect the interests of investors." *See* Daniel M. Covitz & Paul Harrison, *Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate* (Dec. 2003) at

http://www.federalreserve.gov/pubs/feds/2003/200368/200368pap.pdf.

The real question is not whether there are potential conflicts of interest in the "issuer pays" model, but whether they can be effectively managed by S&P and other credit rating agencies. Mr. Erik Sirri, director of the SEC's Division of Market Regulations, recently testified at a congressional hearing that the conflicts raised by this long-standing business model are indeed manageable. As Mr. Sirri testified:

> "Typically, [rating agencies] are paid by the underwriter or the issuer. That presents a conflict. But we believe that conflict is manageable. Credit rating agencies should have polices and procedures in place, and they should adhere to those policies and procedures when they evaluate deals."

S&P maintains rigorous policies and procedures designed to ensure the integrity of our analytical processes. For example, analysts are not compensated based upon the amount of revenue they generate. Nor are analysts involved in negotiating fees. Similarly, individuals responsible for our commercial relationships with issuers are not allowed to vote at rating committees. These policies, and others, have helped ensure our long-standing track record of excellence. As previously noted, our track record speaks for itself. Moreover, the Credit Rating Agency Reform Act of 2006, and the SEC's implementing regulations, give greater assurance that those policies will be enforced.

S&P Does Not "Structure" Transactions

Similar misunderstandings have led some to question whether rating agencies "structure" transactions, thereby threatening ratings independence. These questions are particularly troubling as they give false and negative impressions about a practice that benefits the markets — the open dialogue between issuers and ratings agencies.

It is true that our analysts talk to issuers of RMBS transactions as part of the ratings process, as they have traditionally had discussions with corporate issuers with respect to rating their non-structured securities. This dialogue provides benefits to the marketplace. Critical to our ability to rate transactions is a robust understanding of those transactions. Reading documents and reviewing the results of modeling are important, of course, but so is communication with the people responsible for the transaction itself. Through dialogue with issuers and their representatives our analysts gain greater insight into transactions to be rated, including any modifications to those transactions that may occur as the process goes forward. This dialogue promotes transparency into our ratings process, a virtue we believe in, and one that regulators have consistently espoused.

Nor does the dialogue amount to "structuring" by S&P, even in cases where the discussion is about the effect different structures may have on ratings. S&P does not tell issuers what they should or should not do. Our role is reactive. Using our models with set publicly available criteria, issuers provide us with information and we respond with our considered view of the ratings implications. In the process, and as part of our commitment to transparency, we also may discuss the reasoning behind our analysis. Those who question this practice ignore that the ratings process is not and should not be a guessing game. Without informed discussion, issuers would be proposing structure upon structure until they stumbled upon the structure that best matches with their goals. That certainly would not make the markets more transparent and efficient.

Nor should anyone view as suspicious the fact that some issuers structure transactions so as to achieve a specific rating result. Indeed, a variety of potential structures could merit a particular result. Our role is to come to a view as to the structures presented, but not to choose among them. Again, we do not compromise our criteria to meet a particular issuer's goals. As noted, we make criteria publicly available. If we were not applying our criteria to particular transactions, it would be readily apparent to the market and would immediately diminish the credibility — and thus the value — of our ratings business.

Credit Enhancement — How Securities Backed By Subprime Mortgages Can Receive, and Merit, Investment Grade Ratings

A potentially incomplete understanding of the ratings process has also led to questions about how a pool of subprime mortgage loans can support securities with investment grade, even 'AAA' ratings. The answer lies in the concept of credit enhancement.

As discussed earlier, credit enhancement — additional assets or funds — affords protection against losses in deteriorating conditions. When an issuer comes to us with a pool of subprime loans to be used as collateral for an RMBS transaction, S&P is well aware, of course, that all of this collateral is not likely to perform from a default perspective like 'AAA' securities. Nonetheless, the pool of collateral loans *will* yield *some* amount of cash, even under the most stressful of economic circumstances.

A key component of our analysis is looking at the pool of collateral to determine how much credit enhancement — extra collateral, for example — would be needed to support a particular rating on the securities to be backed by that collateral. To do this, we analyze the expected performance of the collateral in stressful economic conditions. To determine the amount of credit enhancement that could support an 'AAA' rating, we use our most stressful economic scenario, including economic conditions from the Great Depression. The stress scenarios are then adjusted for each rating category. Thus, if our analysis of a particular collateral pool's expected performance indicates that the pool would need 30% credit enhancement to support an 'AAA' rating, the issuer would have to have 30% additional collateral above and beyond the value of the securities issued in order for the securities issued by the pool to have enough credit enhancement for an 'AAA' rating. To put it in more concrete terms, if the pool was comprised of, for example, \$1.3 million in collateral, it could only issue \$1 million in 'AAA' rated securities in this scenario. This way, if the collateral performs poorly — and thirty percent in losses is very poor performance — there will still be sufficient collateral to cover losses incurred upon loan defaults. This credit enhancement figure would, of course, be lower for ratings other than 'AAA', as those ratings address the likelihood of repayment in less stressful economic environments. For example, the issuer might be able to issue \$1.2 million in 'BBB' rated securities backed by the same collateral pool. Thus, it is not the case that through securitization, poor credit assets magically become solid investments. Rather, it is because, in our example, a pool has \$1.3 million in collateral to support \$1 million in securities that it may receive an entirely appropriate 'AAA' rating on those securities.

S&P Has Been Warning the Market, and Taking Action, in Response to Deterioration in the Subprime Market Since Early 2006

Others have questioned whether S&P has acted quickly enough in response to the deteriorating subprime market. Again, we believe these questions result from an incomplete understanding of the facts. S&P has spoken out — and taken action — early and often on subprime issues.

For some time S&P has been through our publications repeatedly and consistently informing the market of its concerns about the deteriorating credit quality of RMBS transactions. For example:

- In a January 19, 2006 article entitled *U.S. RMBS Market Still Robust, But Risks Are Increasing And Growth Drivers Are Softening,* we said: "Standard & Poor's expects that some of the factors that drove growth in 2005 will begin to soften in 2006 . . . . Furthermore, Standard & Poor's believes that there are increasing risks that may contribute to deteriorating credit quality in U.S. RMBS transactions; it is probable that these risks will be triggered in 2006."

- On May 15, 2006, in an article entitled *A More Stressful Test Of A Housing Market Decline On U.S. RMBS,* we reported on the results of our follow-up analysis to our September 2005 housing-bubble simulation. We stated: "[t]he earlier simulation had concluded that most investment-grade RMBS would weather a housing downturn without suffering a credit-rating downgrade, while speculative-grade RMBS might not fare so well . . . . In the updated simulation . . . [S&P used] more stressful macroeconomic assumptions [which] lead to some downgrades in lower-rated investment-grade bonds."

- On July 10, 2006, in an article entitled *Sector Report Card: The Heat Is On For Subprime Mortgages,* we noted that downgrades of subprime RMBS ratings were outpacing upgrades due to "collateral and transaction performance." The article also identifies "mortgage delinquencies" as a "potential hot button," and notes that such delinquencies "may become a greater concern for lenders and servicers."

- On July 17, 2006, we noted a 38% increase in downgrades in U.S. RMBS, a significant number of which came from the subprime market. *Structured Finance Global Ratings Roundup Quarterly: Second-Quarter 2006 Performance Trends.*

- On Oct. 16, 2006, in our *Ratings Roundup: Third-Quarter 2006 Global Structured Finance Performance Trends,* we reported a 15% decline in upgrades for U.S. RMBS while the number of downgrades more than tripled compared to the same period in 2005. We also noted that the quarter's ratings actions among RMBS transactions had set a record for the most performance-related downgrades.

- Then on December 8, 2006, in an article entitled *Credit Trends: 2007 Global Credit Strategy: Asset Class Outlook*, we informed the market of our view that "[c]redit quality in the RMBS sub-prime market has been under scrutiny this year. Standard & Poor's RMBS surveillance group sees the environment ahead as portending greater downgrade potential along with lower upgrade potential." We also stated that "the jump in third-quarter downgrade activity for the sub-prime market raises some risk flags for this segment; with 87 third-quarter downgrades adding to the 46 downgrades of the second quarter and 34 in the first."

- On January 16, 2007, in an article entitled *Ratings Roundup: Fourth-Quarter 2006 Global Structured Finance Performance Trends*, we stated: "Rating activity among subprime transactions has started to shift to being predominantly negative from being predominantly positive. . . . We expect this trend in subprime rating performance to continue during 2007."

- Ten days later on January 26, 2007, in our *Transition Study: U.S. RMBS Upgrades Are Down And Downgrades Are Up In 2006*, we reported that for 2006 "[d]owngrades overwhelmed upgrades for subprime mortgage collateral" and that we expected "losses and, therefore, negative rating actions to continue increasing during the next few months relative to previous years."

- Our statements to the market continued throughout the first half of 2007. On March 22, 2007, in an article entitled *A Comparison Of 2000 and 2006 Subprime RMBS Vintages Sheds Light On Expected Performance*, we stated: "[w]hile subprime mortgages issued in 2000 have the distinction of being the worst-performing residential loans in recent memory, a good deal of speculation in the marketplace suggests that the 2006 vintage will soon take over this unenviable position."

- In an April 27, 2007 article entitled *Special Report: Subprime Lending: Measuring the Impact*, we stated: "The consequences of the U.S. housing market's excesses, a topic of speculation for the past couple of years, finally have begun to surface. . . . Recent-vintage loans continue to pay the price for loosened underwriting standards and risk-layering in a declining home price appreciation market, as shown by early payment defaults and rising delinquencies."

- Then on June 26, 2007, in an article entitled *Performance of U.S. RMBS Alt-A Loans Continues To Deteriorate*, we reported: "The most disconcerting trend is how quickly the performance of these delinquent borrowers has deteriorated. We continue to see migration from 60-plus-day to 90-plus-day delinquencies within the 2006 vintage, suggesting that homeowners who experience early delinquencies are finding it increasingly difficult to refinance or work out problems, as opposed to being able to 'cure' falling behind on payments."

None of these warnings were hidden by S&P and I will gladly provide the Committee with these documents. In addition to these warnings, we also took action in response to subprime deterioration. For example:

- On June 1, 2006, almost sixteen months ago, we tightened our criteria through changes in our LEVELS® model targeted to increase the credit enhancement requirements for pools with subprime loans.- In announcing these changes to the market, we specifically identified subprime loans, such as "[l]oans with simultaneous second liens (especially those with very low FICO scores)", as loans "much more likely to default than non-second-lien loans with similar FICO scores."

- Then in February 2007, we took the unprecedented step of placing on CreditWatch negative (and ultimately downgrading) transactions that had closed as recently as 2006. As we informed the market in the accompanying release: "Many of the 2006 transactions may be showing weakness because of origination issues, such as aggressive residential mortgage loan underwriting, first-time home-buyer programs, piggyback second-lien mortgages, speculative borrowing for investor properties, and the concentration of affordability loans." In a February 16, 2007 Los Angeles Times article, S&P's announcement was described as "'a watershed event' because it means S&P is now actively considering downgrading bonds within their first year." *See S&P to Speed Mortgage Warnings*, Los Angeles Times, Feb. 16, 2007.

- We continued taking downward action through the Spring. In May we announced that "Standard & Poor's Ratings Services took 103 rating actions affecting 103 classes of residential mortgage-backed securities (RMBS) transactions backed by subprime, closed-end second-lien, and Alt-A loan collateral originated in 2005 and 2006; we lowered 92 ratings . . . and placed 103 ratings on CreditWatch negative . . . . These rating actions were due to collateral performance." We also noted that "[m]ost of the transactions affected by CreditWatch placements (and no downgrades) have not experienced significant losses. The placement of our ratings on CreditWatch when a transaction has not experienced significant losses represents a new methodology derived from our normal surveillance practice."

- On June 22, 2007, we announced further ratings actions in an article entitled *133 Subordinate Second-Lien, Subprime Ratings From 2006, 2005-Vintage RMBS On Watch Neg, Cut.* We explained that "[t]he downgrades and CreditWatch placements reflect early signs of poor performance of the collateral backing these transactions."

- Then in July of this year, we again took action in response to increasingly bad performance data, including loss levels that continued to exceed historical precedents and our initial expectations. Specifically:

- We increased the severity of the surveillance assumptions we use to evaluate the ongoing creditworthiness for RMBS transactions issued during the fourth quarter of 2005 through the fourth quarter of 2006 and downgraded those classes that did not pass our heightened stress test scenario within given time frames.

- In addition, we modified our approach for ratings on senior classes in transactions in which subordinate classes have been downgraded.

- We also announced that, with respect to transactions closing after July 10, 2007, we would implement changes that would result in greater levels of credit protection for rated transactions and would increase our review of lenders' fraud-detection capabilities.

No one can see the future. The point of these articles and actions, however, is to highlight our reaction to increasing subprime deterioration — looking, as we always do, to historical or paradigm-shifting behaviors to help analyze long-term performance. Consistent with our commitment to transparency we repeatedly informed the market of our view that the credit quality of subprime loans was deteriorating and putting negative pressure on RMBS backed by those loans. And, consistent with our commitment to analytical rigor, we revised our models, took action when we believed action was appropriate, and continue to look for ways to make our analytics as strong as they can be.

Impact of The Credit Rating Agency Reform Act of 2006

Earlier this year, the Credit Rating Agency Reform Act of 2006 took effect. As a result, over the past few months, S&P has been actively engaged in the process of implementing the requirements of the Commission's new Rules regulating NRSROs under the Act.

On June 25, 2007 we filed our application to register as an NRSRO. The application includes, among other things, our procedures and methodologies for determining ratings;

credit ratings performance measurement statistics; and information related to our ratings analysts and the largest users of our credit ratings. In addition, the application includes a description of our policies for preventing the misuse of material, non-public information and addressing and managing potential conflicts of interest. We also hired a Chief Compliance Officer who is responsible for administering and overseeing these policies and procedures and ensuring compliance with applicable securities laws.

Additionally, S&P has continued its ongoing efforts to develop and streamline internal record-keeping policies and procedures in order both to ensure the integrity of the ratings process and to satisfy Commission requirements that records be available for inspection. We recently received a notice of examination from the Commission seeking the production of a substantial amount of documents that may relate to the issue of the potential conflict of interest discussed above. We are in the process of complying with this notice.

S&P supported final passage of the Credit Rating Agency Reform Act and remains committed to that Act's stated goal of improving ratings quality for the protection of investors and fostering oversight, transparency and competition in the credit rating industry. Given that we are relatively early in the process of seeing this new law fully implemented, we would respectfully urge you to allow the Commission to proceed with its task of enforcing the provisions of the new law and the regulations so recently adopted before Congress proposes any further actions.

Conclusion

I thank you for the opportunity to participate in this hearing. Over the past several decades, S&P's consistent approach has been to evolve our analytics, criteria, and review processes when appropriate, and you can expect that same approach in light of new consumer credit behaviors in all markets, including residential mortgages. Let me also assure you again of our commitment to analytical excellence and our desire to continue to work with the Committee as it explores developments effecting the subprime market. I would be happy to answer any questions you may have.

Statement of Lawrence J. White*
For the Committee on Banking, Housing, and Urban Affairs
United States Senate
September 26, 2007
Hearing on "The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets"

I. Introduction

Thank you for the opportunity to testify before this Committee on this important topic.

Today the subprime residential mortgage market -- and credit markets that are related to the subprime market -- are experiencing substantial distress and losses and are likely to continue to do so. It is now clear -- and was clear to some observers at the time -- that during the past few years there were:

-- mortgage borrowers who shouldn't have been borrowing;

-- mortgage brokers who were giving poor advice to borrowers;

-- mortgage originators who should have maintained higher underwriting standards and shouldn't have been originating as many subprime mortgages;

-- mortgage-backed securities (MBS) packagers who shouldn't have been bundling and selling these MBS and other "structured-finance" derivative securities that were based on these MBS;

-- investors who shouldn't have been buying these securities; and

-- bond rating companies who shouldn't have been as initially optimistic about these securities and who were subsequently slow to recognize these securities' problems.

There is plenty of blame to go around.

The purpose of my testimony today, however, will not be to try to provide a "play-by-play" analysis of "who did what to whom." There are others who are better placed to do that than am I.

* Professor of Economics, New York University Stern School of Business. Some of my recent published writings on the bond rating industry are listed at the end of this statement.

Instead, I want to try to provide context and background: Why the bond rating industry is playing its current role in today's capital markets; how we got to where we are today; how recently enacted legislation may change the industry; and why, at least with respect to the bond rating industry, the Congress should refrain from the temptation of trying to fix the problems by passing new legislation.

There are at least two reasons for counseling restraint: First, preventing the kinds of mistakes that the bond rating firms made is difficult to do legislatively and runs great risks of stultifying the industry. The participants in the financial markets -- if given the opportunity -- are capable of shifting their business away from entities that cannot be trusted, which provides powerful incentives for correcting mistakes. Equally important, the bond rating industry is currently functioning under the auspices of a new law, which is only one year old, and new regulations, which are only three months old, that implement the provisions of that law. The new law, which was intended to encourage greater competition by reducing the regulatory entry barriers that had surrounded and protected this industry for over 30 years, should be given an opportunity to show its worth.

The remainder of this statement will expand on these views.

II. Some background

Until recently, the Security and Exchange Commission's (SEC) protective wall around the major bond rating companies was one of the best-kept secrets in Washington. Only after the Enron debacle of late 2001 and the Congressional hearings that followed did the SEC-created category "nationally recognized securities rating organization" (NRSRO) gain a little bit of recognition, and even today it still is far from a household term.

The SEC's regulation of the bond rating industry began in 1975, with perfectly good intentions. As bank and insurance regulators earlier had done for their regulated industries, the

SEC wanted to use corporate bond ratings to help set minimum capital requirements for broker-dealers.

Before proceeding further, it is important to recognize these efforts for what they were and still are: The financial regulators were and still are delegating ("outsourcing") to third parties their regulatory judgments as to the suitability of bonds in their regulated institutions' portfolios. This is an important point to which I will return below.

The SEC realized in 1975 -- apparently, for the first time among regulators -- that specifying the use of ratings also required specifying *which* rating companies' ratings could be used. What would prevent a bogus rating company from awarding (for a suitable fee) "AAA" ratings to *any* corporation's bonds? Could the broker-dealers then use those "ratings" for regulatory purposes?

So, the SEC duly created a new regulatory category -- NRSRO -- and immediately "grandfathered" the three major incumbent bond raters -- Moody's, Standard & Poor's (S&P), and Fitch -- into the category.

In the following 17 years, through 1992, the SEC bestowed the NRSRO designation on only four new entrants -- but mergers among them and with Fitch had reduced the field to just the original three by the end of 2000. There were no new NRSRO designees by the SEC between 1992 and February 2003. Also, the procedures underlying SEC's designations (during the rare times when they occurred) were opaque: The criteria for defining NRSRO were never specified, and the designations were (and continued, through May 2007, to be) made quietly, with little explanation and no press release, through "no action" letters issued by the SEC staff to the new designee.

After 1975, other financial regulators adopted the SEC's NRSRO designations for their regulatory purposes (i.e., increased the extent of their delegation of suitability judgments), which greatly widened the impact of the SEC's NRSRO decisions.

III. Why has the NRSRO designation mattered?

Why did the NRSRO designation matter, and why does it still matter? Almost all regulated financial institutions -- banks, insurance companies, pension funds, etc. -- must heed the NRSROs' ratings in deciding which bonds they can hold in their portfolios. For example, banks cannot hold bonds that are below "investment grade" -- as designated by (and only by) NRSROs.

The SEC's NRSRO designation, combined with the financial regulators' liberal use of the designation for regulatory purposes, has thus provided the NRSRO incumbents with a captive audience: regulated financial institutions that must heed the NRSROs' ratings. In turn, since these financial institutions are major participants in the bond markets, the bond markets generally must heed the NRSROs' ratings -- even if some or most (or possibly all) of the participants disagree with the ratings.

Simultaneously, it is difficult (though not impossible, as the existence of a few smaller, non-NRSRO bond rating firms attests) for firms to enter and survive in the bond rating business without a NRSRO designation. Without the captive audience enjoyed by the NRSROs, survival for such firms is clearly more difficult.

The potential for bad economic outcomes under this restrictive and protective regulatory regime is clear. Not only are the standard consequences of inadequate competition -- excessively high prices and profits, and stodgy behavior -- to be expected. This regulatory arrangement also runs the risk of the squelching of new ideas and innovations in bond ratings and solvency assessments if the handful of incumbents somehow conclude that the innovations are not worthy of their notice.

This innovation question raises a larger issue: Under this regulatory regime, how could one tell if the bond rating firms meet a market test? With regulatory requirements that the NRSRO incumbents' ratings must be heeded, the capital markets have no choice but to heed them. The capital markets have no way of knowing or discovering whether there are better, more efficient and effective ways of assessing the creditworthiness of bond issuers -- or whether there are better, more efficient organizations that could conduct those assessments. The efficiency of those markets themselves is potentially affected.

It has often been argued by the incumbent NRSROs' representatives and allies that the incumbents have a good track record in the predictions that follow from their ratings; e.g., "AAA" bonds rarely default, "CCC" bonds default far more frequently, etc. Although this is correct, the same types of predictions could be gained from just observing the market spreads on various types of bonds, and one cannot (without more) tell if the incumbents' ratings might just be following and mimicking market spreads and not providing any truly new or valuable information to the capital markets.

Another, more sophisticated defense of the incumbent NRSROs rests on the perception that changes in the incumbents' ratings generally are followed by changes in market prices for the affected securities. These price changes, it is argued, indicate that the NRSROs ratings do provide valuable information to the capital markets. However, it is unclear whether the market reactions indicate that the change in the ratings has truly told the markets something new about a security's default probabilities, or whether instead the markets are simply reacting to the change in the "location" of the security's rating, which is now closer to (or farther away from), or has just crossed over, a crucial regulatory boundary -- e.g., the "investment grade" boundary that determines whether or not banks can hold a bond in their portfolios.

None of this discussion should be interpreted to mean that bond raters necessarily have no role to play in the capital markets. In principle, they can provide valuable information that will help investors learn who are the better (and worse) risks among borrowers and concomitantly also help the better borrowers "tell their story" more effectively. But the regulatory delegations by the financial regulators, combined with the entry barriers of the NRSRO system, have meant that there has been no market test as to whether the current NRSRO incumbents do actually play that role.

IV. Some recent history

In the aftermath of the Enron debacle, the financial press revealed that the major (NRSRO) bond raters had kept "investment grade" ratings on Enron's bonds until five days before Enron's bankruptcy filing. Subsequent Congressional hearings included attention to the SEC's restrictive NRSRO designation regime and its opaqueness, as well as to the incumbent NRSROs' business model of charging fees to the bond issuers (rather than to investors, as had been the business model prior to the 1970s) and the potential for conflicts of interest and abuse that could accompany it. The Sarbanes-Oxley legislation of 2002 mandated that the SEC issue a report on the NRSRO system, which it did in January 2003. And in April 2005 the SEC proposed regulations that would establish formal criteria for the designation of NRSROs. But the proposed regulations were never finalized, and the NRSRO regime remained intact.

Meanwhile, the SEC did designate a few more bond rating firms as NRSROs: Dominion Bond Rating Services, a Canadian firm, in February 2003; and A.M. Best, a specialist rater of insurance companies, in March 2005. More recently, in May 2007, two Japanese bond rating firms -- Japan Credit Rating Agency, Ltd., and Rating and Investment Information, Inc. -- were designated as NRSROs.

In 2005 legislation to effect a major lessening of the entry barriers of the NRSRO system was introduced in the House of Representatives. The legislation was approved by the House in the summer of 2006. The Senate accepted most of the House's provisions but made some significant modifications and passed its version in September 2006. The House acceded to the Senate's version, and President Bush signed the Credit Rating Agency Reform Act of 2006 on September 29, 2007.

The legislation does not eliminate the NRSRO system, but it does aim to reduce the barriers to entry that the SEC had erected, as well increasing transparency. The Act allows any firm that has been issuing ratings for three years to apply to the SEC to be registered as a NRSRO (the incumbent

NRSROs must also apply), and it requires the SEC to establish a relatively timely and transparent process for approving or rejecting applications. The "good character" requirements for an NRSRO organization (incumbents as well as applicants) are relatively modest. The Act makes clear that the SEC is not supposed to favor any specific business model for NRSROs. Overall, the clear intent of the Act is to open entry and encourage greater competition in the bond rating industry.

The SEC promulgated final regulations that implemented the Act's provisions in June 2007. The final regulations maintain the general spirit and substance of the Act.

The Act does not go as far as I would like. I would strongly prefer the simple elimination of the NRSRO designation and the concomitant withdrawal of the regulatory delegations of safety judgments that have given so much power to the SEC's NRSRO decisions. The participants in the financial markets could then freely decide which bond rating organizations (if any) are worthy of their trust and dealings, while financial regulators and their regulated institutions could devise more direct ways of determining the appropriateness of bonds for those institutions' portfolios. Also, I fear that some of the "good character" provisions of the Act might be used in the future to create new barriers to entry.

Nevertheless, the Act provides a welcome shift in public policy toward a more competitive rating industry.

V. The current situation

As I noted in the Introduction, the subprime mortgage debacle represents multiple failures at multiple levels. This hearing is about the bond raters' role.

I have no special knowledge as to why the bond raters were overly optimistic with respect to the repayment prospects of the subprime mortgage borrowers during the past few years. It is clear that they were not the only parties who were overly optimistic, nor was the mortgage market the only place where excessive optimism prevailed. Risk generally was being undervalued in credit markets.

However, to the extent that participants in the residential mortgage markets -- including the bond rating firms -- were counting on the persistence of low interest rates and the continuation of double digit increases in housing prices, so that even weak or speculative mortgage borrowers could "always" sell their houses at a profit or refinance into a low interest mortgage to avoid defaults, then these participants were being hopelessly and unrealistically optimistic.

Further, the bond raters' excessive optimism played a special enabling role. Their excessively optimistic ratings on some MBS and related structured finance derivative securities (such as collateralized debt obligations, or CDOs) that were based on subprime mortgages meant that these securities carried lower interest rates, which in turn meant that the underlying mortgages carried lower interest rates -- which allowed more subprime borrowers to qualify for mortgages. With less favorable ratings, fewer subprime mortgages would have been originated, and fewer defaults would have subsequently occurred.

Separate from this excessive optimism has been the bond raters' delays afterward in downgrading these securities as borrower defaults mounted. These delays could not affect the original defaults; once the mortgages were originated, the subsequent performance of those mortgages could not be affected by any post-origination delays in downgrades of these securities. The delays only affected (to the extent that market repricings had not already fully anticipated the changes) who would bear the losses on these securities.

Here, the story as to why the bond raters have been slow to downgrade is clearer. To a large extent -- with only one new element -- it is a repeat of the reasons for their delay in the Enron and other, earlier downgrades.

First, the bond rating firms have a conscious policy of not trying to adjust their ratings with respect to short-run changes in financial circumstances; instead, they try to "rate through the cycle". Regardless of the general wisdom of such a philosophy, it does mean that when the short-run changes are not part of a cycle but instead are the beginning of a longer-run trend, the bond raters will be slow to recognize that trend and thus slow to adjust their ratings.

Second, the two leading bond rating firms -- Moody's and S&P -- have not been unaware of the adverse consequences of their downgrades for the downgraded securities and for the securities' issuers. The downgrade will likely make the raising of capital more difficult and expensive. Further, some bond covenants contain ratings-dependent "triggers" that can force redemptions (this is true of some structured-finance bonds, as well as corporate bonds), further exacerbating the problems of a company that may already be stressed. This consciousness of the consequences has tended to make them more cautious and conservative with respect to downgrades.

Third, the downgrades are a recognition that their earlier ratings were wrong -- and wrong in an adverse way. Few individuals, or organizations, enjoy admitting that they were wrong. This too must also cause delay.

Fourth, and this is a new element in the current situation, the bond raters have had to deal with (for them) a new kind of risk. For their traditional ratings of corporate, municipal, and sovereign bonds, and even for rating simple MBS, they have focused solely on credit (or default) risk: the possibility that the borrower will fail to repay its obligations in full and in a timely manner.

In rating collateralized debt obligations (CDOs), however, where the underlying collateral was MBS and other securities, an extra feature could affect the ability of the CDOs to be paid off in full and in a timely manner: liquidity risk, which is the risk that the markets for the underlying collateral will become illiquid (perhaps because of fears and uncertainties among market participants as to underlying repayment possibilities), leading to unusually wide spreads between bid and ask prices for those underlying securities. Those wider spreads, in turn, could trigger forced liquidations of the asset pools underlying the CDOs and lead to unexpected losses to the investors in the CDO securities, even if the underlying collateral were ultimately to perform with respect to credit risk along the lines that had been predicted.

I believe that the bond raters were slow to recognize this additional element of risk, which further contributed to their delays in downgrading.

VI. What Is to Be Done?

With large losses in the residential subprime mortgage and related markets -- some estimates have been in the vicinity of $100 billion -- and large numbers of households facing defaults and foreclosures, the temptations for legislative and regulatory remedies are great. Since this is a hearing on the bond rating firms, I will confine my comments to their domain: I strongly urge the Congress *not* to undertake any legislative action that would attempt to correct any perceived shortcomings of the bond rating firms. I base this plea on two grounds:

First, it is difficult, if not impossible, to legislate remedies that could somehow command the bond raters to do a better job. One could imagine legislation that would mandate certain business models -- say, forcing the industry back to its pre-1970s model of selling ratings to investors, because of concerns about potential conflicts of interest -- or that would mandate certain standards of required expertise as inputs into the rating process. But such legislation risks doing far more harm than good, by rigidifying the industry and reducing flexibility and diversity.

If given the opportunity, the participants in the financial markets will learn about persistent mistakes and will take their business elsewhere, thereby providing strong incentives for improved performance without the need for legislation.

Second, as was discussed above, the Credit Rating Agency Reform Act of 2006 was signed just a year ago, and the final implementing regulations were promulgated only three months ago. Including the two firms that were newly designated in May 2007, just before the final regulations were promulgated, there are now seven NRSROs. The SEC's more timely and transparent procedures under the Act should yield at least a few more.

The financial markets -- and equally important, financial regulators -- should be given an opportunity to adjust to the new circumstances of a more competitive ratings market, with more choices, more business models, and more ideas. It will be important to see whether and how the financial regulators adjust their regulatory delegations in this new and potentially different environment.

In sum, the new Act should be given the opportunity to show its potential for beneficially changing the bond rating industry.

VII. Conclusion

The subprime mortgage debacle and its related consequences are an unfortunate reality today. The losses are likely to be substantial, and they will be borne widely. Many parties can share some of the blame. The major bond rating firms, who were clearly excessively optimistic with respect to the repayment prospects of subprime mortgage borrowers over the past few years, surely share in some of that blame.

If given the opportunity, however, the financial markets will find ways of fixing problems so that they are less likely to occur in the future. The Credit Rating Agency Reform Act of 2006, passed only a year ago, provides that opportunity. It replaces the former repressive, protective regulatory regime that surrounded the bond rating industry with a more open and transparent framework that is likely to yield more competition, more alternatives, and more ideas. That new framework deserves a chance to succeed.

Some recent published writings on the bond rating industry by Lawrence J. White

"The Credit Rating Industry: An Industrial Organization Analysis," in Richard M. Levich, Carmen Reinhart, and Giovanni Majnoni, eds., Ratings, Rating Agencies, and the Global Financial System. Boston: Kluwer, 2002, pp. 41-63.

"The SEC's Other Problem," Regulation, 25 (Winter 2002-2003), pp. 38-42.