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TURMOIL IN U.S. CREDIT MARKETS: THE ROLE OF CREDIT RATING AGENCIES

HEARING

BEFORE THE

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

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

ISSUES INVOLVING THE RATING OF STRUCTURED FINANCE INSTRUMENTS BY THE NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS (NRSROS), AS WELL AS RECENT INITIATIVES THAT THE NRSROS HAVE ADOPTED AND RECOMMENDATIONS FOR LEGISLATIVE, REGULATORY AND VOLUNTARY CHANGES TO IMPROVE THE CREDIT RATING PROCESS

TUESDAY, APRIL 22, 2008

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C O N T E N T S

TUESDAY, APRIL 22, 2008

TURMOIL IN U.S. CREDIT MARKETS: THE ROLE OF CREDIT RATING AGENCIES

TUESDAY, APRIL 22, 2008

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

The Committee met at 10:12 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order, and my apologies to my colleagues and others for being a few minutes late this morning. I was taking the shuttle down, which is always a bit of roll of the dice. So I apologize for being a few minutes late, but I want to thank all in attendance for being here this morning. Let me share some opening thoughts. I will turn to Senator Shelby and then to other Members of the Committee who would like to make, if they so desire, some opening comments on the subject matter of today's hearing.

Today we are going to talk about the role played by the credit rating agencies in the subprime mortgage crisis. I asked the staff a short time ago, just to go back over this, this is our 13th hearing this year on this subject matter or related matters to it. We had 35 hearings last year. So it is almost 48, close to 50 hearings since beginning February 7th of last year. Some of those hearings were conducted by my colleagues here. I want to thank Jack Reed particularly for doing some of this last year—in fact, on this very subject matter. And Senator Shelby, of course, has been deeply involved in these issues, and we owe him a debt of gratitude for what he has done. But the Committee has spent an inordinate amount of time over the last year on this subject matter. Including even when we had hearings on student loan issues the other day, it was really related in many ways to the subprime problem. So almost every other matter we are looking at bears some relevancy to the subject matter here today. We could have a hearing on credit rating agencies, but obviously in the context of the subprime mortgage crisis, it has real relevancy.

Senator Reed, as I mentioned a minute ago, chaired a hearing of the full Committee on this subject matter, and Senator Shelby, of course, has been deeply involved in the subject matter of credit rating agency reform. In fact, during his tenure or stewardship as Chairman of this Committee, he not only held hearings on the topic of the credit rating agencies, but, in addition, the Committee passed legislation. That legislation, the Credit Rating Agency Reform Act of 2006, was signed into law on September 29, 2006. It makes important reforms in the area of capital market reforms, which in my view were prescient.

Credit rating agencies played a very important role in our economy and continue to do so. They provide opinions to investors about the ability of debt issuers to make timely payments on debt instruments. That may sound like a simple modest function, but it is an indispensable one. Decisions about how to invest enormous sums of money are based, at least in part, on credit ratings. As one commentator has said, "Credit rating agencies can, with the stroke of a pen, effectively add or subtract millions from a company's bottom line, rattle a city budget, shock the stock and bond markets, and reroute international investment."

We have seen over the past few months just how influential a role credit rating agencies play in our markets, and particularly in the structured finance markets, and not in a positive sense. Credit rating agencies have played a central role in the subprime mortgage crisis and, by extension, on the volatility and illiquidity plaguing our capital markets.

During the past several months, these agencies, which are technically referred to as nationally recognized statistical rating organizations, have downgraded their ratings of thousands of tranches of residential mortgage-backed securities. Bloomberg recently reported that the three largest of these organizations began cutting in July and have since either downgraded or put on review a total of 38,000 subprime bonds. Moody's and S&P combined have downgraded more than 9,500 of these securities dating from 2005. These downgrades meant that, with the stroke of a pen, again, assets once seen as safe and profitable were suddenly something quite the opposite.

Many investors who by Federal or State law must invest in securities within investment grade ratings were suddenly forced to sell. Others suddenly found the value of their securities reduced to a fraction of their previous value. The net result is that investors have lost tens of billions of dollars.

The impact of these downgrades has spread beyond the downgraded bonds themselves. Imagine, if you will, using this analogy, going to a grocery store to buy food for your family. You are told that almost all of the food in the store is safe and healthy, but that a small fraction—a small fraction—of the items contained a very toxic substance that could cause serious illness or death. It is doubtful that you or anyone else is going to be doing much shopping in that store without some assurance that it is free from the taint of any toxic substance.

In the same manner, the downgrading of some subprime mortgage securities have sown doubt and fear in investors about a much larger universe of securities. It has cut investors' appetite for subprime mortgage securities generally and for a host of other asset-backed securities. As a result, our credit markets are experiencing unprecedented levels of volatility and illiquidity.

These recent rating downgrades have raised serious questions about the role, function, and performance of credit rating agencies. For instance, do the credit rating agencies give ratings that are overly optimistic in order to obtain more business? Do they sufficiently analyze the data they are given by clients before issuing ratings? Do they properly manage real or perceived conflicts of interest with clients who pay for rating and/or consulting services? And, last, when Congress acted 2 years ago, it gave the SEC the authority "to prohibit or require the management and disclosure of any conflicts of interest." Has the SEC used this authority effectively? Can or should it do more?

These are some of the important questions that our witnesses will address this morning. The investing public, of course, deserves to know that every step is being taken to protect one of their most basic rights, and that is the right to sound, reliable, credible information. They deserve to know that our regulatory agencies will apply and enforce the law with vigor on their behalf. And they want to see the credit rating agencies demonstrate that they have learned from their mistakes and have reformed their practices so that this very sorry chapter in their history will never be repeated.

I want to welcome Chairman Cox of the SEC to the Committee once again. We know he is currently working to implement by rulemaking the new act, and we look forward obviously to hearing his testimony this morning. Let me also welcome our other distinguished witnesses who will be here this morning. We appreciate their willingness to appear before us.

Let me now turn to Senator Shelby and then to other Members of the Committee for any comments they may have about this very, very important subject matter.

OPENING STATEMENT OF SENATOR RICHARD C. SHELBY

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

Since our last hearing on this subject, the situation in our financial markets has underscored the role played by the rating agencies. The past few months have also demonstrated that the rating agencies were not meeting their responsibilities. We have witnessed this series of ratings downgrades particularly in structured finance. It seems that rating agencies grossly underestimated the risks associated with these securities. Unfortunately, these products were widely distributed and held by a broad array of investors and institutions. The severity of these downgrades sent banks, pension, and money market funds scrambling for capital. Plunging investor confidence ultimately led credit markets to tank worldwide.

The markets for commercial paper, municipal securities, and auction rate securities have all experienced disruptions in part because financial institutions no longer trust the credit ratings of issuers, bond insurers, and other counterparties. Rather than conduct their own due diligence, too many investors appear to have relied solely on credit ratings to assess credit risk. And while credit ratings play and should continue to play an important part in evaluating risk in our economy, over reliance on the ratings of just a few firms appears to have diminished the amount of independent risk assessment undertaken by market participants.

Because rating agencies underestimated the risk of subprime-based securities, these securities were allowed to spread throughout our financial system without their real risk being detected until it was too late. In our modern economy, we need not only better ratings but also more market participants assessing risk to prevent this from happening again.

Before the current crisis began, this Committee worked and enacted the Credit Rating Agency Reform Act of 2006. This act sought to improve the quality of ratings and to foster accountability, transparency, and competition in the industry. The Securities and Exchange Commission was given broad authority to enforce this act. Last year, the SEC issued initial rules governing registration of NRSROs and prohibiting certain conflicts of interest. These rules have opened up the process for new firms to become NRSROs, fostering more competition in the industry. The SEC is now preparing to propose additional rules to implement the act.

Today, we look forward to hearing Chairman Cox discuss the types of rules the SEC is considering adopting and what additional reforms he believes are needed. I believe the SEC has a chance to help restore confidence in our markets and establish a more competitive and accountable credit rating industry. For example, rules that improve the transparency of the ratings process will make it easier for investors to assess and compare ratings.

I am also interested in the preliminary finding of the SEC's ongoing examination of the rating agencies, and we would like to learn more about the relationship between the agencies and investment banks. A rating, after all, is only as good as the information on which it is based.

If there was insufficient due diligence and risk assessment in the process of creating and underwriting structured financial products, the ratings will be flawed from their inception. We found that they were.

Mr. Chairman, given the critical role underwriters played in this crisis, I hope that our examination—I believe our examination is incomplete without the participation of the firms that created these products, and I hope that we will address those two in the future. The sophisticated underwriters that structured and sold these securities reaped huge fees for their efforts, regardless of how the securities performed for investors. I hope their absence from this discussion is not permanent, Mr. Chairman.

Chairman DODD. Well, thank you very much, Senator Shelby. Just on that point of the investment banks, we had a hearing last year—in fact, Senator Reed looked into that.

Senator SHELBY. We did.

Chairman DODD. And I am certainly willing to hold an additional one. As I mentioned, we have had a lot of hearings on the subject matter, but certainly that is a very legitimate question that you raise, Senator Shelby, and we will do that.

Senator Reed.

Senator REED. Mr. Chairman, I will yield to Senator Menendez. He has——

Chairman DODD. Fine. Absolutely.

OPENING STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you. Let me thank both Senator Reed and Senator Schumer for their courtesy. I have to chair a Foreign Relations Subcommittee hearing at 10:30, and I hope to get back for our second panel, Mr. Chairman. So I appreciate them both for their courtesy. This is something I have been following along with the Committee and am very interested in.

Over the last year, we have grappled with a foreclosure crisis that has swept across our country, devastating families and neighborhoods and a credit crunch that has spread throughout our markets with ripple effects throughout our economy. Within the turmoil, there are many pieces for us to focus on as we seek to help homeowners, stem any further spillover into other markets, and work to stabilize our economy. But the worse mistake I think we could make is not to learn from what happened and to let the cracks in the system slip by unfixed. Our credit rating system threatens to possibly be something that slipped by, and I am glad through your leadership and the Ranking Member's that we are not letting that happen.

Last year, we held what I thought was a very important hearing to examine one of the most severe and overlooked cracks in the mortgage and the securitization chain. While the credit rating agencies were not a direct cause of the subprime crisis, they certainly were a key link in the securitization chain and had a hand in perpetuating a mortgage process in which no one asked the right questions. That chain failed in large part because the very ratings that the market was supposed to rely on were flawed. And often I think they played the conflicting roles of referee and coach.

Recently, we witnessed what happens when the whole system fails. Extenuating circumstances or not, our regulatory system did not know what hit it when Bear Stearns collapsed. In addition to the questions I and many of my colleagues have had about how our regulators missed the warning signs, I have serious questions about the role that the ratings played or could have played in helping raise flags earlier. The fact is credit ratings play an essential role for our markets. Issuers depend upon them to seek investments. Investors depend upon them to know the creditworthiness of the investments they are making. The system as a whole depends upon them to track risk. But the question is: Who is rating the rating agencies? And that answer has been clear: No one.

So I want to applaud the SEC for taking seriously the need to reform this process. I have raised some questions with the Chairman when he came to visit—I appreciate his visit—of whether some of the SEC plans go far enough, and I hope we can find solutions that will increase disclosure and root out the practices that keep the ratings from being what they should be: fair, simple, and accurate.

Finally, I hope, Mr. Chairman, we look at the bigger picture for a moment. This discussion about how to reform the rating system is largely cleaning up the mess. We are still mopping up the aisles and trying to figure out what broke and why. But beyond this, as I spoke to Chairman Cox when he visited me—and, again, I appreciate that visit—the larger challenge at hand is getting ahead of the curve. The problem is not just that the ratings were flawed or that there are conflicts in the system. It is that what is going on in the market and on the street is light years ahead often of what is going on in our regulatory system. How can our regulators watch for the warning signs and respond if they do not even know what the signals are? I feel like they are in the same struggle as parents who cannot keep up with their teenage kids texting back and forth on their cell phones.

The fact is much of our market operations are taking place in a language all its own, and we need our regulators to be fluent in that language as well. And I am looking forward to the Chairman's proposals in this particular regard and the Commission's proposals, and I am hoping that we will have a system that puts us ahead of the curve.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Corker.

[No response.]

Chairman DODD. Senator Reed.

OPENING STATEMENT OF SENATOR JACK REED

Senator REED. Well, Mr. Chairman, thank you very much, and I will make some comments.

First, welcome, Chairman Cox. We have been down this road before. In the wake of Enron, we saw flaws in the credit rating system. We have tried to address those faults. I want to commend Senator Shelby for his efforts as Chair last year and at least giving the SEC some authority and some traction in this regard. But I think what we have seen in the last 12 months has been another indication that we have to take more directed action.

Twelve months ago, when at your request I chaired a hearing, the subprime crisis was seen as a $19 billion worldwide phenomenon that was already self-correcting. That is not the case, and so I think we have to do much more. We have to ensure that the Commission has the authority to adequately supervise, regulate, or direct the credit rating agencies. We have to ensure, I think, that the new rules that they are promulgating really do the job. As I said, we have been down this road before, and we are still going down it. I think we want to reach an appropriate conclusion.

We have to, I think, ensure that we have the appropriate balance between market discipline and good rules and regulations. That is something, I think, that is out of balance at this moment.

I will conclude with the comments of Lew Ranieri, who created the mortgage-backed security years ago, when he said, "The mortgage-backed security sector was unfettered in its enthusiasm and unchecked by today's regulatory framework. We have a quasi-gatekeeper in the rating services, and in the end the SEC is the regulator of the capital market. It is the one who can touch this stuff and make a difference." And I think we have to touch this stuff and make a difference now since we have not in the past.

Chairman DODD. Thank you very much, Senator. And, again, for the purpose of the record, all statements, complete statements of Members and witnesses, will be included in the record as well.

Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, thank you for holding this hearing, and also Ranking Member Shelby. I would just make a few brief comments.

The nationally recognized statistical rating organizations play an important role in financial markets. Confidence in these ratings have been shaken following a number of downgrades of residential mortgage-backed securities. And so this lack of confidence is of concern to me. I have said this to a lot of people, I believe. And I just would remind us of a quote from former Federal Reserve Chairman Alan Greenspan when he said that people believe that they—meaning the credit rating agencies—"knew what they were doing, and they don't. What kept them in place was a belief on the part of those who invested in that that they were properly priced."

Now everyone knows that they weren't, and they know that they can't really be properly priced. And I am anxious to hear what Chairman Cox might have to say about that particular statement.

As always, I would like to welcome my friend and former colleague from the House. It is always good to see you, Mr. Chairman.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Well, thank you, Mr. Chairman. I very much appreciate the opportunity to have this hearing and very much appreciate your being here. And I think it is appropriate because, at least to me, credit rating agencies were the weak link in the subprime crisis. They, along with mortgage brokers, are probably more at the center of this than just about anybody else. And, incidentally, at least until we passed our legislation—and much of the action occurred before that—neither the mortgage brokers nor the credit rating agencies had any real regulation at all. And so it is difficult to ask the SEC—they now have regulation, and we have met and talked about—have the ability to look at things like conflict of interest, but they did not back then. So, to me, the credit rating agencies are at the heart of this problem, and we need to do a thorough examination of what is happening. That is why I appreciate you, Mr. Chairman, and the Ranking Member being so interested in this issue, which he was when he was Chairman as well, as well as Senator Reed.

Second, I really regret that the heads of—I want to commend Fitch's for sending their CEO, but where are the heads of Moody's and Standard & Poor's? The bottom line, this is really serious stuff. The whole world is focused on this. And for the CEOs not to come is very disappointing. They should be here. And particularly they should be here because I met with the President of Moody's a while ago, and I asked him, Did Moody's do anything wrong? And he said no. I would like to know if he still believes that. He said no, they did nothing wrong. I was incredulous.

And so, again, I think the credit rating agencies really have an obligation to send their leaders and to find out what happened and what is going on here. And I want to register my disappointment.

Third, to me, the nub of this problem is conflict of interest. Obviously, when you are paying for a rating, there is an inherent conflict of interest, and that has to change. And there was a story in *The Wall Street Journal*—which I would just ask unanimous consent to put into the record.

Chairman DODD. It will be included.

Senator SCHUMER. It is an article from April 11th that just documented one instance of a conflict where analysts were changed because people did not like the rating agency. Here is a quote from the article: "On occasion, Moody's agreed to switch analysts on deals after bankers complained." And another quote: "There was, rather, a palpable erosion of institutional support for rating analysis that threatened market share." Moody's decided they would increase market share in this area, and their standards declined at the same time.

Conflict is inherent sometimes, and, look, sometimes there are legitimate reasons to complain: you did not take this into account; there has to be a dialog between the agency and the issuer. But disclosure is key, and I asked you, Mr. Chairman, when we met, would you make sure that this is all disclosed when an analysis was changed after a complaint or if a rater was switched? That should be known. Again, you cannot say that the issuer can never complain. Maybe they missed something. But at least disclosure would be a prophylactic. And the new legislation that we supported and Chairman Shelby shepherded through this Congress allows for that disclosure, and we eagerly await the regulations that you will have.

One final point I would make here. For somebody to say nothing is wrong, here is the nub of it: How did no-doc loans, loans with no documentation that were parts of these packages, get AAA ratings? Now, when you ask the credit rating agencies how did no-doc loans deserve AAA ratings, they said, well—not them but the people analyzing them. They say, well, they thought housing would go up no matter what. And so, therefore, it did not matter if the guy could not repay, so you did not have to look at the loan.

Well, maybe they should have paid one of us. We could have told them housing prices would go up forever. We did not need to do any analysis either, or somebody, or the guy on the street.

So something is really wrong here. Something is really wrong. I know some of it has been self-corrected already, but there has to be more to be done, and this hearing is a very constructive step along that path. And I thank you for holding it, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

We invited the CEO. Today is their shareholder meeting, and so he—though we could maybe schedule it another time. I did not know that at the time, and he let us know he would have been here but for presiding over the shareholder meeting. Moody's, anyway, I want to include that in the record.

Senator SCHUMER. Well, I would like an opportunity for them maybe to come back at some point if we have time, either at the Committee or the Subcommittee level.

Chairman DODD. Very good point.

Senator Tester.

OPENING STATEMENT OF SENATOR JON TESTER

Senator TESTER. Thank you, Chairman Dodd and Ranking Member Shelby, for calling today's hearing on credit rating agencies as another in a series of hearings looking into the turmoil in the credit markets. I want to welcome Chairman Cox and the members of the second panel.

My stay here today is going to be limited because I have to chair on the floor, but this is a topic that is both timely and critical as issues that surround the credit rating agencies and their role in the current credit market crisis keep arising. In Montana, we are confronted with uncertainties in the student loan market, as the auction rate bond market is no longer viable, due in no small part, some say, to mistrust in the credit rating agencies.

As important as it is to delve into the oversight of the credit rating agencies, I really want to spend my opening statement today addressing the distinguished witness Chairman Cox on the possibility that market manipulation led to the fall of Bear Stearns leading up to its merger with JPMorgan Chase.

Mr. Chairman, you testified before this panel on April 3rd, along with Chairman Bernanke and other distinguished panelists, to discuss recent actions of Federal financial regulators as it related to the Government's role in the Bear Stearns saga. At the time, I inquired if there is any evidence suggesting that speculators had bet heavily that Bear Stearns' share price would fall, known on Wall Street as "short selling." You responded, and I quote, "I am a little bit constrained because the SEC is in the law enforcement business." You then continued to say that the SEC pursues insider trading aggressively and that your agency was mulling several law enforcement matters that have not been filed in any U.S. court.

A week after, on April 10th, I sent a letter to you and to Attorney General Mukasey asking you to immediately and thoroughly investigate whether illegal insider trading led to last month's downfall of Bear Stearns. To date, I have not heard back from your office, nor have I heard back from the Department of Justice. I understand your response is currently being drafted and will likely echo the sentiments that you told me on April 3rd, that you were in the law enforcement business and cannot confirm nor deny, but you will investigate if any wrongdoing has taken place.

While I respect that, and I admire the SEC for playing an integral role in the investigations of securities law violations, I want you to know that this is not an ordinary situation, and the events that followed what some view as market manipulation were unprecedented—a $29 billion loan from the Government to facilitate a merger of two of the world's largest banks.

I am not sitting here to criticize the Federal Reserve Bank of New York for their actions if risking nearly $30 billion of taxpayer dollars with a limited amount of due diligence was necessary, but I do want to know if it could have been avoided, if speculators conducted insider trading to make a buck, a whole lot of bucks, which led to taxpayers being forced to stand behind the loan that is big even by Washington, D.C., standards, much less the standards of my home State of Montana.

As I stated earlier, I will have to leave very shortly to go preside on the floor, but we will continue to have a dialogue. You will continue to hear from me in the coming months on the need for a thorough investigation. Hopefully that is going on as we speak, and hopefully it will get to the bottom of the situation. I have asked other financial regulators, investors, and knowledgeable individuals their thoughts, and to a person, they believe fear and speculation alone did not eat up Bear's significant liquidity position. But I want to hear it officially from you.

So thank you, Chairman Cox. Thank you, Chairman Dodd.

Chairman DODD. Thank you very much, Senator.

Senator Bayh has joined us. Senator, do you have any opening comments you want to make?

Senator BAYH. Thank you, Mr. Chairman. No. I am looking forward to hearing from Chairman Cox, and I did want to note my—this takes me back a few years, Mr. Chairman. My corporate law professor in law school, John Coffee, is here, and I just wanted to give him my best regards.

Chairman DODD. Now we are going to really have an interesting hearing.

Senator BAYH. And for both our sakes, I hope he will not disclose what my grade in the course was.

Chairman DODD. I tell you, we expect very tough questioning from you, though, Senator, of the witness.

Chairman Cox, welcome to the Committee once again. You have been before the Committee on numerous occasions over the last year, and we appreciate your being back here today.

Mr. COX. Thank you. Senator Tester I notice is just leaving, but——

[Laughter.]

Mr. COX. Just on your way out, I think you recognize that both the Department of Justice and the SEC do not confirm investigations into people for privacy reasons before they have been publicly identified with wrongdoing. But I also stated at that hearing that the problem with Bear Stearns was too big to miss and people should take comfort that the SEC was doing its job in this area. So I hope to signal by that within the silent forum that we all must operate in the law enforcement agency business that that is the case. And beyond that, I look forward to speaking with you in private to give you the maximum amount of comfort in that respect.

Senator TESTER. You took the words right out of my mouth, Chairman Cox. I would like to set up a meeting with you, and we can visit about the issue in private. That would be great. Thank you.

Mr. COX. Thank you.

Chairman DODD. Thanks very much. Mr. Chairman, we look forward to your statement.

STATEMENT OF CHRISTOPHER COX, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. COX. Thank you, Chairman Dodd, Senator Shelby, Members of the Committee, for inviting me today to discuss the work of the SEC concerning credit rating agencies.

When Congress passed the Credit Rating Agency Reform Act and President Bush signed it into law in late 2006, its purpose was to improve ratings quality by fostering accountability, transparency, and competition in the credit rating industry. Prior to the Rating Agency Act, credit rating agencies were essentially unregulated by the Federal Government, and the SEC had no authority to make rules governing their business or to subject them to examinations as nationally recognized statistical rating organizations. With the passage of the act, the Commission became their regulator, and since that time, we have devoted considerable new resources to this responsibility.

Since the end of September 2007, seven credit rating agencies, including those that were most active in rating subprime-related products, have been subject to the Commission's new oversight authority, and subject as well to our newly adopted rules. In the 6½ months since the SEC's authority over CRAs went into effect, the Commission has aggressively used its authority to examine the adequacy of their public disclosures, their recordkeeping, and their procedures to prevent the disclosure of material non-public information.

The review process has included hundreds of thousands of pages of the rating agencies' internal records and e-mail. In addition, the staff are reviewing the ratings agencies' public disclosures relating to the ratings process for those securities, and Commission staff have analyzed the ratings history of thousands of structured finance products. These extensive examinations have involved approximately 40 SEC professional staff.

Much has been accomplished already on these examinations, but there is still much more work to be done. The Commission expects that the report describing the staff's observations from the examinations will be issued by early summer. At this stage, with more examination work to be completed and the staff's across-the-board inferences yet to be drawn, it is premature to describe the results. I can say that it appears the volume of the structured finance deals that were brought to the credit rating agencies increased substantially from 2004 to 2006, and at the same time, the structured products that the rating agencies were being asked to evaluate were becoming increasingly complex, with many employing derivatives such as credit default swaps to replicate the performance of mortgage-backed securities.

Meanwhile, the loan assets underlying these securities shifted from primarily plain vanilla 30-year mortgages to a range of more difficult-to-assess products, including ARMs and second-lien loans. We are currently evaluating whether and how the credit rating agencies adapted their ratings approaches in this rapidly changing environment. We expect the results of these staff examinations will provide significant and useful new information that will help not only the SEC but also issuers and users of credit ratings to address the problems that we have seen.

Because the Commission's authority over credit rating agencies took effect just over 6 months ago, the SEC is already far along in preparing for a second round of rulemaking. This second round of rulemaking will be based on information provided by the staff's ongoing examinations of these firms as well as the many empirical analyses provided by regulators and industry groups, academics, and multinational organizations, including many in which the SEC itself has participated. I expect the Commission will issue rule proposals for public comment in the near future. Of course, the internal development process for these rules within the Commission is still very much ongoing. So while I am happy to provide you today with an outline of the rulemaking areas that are under consideration, I do so with the caveat that what ultimately is included in these new proposed rules has yet to be decided.

That said, the rules that we are likely to consider will fall into three broad categories: rules designed to foster accountability, rules to enhance transparency, and rules to promote competition in the credit rating agency industry. These, of course, are the three goals of the Rating Agency Act itself.

To strengthen accountability, the new rules may include requirements for enhanced disclosures about ratings' performance. This would enable market participants to better compare one NRSRO with another. To ensure NRSRO accountability for the management of their conflicts of interest, the new rules could include specific prohibitions on certain practices. They could also establish requirements to address potential conflicts of interest that could impair the process for rating-structured products.

Among the conflicts of interest that could be addressed are the provision of consulting services by credit rating agencies to the issuers of the securities that they rate and the rating of structured securities that the credit rating agency itself helped to design. The proposed rules may also include requirements that the firms furnish the Commission with annual reports describing their internal reviews of how well they adhere to their own procedures for determining ratings, managing conflicts of interest, and complying with the securities laws.

In the second category of enhancing transparency, the Commission may consider rules to require the disclosure of information underlying the ratings of subprime-related products, including, for example, the particular assets backing MBS, CDOs, and other types of structured products. This would allow market participants to better analyze the assets underlying the structured securities and reach their own conclusions about creditworthiness.

Making this data available to the market could particularly benefit subscriber-based NRSROs who could use it to perform independent assessments of the validity of their competitor's ratings. Other improvements that the new rules could make in the area of transparency could come from enhanced disclosure about how NRSROs determine their ratings for structured products. This new disclosure could include, for example, the kind of analysis that is done on the degree to which the mortgages behind asset-backed securities conform with underwriting standards. Additional disclosure could be required as well for the firms' procedures for monitoring their current credit ratings. The Commission may also consider rules to help investors to readily distinguish the ratings for different types of securities such as structured products, corporate securities, and municipal securities.

In the third area of potential rulemaking, promoting competition, the new rules could include provisions to enhance disclosure about ratings' performance so that it affords other credit rating agencies, including newly recognized NRSROs, an opportunity to identify flaws in their competitive approach or to demonstrate to investors that their ratings performed better. The Commission is also reconsidering its extensive reliance on credit ratings in our own rules. Limiting the use of credit ratings for regulatory compliance purposes could encourage investors in the marketplace as a whole to use ratings for their informational value rather than merely to satisfy a regulatory requirement. This could induce greater competition among rating agencies to produce the highest-quality, most reliable ratings.

Yet another way the new rules might seek to enhance competition could be to ensure that all NRSROs have access to the same information underlying a credit rating. In that way, regardless of whether the NRSRO follows the issuer-pays approach or the subscriber-based approach, there would be no competitive advantage or disadvantage based on access to information on the assets underlying a structured credit product. And at the same time, NRSROs that were not paid by the issuers to rate securities could develop their own track record for rating these products.

To the extent both the issuer-pays and the subscriber-based models were to flourish in a competitive marketplace, each could act as a healthy competitive check on the other. Of course, because this planned proposed rulemaking is ongoing, there could and undoubtedly will be other subjects covered in the draft rules that the staff will present to the Commission for its consideration.

In closing, Mr. Chairman, I want to emphasize that the Commission is very much open to ideas from the Congress on this proposed rulemaking, and we especially welcome ideas from this Committee since you are the authors of the Credit Rating Agency Act and it is your intent in writing the law that the Commission is now working to fulfill.

I appreciate this opportunity to provide the Committee with this update on the SEC's new regulatory responsibilities for credit rating agencies, and I look forward to answering your questions.

Chairman DODD. Well, thank you very much, Mr. Chairman, and I want to ask the clerk to put up about 7 minutes per Member here so that we can give everyone a good chance to raise some issues with you.

First, I was pleased to hear your plans to require greater clarity of methodologies and to make issuer data available to all NRSROs and to propose needed reforms. Let me ask you a couple of sort of underlying questions, and then there is a series of specific ideas that have been raised, including some of our witnesses who submitted their testimony and will be before us a little later this morning.

I guess one question we would have for you, all of us would up here, putting aside the various ideas, do you need any additional statutory authority, do you think, for the SEC to act? And if so, would you share with this Committee what limitations you have in that regard and what recommendations you would make if, in fact, there is a gap in terms of what you think you need to do and the authority that you have been given either by the legislation we adopted or previous legislation?

Mr. COX. Mr. Chairman, thank you for the question and for the opportunity. In connection with this latest proposed round of rulemaking, we have come upon a number of topics where we had to ask ourselves, Do we have the authority aggressively to do this? And thus far, the answers that we have been able to give are all yes. We do have the authority, not only in the Rating Agencies Act, but also under the Exchange Act and the other Commission authorities in combination. And so thus far, what we have in mind is amply supported by the new legislation that you have just written.

Chairman DODD. The second question would be budget. I expressed in my views and estimates letter to the Budget Committee of February 25th of this year, I raised concerns as to whether or not the President's fiscal year 2009 budget request of $913 million for the SEC would be adequate to examine and regulate the NRSROs as well as to deal with enforcement, the subprime crisis, consolidated supervision, and other issues.

Do you feel, Mr. Chairman, that the amount that you are going to be given here is enough, will provide enough resources to effectively oversee the securities markets? And if not, would you share with the Committee what you believe you are going to need?

Mr. COX. Mr. Chairman, as you know, the budget that the President has put before you is the largest budget that the SEC would ever have received. It is approaching $1 billion. I think it would be appropriate for this Committee as authorizers to consider both the CSE program and the CRA program from the standpoint of their place within the agency. I think overall the nearly $1 billion that Congress has provided us in the latest budget is ample for the overall achievement of our goals, and I have been able as CEO of the agency to allocate resources, for example, to credit rating agencies and to our CSE program.

At the same time, because both of these programs are relatively new, the CRA program itself very new and it has never been the subject of extensive consideration, therefore, on the Appropriations Committee, and because the CSE program is a voluntary program based on old authority and not itself authorized in law, I just think it would be very useful if there were a dedicated funding stream for these two significant new responsibilities for the agency because they have changed overall the responsibilities of the SEC.

Chairman DODD. Well, we will take that into consideration. Of course, we have some Members of the Appropriations Committee here, including Senator Shelby, so we can examine that issue further.

Let me raise a couple of specific suggestions that will be raised in testimony from some of our witnesses coming along that I thought were interesting. Again, I agree with your intent to enable market participants to better compare the rating agencies. And Professor Coffee has proposed an idea along these lines that I think has some merit, and I would be interested in your own reaction to it, and that is, a neutral website that displays the past ratings for each security rated by multiple NRSROs so investors could compare the accuracy of the different rating agencies.

I wonder what your views would be on a proposal such as that, and could the SEC maintain such a website? Is there anything that would prohibit you from doing that?

Mr. COX. Well, the idea of enhancing the transparency of the ratings themselves and their performance is at the heart of what we have been talking about, of course. Making the information as easily available to the public in the most easily comparable form also is a natural objective. And so Professor Coffee's proposals in that respect are very much consonant with at least what I am thinking and I believe what the Commission staff and perhaps the other Commissioners are thinking.

As you know, the statute, I think wisely, says that the Federal Government should not dictate the ratings themselves, should not tell rating agencies in this competitive market precisely how they should do it, but there is ample support in the statute for disclosure around these things. So provided that the scorecard was disclosure and not indirect regulation——

Chairman DODD. No, I think that is what we are talking about. Professor Coffee can contradict me when he testifies, but I think the idea was just to allow—so you would have some way of looking at the accuracy of this and making judgments.

Mr. COX. The final point that I would make is that were the disclosure mandated to be tagged with XPRL data tags in interactive data form, then almost anyone could put together their own comparative scorecard, and I think that a lot of financial intermediaries on the Web would do this probably for free for consumers and investors in addition to whatever the SEC might do on its own website.

Chairman DODD. Yes. Of course, the SEC, that Good Housekeeping Seal of Approval is a very valued determinant.

Mr. COX. Yes, of course, and if the SEC requires more detailed disclosure beyond what already is provided on the NRSRO, then, of course, all of that data would be official SEC-filed data.

Chairman DODD. An additional suggestion from Professor Coffee would have the SEC temporarily suspend an NRSRO, the status of a rating agency that consistently errs in rating a particular type of security over a period of time. What are your thoughts on that?

Mr. COX. The authority that you have just given to the SEC includes not only censure but revocation of the registration of an NRSRO.

Chairman DODD. So you have that authority?

Mr. COX. Yes, we do.

Chairman DODD. There has been——

Mr. COX. Now, I should add, not if that authority were to be used to sanction someone for getting the rating wrong, but for violating any of the rules or provisions of the statute, that sanction would be appropriate. And as I mentioned before, you did not want us, the SEC, to actually regulate the substance of the ratings. But we would not revoke a registration for that reason.

Chairman DODD. There has been a suggestion as well that a rating agency separate its rating business from its rating analysis function. We have heard similar arguments in the past in other related areas of financial services. What is your reaction to that suggestion?

Mr. COX. Conflicts of interest of that sort are very much at the heart of what we are looking at in the proposed new rulemaking, and I agree both with the mandate in the act very strongly and with the inferences that have been drawn from it that conflicts of interest are directly related to some of the problems that we see in the market.

Chairman DODD. Let me come back to the previous question. I heard your answer to it. It is one thing to break rules and certainly suspend. I understand that, you have that authority. What I was driving at more is the error in judgment of consistently—I am not talking about, obviously—and this would have to be, you know, over a period of time you get just error after error in judgments and drawing conclusions about various instruments here. It seems to me there that—well, anyway, you don't believe that that is an appropriate role for the SEC where you have a consistent error in judgment on these ratings, that that would be a justification for suspending that rating agency's function?

Mr. COX. Well, what the law contemplates—and I think what our rules will flesh out when they become final later this year—is a world in which everyone knows what the rating agencies are doing and why and how. We know what their internal procedures are. We know how they deal with conflicts of interest. We know what the prohibited practices are. If then in a competitive world their ratings fare less well even though they are performed exactly according to spec than someone else's, that fact alone would not be grounds under the statute for revocation of their registration.

If, on the other hand, the reason that their ratings were consistently wrong is that they had not followed the procedures that they described, not disclosed fully what they were doing—they had, for example, changed their ratings model under pressure to get business or what have you, or committed any other kind of error, or worse, in judgment, then I think their registration under the statute could be revoked by the SEC, and we would have the authority to do so.

Chairman DODD. My time has expired, but I suspect my colleagues may want to pursue this line of questioning with you a little further.

Senator Shelby.

Senator SHELBY. Thank you, Senator Dodd, and thank you for bringing that up. I want to continue along that line for a minute.

If some firm or NRSRO is consistently wrong on their ratings, you know, they rate them, then they are downgraded—and we have seen this over and over and over consistently—wouldn't that call in, just common sense, the confidence of that firm, or whoever it was? And why wouldn't you jerk their license or whatever they have to do business if they are consistently wrong, they are ignorant, they are incompetent, or they do not care, or they are sloppy, they are not diligent? I think that is what we were getting at, among other things.

Mr. COX. Well, I think it stands to reason that there would be a connection in most cases—this is obviously a hypothetical discussion—between that kind of horrible track record and failure to follow all of the good hygiene that is mandated in law and regulation. This has heretofore been an unregulated industry. Once the regulations are in place and once people have an opportunity to either be in compliance or not with them, you will be able to draw a correlation, I imagine, between compliance with the law and regulation and failure in the marketplace.

Senator SHELBY. But incompetence in the marketplace like this, especially rating securities that are so important, I think calls for rigorous enforcement of the rules and whatever they are. But you take doctors, if they are incompetent, they jerk their license, you know, lawyers after a while, but why not something like this that goes to the very heart of our financial system?

Mr. COX. Well, I think you may be asking me for advice on new legislation, because what I am trying to do is interpret——

Senator SHELBY. I think Senator Dodd asked did you need anything else.

Mr. COX. Yes, interpret——

Senator SHELBY. You might and you might not. I do not know.

Mr. COX. Well, I will say that if you want the SEC to revoke the charter of a credit rating agency simply for being wrong, even though it has followed all of its own rules and procedures, fully disclosed them, and fully disclosed the basis for all of its ratings, then we would need new law to do that because——

Senator SHELBY. Mr. Chairman, we are not asking for being wrong once. I believe Chairman Dodd used the words "consistently wrong," which would bring about incompetence, the lack of diligence, and so forth. A lot of these rating agencies have been consistently wrong on the subprime, and I think they have contributed greatly to the financial debacle that we have today. Do you not agree with that?

Mr. COX. Actually, over a long period of time in a number of circumstances, I have observed the pattern of ratings of very high levels, preceding almost by days in many cases horrible consequences thereafter. There is no question that the legislation that you provided us and the new authorities that we are going to exercise are much needed for that reason.

I think, however, that the judgment that you made in passing the law is a good one, that there is a role for competition here; that if the Federal Government were to be the open arbiter of whether ratings approaches were good or bad, that would probably result in poorer ratings performance over time because people would not be able to update their models without regulatory approval. They would always stand to be second-guessed and so on. I think a system such as the one that you have designed in which everyone has to be aboveboard about the approach that they are taking and they are subjecting to competitive pressures, they are accountable, they are transparent, is probably most likely to get us the results that we want to achieve.

Chairman DODD. Richard, would you let me——

Senator SHELBY. Go ahead.

Chairman DODD. Just on this point, Mr. Chairman, under the act that was signed in 2006, let me just read the language here and see if this gives you any pause in terms of your response. It is entitled, under Section 3, "Grounds for Decision. The Commission shall grant registration under this subsection," and then there are two or three—or two subparagraphs. Subparagraph (2), "unless the Commission finds, in which case the Commission shall deny such registration, that, one, the applicant does not have adequate financial and managerial resources to consistently produce credit ratings with integrity." Now, that would be at the initial granting of a charter. So we are talking about something a little different here, and that is to withdraw a charter or to suspend a charter.

So if you make a decision to grant one based on the ability to produce results with integrity, it would seem to raise the question that at least the Commission would have the authority to suspend that charter if, in fact, that integrity were compromised.

Mr. COX. I think that is exactly right. In fact, that is authority that we intend to use aggressively. That provision, of course, goes to resources. So I think we are talking hypothetically here.

What we have done, rather unnaturally, in this hypothetical discussion is we have isolated just the ratings performance, and we have imagined that it has nothing to do with lousy management or violations of rules or procedures or other things, which undoubtedly in the real world it would. But this provision that you have just cited concerning failing to maintain adequate financial and managerial resources goes to quantity, and if the place spent tens of millions of dollars on their analysis, they probably would get past this.

In any case, the provision that is the bar to our regulating the substance of credit rating agencies and the procedures by—or, pardon me, the substance of credit ratings or the procedures by which they are adopted is prefaced with the legislative language, notwithstanding any other provision of law. So it trumps everything else in the statute, and it says that what we cannot do is regulate the substance of credit ratings, and we cannot by regulation prescribe the methodologies by which they are obtained.

Senator SHELBY. Chairman Cox, what are we trying to do with the rating agencies? Maybe you have a different take than I have. I hope we are trying to restore confidence in the rating system, their methodology, how they do what they do, because there is no trust out there in the market today. I don't know many people that trust the rating system. They see that as a big contributor of where we are today and what we are trying to do, working with the SEC, and I was trying to do when I offered that legislation, what Chairman Dodd is trying to do now, is to give the SEC the tools that you need not to do business as usual. Doing business as usual with a rating agency, that is gone. So many conflicts of interest, as I see it, always so many cozy relationships, so much money made if the ratings went this way and that way.

How do we change that? That is what we are after, is transparency and so forth, because I think the rating agencies can play and have played a tremendous positive role in our financial markets. But today, my gosh, you know, would I buy bonds that Moody's or S&P rated AAA without looking at them and having somebody else look at them closely? No. I would be foolish to do it, wouldn't I be?

Mr. COX. I think that is exactly right, Senator. And as you know, as the author of the legislation, the overarching purpose is to improve ratings quality. The devices of transparency and accountability and competition are the means to achieving that result. And, of course, improving the quality of ratings is the prerequisite to improving confidence in that whole rating system.

Senator SHELBY. Well, you are the Chairman of the SEC. There have been some recommendations to Secretary Paulson to change the role of the SEC, to make the Fed, you know, the great arbiter of everything, which I think would be kind of dangerous and foolish myself. But if the SEC is not going to do the job, somebody else will have to do the job. I hope that you and your leadership and your other Commissioners will do the job that needs to be done. We are at a crisis here, a crisis of trust, a crisis of confidence, looking at rating agencies with so many obvious conflicts of interest. I think it is horrible.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Shelby.

Senator Reed.

Senator REED. Well, thank you, Mr. Chairman.

Borrowing an analogy from another field, do you think that any of these rating agencies were guilty of malpractice, not meeting the standard that you would expect as the Chairman of the Securities and Exchange Commission in the execution of their responsibilities to rate some of these securities?

Mr. COX. That is one of the questions that we are asking and in part coming to answers on in our ongoing examination of the three largest firms. As you know, we have some 40 people on that project right now, and we expect to report fully to you by early summer.

Senator REED. Your typical remedy, again, using this rough analogy, for malpractice is some type of action against the individual institutions and restitution or something, or at least to correct the behavior. And I am trying to sort of connect the dots here between at least the possibility of not operating appropriately and any type of sanction. They claim—and the claim has been, I think, affirmed—that they are protected under the First Amendment in terms of any type of legal liability.

How do we get them to behave differently if, in fact, there is a serious question of misperformance?

Mr. COX. Well, I think that from the fourth quarter of 2007 forward, we are in a different world, because now we have a regulated industry with legal standards of conduct, as we were just discussing. They can be censured. They can be hit with targeted sanctions. They can get the death penalty. There are all sorts of regulatory norms that they will now have to comply with.

In addition, we will have a marketplace that is now much more competitive, not so oligopolistic. We already have additional credit rating agencies that have been able to enter the business as NRSROs as a result of the new legislation. And the disclosure and transparency that the new regime should provide will force—I think it is the legislative intent, and we expect it as well—some quality as a result.

Senator REED. You said, Mr. Chairman, that you have got 40 individuals working on this analysis. When you implement the regulations, will you have the dedicated staff of roughly that size with the expertise to continue to evaluate the performance under the new regulations?

Mr. COX. It is not necessary to have the current examination staff on a permanent basis as part of the CRA program. But we do have budgeted approximately in the range of 10 to 20 people over the long haul for this purpose.

Senator REED. It just seems to me that in everything we read about these products, they are inherently complicated, complex. In fact, many people will not buy them. Jamie Diamond has been quoted several times saying, “They are too complicated. I do not understand them. I will not buy them.” And yet you will have about 20 people who are going to overlook the credit rating agencies. Do you think that is adequate resources to ensure that they are—unless it is simply procedural, they check the blocks, you know, we did this, we did this, we did this, but with no substantive regulation?

Mr. COX. For purposes of managing the registration and inspection regime—and, remember, we can use the resources as we are using now our Office of Compliance, Inspections, and Examinations for this purpose in the future as well. But for the ongoing purposes of managing the registration and compliance regime, I think that that is about the right number.

On the other hand, the reason that I am inviting the views of this Committee on the size and scope of this program is so that we can be sure that within the context of the overall SEC, we have, in fact, right-sized this function. It is a brand-new function. We want to get it right.

Senator REED. In that regard, how thoroughly will you anticipate the staff looking down through—and maybe this is not exactly correct, but a simple security model of a mortgage-backed security, where there are actually mortgages and a pool of mortgages, you sell securities. Then there is the CDOs, which basically gets more complicated, CDOs, squares, et cetera. Do you anticipate that your staff would be looking all the way through independently to the collateral of these securities, or at least on a spot-checking basis?

Mr. COX. Most certainly on a sampling basis, and probably across the board just in terms of the different genres of products that are being rated.

Senator REED. You raised in your opening statement the possibility of less reliance under the SEC rules on ratings. Can you amplify that?

Mr. COX. One of the concerns that has been expressed in several of the multinational fora, including the Financial Stability Forum and IOSCO, is that that there was insufficient attention paid to what these rating were and what they were not and that there was in some cases nearly mindless reliance on the fact that it said AAA. In order to make sure that the ratings are understood for what they are and what they are not, we are going to have a lot of new disclosure. At the same time, we want to make sure that there is not a check-the-box mentality, and if the rule says you can do X if you have a AAA rating, that might induce that kind of behavior.

So we will not be able to purge, by any means, our rules of references to ratings, but there may be some fine-tuning that we can do in order to make sure that we do not create that moral hazard.

Senator REED. Well, it would seem to me that, theoretically, as you diminish purposely the role of the ratings, not that, you know, Good Housekeeping Seal of Approval, put the onus, I think, either directly by rules for publicly registered companies to independently evaluate the ratings that they are either buying or they are arranging to obtain, that might be appropriate for some larger institutions, but for small investors, for municipalities, for people who are looking—do not have the infrastructure, how effective would that be?

Mr. COX. Well, I think if the only consequence of a change were to increase the investor burden, then we would not have accomplished the objective. We have got to be very, very sensitive to that. The opportunity, I think, that we have is to state very clearly in our rules what is the point that we are trying to establish, what is the objective test that we are asking people to meet. And if a rating——

Senator REED. What is that test?

Mr. COX. It depends entirely on the circumstances. The ratings themselves are mentioned in rules and in statute, I should add, in many different contexts. But if we can simply clearly state, and in plain English, what it is that the law and the rules are trying to accomplish by referencing these ratings, we can add a little more context to it so it is not just a mindless act of I got the rating even if the use of a rating for that purpose would not be appropriate.

Senator REED. Thank you.

Chairman DODD. Thank you very much.

Senator Corker.

Senator CORKER. Yes, Mr. Chairman, thank you.

I thank you for your testimony, Mr. Chairman, also, and we have had you up here many times, and we appreciate very much the position that you are in.

I have to tell you, the rating agencies do not spend a lot of time on accounting issues, and we have heard of the fact that they are not audits, which obviously they are not. But it seems to me that it would be almost impossible in many cases for a rating agency to give a rating without at least looking at some of the basic accounting principles that are being dealt with.

I spent all day yesterday with the leaders of financial institutions in New York, and this whole fair-value accounting system, which needs some kind of updating, there is a huge, huge issue there. But for them not to at least get into some of the things that are occurring there as a rating agency and how judgments are being made as to assets being written down and that type of thing seems to me a very important—and there are many others—a very important thing for a rating agency to be able to do to actually issue a rating. Otherwise, I do not know how it would occur, and I would love for you to comment on that if you would.

Mr. COX. Well, there is no question that particularly in terms of market pricing, those kinds of accounting judgments associated with fair value and related issues have had big impacts. The rating agencies have described on occasion their purpose and their object as being slightly different than predicting market prices. They are in the business, they tell us, of predicting the creditworthiness of the ultimate instrument on maturity and so on, and that, therefore, gainsays a lot of the wave motion that might occur, even if the wave motion capsizes the boat in the short run. And so these issues, at least in the current market turmoil, have really conflated—I do not think it is any longer possible to neatly parse what is the ultimate creditworthiness of the instrument from what is going on in the marketplace.

If an instrument, for example, is totally illiquid, then it is reduced to something like worthless for an indefinite period of time, and it is very difficult for adults to say that, nonetheless, it is a very valuable security and we want to own it because ultimately it is going to pay off.

Senator CORKER. So then what should be the role? I mean, should rating agencies not indulge more, if you will, on the accounting side? I mean, is that not a valuable piece of information for them, if you will, as to—because there are people, obviously, that do rely on these ratings; you know, that is what they have been put in place for in the first place. Is that not something that rating agencies should be somewhat involved in as they make these ratings?

Mr. COX. Yes, I think one of the sources of confusion for investors has been this big gulf between what they see happening in the marketplace and what they say with the ratings. And before the round of significant downgrades, there was this big gap. Ultimately, many of the downgrades had the effect of conforming the ratings with the judgment of the marketplace. And so I think that there is no question what is going on now inside the rating agencies is informed by this much different world.

Senator CORKER. Talk to us a little bit about the notion that has been floated—and we have heard a lot from constituencies about this—of separating out ratings for structured finance itself and the impact that that might have, if you will, on those particular instruments. If you would, expand a little bit on those discussions.

Mr. COX. Well, the suggestion has been made—and it is under careful consideration by the SEC and may be included in our proposed rules—that there be different symbologies for different kinds of products, whether they be structured products, corporate or municipal, for example. There is no question that a AAA rating on a structured product is very different than on a corporate, and yet the same labels being applied to all of these things might have caused confusion in that respect in the marketplace.

So I think this is a very valuable subject for us to explore in connection with our proposed rulemaking, and I can confidently predict, even though I do not know what the ultimate proposed rules look like, that we will expose that whole idea for public comment.

Senator CORKER. And that would obviously have a tremendously dampening effect on the structured finance market if that occurred, at least in the short term. Is that not correct?

Mr. COX. I do not think that would be the idea at all. The idea would rather be to let people know exactly what it is, what a rating means.

Senator CORKER. And is there a notion of maybe actually stamping structured finance as sort of a scarlet letter-type approach, if you will, to this type of financing?

Mr. COX. Well, there have been calls from State governments and State finance officers for different symbology for municipals as well. They believe that having—at least some people believe that having different symbology would actually advantage them because they believe their default rates are provably lower. And so I do not think it is inherent in the nature of having unique symbology that you are advantaged or disadvantaged in the marketplace. It is just simply a way for people to understand what it is they are talking about.

Senator CORKER. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Bayh.

Senator BAYH. Thank you, Mr. Chairman, and you, Mr. Chairman.

It seems to me that the issue we are focused on here, Mr. Chairman, is that one of the principal factors that has led to the market failures we have experienced—and I gather Senator Schumer touched upon this before I arrived—at the originating end you had brokers who had incentives to just kind of get these mortgages out the door and not adequately assess the underlying risks involved, the likelihood of the mortgages being repaid, you know, that sort of thing. Here we had the rating agencies giving their blessings to the repackaging and selling of these loans, again, possibly with incentives to do that without really digging in and accurately assessing the risks involved. And markets can't function very well without access to accurate information, and so here we are today to try and ensure that we do have accurate information going forward.

Mr. Chairman, it seems to me that this is in some ways analogous, as I think you mentioned in your testimony, to some of the accounting issues that we dealt with before. I mean, for example, can you imagine any reason why a rating agency should be allowed to pass judgment on products that it has itself helped to structure? Isn't there just an unavoidable conflict in such an arrangement? And didn't we decide that in some respects in the accounting arena?

Mr. COX. Well, there is an unavoidable conflict in that arrangement, and there are, in fact, other unavoidable conflicts that are built into either the issuer-pays or the subscriber-based models. And so what we are preparing to do in our proposed rulemaking is in some cases just flat out to prohibit them if we can see our way clear to doing that without disrupting markets and the ability of firms to function. And on the other hand, if you cannot bar a practice altogether without upending the whole thing, then to come up with approaches to manage those conflicts very clearly, for example, to make sure that at a minimum people who are in the business of negotiating fees do not have anything to do with the ratings process.

Senator BAYH. If we are going to be living going forward in a more robustly competitive world with new entrants coming into the rating marketplace, as you were describing, why would a prohibition not work since there are all the new entrants coming in and it would presumably be easier to just prohibit this without it disrupting the marketplace?

Mr. COX. Well, the only reason I left it open to either interpretation is I did not say what specific practice it was that we are talking about prohibiting.

Senator BAYH. Same thing for consulting——

Mr. COX. Without question, the easier way, even from, I would think, the firm's standpoint because they know what the rules are, would be just to flat out prohibit these virulent practices.

Senator BAYH. Same thing for consulting services by rating agencies?

Mr. COX. Yes. I think that is undoubtedly a conflict of interest, and properly structured, speaking for myself, I do not see why that could not be prohibited. But I should add once again, because while I am appearing here as an individual and as Chairman, that I am part of a five-member Commission, that there are a lot of issues here, and I do not know what we might propose in our rules.

Senator BAYH. In the previous enactment of the new law governing this area and the new robust nature of the competition you have described that is beginning to take root in this area, is it your opinion, did real competition exist among these ratings agencies before this problem we have encountered here? Was there real competition or not?

Mr. COX. Barely. If——

Senator BAYH. Somebody used the word "oligopoly," I think.

Mr. COX. I think that was I earlier in this proceeding, and that is my view. This industry needs more competition, and the legislation that you have passed will help it to mature into a much more competitive industry. That in turn, I believe, will improve the quality of the ratings.

Senator BAYH. Do you see a problem between—again, competition and markets function very well. It is somewhat dependent upon the incentives that exist in the marketplace. Is there the potential for a disconnect, a continuing disconnect between short-term incentives and long-term incentives leading rational decisionmakers to perhaps make decisions that are in their own best interests but not in the better interests of the overall functioning of the marketplace? I will give you an example here.

Just as the loan originators, the mortgage brokers, were pushing a lot of this stuff out because they were compensated in many cases by volume rather than the ultimate accuracy of the loans they were making, do we have a problem here? I know at least one of the rating agencies was publicly held directly; another is held under another publicly held company. In any event, you might get people who were being compensated because of their short-term performance, and they get bonuses. If they have stock in a publicly held company, they can cash their options or sell their stock as it becomes unrestricted. So they are making real money in the short run, so there is a real incentive to do that, even if in the long run, if things go badly, there may be some risk to the reputation of the firm and ultimately the long-term value of the stock in the firm, but the pressure is on now, they are being compensated to perform now. What about that disconnect? And how does the marketplace take that into account? Were there such strong, you know, personal reasons to make a set of decisions today but then in the long run a rational decisionmaker might not make? What do we do about that ongoing problem with the way people are compensated in these businesses? And how does the competitive model—is there a risk to the competitive model when you have that kind of disconnect between the short-term incentives and perhaps long-term factors?

Mr. COX. Well, that is very much a part of the short-termism that afflicts our markets overall. There has been on occasion a call to eliminate quarterly guidance for earnings for companies, for example, for related reasons. The compensation structure of a firm, and I would think now credit rating agencies, since they are now a regulated industry, have to be thought of in terms of the objects of the regulation and the objects of the ratings themselves in that particular industry's case.

So as we look at conflicts of interest, compensation won't be off limits.

Senator BAYH. Oh, it won't. Very good, because it seems to me, again, you could have, let's say, with, you know, seven participants or nine or ten, whatever the number ends up being, if we have a system that rewards people for making certain kinds of decisions in the short run, irrespective of their accuracy in the longer term, we could get, you know, warped outcomes that affect the entire marketplace and, hence, you know, the economy and society at large that would not be in anybody's best interest. So I am glad to hear that you will be addressing some of those issues as well.

Mr. Chairman, thank you. I am surprised you can do the rest of your day job. You have been up here with us so many times. But we do appreciate it very much.

Mr. COX. Well, if I may say so, Senator, in respect of this particular part of my job, writing regulations under this statute, it is of enormous value for me to have these conversations, these colloquies, because as I said, it is the intent behind this legislation, which is so fresh, that we are trying to flesh out with the regulations. And so I am entirely sincere when I say we want all the ideas we can get. This is the second round of rulemaking, and it is the most important one, because it is based on the very recent experience that we have had in the subprime debacle.

Senator BAYH. Thank you.

Chairman DODD. Thank you, Senator. Hence, the initial question: Do you need more statutory authority? What I do not want to discover here is have you complete this process and turn around and discover you needed additional authority to do something and we did not provide it for you when we had an opportunity to do so. And I heard your answer to the question, but I assume you will keep us posted if you encounter something different.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

Where I see the greatest conflict of interest might be in the payment model that has been set up with the credit agencies; in other words, the one who is being evaluated ends up paying the credit agency for the outcome. Do you see a conflict there that concerns you? Or are you comfortable with that model?

Mr. COX. Well, it is a necessary conflict of interest that somebody pay, because whoever pays is going to have some interest. And so in the issuer-pays model, you get one set of conflicts. In a subscriber-pays model, there are other kinds of conflicts that can arise; for example, the people who want to include certain things in their portfolio might want to have ratings that permit them to do so. And so there is really no way out, provided that someone is paying. What you are stuck with is recognizing and sharply identifying those conflicts and then managing them.

Senator ALLARD. Even if the taxpayer pays, there is a conflict, I guess, in a way. Or is there not?

Mr. COX. Well, there is a conflict with the Federal budget, I would imagine at some point.

Senator ALLARD. Yes.

Mr. COX. If we nationalize all these functions.

Senator ALLARD. You know, it is not that that model has not been used. I think in my own profession where we write a health certificate, when we write a health certificate, we are an agent of the Federal Government. We are paid by the—we act as an agent for the Federal Government, and we also act as an agent of the State that the animal is being shipped to. But the one who pays us is the one who is shipping the animal and is asking for—you know, and he will pay, and obviously we will pay a fee or whatever. But the consequences of not finding that you did something that was unethical or whatever can be pretty severe, and you could lose your license and not be able to practice in the profession.

Do you think that you have the consequences there that are severe enough to prevent bad behavior?

Mr. COX. There is no question, Senator. In addition to the sanctions that can be applied directly to the rating agencies under this new law, sanctions can be addressed to their associated persons. And so every single individual who works in an NRSRO can be the subject of SEC sanctions as well.

Senator ALLARD. I want to take you into a hypothetical area because "consistency" has been a term that has been frequently used by my colleagues here on the panel, you know, consistent results.

If we were to use—and we have consistency, I guess, in law. How in the world do you evaluate what consistency is? I mean, is it 20 percent error? Is it 30, 40, or 50? Or is it some deviation from the normal from your competitors? Do you have any idea how we would determine consistency?

Mr. COX. I think to begin with, it would depend upon the subject of the rating. It would depend upon the industry and its volatility and its history. So that coming up with a very simple rule of thumb that would apply across the board to everything in the capital markets I think would be impossible.

The best approach to that kind of complexity is to have the maximum amount of disclosure of all the material information and then to permit comparison in the marketplace.

Senator ALLARD. Let me ask a question about disclosure. If you have foreign securities, is disclosure a problem? You know, you might, for example, have a business that is partially owned by some foreign government. And so how do you get an adequate disclosure as to the background of how you are going to valuate that security? It kind of gets to the accounting issues, I think, that we were talking about earlier here on the Committee. How do you handle those kind of foreign securities?

Mr. COX. Well, transparency varies dramatically from jurisdiction to jurisdiction, and in some cases, one is left with nothing more than a brand name to go on, because there is so little behind it when making an investment decision.

On the other hand, in some other jurisdictions, there is a great deal of transparency, and the level of accounting detail and disclosure about management and ultimate parents and so on is what we would be accustomed to here in the United States, ordinarily so.

So it just depends entirely on the jurisdiction in which——

Senator ALLARD. A brand name is pretty subjective, isn't it?

Mr. COX. Yes, of course. And I think that people investing in those parts of the world tend to use diversification at some protection for the risk that they are taking.

Senator ALLARD. I have always been under the impression that what happens in the marketplace as far as rate of return is somewhat influenced by the risk of the investment. Do you think that holds up still today? And do you see a correlation between—I suppose there is because what happens with the rate of return—I mean, when they do an anticipated rate of return, I suppose they take into account how the rating agency rated that particular security.

Mr. COX. The correlation between risk and return is as ironclad as the certainty of death and taxes.

Senator ALLARD. And you see it—and what you are seeing in—did you see an instance in these securities, particularly the home mortgage products, was there a higher rate of return with those more risky mortgages or not?

Mr. COX. Well, I think that part of the alchemy that led to what we saw in the subprime turmoil was this sense that there was a cost-free way to improve the return.

Senator ALLARD. A cost-free way to——

Mr. COX. Yes. It turned out not to be the case.

Senator ALLARD. Yes. But there was an anticipation of greater return on their investment, would you say?

Mr. COX. Yes, of course.

Senator ALLARD. And so——

Mr. COX. And from the issuer standpoint, the opportunity to securitize permitted them to borrow at lower rates.

Senator ALLARD. And that assumption of where that rate of return came from, do you think it was just the experience of the investor with the market? Of course, every individual would have different experiences in that regard. Or was it based pretty much on credit rating? Or both?

Mr. COX. Well, I think the overall sense in the short run was that a better mousetrap had been built, that one of the working parts of that mousetrap was the credit rating, and even against the evidence, late in the game people clung to the hope and the belief that somehow it could be true.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much. You raise a couple of issues, and I think Senator Schumer may be on his way over as well to ask a couple of questions before we move to our second panel.

If I may, we received a letter yesterday from a group of individuals, the Real Estate Roundtable, the Mortgage Bankers Association, Commercial Mortgage Securities Association, the National Association of Realtors. I presume that was all one letter. Was that one letter?

They were opposed to proposals of the President's Working Group to differentiate between credit ratings for structured finance products and other assets. What is your reaction to that? I will see you get a copy of the letter, too, but I would be curious what is your reaction.

Mr. COX. Just a moment, if I may.

[Pause.]

Chairman DODD. They make a case, by the way, in the letter, in fairness, they say that the changes would—and I quote them here—"contribute to greater market volatility and investor confusion."

Mr. COX. Well, I have not seen the letter myself, but this is a subject that I think we are very interested in. I know that at IOSCO, regulators around the world are interested in this topic; within the Financial Stability Forum, it has been discussed; within the President's Working Group it has been discussed; at the staff level at the Securities and Exchange Commission and at the Commissioner level, it has been discussed.

So I would predict that whatever occurs in our proposed rules, we would ask the public questions about this and engender more of that kind of comment on both sides of the issue.

Chairman DODD. I would be very interested in hearing if you do develop that or where maybe the Commission is heading with that. I would be interested.

Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman. And thank you. I am sorry that I could not be here for the testimony, but I have a few questions based—some based on our discussions that we had, which I want to again reiterate I appreciate your coming to my office and briefing me on these ahead of time.

Now, we all know now that the SEC has stronger oversight authority over the agencies since the legislation that Senator Shelby, Senator Dodd, and others of us endorsed is now the law. And so you have had examiners at the firms, and my focus is on the conflict of interest issue.

I know your investigations are ongoing, but can you just give us a sense of what you found regarding the agencies' compliance with their stated procedures intended to control conflict? In other words, the article here that I referred to earlier, which I found did a very good job, seems to indicate that before you were given authority, there were conflicts and nobody paid much attention to them within the credit rating agencies themselves. Is it getting better? Do they have their own controls? Does some little buzzer go off when a supervisor wants to change the person on the job because he is not giving or she is not giving as good a rating?

Tell me—I am not asking for any specific investigation about a specific agency. I am asking in general how good are the agencies at uncovering these conflicts now that it is against the law to—you know, now that these conflicts are against the law.

Mr. COX. Well, I feel very confident in saying that it is better. It is better for obvious reasons. There is so much focus on this right now and so much has gone wrong that many have reacted with alarm, and there is a lot of attention being paid to it.

We have in the course of our examination thus far found examples of apparent failure to adequately manage conflicts of interest, and some instances have even occurred this year.

Senator SCHUMER. So it would be better, but there are still lapses, even after all the focus on credit rating agencies. Is that a fair way to put it?

Mr. COX. That is a fair way to put it.

Senator SCHUMER. And what are you doing when you find these lapses?

Mr. COX. Well, of course, we are in there with live bodies in real time, and so anything that is brought to our attention is dealt with on the spot. But, in addition, we are going to make broad inferences based on our examination of the three largest firms and present those publicly, as well as to the firms in early summer.

Senator SCHUMER. Good. So we will learn about some of these lapses.

Mr. COX. Yes.

Senator SCHUMER. And that should be somewhat prophylactic as well in terms of preventing them from doing it again.

Is it that the agencies do not want to? Or is it just so embedded in their culture? You know, this article points out when new management came in at Moody's, the whole world changed because they wanted to increase market share in something that ended up being risky, although it probably was not thought to be risky at the time. When you go to the higher-ups in the firms, do they want to change? Do they want to get rid of these conflicts of interest? Or do they say, hey, we will lose business, we better be careful and not do it so fast?

Mr. COX. Well, it sounds as if you have, as I have, met with the leaders of these firms, and they certainly express a strong desire to deal with these problems and to take them seriously. I think the only proof, however, is going to be in the pudding.

Senator SCHUMER. Right, and they are not there yet. OK.

One other question related to this, and I thank you, Mr. Chairman. People have questioned the agencies' reliance on information supplied by the issuer to determine their ratings. You know, I guess the average person, maybe even the average investor feels that the credit rating agencies do not just take the information that is given, but go investigate and see if it is for real, because obviously the issuer is going to put their best foot forward.

Have you found—shouldn't there be some disclosure on the amount, or the lack thereof, of the due diligence that is performed on a bond?

Mr. COX. Yes.

Senator SCHUMER. In other words, if they did not investigate it, if it has another no-doc loan in some other area, they should say that clearly: This is has no documentation, and we did not investigate it; or, It has documentation, and we did not investigate it; or—you know what I am saying.

Mr. COX. Yes, that is an important subject for disclosure. It is one that I mentioned in my testimony that I think may well be covered in our proposed rules.

Senator SCHUMER. Right. Now, let me ask you this: Do you think—this is, again, based on that article, which I guess you might think from my testimony I am obsessed with, which I am not.

[Laughter.]

Senator SCHUMER. But do you think that—it is just a good article. That is all. I did put it in the record in my opening statement, Mr. Ranking Member.

Do you think significant changes in market share should automatically trigger enhanced scrutiny by the SEC over the rating agency activity? If all of a sudden they rated 20 percent of these bonds and now they are getting 70 percent in a year, something is up. What do you think of that idea?

Mr. COX. Well, because you provided it to me, I have had a chance to read that article, and——

Senator SCHUMER. Oh, there you go.

Mr. COX. There is absolutely no question that that kind of red flag should be a guidepost for an examiner.

Senator SCHUMER. Good. That is good to hear. And what about other red flags, such as significant deviation in ratings performance from historic averages or significant analyst turnover? In other words, you may not have the specific on this case, but you are seeing there are a lot of analysts that have been turned over lately. Should that also provide a similar red flag?

Mr. COX. I think so. Obviously, the facts will inform in any particular examination where the examiners want to go, and I think over time, as the SEC develops more and more expertise in this, we will have, either formally or informally, a whole set of——

Senator SCHUMER. Right. And we can expect some of these in the proposed rules that you are going to put out this summer, I presume.

Mr. COX. Yes, although what we are talking about right now is the kind of thing that examiners are going to look to.

Senator SCHUMER. Right, or guidance to the examiners that might be made public. We are going to see concrete evidence of some of these things happening, and it will be sort of out there publicly that you are doing it.

Mr. COX. I——

Senator SCHUMER. Not specifics. The general things.

Mr. COX. I can undertake to do that, yes.

Senator SCHUMER. Good.

Mr. Chairman, thank you.

Chairman DODD. Thank you very much, Senator.

Let me ask one more question. Again, Professor Coffee is here and obviously is going to be testifying, but he, I thought, raised a very good issue in his testimony. It goes beyond the issue of the due diligence and all of the questions that Senator Schumer, Senator Shelby, Senator Reed, and Senator Corker raised, and that is the staleness of data. It is one thing to get it wrong initially, but then to have a conclusion hanging around for a long time, when information emerges that would certainly warrant at least someone stepping up to the plate and saying something—in fact, he calls it the "gravest problem" may be the staleness of the debt ratings. And I guess the agencies—are agencies timely in updating ratings and withdrawing obsolete ratings? What standards should they observe in that process?

On page 8 of his testimony, the professor points out that major downgrades of CDO securities came more than a year after the Comptroller of the Currency first publicly called attention to the deteriorating conditions in the subprime market and many months after the agencies themselves first noted problems in the markets. I think it is a very good point, and we have talked a lot about the front end of this. But the staleness of data I think is a very good observation. What is the reaction of the Commission to that?

Mr. COX. Well, I think that overall, first, I should say that the contribution that Professor Coffee has made to this whole discussion has been exceptional, and I want to thank him, and I am glad you have him on your next panel. I am glad he is here today. And certainly at the agency, we have spent a good deal of time taking all of that in.

Second, at least as a matter of pure disclosure, it seems completely feasible to deal with this issue, to require disclosure of how often the models are updated and how they do surveillance, how the rating agencies do surveillance of their past ratings.

Chairman DODD. I appreciate that.

Senator Shelby.

Senator SHELBY. I want to pick up on something Senator Schumer brought up. Thank you, Senator Dodd.

How do you measure these rating agencies in a sense? Transparency will help, but the SEC has to play a role here because this is such a debacle. They tell us at times—and I have talked to some of them—well, gosh, you know, we are just giving our opinion. Are they? Is it more than my opinion? They say, well, under the First Amendment of the Constitution, we are just giving our opinion, free speech. But they are selling this information, and then it is relied on all through our financial system. So there is something amiss here, Mr. Chairman. You know, as Chairman of the SEC, I know you are going to look at all this, but Senator Dodd brought up that the Comptroller of the Currency has to start asking some questions about some of the subprime things. Where were the rating agencies early on in this? I am afraid what they were doing is continuing to rate a lot of these subprime securities at investment grade, some even AAA and so forth. And, Mr. Chairman, I will ask you as you get into this: When did they start downgrading their ratings? Was it after the whole thing was in a free fall?

I do not know, but I just know something is amiss here in all of this. We went through the Enron deal, but, gosh, this is so much bigger, you know, in many ways than that. And I know that the rating agencies play an integral role here. The SEC has to play a big role of oversight here. Make no mistake about it.

Mr. COX. Well, I think the fundamental answer to your question of how you measure their performance is the quality of their ratings. And, you know, up until very recently, there has not been a lot of competitive pressure on that quality, and so whatever——

Senator SHELBY. Is that because everybody bought into it, you know, the euphoria?

Mr. COX. It is for a variety of reasons, but not least of which is that there are very few of them, and yet ratings were by regulation and by law in many cases required. And so they had a Government-required function. There was no place else to shop, and so that is not a good competitive climate to begin with.

The measurement of the quality of ratings is inherently subjective. It is going to be quantitative, to be sure. It is going to be analytical. But there are so many things that go into it, it is going to inherently be subjective. It is the kind of thing that markets are good at.

Our disclosure system at the SEC when it comes to price discovery for all sorts of things, like corporate equities, helps people arrive at a very specific number, the price for a security, whether people think that that price is the future discounted cash-flow, the quality of management, new product introductions, or what have you. Reducing complexity to a measurement like that is what markets are very good at, and the SEC is very good at disgorging information to the public and making sure there is full disclosure so that the public can make those judgments. I think that is what we are about to do now with credit rating agencies.

Senator SHELBY. Mr. Chairman, if the rating agencies are the linchpin of our financial markets, our securities market—and a lot of people believe they are—our linchpin is broken right now as far as confidence, trust in the financial markets. And I believe it is going to be—a lot of what you do, and your other Commissioners, and what we try to help you do is going to help restore some of that. But the old way of doing business with the rating agencies, that has got to go. I believe it has to, and it should have already gone.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, and I am going to leave the record open, Mr. Chairman, for additional questions that may come from members here. We have a second panel I want to get.

Senator Reed and I were chatting and, you know, raised the issue—which I will not raise with you right now because—unless Jack wanted to bring it up, but the whole notion of whether or not—I have had some people say to me, Why even bother having rating agencies in this day and age? There is a case to be made for people who are in this world who wonder whether or not we are just spinning our wheels in a sense by doing this. I think there is an argument for it. And, second, why not even consider the possibility of sort of a nonprofit sort of a credit rating agency, have a colleges approach that sit and determine whether or not something is a good institution or not, to take all the conflict out altogether?

Now, that is a bigger question than what we have asked you to do here, but do you have any quick comments on that at all? I mean, that is an idea that has been raised by some. We may never be able to address—as you point out, both from the subscriber as well as the issuer, the conflicts are going to be there, no matter which side of this you flip it. And so are we reaching a point that maybe we ought to be talking about a different system altogether? To go to the question Senator Shelby has raised here, if this is the linchpin in all of this. What are your thoughts on that?

Mr. COX. I think it is entirely possible to have private sector entities that are commercial in nature that are, nonetheless, independent from the securities that they rate and who do a good job of it.

There is a conflict of interest in virtually every commercial relationship in the sense that, you know, if you go to the dentist and it is the dentist's interest to charge as much money as possible and you do not really know that much about dentistry, well, the dentist could tell you that you need all your teeth replaced.

Chairman DODD. I can sue that guy for medical malpractice. I cannot sue this guy.

Mr. COX. Well, I think that that is what is changing. The result of the legislation that you passed and the regulatory authority that you have given us, the ability that we now have to define practices, define what is necessary to manage, mitigate, or end entirely those kinds of conflicts of interest makes this all very different.

The authorities that we have under the securities laws will now apply in like way to participants in this market; not only the firms themselves but their associated persons will now be subject to sanction by the SEC. And so the difference between being completely unregulated, which was the case 6½ months ago, and now being a regulated industry is enormous. And I think there is a good deal of reason to expect that it will do a lot of good.

Senator SCHUMER. Mr. Chairman?

Chairman DODD. Yes.

Senator SCHUMER. Just one question, if I might. I mean, there is an intermediate step. Senator Dodd's ideas are, as usual, intriguing. But do you think there is less conflict in the investor when the investor pays the agency as opposed to the issuer paying the agency? I mean, it is conflict from the other side. It puts the premium on not AAA but maybe failing grade, you know; or it moves it in one direction rather than the other, is a better way to put it. But does one make more sense than the other? Should that be something that is seriously explored as well?

Mr. COX. Well, I think that both make more sense in combination, because each is a check against the other. And what your legislation has opened the door for now is relatively easy entry into the market for subscribed-based ratings.

Senator SCHUMER. And there are few right now.

Mr. COX. There are already two that we have registered. I expect there will be more in short order.

Chairman DODD. Interesting. Mr. Chairman, very good We thank you immensely, and please stay tuned. And stay in touch with us, too, on this issue, on that question. If there is additional statutory authority that your agency thinks you may need in this area, this Committee would very much want to know that as soon as possible.

Mr. COX. Thank you very much, Mr. Chairman.

Chairman DODD. If our second panel would come up quickly, and I apologize. You have been waiting a long time.

We hardly need to introduce Professor Coffee. He has been talked about so often here that he has already been sort of introduced. But Professor John Coffee, Columbia Law School, served on distinguished legal bodies, published significant research, and contributed to the work on Sarbanes-Oxley.

We are pleased to welcome Dr. Arturo Cifuentes, the Managing Director on the Structured Finance Department of R.W. Pressprich, and former Managing Director of Global—the global head of collateralized debt obligation research at Wachovia Securities.

I want to welcome the representatives of the three largest NRSROs: Vickie Tillman, Executive Vice President, Standard & Poor's; Claire Robinson, Senior Managing Director of Moody's Investor Service; and Stephen Joynt, President and Chief Executive Officer of Fitch Ratings.

I want to underscore the point that Senator Schumer raised earlier, and I understand in Moody's case there was a conflict today because of shareholder meetings. And obviously his obligation is to be there for that. But for these other rating agencies, I would very much like to have heard from the heads of them. We have got people here from these agencies, but, candidly, it is a little more difficult to expect them to respond to these questions that we are all going to have for them.

Senator SHELBY. May I say one thing, Mr. Chairman?

Chairman DODD. Let me turn to Senator Shelby.

Senator SHELBY. Mr. Chairman, I want to associate myself with your remarks. I want to commend the President and Chief Executive Officer of Fitch Ratings for coming to this hearing. But I am disappointed, as you are, and Senator Schumer was, and others, that the other CEOs of Standard & Poor and also Moody's, regardless of conflict—this is a Senate hearing on something that I think is very, very important. And we are going to get them here, I hope, Mr. Chairman, because although they will have able people here testifying on their behalf, it is not like having them here themselves.

Thank you.

Chairman DODD. I appreciate that.

I appreciate your patience. First of all, you have been—I hope this hearing has been instructive as you have been sitting there listening to all of this, and helpful to some degree. Certainly you have heard the expressions expressed by almost every member here about their concerns about all of this and the importance of this issue. So let me begin by asking for your comments, and, again, your testimony will be included in the record, beginning with you, Professor Coffee, and we will then turn to Ms. Tillman, Ms. Robinson, Mr. Joynt, and Mr. Cifuentes.

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

Mr. COFFEE. Thank you, Chairman Dodd, Ranking Member Shelby, and it is a pleasure to be back again in front of your Committee. In order to be brief, let me break my testimony down into three short segments.

First, and very briefly, what have we long known about the rating agencies? And I suggest none of this is about to change. We have long known that they face limited competition, and if you want, they share an oligopoly.

Two, we have long known that they face very little liability to investors, and, indeed, they have never been held liable to investors. That is different than every other financial gatekeeper, auditors, securities analysts, or anyone else.

Next, they have a built-in conflict because they are a watchdog paid by the party they are to watch. Now, auditors are also, but auditors face real liability.

And, fourth, they have a business model under which they can make money, even if no one trusts their ratings, because they are also selling regulatory licenses. Institutional investors cannot buy debt securities without their rating, and that protects them even if they are off the mark.

OK. That is what we have always known. What have we learned recently? We have learned, first of all, that the rise of structured finance was immensely profitable, but it did destabilize this industry by aggravating those longstanding conflict of interest problems. Why? There is no single corporate issue that has any leverage over a major ratings agency. But structured finance is controlled by basically five or six large investment banks. They package these deals on a monthly basis. They do have some real leverage with respect to their rating agencies, and thus, that means for the first time there are clients that have clout with respect to you. That was different than the past.

Next we have learned that rating structured finance is very different than rating straight corporate debt. You rate straight corporate debt largely based on publicly available financial information, SEC reports, stock market and bond market prices—all of which tell you a lot. You rate a pile of mortgages—3,000 mortgages in this pile—it is opaque, it is non-transparent. It is much more difficult to do, and it is done basically on a quantitative model—a quantitative model that has never been in existence that long enough to have been fully checked out. That is point one.

Point two of what we learned recently, loan originators and investment banks have learned how to game the model, how to play with it. This is partly because for a large advisory fee, the rating agency showed them how their model works. And once you are shown how it works, you learn how just tweaking it a little bit and selectively editing the data can get you a better rating.

Now, I am not saying that rating agencies engage in fraud. What I am saying instead is that because the rating agencies are very vulnerable to selectively edited information, and also to misleading information, we have a system that is defenseless against loan originators and others who have strong incentives to try and game the system.

Next point. Because the credit rating agencies do not perform any due diligence themselves—and some of the Senators were making this point earlier—because they do not do verification work themselves, they are almost uniquely vulnerable, maybe even defenseless, to selective editing and misinformation given to them by loan originators who have every incentive to game the system and try to get a higher rating.

OK. The credit rating agencies also appear to have responded, in my judgment, in a fashion that I have to call tardy and slow to massive changes in the housing market. The Comptroller of the Currency and others—and they knew it themselves—saw major changes in which for the first time home purchasers were getting 100 percent financing without any equity stake. They were able to get mortgage loans based on no documentation. All of these things means that you are vulnerable to significant problems, and there was a worldwide market demanding all of the CDO securities that you could sell if they had that letter rating. All of this meant there was vulnerability, but it was not until after the crisis broke that we saw the major fall, the major downgradings, which really as a major downgrading began in July of 2007.

Now, against that backdrop, what do I suggest most needs to be done? Well, let me suggest that the single biggest problem is probably that no one verifies the data. In the world of structured finance where you are using a quantitative model, the oldest rule about quantitative models is: Garbage in, garbage out. And you are going to get people selectively giving you somewhat incomplete information, and there is little you can do about it. Even for the future, we have to expect that loan originators will continue to provide biased or selectively edited information. It is in their own self-interest.

It is difficult to overstate this. This is almost as if the credit rating agency were in the position of an accounting firm that went to the corporate client and said, Give us your data, your revenues, your costs, your liabilities, and thank you very much; we won't check this, we will just produce your net income figures, and we will tell the world what your earnings per share is.

That is where I think you have to begin, and I suggest that SEC rules to be meaningful have to introduce some form of greater verification. Verification is being done. I recognize it cannot be easily done by the rating agencies because they do not have the in-house staff to carefully verify thousands of thousands of securities.

But issuers and underwriters today hire independent, due diligence firms that go out there and evaluate the quality of the collateral in the loan pool. That information, I suggest, should also be provided to the rating agency. And, indeed, the strongest rule that I would suggest to you is that NRSROs, Government-licensed rating agencies, should not be able to give an investment grade rating on structured finance products without having before them some report from an independent expert that sampled the loan collateral and reported that the loan collateral met the following parameters: there were not more than 10 percent of these mortgages that were without an equity investment, there were not more than 10 percent that had no documentation, or there were more, and we will disclose that. That I think is necessary so that we have a gatekeeper that really has both the auditing and sampling component as well as the analytical component.

I would suggest to you today that the credit rating agencies have a lot of competence, a lot of skill of analysis, but very little on verifying and gathering data.

Now, two other ideas that are in my testimony, I will be very brief about these. One, there is the problem of stale ratings. If you compared the debt rating agency to the securities analyst—and they are functionally similar—securities analysts update their ratings on a quarterly basis. I would suggest there is a lot of harm to the smaller institutional investor—and you have them in each of your districts. These are the school boards, the colleges, the charities, and the endowments who sit there and see that 2-year-old credit rating, that may no longer be accurate, that may no longer even be what the agency itself would give under its newer model. I would suggest something like an annual revision requirement. You go back, you review it, and you either renew it, change it, or withdraw your rating. But stale ratings are dangerous to less than sophisticated institutional investors.

I would suggest something like an annual revision of your rating; and, second, when you change your model, make a material change in your model of methodology, you should go back and figure how that would change your past ratings, because today there are ratings that are sitting out there even though the model has changed and you would not give that same rating today.

The last thing I would suggest to you besides dealing with this problem of staleness is the financial scoreboard. I think there are lots of less than sophisticated institutions that sit there and know one rating agency or two. They do not know there might be eight or nine or ten in another year from now. If you had the SEC giving us one financial scoreboard that showed the ratings of all of the NRSRO rating agencies, what would they learn? They would learn that, well, agency one and agency two gave an investment grades. Some of these newer subscriber-pay rating agencies are more critical and have given it junk or intermediate status. You would learn the diversity of opinion. And when you learn that diversity of opinion, you might decide to put your short-term money in Government securities or something else rather than AAA-rated CDOs.

I think the SEC would be the right party to do this because you do need to standardize some of the terms. Things like default rates that should be on this website can be computed in different ways. I do not know which way is best, but I think the SEC could give us one standardized technique so they could tell us the default rates on these various classes of products for each of the major rating agencies that are NRSROs.

I think I have gone over my time, so I will stop there and answer any questions that you have.

Chairman DODD. No, that is very helpful and very insightful as well. Obviously, we want to hear the witnesses.

I hate to interrupt here. Have you voted, Jack?

Senator REED. No.

Chairman DODD. All right. What we will do is we will go over and vote, and whoever gets back here first, just start right in. So if you would be patient for about 7 minutes, we will come right back to you. I apologize to you, but we have a vote on the floor of the Senate. But thank you very much for your testimony, Dr. Coffee. When we come back, we will hear from Ms. Tillman.

The Committee will stand in recess.

[Recess.]

Senator REED [presiding]. If I can ask you to take your seats, Chairman Dodd asked the first returning member to reconvene and to begin to take the testimonies. And I believe we have concluded with Professor Coffee.

Ms. Tillman, please.

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

Ms. TILLMAN. Thank you, Mr. Chairman, Mr. Ranking Member, Members of the Committee, and good morning. I am Vickie Tillman. I am Executive Vice President and head of the ratings business for Standard & Poor's, and I appreciate the opportunity to speak before you today.

Senator MENENDEZ. Ms. Tillman, could you put your microphone toward you.

Ms. TILLMAN. Oh, sure.

Senator MENENDEZ. Thank you.

Ms. TILLMAN. You are very welcome.

At Standard & Poor's, a core principle of our business and key driver of our long track record of analytical excellence is a constant commitment to improvement. Over the past several months, rating agencies have been the object of significant focus, including much critical attention. We have listened to, and reflected on, the numerous comments and concerns, and we have focused our efforts to enhance our ratings process, provide better and more information to investors, and promote confidence again in our ratings. The result has been a series of actions that we announced in February earlier this year. But before I go over those actions, I would like to note that ratings speak only to creditworthiness, and there have been a significant number of downgrades, and downgrades, again, are not defaults. They are movements because things do change in the environment. But there have been significant downgrades in the RMBs area and in other structured finance securities. But, to date, the volume of actual defaults on those securities has been less than one-fifth of 1 percent of all U.S. RMB assets Standard & Poor's has rated between 2005 and the third quarter of 2007. And those numbers at one-fifth of 1 percent are those that have actually defaulted.

I have attached to my testimony a detailed description of these actions that we released in February, and they include an update that we published earlier this month outlining the significant progress we have made to date in implementing them.

In total, there were 27 different initiatives. I would like to highlight four broad categories.

The first category of actions relates to our governance procedures and controls. Notably, initiatives in this category include: establishing an "Office of the Ombudsman" to address concerns related to, for instance, potential conflicts of interest; implementing "look back" reviews when analysts leave to work for an issuer; implementing periodic rotations for lead analysts.

The second area is in analytics. The category of actions focuses on the substantive analysis we do in arriving at our ratings opinions. Notable initiatives in this category include: establishing an independent "Model Oversight Committee" to assess and validate the quality of the models used in our analysis; complementing traditional credit ratings analysis by highlighting non-default risk factors that can affect rated securities, such as volatility of ratings, correlation, and recovery.

The third area is in terms of information. Notably, initiatives in this category include: presenting "what if" scenario analysis in our rating reports; implementing procedures to collect more information about the processes used by issuers and originators to assess the accuracy and integrity of their data and their fraud detection measures; increased dissemination of ratings-related data, including default statistics; developing an identifier to highlight when a rating is on a securitization or a new type of structure.

And the final area is very important as well, and that is education. And these actions relate to our efforts to educate the market about ratings, their role, and their limitations. Notably, initiatives in this category include: launching a market outreach program to promote better understanding of complex securities that Standard & Poor's may rate; working with other NRSROs to promote ratings quality through the introduction of best practices and issuer disclosure standards.

We have been working aggressively to implement these actions. We welcome further suggestions as to how we can enhance market confidence and continue our tradition of quality of ratings that offer opinions on creditworthiness to the market.

In addition to these initiatives, we have been engaged in discussions with legislators, regulators, market participant in the United States and around the world. For example, we have actively been involved with IOSCO as it considers possible revisions to the model of a code of conduct as it relates to securitization. Similarly, we have participated in an ongoing review of rating agencies by CESR and having engaged with the Financial Stability Forum members in a dialog about their suggestions. Here at home, we have been working with the SEC as it conducts its first exam of our ratings process under a recently established regulatory framework. That exam is still in progress. Its scope is extensive, and the SEC staff has been extremely active and thorough in their work.

We look forward to the SEC's completion of its work, and we are committed to addressing any recommendations that the Commission may have following its review process.

We are also focused on the work being done by the President's Working Group. We fully support the group's efforts to bring transparency, stability, and confidence to the capital markets, and we look forward to working with them to help drive the effective functioning of the credit markets.

In conclusion, I would like to thank you for the opportunity to participate in this hearing, and I would like to let you know that we are committed to improving on our analytical excellence and our desire to continue to work with the Committee as it explores developments affecting the capital markets, and I would be happy to answer any questions that you may have. Thank you.

Chairman DODD [presiding]. Thank you.

Ms. Robinson, welcome.

STATEMENT OF CLAIRE ROBINSON, SENIOR MANAGING DIRECTOR, MOODY'S INVESTORS SERVICE

Ms. ROBINSON. Good morning, Chairman Dodd and Members of the Committee. I am pleased to be here on behalf of my colleagues at Moody's Investor Service to discuss our views of some of the recent developments in the credit markets and the initiatives underway to address them, both at Moody's and across the industry.

As you are well aware, the global credit markets have seen incredible turmoil over the past year. That turmoil has been driven by many causes, one of which is the deterioration in the U.S. housing sector resulting from an unprecedented confluence of factors. These include a sharp erosion in mortgage underwriting standards, misrepresentations in the mortgage application process, the steep decline in home prices, and a sharp contraction in credit available for refinancing.

The rating agencies are one of many players with historically well-defined roles in the credit and structured finance markets. We believe that addressing the current challenges in the credit markets, including the general loss of confidence among many individuals and institutions, will require action on the part of all market participants. We are eager to work with the Congress, regulators, and other market participants to that end.

Over the past several months, Moody's has been working constructively with various global authorities, policymakers, and others to identify and begin implementing initiatives that can enhance confidence in the global credit markets. We have been cooperating fully with the SEC in its review of these issues. That review has been extensive, and it is continuing.

The President's Working Group in the U.S. and the Financial Stability Forum internationally also have examined the current market turmoil and developed a series of recommendations for addressing it.

We believe that implementing these measures globally can have a positive impact in helping to address some of the current issues in the credit markets. And we have already begun to adopt many of these recommendations.

Moody's has always been committed to continuously improving our ratings processes and analytic capabilities. We have recently undertaken several significant initiatives to enhance the quality of our analysis, address concerns in the marketplace, and further improve the usefulness of our credit ratings to investors. These measures include steps to: enhance our analytical methodologies, enhance our review of the due diligence process conducted by originators and underwriters, provide more clarity about the credit characteristics of structured finance ratings, promote objective measurement of ratings performance, continue effectively managing potential conflicts of interest, and enhance investors' understanding of the attributes and limitations of our ratings.

Let me elaborate on two of these initiatives.

Moody's has implemented several measures to further demonstrate the independence of our rating process. These include formalizing the separation of our ratings-related and non-rating businesses, enhancing our credit policy function, and codifying our existing policies about analysts' communications with issuers.

We are also implementing a lookback review to confirm the integrity of analysis performed by any analyst who goes to work for an issuer or issuer's agent that he or she covered while at Moody's.

We have also undertaken a review of our rating system for structured securities. We have proposed five different potential alternatives to the current structured finance rating scale and asked market participants for their reactions to these proposals. Those alternatives could include moving to a completely new rating scale, adding a modifier to ratings on the existing scale to identify them as structured finance, or adding a suffix to the existing rating scale to indicate rating volatility risk.

Finally, recent events show how rapidly and dramatically markets can change in today's global economy. That is why we believe improvements to all market practices, including improvements to credit analysis, must be pursued vigorously to restore confidence in credit markets. We are firmly committed to the effectiveness, integrity, and transparency of our rating methodologies and practices. In this regard, we look forward to continuing our dialog with the authorities and market participants to help strengthen confidence in the financial markets.

I am happy to respond to any questions.

Chairman DODD. Thank you very, very much. We appreciate your being here.

Mr. Joynt, we thank you very much.

STATEMENT OF STEPHEN W. JOYNT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FITCH RATINGS

Mr. JOYNT. Thank you, Mr. Chairman, for inviting me. My name is Steve Joynt. I have been President and CEO of Fitch Ratings. I have been with the company for 18 years, and I have been President for 12 years, so I have a good degree of experience in the industry. I am happy to answer your questions after some brief remarks.

The past 10 months have seen continuing deterioration in first the U.S. and then in global fixed-income markets. Severe asset quality deterioration in the U.S. subprime market and related CDO securities initially caused large market price declines that required revaluations of these securities by financial institutions because ultimate credit losses are now expected to be far greater than anyone anticipated.

Today's market stresses, however, have become more broad based and emanate from a global reassessment of the degree of leverage and the appropriateness of short-term financing techniques inherent in today's regulated and unregulated financial institutions. Deleveraging is dramatically reducing liquidity and contributing to price volatility. Many financial market participants today are seeking ways to enhance stability in the system.

Fitch's contribution to a better functioning market requires a reassessment of the changed risk environment, rating changes that reflect these changes in risk, ratings that are more stable and reliable, an improvement in our analysis and modeling techniques, and, finally, full transparency so investors and all market participants can understand and use our ratings to supplement their own risk analysis and their own decisionmaking.

Like all of the major rating agencies, our structured finance ratings have not performed well and have been too volatile. We have downgraded large numbers of structured finance securities, particularly in the subprime mortgage and CDO areas, in many cases by multiple rating notches. While we still expect almost all AAA securities to pay off, we have downgraded many, and some previously highly rated securities are at risk of incurring losses in the future.

While we were aware of, and accounted for, the many risks posed by subprime mortgages and the rapidly changing underwriting environment in the U.S. housing market, we did not foresee the magnitude or velocity of the decline in the U.S. housing market nor the dramatic shift in borrower behavior brought on by the changing practices in the market. We also did not foresee and are surprised by the far-reaching impact the subprime crisis has had on markets throughout the world.

Understandably, the rating agencies have lost some confidence of the market for which I am disappointed. I think it will be a long and difficult road to win back confidence. We have, however, aggressively started down that road, and we believe we are making progress, although slowly.

To win back investor confidence, we simply must do a better job with our structured finance ratings and all our ratings. Our structured finance ratings must be more predictive and stable. Our research and analysis must be more forward thinking and insightful. We must tell investors about what might happen tomorrow instead of just what has happened yesterday. We, of course, remain committed to ensure that our work is of the highest integrity and objectivity.

We have reevaluated our ratings across all structured finance areas and the financial services industry broadly as the credit turmoil has progressed. We are working hard to anticipate what might come next. Fitch has also been busy reassessing our structured finance criteria and models, changing them to reflect what we have observed in this turmoil. It has been our belief that we best serve the market by concentrating our efforts on improving our ratings, our criteria, and our models before doing anything else.

As we conduct this work, we have decided to stop rating new issues in some structured finance markets that have experienced some of the greatest turmoil, such as CDOs. We will remain out of these markets until we can assure the market and ourselves that we have adequately updated our models and criteria to reflect what we have observed during this turmoil.

The world's financial infrastructure has become increasingly interconnected, and it seems as a result that credit ratings have become increasingly important to all market participants. Unfortunately, we have come to learn that ratings have been used in some cases as a proxy to measure liquidity and market risk, which ratings were never designed to address. Accordingly, we must do a better job at providing ratings and additional tools that allow investors to better assess risk in this increasingly complicated environment.

We have been busy working with the other rating agencies as a group to increase transparency and the quality of ratings and to address the many varied concerns of regulators around the world. Here in the U.S., we have worked with the SEC extensively in their extensive examination of us. They began their formal examination last September. They have been conducting a thorough examination. We believe that will prove constructive to the SEC as it undertakes the important work Chairman Cox described, considering new rules for credit ratings and credit rating agencies. We support their efforts to improve transparency, integrity, and quality of ratings, and we believe their work will aid our efforts to win back investor confidence.

We have been actively meeting with the staff of this Committee and the staff of the House Financial Services Committee, who have both taken a leadership role in understanding this market turmoil. And since last spring, we have been meeting with the Treasury Department, many bank regulators, State insurance commissioners, and many State and local officials, as well as the broad base of investors to share our perspective and gain insight from them.

Thank you. I am happy to answer your questions.

Chairman DODD. Thank you very much.

Mr. Cifuentes, thank you for being here.

STATEMENT OF ARTURO CIFUENTES, Ph.D., MANAGING DIRECTOR, R.W. PRESSPRICH & CO.

Mr. CIFUENTES. Good afternoon, Chairman Dodd, Senator Shelby, Members of the Committee. My name is Arturo Cifuentes. I am an investment banker based in New York. Thank you very much for the opportunity to be here. I am really honored to have my opinion considered in the matter at hand.

I submitted yesterday a long sort of statement with my recommendations and my views. I am not going to read it here. I am just going to make a couple of points which I think are relevant. As I said in my testimony, just for the sake of clarity, my opinions here are my own opinions, for good or for bad. I do not intend to represent anybody but myself.

One thing that we have here and I think is important to realize is that the press and in general there has been a view that the U.S. is having a credit crunch or a subprime crisis. Actually, I happen to believe that that is true, but actually the situation is far more serious than that.

What we really have is the collapse of the alternative banking system, and by that I mean the system of finance that was created with securitization and credit derivatives, and that is very unfortunate because that was a big engine of growth behind the U.S. economy, and now there is a limit of trust. The market does not seem to be really convinced that the structured finance ratings are accurate, and that has impacted that market; for example, the asset-backed commercial paper is impacted. That is a very serious problem. So I think there is an issue of trust here.

The other thing we need to keep in mind, this is a very global market; 50 percent of the participants in the fixed-income market are outside the U.S., and they trust the market because they trust the transparency of the market and they like the ratings. We are at the risk of losing that right now.

Now, we are going to march into the right thing. I think it should—I mean, we have this view that the rating agencies are getting quite a few things wrong, but I think it is important to realize the nature of the problem. The rating agencies, unfortunately, initially rated the mortgages wrong. So there was a mistake there. For whatever reason, the rating of the mortgages was wrong.

Then there was a second mistake, and I am going to use a term that sounds a little bit technical here, but, nevertheless, we have to mention it: CDOs of ABS. So I included a diagram here at the end of my testimony to clarify the issue of what is a CDO of ABS. But the point is there was a second mistake there. So, in addition to the wrong ratings on the mortgages, we had the wrong ratings on the CDOs of ABS. These were securitizations that included already the mortgages.

And the further reality is also this happened at the same time, so they all got it wrong at the same time, which really magnified the problem. Now, I am not trying to suggest that the rating agencies acted in coordination to give the wrong ratings, but I think the system somehow encourages that kind of outcome.

I just want to make one issue that might sound a little bit theoretical, but I think we need to keep it in mind, and then I am going to make a couple of recommendations.

If you remember, initially the ratings were created with the whole purpose of giving investors information regarding credit risk. That is it. Information for investors. And that was fine. Later, the regulators sort of took advantage of that and decided to use the rating as a proxy for other things, I mean, for example, capital requirements, where the bank needs enough resources, et cetera.

Now, so we have two constituencies right now. We have the regulators using the ratings, and then we have here the investors. It is not obvious to me that both have the same goals in mind. It is not that they have contradictory goals, but a rating which is good for the regulator, presumably a rating that needs to be more stable, is not necessarily a rating useful for somebody who is an active participant trading securities in the secondary market. I mean, there is a little bit of—I do not want to say conflict of interest, but it is not clear that these two things are the same. So something to think about there.

I want to also mention something that, unfortunately, in my opinion, has taken a great deal of attention in the press and everywhere, and I think it is the wrong issue, and it is not a good idea to spend a lot of time talking about that because it is not the main problem. There is a much more serious deal.

We have talked about the conflict of interest because allegedly the investment banker pays the fee to the rating agency. I believe that is not the case. In reality, what happens, an investment banker raises money. You issue the securitization bonds, and at the same time, everybody gets paid—the rating agencies, the lawyers, the trustee, et cetera. So I do not believe there is a link there between the—I mean, paying attention to that potential conflict of interest, in my opinion there is no problem there.

In addition to that, there has been the thought that the rating agencies have somehow been involved in designing this concept. Having been on all sides of this business, that is simply not the case. You have the regular give-and-take between what could have been an architect that wants to build a building and the city engineer telling him what he can and cannot do. So that is not really a serious problem.

What I do believe is a serious problem—and if you remember one thing of my testimony, I think that is probably the key point here. We need to have a Chinese wall. We have gone through this road before. This is the same situation we had when we had the issue with the research in investment banking before. You remember at that time there was a gentleman or a lady writing research on the research side, and then there is the business side. So there is a very serious conflict of interest here. Evidently, if you have a rating analyst who is rating something and the person who is supervising the analyst is more concerned about credit risk, creates a very serious problem of interest.

Now, this is more serious than investment banking or any other activity because if I do not like the research that the bank writes, I just do not read it, or I toss it and do not pay any attention to it. But the rating agencies have regulatory power. So the opinion of the research analyst or the credit analyst is very, very relevant. So I think the idea of having a Chinese wall in which analysts will be protected, I think it is something that we should think about.

The other point that I believe—I made a few points there, some correlated highly with what Professor Coffee said, so I am not going to expand on that. But one thing that puzzles market participants at this point, because they do not believe very much in ratings—and when I say ratings, I mean just for the sake of clarity, I am talking about structured finance ratings. I am not talking about corporate debt or emerging market or any security. Well, it seems like the rating agencies got it very wrong in the structured products, and so people wonder what else do they need to do in order to prevent from backing the security—yes, I mean, it seems like it could be unfortunate. We might be in a situation in which we have only three ratings agencies, and there is nobody on the horizon. That is why I am a little bit concerned about the 3-year requirement in terms of operating as a rating agency before you are approved. And I would pose that it is difficult to operate as a rating agency and making any money if you are not allowed to issue real ratings. I mean, you would need venture capital or somebody willing to finance you for 3 years.

One final point that I would like to make, and, again, it might sound a little bit academic here, but we have been talking about ratings, and we have been talking about mortgages and subprime, et cetera, et cetera. Well, that is fine, but in my view, that is 50 percent of the problem. The other 50 percent of the problem are the CDOs of ABS, which in my view were rated using wrong assumptions.

If you look at what happened in 2007, CDOs of ABS I believe accounted for more than 90 percent of CDOs downgrade. As I show in my diagram here, this is the securitization, so using information that is probably contaminated or something like that.

So, I mean, that is something to look into. That market obviously is completely paralyzed today, but just a casual inspection of the morals and assumption that were done for CDOs of ABS, it seems to me that maybe they were a little bit too relaxed. I mean, that is my impression based on some preliminary observations.

The only thing—I think I am going to stop here. The only comment that I would like to make just in response to some of the things that have been said is that, well, maybe the reason we are seeing this massive amount of downgrades is because there is a unique situation, and the U.S. housing market maybe is having an extraordinarily bad time. Well, there is some truth in that, but I happen to believe that the argument is a little bit circular, because we would not be having this situation if somebody would have said initially, look, I am not going to allow you to put these mortgages in these CLOs because they are really bad. So I would make the case that perhaps the situation was exacerbated—in fact, it was not stopped because some of the ratings in these mortgages were not particularly accurate.

So I think I am going to stop here. I thank Chairman Dodd and Senator Shelby, and I really appreciate being here, and I would be happy to answer whatever questions you may have.

Chairman DODD. Well, thank you very, very much, and I will ask the clerk to keep the clock on about 5 minutes here so we can get around. We have kept you a long time this morning, and we will probably have a lot of additional questions to raise with you.

Let me, if I can, jump right in. Ms. Robinson, let me begin with you on the due diligence issue, if I could. It has been raised earlier. You have heard the conversation. I think Senator Corker was sort of talking about it to one degree. Senator Shelby raised it and others have as well. And I am looking at Moody's Code of Professional Conduct, and let me quote it. It says, "Moody's has no obligation to perform and does not perform due diligence with respect to the accuracy of information it receives or obtains in connection with the rating process. Moody does not independently verify any such information." That is of June 2005. Now, it may have changed. Maybe that has changed since then. If it has, you will correct me.

Obviously, when you have got a proliferation of liar loans, as we know about, the no-doc loans going forward here, how do you answer the question that obviously you probably have been asked before, that a rating agency should not be required to perform some due diligence when you are branding these bundles as being AAA, and yet not a heavy due diligence would have informed one that these products were anything but investment grade. I mean, these were products here that were very shaky, and how do you make that case that there is not a requirement here since so many people are relying—their long-term financial security, the security of a municipality, foundations, colleges, all these things depending upon that, and that there is no requirement for any due diligence and a Code of Conduct of ethical conduct when so much has been at risk here and so much lost for people, how do you address that?

Ms. ROBINSON. Well, Mr. Chairman, the accuracy of the information that we receive is central in importance to our analysis. And we rely on the work of other parties to verify and establish the accuracy of that information. So, first of all, it is primarily the responsibility of the issuer and the loan originator to provide information to rating agencies and others that is accurate.

Furthermore, the underwriters, the investment bankers who market the securities have an obligation to perform due diligence on the loans included in the securitization. And, finally, information presented in the offering documents associated with those securities is vetted by accounting firms.

And so I agree that the accuracy of the information is very important, but there are others whose role it is to check and verify that information.

Chairman DODD. But people are relying—I mean, people are saying this is—Moody's puts its Good Housekeeping Seal of Approval on this. That is what people are counting on. I am counting on when you say this is AAA, Senator Dodd, this is a good product here, I am saying, you know, Moody's told me so, Moody's gave me that advice. And you are suggesting to me here that you do not bear any responsibility to me as someone who is counting on you here to do any kind of work at all to let me know that something is not—I understand that others have obligations, but what is the obligation of the rating agency if not to do some homework on this, so that when I count on you to give me that recommendation, that there has been some work that has caused you to draw that conclusion, not some lesser conclusion about it?

Ms. ROBINSON. Well, Mr. Chairman, our role as a rating agency is to provide our best opinion about the credit risk associated with the securities that we rate. And our opinion really goes to the creditworthiness of the securities.

Chairman DODD. Well, let me—I do not want to—I have limited time here. Let me go to you, Mr. Joynt. We thank you for coming today.

Mr. JOYNT. Sure.

Chairman DODD. All my colleagues, we express our gratitude to you.

Mr. JOYNT. Thank you.

Chairman DODD. And I raised earlier Professor Coffee's—which I thought was a very, very good point, the staleness of data. And I do not recall your exact statement in your opening remarks, but you talked about an obligation to sort of be current. At least that is how I read your statement. And yet here you have downgrades that did not occur—here you had—they came after the Comptroller of the Currency had drawn his conclusions. They come after, months after the agencies themselves know there are problems in the markets. You know, you say you were surprised by this. When we met here last year and asked the Federal Reserve staff, when did you have any idea this problem was becoming—I was stunned as the new Chairman of this Committee to learn it had been 3½ years earlier that they began to identify a problem. Now, that is a separate issue. But the fact of the matter is how could you be stunned if you—it seems to me if you were doing your work in this area, one, how do you get stunned by it as a rating agency? And, second, what about the staleness of the information? Why can't we do a better job here? When you are getting the Comptroller of the Currency and regulatory bodies acting and yet still the downgrades do not occur until months after that occurs, I mean, the credibility has been shot here.

Mr. JOYNT. Yes. So I think the awareness of the problem from subprime loans in the first instance was most obvious, to us at least, in the beginning of last year and only started being reflected in the delinquency data that we were seeing in the securities that we were looking at in a way in which we could incorporate that new information into our modeling.

Chairman DODD. Did you pay any attention when the Comptroller of the Currency—I mean——

Mr. JOYNT. Of course. Also, we need to recognize that we reflected, as did others, that the underlying loans were quite poor quality, and so when we are speaking about giving high ratings, behind those high ratings was a large amount of subordination. So there was a recognition that the loans were not—were subprime, were very weak. So it obviously was not enough recognition in hindsight, but it was not like we were unaware of these being weak loans. We were not aware, it is certainly true, and did not do the due diligence function of trying to recognize whether there was fraud involved in the origination of loans. That is certainly true. And I believe that has become one of the biggest accelerants for why there have been problems so across the board in the mortgage markets itself, so extending to all, and even prime mortgages now. So that part we did not do. But we were aware of the weakness of the loans. We were aware that the securities in being put together were tranched so that senior classes were supported by junior classes. But I——

Chairman DODD. But did any of you think—were any of you facing liability that someone could sue you for not being forthcoming with information, that that might change the reaction of the agencies, the fact that you are sort of protected under the First Amendment—and I see my good friend Floyd Abrams here, who I respect immensely as a good First Amendment lawyer, and I have great respect for the First Amendment. But the whole idea you are insulated in a sense—anyone else gives me bad information like that, I can sue them. I can take them to court.

Mr. JOYNT. Yes. So that is difficult for me to answer. I am not a lawyer. But I would say that our reputation is as important to us as the money that might come from a lawsuit, and that has been damaged. So by not being able to be accurate and forward thinking about our ratings, then you—you are holding us accountable, not you but everyone, accountable for that and reflecting on how good the credit ratings are. And so I think that is pretty significant. We treat that seriously.

Chairman DODD. Senator Shelby.

Senator SHELBY. All this is troubling to me, the role of the rating agencies, lack of due diligence and so forth. Professor Coffee, thank you again for coming here to bring some light to this subject, and I mean this sincerely. You were succinct about what you believe needs to be done.

Were the rating agencies basically blinded by events? In other words, the subprime situation was going on. They were pumping them out, the assemblers of it, and they were rating them, and they were all making a lot of money. But this product was a new product, as I understand it, the packaging and slicing and so forth and rating of subprime loans as opposed to the old method of very few defaults and so forth. Were they blinded by greed? Were they blind to the situation? Were they blinded by the fact that they were telling themselves and others were telling them that, gosh, their opinion—they just gave their opinion, it did not mean anything, yet as I said earlier, it seems to be the linchpin of the financial industry. What is your comment there?

Mr. COFFEE. I do not know——

Senator SHELBY. Turn your microphone on.

Mr. COFFEE. I cannot tell you whether they knew these ratings were false. I do not happen to believe that. I happen to believe that in a bubble market and a time when everyone sees prices rising and the world getting better and great profit being received, you do not look too carefully at whether the data you are receiving is phony. And you are structurally in a position where you are relying upon the loan originator to tell you everything because you yourself do not have the in-house capacity to do that verification.

As we go forward, I think the answer is to try to find ways to bring third-party verification into the credit rating process.

Senator SHELBY. Do you believe that credit rating agencies should have some responsibility for what they rate and how they rate it because so many people rely on it in the marketplace?

Mr. COFFEE. Absolutely. They are the unique financial gatekeeper in that they do not have liability—and I am not pushing liability remedies as the answer.

Senator SHELBY. We know.

Mr. COFFEE. But they do not have anything like the risks and exposure of accountants or securities analysts. And they are functionally a securities analyst for debt markets. So I think we should look at the reforms that Congress and the New York Stock Exchange and the NASD have recently imposed on securities analysts to reduce conflicts of interest. That would involve Chinese walls around the rating agency, less consulting income, and other ways——

Senator SHELBY. Consulting income, conflicts?

Mr. COFFEE. Well, you have heard Chairman Cox say he is thinking seriously about this, and I congratulate them, because I think that deserves a serious look.

Senator SHELBY. Do you believe that the SEC—and you teach law and you are into all this very deeply. Do you believe the SEC can help remedy this situation?

Mr. COFFEE. Well, they can certainly help remedy it. I think there are some ways in which they have to take maybe some bolder steps than I have yet heard——

Senator SHELBY. Absolutely.

Mr. COFFEE [continuing]. About both verification, staleness, and some way that you can ultimately tell a rating agency that it no longer is an NRSRO without having to prove they were personally at fault. If you have to show that they were personally at fault, we are talking about 5 years of litigation because they will get challenged in court.

I think the real outlier, the rating agency that has a 50-percent default rate when the next highest default rate is 20 percent, should not continue to be an NRSRO because too many people are relying upon them.

Senator SHELBY. Ms. Robinson, Moody's 12-month downgrade rate for global structured finance products reached a historic high of 7.4 percent in 2007. In a recent Wall Street Journal article dated April 11th of this year, Moody's President, your President, Brian Clarkson, was cited as saying that the top thing that could get a Managing Director fired was inaccurate ratings. Is this report correct, that inaccurate ratings are the top thing that can get somebody fired? And if so, what steps has Moody's taken to hold its executives accountable for its poor ratings?

Ms. ROBINSON. Well, the accuracy of our ratings are a primary concern, and, you know, we are a learning institution, you know, we like to say, and we are constantly reevaluating our analysis and our methods to make sure that we incorporate all of the information that is available to us at the time. You know, our business really rests on our reputation and the confidence——

Senator SHELBY. And your reputation is in tatters right now, wouldn't you think, in the financial world, all the rating agencies, or challenged deeply now? You wouldn't agree to that?

Ms. ROBINSON. Oh, yes, we are challenged at the present time.

Senator SHELBY. Ms. Robinson, in your written testimony, you also stated that Moody's tracks debt for more than 11,000 corporate issuers, 26,000 public finance issuers, and 110,000 structured finance obligations—110,000. How often does Moody's review and, if necessary, update each rating, or do you do that when you see pandemonium in the marketplace?

Ms. ROBINSON. Well, to take an example of the RMBS market, we receive data monthly on all of the mortgage-backed securities that we rate. We have a separate surveillance team that is charged with reviewing those ratings, and we review that data every month.

Senator SHELBY. Professor Coffee, what would you say that the SEC, and perhaps this Committee as the Committee of jurisdiction, needs to do to make sure as best we can that we can restore some confidence in the rating agencies and what they do?

Mr. COFFEE. I think there——

Chairman DODD. The microphone again.

Mr. COFFEE. I think there are a number of things. You already heard me talk about the need for getting some kind of verification——

Senator SHELBY. Absolutely.

Mr. COFFEE [continuing]. A mandatory element before you give an investment grade rating on structured finance. You heard me talk about currency, and I would say there should be at least the requirement that you annually reaffirm, republish, reduce, or withdraw your rating, not just get information but state it again: I am reaffirming this because I believe this, or I am upgrading, downgrading, or withdrawing it.

I also would say when you change your model, you have got to, within 90 days, say we are going to reduce ratings on every model that would produce different results had it been used back when these ratings were given. That is what I talked about earlier with the financial scorecard.

Beyond that, I would tell you that you probably should disclose all fees. When you give a rating, there is today a problem of what I will call the hidden advisory fee. You get a fee as a consultant and as advisor, and you get a fee when you give the rating. This produces an incentive for what I will call "forum shopping." You can find out from five agencies what their fee will be and get it from only the one or two that give you the highest rating. Forum shopping is a problem. One way to discourage forum shopping is to require rating agencies to disclose any fee they have received from an issuer or a structured finance offering, even if they did not give the rating, and that could show up on the SEC's website, because they could show you that for this offering there were four ratings, two other agencies that got fees but did not rate. That would tell you there is something funny here that they got a fee and didn't give a rating. So forum shopping is one of the problems.

I have also suggested in prior testimony that there is an SEC rule called Regulation FD which effectively exempts the credit rating agencies and thereby permits selective disclosure. There are new agencies coming in that are subscriber-paid. I wish them well. It is a new form of competition. But they are not going to get co-operation from any issuers or underwriters because they prefer dealing with the agencies that they pay because they can predict what will happen with the agencies——

Senator SHELBY. We have got to change the rules, have we not?

Mr. COFFEE. You have got to change Regulation FD so that all rating agencies get access to the same data.

Senator SHELBY. I hope the SEC is listening.

Chairman DODD. They are listening.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. COFFEE. Thank you.

Chairman DODD. Senator Reed.

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

Professor Coffee, one of the themes that is constant in Chairman Cox's comments and the questions of my colleagues is accountability. Today, before this new regulation is proposed, other than shareholders, who are the rating agencies accountable to in a material sense?

Mr. COFFEE. It is easier——

Chairman DODD. Again, you have got to——

Mr. COFFEE. It is easier to say ways in which they are not accountable. They do not have private liability. There is no regulatory agency like the NASD or PCAOB for accountants that has jurisdiction over them. It is only now that the SEC is proposing rules.

Sure, they have a reputation, but in a world in which for the past there have only been three agencies, it is not a world where reputation counts as much. And reputation means less when you are also selling a regulatory license. So even if the market does not trust you, they will still pay you a fee to get that regulatory license.

They are left in a position where they are only very weakly accountable and less accountable than the other major financial gatekeepers.

Senator REED. Chairman Cox suggested that when these new rules are rolled out, there will be a new world, a world in which the presumptive immunity from even a suit for negligence would be overturned. Can you comment on that? What is your sense of this newer world that is emerging?

Mr. COFFEE. I have a great respect for Chairman Cox, but the devil is always in the details. And I do not know what these new rules will say. I think that there are areas in which we need some strong rules, and while I thought he gave us a strong statement, much of it was a little opaque on exactly what the rules are going to look like. And I cannot evaluate rules until I see them.

But I do not think absent some kind of either liability risk of possibility of suspension or forfeiture that we are going to have the same governmental oversight powers over the rating agencies that we have over the accounting profession or the securities analysts.

Senator REED. A final question, because you have all been very patient, and I am not picking on Professor Coffee, nor anyone else. Thank you all, ladies and gentlemen, for your testimony. But it would seem—I mean, I think the system could be described as there is absolutely no incentive for an investment bank that is putting together an issuance and going to a credit agency to then come back and say you gave us a lousy rating, because what they are trying to buy is the best rating, and when they get it, they have got what they paid for.

So there is nothing in the system today for any one individual to come back and say you did not do the job. And that goes back, I think, to the same point about it is easier to list the lack of accountability than the points of accountability.

Mr. COFFEE. And as a result, this market has collapsed. No longer are there any real estate mortgage-backed securitizations. There are also very few commercial mortgage securitizations. Thus, I think the industry does have a common interest with the regulators. This market is not going to come back, and there are not going to be fees for rating securitizations that do not happen, unless we can make the rating agency credible again.

So I want to focus prospectively, and I think the industry as well as regulators have to find a way to create confidence, because without it there are not going to be fees.

Senator REED. Thank you very much.

Thank you, Mr. Chairman.

Chairman DODD. Just to make that point—I think I made it the other day in a hearing here. In the commercial mortgage-backed security area, last year that industry did $230 billion worth of business in 2007. And this year, as of late April, they have done $5 billion worth of business, just by comparison, to give a sense of the magnitude of the problem.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. It is another great hearing, and I just want to emphasize something that Ms. Robinson said. And, by the way, I want you all to know I am loath to sort of pile on after the fact. You know, it is not really what I like to do. I will say in this case that it is hard not to, OK? But obviously you guys have lost reputation, credibility. I know recently I called about a specific thing. I remember the broker saying, "Oh, this is AAA rated," and now I guess all of us in the world are realizing, What difference does it make if it is AAA rated?

I would just go back and say to the Chairman that we make people use these folks, and I think that is something that we need to look at. We make people use these folks. And then if they do not use them, in essence, they cannot issue securities. So that whole situation is something we need to certainly look at.

But, Mr. Coffee, I really enjoyed your testimony. I have never taken any law courses. Yours is one I actually wish I had taken. But what would the third party do that you mentioned earlier? You talked about a third party being involved in some verification. What exactly would they do?

Mr. COFFEE. Well, what they do today, and they do this for the underwriters. The underwriters will hire a so-called due diligence firm—the best known is Clayton Holdings, Inc.—and they will send a team of investigators out to look at this mortgage pool. There may be in the old-fashioned real estate-backed securities, there may have been 5,000 mortgages in this pool. They will sample it, and they will do the kind of sampling that is similar to what an auditor might do to say they are reasonably confident that no more than 10 percent of these loans lack documentation, no more than 10 percent of these loans had no equity stake, no more than 10 percent of these loans had a credit score below the minimum level that the bank or underwriter wants.

So they will tell you how many of these loans are exception loans, outside the normal lending criteria. And if you hear there are 30, 40, or 50 percent, which was the statistics that were occurring in 2007 and 2006, you now have a warning signal that tells you this is really dangerous.

I think if you give that information to the rating agencies, they will respond by downgrading or not giving an investment grade rating. The underwriters overlooked this in some cases because they thought their lawyers could write boilerplate that would protect them from any fraud liability. But I think the rating agency would be more sensitive to this if they got the information.

Chairman DODD. Can I ask a simple question?

Senator CORKER. Yes.

Chairman DODD. Why wouldn't you have the rating agency—why hire a consultant? Why not just do it?

Mr. COFFEE. Because—you heard the numbers—there might be 100,000 securitizations out there that they have to perform ratings on. The underwriters are already doing this and bearing the cost. If you give this information to the rating agency, whether it is the bank that gives it to them or whether it is the third-party firm, I think you have a way that will work, and it is more feasible, given the small in-house staff.

Chairman DODD. Thank you, Bob.

Senator CORKER. Of course, no, no. Of course, the fact is the underwriter is driven to get this product out, too. So there are actually conflicts there, too.

Mr. COFFEE. Lots of conflicts in this business.

Senator CORKER. OK. So I would go back—actually, that was my next question.

Chairman DODD. How about having the underwriter have some skin in the game, too? That may increase the likelihood of accountability, I think.

Mr. COFFEE. The underwriter does have liability and is somewhat better deterred, but the underwriter's liability is for fraud, and if he puts in a lot of boilerplate disclosures, it will say, "We told the market that there was this problem."

Senator CORKER. There is not, I do not think, any meaningful liability there. But going back to the liability issue—and obviously I think all of us are really puzzled to realize that there is just absolutely zero liability. You would have to perform—I am talking to the rating agencies now. You would have to perform lots of due diligence to take on liabilities, and just sort of the flip side of this is obviously fees would be very different if you were taking on liability—is that correct? Rating agency charges would be much, much higher, much different if you were taking on liability. Is that correct?

Mr. JOYNT. Yes.

Senator CORKER. OK. And is it reasonable for us sitting here, realizing the meltdown that has occurred was reliance upon—and the reliance that was placed in structured finance being rated AAA, AA, whatever. Should you have liability? I mean, would that be a good step forward for your various companies? Obviously, it would change your entire business model, but is that something you would actually advocate?

Mr. JOYNT. I would say no. I do not think in the case of the responsibility for the due diligence, which we assume someone else is doing, that we would have to structure ourselves in such a way that we would be organized to do that and charge for it appropriately. But it is not really our main business function. It is not the business that I really want to be in. I certainly would not want to take on that business in order to take on liability in that way. We would prefer to have a business model that is opinion oriented, and so that is the business model that we have now.

Ms. TILLMAN. If I may add, you know, I do not totally disagree with what Professor Coffee was saying, because in some of the leadership actions that we are proposing, I think it is important that we get better disclosure and make more of an effort on the quality of the information that we are receiving. Some of the things that we are looking at is just the—yes, the obligation for the due diligence is on the bankers, it is on firms like Clayton that do it for the bankers. They have a whole different business model. But at the same time, we as a rating agency can request and require a certain level of reps. and warranties and/or a certification or comfort level that the types of due diligence that is required to ensure that the quality of the information we get is, in fact, at that level. We do look at—I mean, a lot of the comments here make it appear that we do not do anything. In fact, we do do a lot. We do take all the loans that are in the pool. We run them through our models. We make our model assumptions available to everybody. We publish our scenario analysis. We publish our criteria.

But I do think that there is an important element around the veracity and the integrity of the data quality, and I think that is something the market and the rating agencies need to deal with.

Senator CORKER. I know we have a bit of an interchange. I just have many questions, and I will wait until after Senator Menendez. But the last question in this round, Mr. Cifuentes—I may have pronounced that incorrectly.

Mr. CIFUENTES. No. You pronounced it correctly.

Senator CORKER. Good. Well, I will not try again.

Mr. CIFUENTES. AAA for pronunciation.

Senator CORKER. Thank you very much for being here. The structured finance is basically over.

Mr. CIFUENTES. I hope not.

Senator CORKER. Well, it——

Mr. CIFUENTES. It is in a state of semi-paralysis right now.

Senator CORKER. OK. If you could give us a vision of how this—whatever potion is going to be used to basically cause it to move out of paralysis and how you see the industry being, if you will, in 6 months.

Mr. CIFUENTES. Well, your statement was 90 percent correct. It is not totally paralyzed, but it is very paralyzed.

Basically, what we have right now is asset-backed commercial paper that is very much—CBOs of ABS, that is totally gone, and we slowly see a recovery of CLOs, which are CDOs supported by bank loans. So, broadly speaking, yes, the structured finance market, it is pretty paralyzed right now. I hope that is not forever, because as I said, we are talking about the market in the trillions of dollars. So it is a very significant amount when it comes to financing.

As I said initially, the only way people and investors are going to recover the confidence is the confidence in the ratings. I mean, that is the end of it. I mean, there is nothing beyond that.

Now, I just want to make a brief comment, if I may, if I can elaborate on an important point.

Senator CORKER. Let me just——

Mr. CIFUENTES. Sure.

Senator CORKER. That is a big statement. I mean, that is kind of like the market will return once people believe in the ratings.

Mr. CIFUENTES. That is my hope.

Senator CORKER. But based on the scenario that has just been laid out as to how the ratings occur, how could there be faith in the ratings when there is no accounting activity, there is no audit activity, there is no understanding of how these are really put together. How could there be?

Mr. CIFUENTES. But let me—I think that is a very valid point, and let me elaborate on that, because I work rating CDOs so I do not want to give the impression that we just feed data into the computer.

Just to give you an idea regarding—I work rating CDOs, so I am not familiar with the process of mortgages as to how—but I will tell you about the due diligence, and I think it is something that should be recovered, I guess, if it was lost.

I rated, for example, the first French CLO, a CDO done with French bank loans. So the bank came to us, they told us what they wanted to do. The first thing we did, I took a plane and I went to Paris with a colleague of mine. We met with the CEO of the bank. We looked him in the eye. They showed the loans they had. They had an internal rating system from 1 to 6. Obviously, we said fine. We took a sample of those loans, and we gave it to the people at Moody's who rated bank loans, because I have no idea how to rate a bank loan. They gave sort of a correspondence between the internal rating of the bank and what Moody's had, and then after some verification of the data, we used that to proceed.

My understanding, my recollection, whenever we did CLOs at that time, that is the way it was done. The data was verified. So the point that Professor Coffee made I think is very valid. A rating which is not based on verification of the data, what is it? I mean, basically it's some input that somebody told me that I put into the computer program, and then it comes out OK.

Now, I am not very optimistic about all these things about disclosure and conflict and things like that because, at the end of the day, as it was pointed out, the rating is no longer an opinion. It is an opinion with regulatory power, and you do not have any choice. I mean, you have to use the rating.

So I think at the very least there should be an element of serious due diligence, making sure the quality of the data you are being presented, there is some integrity there. I mean, what it will define statistical processes so somebody gives you a pool with, say, 1,000 loans, you can take a small sample, do some analysis, and at least have a rough idea of how good or how bad they are. Apparently that was not the case.

Senator CORKER. Thank you.

Chairman DODD. Thank you.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you for the hearing, and I appreciate all of our panelists here.

Let me ask the three rating agencies here, in November and December, all three of your agencies downgraded various Bear ratings slightly, but they were still investment grade. The day the collapse was announced on that Friday, you all downgraded Bear. S&P downgraded them to the second lowest investment grade. Moody's downgraded them to three levels above junk, which is non-investment grade. And the question is: Did you make any changes prior to March? Or is that the right timeframe? You did something in November and December, but they were all still investment grade. And you did not do anything until the collapse. Is that a fair statement?

Mr. JOYNT. I do not have the answer off the top of my head on Bear Stearns. I could look into it for you.

Ms. TILLMAN. I would say the same thing. I do not have the answer off the top of my head. I would have to check back and get back to you.

Senator MENENDEZ. I would have thought that on one of the biggest challenges we have had that has spurred $29 billion by the Federal Reserve to prop up JP, you would have thought maybe that question would have been asked of you. But——

Ms. TILLMAN. Yes, but I would like to give you the accurate information.

Senator MENENDEZ. All right. I will look forward to the accurate information. But from all my research, the answer is you did not. And in my mind, how is it possible that Wall Street seemed to know that Bear was in trouble since they started pulling out and demanding their money back before the collapse, yet the regulators seemed unaware of the looming downfall, and we got no signs from the ratings—you know, which to my knowledge, as I said—you can correct me if your facts are different, but remain unchanged until after the collapse.

This goes to the heart of this problem. You know, because at the end of the day, as I listened to Professor Coffee and Dr. Cifuentes, you know, this is about valuating the underlying debt, the underlying instruments. And if you do not have a good sense of that valuation, I do not know how you give these ratings. And if you do not look at the transition over time, as Professor Coffee has suggested, how do you continue to maintain a rating in the midst of Wall Street acting in a different way, the regulators then following up and nothing changing from the rating agencies?

Ms. TILLMAN. If I may, I do know that we had put out articles and made comments on the prime mortgage market, the brokerage market, the securities industry. What I cannot tell you exactly is the chronology in terms of the rating action.

Senator MENENDEZ. But just take for a moment, Ms. Tillman my facts for a given, just for argument's sake. And I am pretty sure you will find them to be the case. If those are the facts, isn't something wrong? Isn't something wrong that you did absolutely nothing in making the appropriate downgrades until after the collapse? What good is it to the investors at the end of the day to have that information after the collapse?

You know, I know you all—I hear you say that you are listening. I wonder whether you are—you are hearing. I am wondering whether you are listening. I did not hear anything in the testimony that leads me to believe that you are ready to make the fundamental changes that I think need to be made and I hope the Securities and Exchange Commission, Mr. Chairman, is going to make, and then this Committee will hopefully instigate them to move in that direction.

Let me ask you another question. Recently, the example of MBIA, Fitch downgraded MBIA's rating from AAA to AA citing a lack of capital. It also called MBIA's outlook "negative." However, S&P and Moody's both kept MBIA's ratings at the highest level. Before Fitch's announcement, MBIA decided it did not want to be rated by Fitch anymore.

Now, Professor Coffee, is that an example of rating shopping?

Mr. COFFEE. It may be, but I cannot tell you. I cannot point the finger and tell you the answer to that question, but it could be.

Senator MENENDEZ. Clearly, if MBIA saw it was going to get downgraded, it basically could have said, well, let me pull the plug and say thanks, but no thanks, because at the end of the day, there is a consequence to it. And so this whole effort of transparency and openness that some of us have advocated for the SEC is incredibly important because it would give people across the spectrum to say, you know, we went to an agency, we decided not to take their rating, and that pretty much gives us at least a cautionary flag at the end of the day.

You know, I do not quite understand how ratings without valuation with an uncertainty—it is almost like, you know, you put—whatever you put into a process, it is what you are going to get out. And if at the end of the day we have ratings without valuations of the underlying instruments and the change of these instruments—these instruments have dramatically changed over time, so understanding the nature of those instruments and what their underlying values are is incredibly important. Otherwise, I do not quite understand how a rating means anything other than the fact that you are largely the only game in town. There may be a couple other rating agencies, but last year, at the end of 2007, of the 356,000 asset-backed securities for which there were ratings, you three did all but 1,000 of them. So that pretty much makes it the only game in town. And when that game is wrong, there is a real consequence to the investors in this country. And that is what is at stake.

So, Mr. Chairman, I look forward to working with you to make sure that we are more aggressive than what I have heard the agencies are willing to pursue themselves.

Chairman DODD. Thank you, Senator, very much.

Let me just follow up on the forum shopping issue to you, Ms. Tillman and Ms. Robinson and Mr. Joynt. You have heard Professor Coffee talk about how this works. Do you have anything to add to that discussion? And is the suggestion about how this works, do you think, a legitimate point?

Ms. TILLMAN. Well, I think at least from Standard & Poor's perspective, we certainly do not like the practice of ratings shopping, if that is what you mean by forum shopping. That is what I am assuming what you are talking about.

Chairman DODD. But it is ongoing.

Ms. TILLMAN. We believe that it does, in fact, happen, yes. But the difficulty, for instance, at Standard & Poor's is we know that when someone comes to Standard & Poor's and requests a rating and then does not choose to have that rating. What we do not know is then who they eventually go to. So if there is a way that there is some kind of disclosure that is involved that can indicate, you know, and let there be transparency around who does give ratings and who does not and who went to the rating agency and not, that is certainly something that Standard & Poor's would feel comfortable with.

Chairman DODD. How about you, Ms. Robinson? How do you feel about that?

Ms. ROBINSON. I think our view is that rating shopping does exist, and I think issuers naturally wish to obtain the best rating they can obtain.

One of the ways in which we feel that we can kind of counterbalance that tendency of issuers is we feel it is very important that we make sure that investors understand what Moody's rating approach is and what Moody's point of view is, because ultimately investors are the users of our ratings. So although issuers obtain the ratings, it is really ultimately investors' comfort level and satisfaction with those ratings.

Chairman DODD. Well, doesn't it help the investor to feel more comfortable if, in fact, they know that maybe they have tried to get a rating from someone else and did not get one? As an investor, aren't I in better shape to be more comfortable if I know that?

Ms. ROBINSON. Oh, well, we are fully supportive of efforts to provide more disclosure in this area.

Chairman DODD. So you would agree with that. How about you, Mr. Joynt?

Mr. JOYNT. I have a slightly different view than that. I disagree with Ms. Tillman on the topic of the rating shopping and the disclosure of the ratings. In the case of MBIA, they asked to withdraw the rating from Fitch. We have maintained it so far and subsequently changed the rating to what we thought was the accurate rating. But they have suggested that we may not have enough information to keep an accurate rating, and we are dialoguing and debating that ourselves. That would be based on public information, the ability to rate on public information.

Several month ago, a large financing, Texas toll road financing, a several-billion-dollar financing, we also were asked not to rate that financing because we thought they were taking on additional debt load, and our rating was falling below the A category into BBB, where the other two rating agencies were continuing ratings at A. So we have been asked and have had to, because we do not have the information, to withdraw the rating in that case.

So I think there is an important job for the SEC and others, in the case of the public finance market, to make sure there is adequate information outstanding for any of the rating agencies to do an appropriate rating.

On the second point, I believe that if you force people to disclose the fact that they have gone to rating agencies and subsequently not accepted their rating, they will limit their initial approach to rating agencies, and our view is probably to the largest and dominant rating agencies so that they do not have to disclose that they went to others and got more conservative rating opinions. So that would discourage competition, I think, in a very significant way.

Chairman DODD. Professor Coffee, how do you answer that?

Mr. COFFEE. Well, first of all, the new agencies are subscriber-paid agencies, and they are not going to be getting a fee. So we are not going to have forum shopping to them. There may be contact and you could ideally disclose any application or any forum submitted. But I do not think that the subscriber-paid agencies are going to be deterred by rules that seek to disclose forum shopping.

Mr. JOYNT. Well, we are not sure all the new agencies will only be investor-oriented, though. Yes?

Chairman DODD. Well, that is why you have got to apply the same rules to everybody.

Mr. JOYNT. Correct. I think the simple remedy, as I was suggesting earlier, is if the SEC had one website and you had all the NRSROs up there, you could say there are three agencies that gave a rating, two that got an advisory fee but did not rate, and one that got an application for a rating but it was withdrawn. You could show that all on one simple chart.

Chairman DODD. Yes. That was, I think, my first or second question to the Chairman. And I think he sort of endorsed the idea. I thought he did, anyway. It was unclear.

Mr. JOYNT. I thought he was at least sympathetic to it, but the devil is in the details.

Chairman DODD. That was the opaque answer I think you talked about earlier.

This has been most fascinating, and it is a very important hearing. Just the hearing itself I think could be helpful to enlighten, obviously, our colleagues and the Committee and others who are following this, but also I think important for the SEC to hear from the office of the legislation about the direction we would like it to move in. And it is very enlightening for us to understand how this works and how we can get it right, because it is a critical component in all of this. And while we have made some recommendations and suggestions on how to deal with the underlying problems of foreclosure, which I think we have got to address, if we do that and do not also structurally address these issues, then these problems can recur again. So it is an important issue to look at.

I thank you all very, very much for being here. I will leave the record open because there were Members who were not able to be here this morning who may have questions and others who were here may have additional questions for you. And I would ask you to respond in a timely fashion, if you could. But I am very grateful to all of you for your presence here this morning.

The Committee will stand adjourned.

[Whereupon, at 1:38 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record to follow:]

Oversight of Nationally Recognized Statistical Rating Organizations

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

April 22, 2008

By
Christopher Cox
Chairman
U.S. Securities and Exchange Commission

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

Thank you for inviting me to speak today to discuss the work of the Securities and Exchange Commission concerning credit rating agencies.

Introduction

When Congress passed the Credit Rating Agency Reform Act ("Rating Agency Act") and President Bush signed it into law in late 2006, its purpose was to improve ratings quality by fostering accountability, transparency, and competition in the credit rating industry. In passing the Rating Agency Act, the Congress acted presciently in response to the latent concerns that policymakers, regulators, and market participants had begun to raise about the reliability of ratings and the ratings process. The law's sponsors noted that the global industry is dominated by a very few major players, and that conflicts of interest may have led to various abusive practices. Among the abuses cited in congressional hearings were instances of sending a company unsolicited ratings along with a bill, tying ratings to the purchase of additional services, and the practice of discounting (so-called "notching") the ratings of other credit rating agencies when rating structured products, where firms allegedly used the lure of higher ratings for the asset-backed securities packages in return for obtaining the business to rate the underlying assets.

The enactment of this law marked a major increase in the responsibilities and authority of the Securities and Exchange Commission. Prior to the Rating Agency Act, credit rating agencies were essentially unregulated by the federal government, and the SEC had no authority to make rules governing their business, or to subject them to examinations as nationally recognized statistical rating organizations ("NRSROs"). With the passage of the Act, the Commission became their regulator, and has devoted considerable new resources to this responsibility. We have done so with a great sense of urgency, given the many and serious market impacts that problems with credit ratings on billions of dollars worth of residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") have produced in the broader marketplace.

Implementing the Rating Agency Act

The Rating Agency Act provided that, in order to put its authority into effect, the Commission must write enabling rules, subject to the public notice and comment process of the Administrative Procedure Act. Under the new law, the entire process was to be completed in no more than 270 days. The Commission promulgated final rules in advance of that deadline, with the result that a formal regulatory program for NRSROs was established in June 2007.

The provisions of the law and the new rules provided that, once the rules were in place, credit rating agencies were required to register with the SEC if they wished to become NRSROs. Following their registration, they would then immediately become subject to various Commission authorities, including the SEC's right to examine their books and records and to take enforcement action against an NRSRO. Such action could include placing limitations on an NRSRO's activities, censuring the NRSRO, or revoking or suspending the registration of the NRSRO. The law required the Commission to review and act on any such registration applications within 90 days. Initially, seven firms applied to become NRSROs, and the Commission approved all seven registrations within the time allowed by the Rating Agency Act. As a result, as of the end of September 2007, seven credit rating agencies – including those that were most active in rating subprime RMBS and CDOs – became subject to the Commission's new oversight authority, and subject as well to our newly adopted rules.

The Commission's Ongoing Examinations

In the six and one-half months since the Commission's authority over the NRSROs went into effect, the Commission has aggressively used its authority to examine the adequacy of their public disclosures, their recordkeeping, and their procedures to prevent the misuse of material nonpublic information. Our examinations are also focusing on how the firms manage their conflicts of interest, as well as their approaches to preventing unfair, abusive, or coercive practices. In addition, during the last six months two additional rating agencies have registered with the Commission as NRSROs.

Even before these credit rating agencies were registered with the Commission and subject to its oversight authority, the Commission staff began to assess their activities based on the information then available to us. Since then, staff from the Commission's Division of Trading and Markets, the Office of Compliance, Inspections and Examinations, and the Office of Economic Analysis have initiated on-site examinations of the largest credit rating agencies.

The review process has included hundreds of thousands of pages of the rating agencies' internal records and email relating to their ratings of subprime RMBS and CDOs. Additionally, the staff is reviewing the rating agencies' public disclosures relating to the ratings process for subprime RMBS and CDOs. In addition, Commission staff has analyzed the ratings history of thousands of structured finance products. These extensive examinations have involved approximately 40 SEC staff members. The examinations are ongoing.

The focus of the staff's examinations is whether the credit rating agencies diverged from their stated methodologies and procedures for determining credit ratings in order to publish higher ratings, and whether they followed their stated procedures for managing conflicts of interest inherent in the business of determining credit ratings. Much has been accomplished already on these examinations, but there is still more work to be done. The Commission expects that the report describing the staff's observations from examinations will be issued by early summer.

At this stage, with more examination work to be completed and the staff's across-the-board inferences not yet drawn, it is premature to describe the results. I can say that it appears the volume of the structured finance deals that were brought to the credit rating agencies increased substantially from 2004 to 2006. In addition, during the period of time under examination, the structured products that the rating agencies were being asked to evaluate were becoming increasingly complex, with many employing derivatives such as credit default swaps to replicate the performance of mortgage backed securities. At the same time, the loan assets underlying these securities shifted from primarily plain vanilla 30-year mortgages to a range of more difficult-to-assess products, such as adjustable rate and second lien loans.

We are evaluating whether credit rating agencies adapted their rating approaches in this environment. The staff is observing that the ratings process used to rate these products may have been less quantitatively developed, particularly as the products became more complicated and involved different types of loans, than was generally believed. This is of significance because the Rating Agency Act strikes a very careful and wise balance in expressly providing that the Commission may not regulate the substance of credit ratings or the procedures and methodologies by which an NRSRO determines credit ratings. Requiring the Commission to engage in substantive regulation would be antithetical to the Commission's traditional disclosure-based mission. Accordingly, the Act required us instead to focus on the adequacy of disclosures about such procedures and methodologies. The staff is currently working to assess whether, and if so the extent to which, these factors contributed to the volume of eventual downgrades, and whether other factors – such as the desire to maintain or increase market share – may have caused the credit rating agencies to be less conservative than their disclosed methodologies otherwise would have indicated.

We expect the results of these staff examinations will provide significant and useful new information that will help not only the SEC, but also issuers and users of credit ratings in this country and around the world, to address the problems we have seen with ratings of subprime-related products.

Basis for New Rulemaking

Because the Commission's authority over NRSROs took effect over six months ago, the SEC is already far along in preparing for a second round of rulemaking that would be based on the information provided by the staff's ongoing examinations of these firms, and informed by a multitude of empirical analyses provided by regulators, industry groups, academics, and multinational organizations – to many of which the SEC has itself contributed.

Our work in this area has included participation with the Department of the Treasury, the Federal Reserve, and the Commodity Futures Trading Commission in the President's Working Group on Financial Markets, as well as with the International Organization of Securities Commissions ("IOSCO") and the Financial Stability Forum ("FSF"), in their respective examinations of the role that credit rating agencies have played in the current market turmoil. We have also conducted an active dialogue with other supervisors on both the underlying issues and potential measures to address the perceived problems with the issuance and use of credit ratings for subprime-related products.

As a member of the President's Working Group on Financial Markets, the Commission actively participated in drafting the Working Group's "Policy Statement on Financial Market Developments" issued last month. This policy statement discusses, among other topics, the impact of credit rating agencies on lending practices, how their ratings are used, and how securitization has changed the mortgage industry and related business practices. We also continued working with our international counterparts through institutions such as the FSF and IOSCO. In March of this year, IOSCO's Technical Committee, of which I serve as Vice Chairman, released for comment a report prepared by its Task Force on Credit Rating Agencies. The report contains a number of recommendations for amending IOSCO's Code of Conduct for Credit Rating Agencies to address concerns raised by the credit market turmoil. In April of this year, the FSF released its report on Enhancing Market and Institutional Resilience.

Each of these statements and reports has noted that ,over the course of the past year, delinquency and foreclosure rates for subprime mortgage loans dramatically increased, throwing into turmoil the markets for securities collateralized by such loans, including subprime RMBS and CDOs backed by or referencing subprime RMBS. There is also general agreement that the high credit ratings on billions of dollars worth of RMBS and CDOs contributed to the increase in market acceptance of these structured finance products.

As performance on subprime mortgage loans deteriorated, the credit rating agencies issued downgrades to their recent ratings of RMBS and CDOs, recognizing that the securities' likelihood of default had changed significantly for the worse. The rating agencies' performance in rating these structured credit products has called into question their credit ratings generally as well as the integrity of the ratings process as a whole. In an era of interconnected worldwide financial markets, the impact of the turmoil in subprime RMBS and CDOs has been widespread, adversely affecting the strength and stability of credit markets on a global scale.

Because so much has been said and written about the genesis of the credit market turmoil, it may be useful very briefly to summarize what both the SEC and most of our fellow regulators believe to have been contributing factors. The first and most basic cause was the relaxation of loan underwriting standards. This occurred coincidentally with the growing practice of financial institutions using the credit risk transfer markets not just as a tool for managing risk, but as a way to generate substantial revenue. In consequence, the practice of packaging and selling mortgages as securities – which had been carried on by both government-sponsored enterprises and private originators – expanded greatly beginning in the early 2000s. At the same time, the complexity of such products and their collateral increased, driven by innovative products such as credit default swaps and CDOs designed to transfer credit risk from one party to another.

For financial institutions to use the credit risk transfer markets as a new source of substantial revenue, they had to find ways to sell RMBS and CDOs to a wide range of investors such as mutual funds, pension funds, hedge funds, banks, structured investment vehicles, and state government-operated funds. That meant getting these securities rated by the credit rating agencies, because many of these investors would purchase the securities only if they carried very high ratings.

Over time, increasingly higher-risk loans were packaged into these securities. This included loans underwritten with limited documentation to verify the borrower's income, and loans secured by second liens on the property. The trusts issuing these securities were structured so that the largest tranches could obtain a triple-A credit rating.

Ultimately, financial institutions began issuing synthetic CDOs composed of credit default swaps on RMBS, or hybrid CDOs made up of a combination of credit default swaps and actual RMBS. The issuers and underwriters for these securities also called upon the credit rating agencies to issue ratings that would enable them to be sold to investors.

The steady rise in housing prices from 2002 to 2006 ensured that the loans underlying these securities performed as well as, or even better than, projected by the credit rating agencies and other market participants. In the middle of 2007, however, conditions changed dramatically. As housing prices trended downward, delinquencies in subprime mortgages began to rise. This then, in part, caused the credit rating agencies to reevaluate their ratings of the subprime RMBS and CDOs. Ultimately, they downgraded many of their initial ratings.

Indeed, the number of credit rating downgrades of RMBS and CDOs is unprecedented:

- As of February 2008, Moody's had downgraded at least one tranche of 94.2% of the subprime RMBS issues it rated in 2006, including 100% of the 2006 RMBS backed by second-lien loans, and 76.9% of the issues rated in 2007. Overall, Moody's has downgraded 53.7% and 39.2% of all of its 2006 and 2007 subprime tranches, respectively.[1]

1 "U.S. Subprime RMBS 2005-2007 Vintage Rating Actions Update: January 2008," Moody's Investors Service, February 1, 2008..

- As of March 2008, S&P had downgraded 44.3% of the subprime tranches it rated between the first quarter of 2005 and the third quarter of 2007. This included 87.2% of securities backed by second lien mortgages.[2]

- As of December 2007, Fitch had downgraded approximately 34% of the subprime tranches it rated in 2006 and in the first quarter of 2007.[3] In February 2008, Fitch placed all of the RMBS it rated in 2006 and the first quarter of 2007 backed by subprime first lien mortgages on Ratings Watch Negative.[4]

The downgrades of the RMBS necessarily led to downgrades of the CDOs collateralized or referencing the RMBS. This widespread downgrading of subprime-related securities contributed to the concern among market participants that the risk of owning these securities was much greater than originally thought. This concern was particularly acute among those investors who relied uncritically on the credit ratings in making investment decisions.

Anticipated Subjects of New Rulemaking

What we are learning from the staff examinations of NRSROs that are the major credit rating agencies, from our extensive participation in regulatory collaborations, and from our ongoing review of the multitude of analyses of the role of credit rating agencies in the current market turmoil is informing the development of proposals for additional rules. I expect the Commission will issue rule proposals for public comment in the near future. However, I must note that the internal development process of the Commission is still very much ongoing. Consequently, while I am able to provide you with an outline of the rulemaking areas under consideration, I must do so with the caveat that what will go into the proposed rules has not been decided yet.

Since the purpose of the Rating Agency Act is to improve ratings quality by fostering accountability, transparency, and competition in the credit rating industry, the Commission's goal in our forthcoming rulemaking is to propose rules that would advance these important objectives. I will cover each of them separately.

Accountability

To strengthen accountability, the new rules that the Commission will soon consider may include requirements for enhanced disclosures about ratings performance. This would enable market participants to better compare one NRSRO with another. If the Commission were to propose rules in this area, we would need to be careful not to

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2 Transition Study: Structured Finance Rating Transition And Default Update As Of March 21, 2008," Standard & Poor's Ratings Services, March 28, 2008.

3 "U.S. RMBS Update," Fitch Ratings, February 20, 2008.

4 Update on U.S. Subprime and Alt-A: Performance and Rating Reviews," Fitch Ratings, March 20, 2008.

prescribe performance measures that would bias the ratings process, indirectly prescribe ratings methodologies, or conflict with the Act's goal of increasing competition in the development of more accurate credit ratings.

To ensure NRSRO accountability for the management of their conflicts of interest, the new rules that the Commission will soon consider may include specific prohibitions on certain practices, as well as the establishment of requirements designed to address potential conflicts that could impair the process for rating structured products. Among the conflicts of interest that could be addressed in this way are the provision of consulting services by credit rating agencies to the issuers of securities they rate, and rating structured securities that the NRSRO itself helped design. To enhance the responsibility of the NRSROs' designated compliance officers, the proposed rules that the Commission will soon consider may include requirements that the firms furnish the Commission with annual reports describing their internal reviews of how well they adhere to their procedures for determining ratings, manage conflicts of interest, and comply with the securities laws.

Transparency

To enhance transparency, the Commission may soon consider new rules that would require the disclosure of information about the assets underlying the mortgage-backed securities, CDOs, and other types of structured finance products they rate. This would allow market participants to better analyze the assets underlying structured securities, and reach their own conclusions about their creditworthiness. This data availability could particularly benefit subscriber-based NRSROs, who could use it to perform independent assessments of the validity of the ratings by their competitors who use the "issuer pays" model.

Further improvements in transparency could be considered in the form of enhanced disclosures about how NRSROs determine their ratings for structured products. This disclosure could include the manner of analysis of the mortgages' conformance with underwriting standards, and the firms' procedures for monitoring their current credit ratings.

The Commission may also consider rules requiring the disclosure of ratings information in a way that makes it possible for investors to readily distinguish among ratings for different types of securities, such as structured products, corporate securities, and municipal securities.

Competition

The rules that the Commission will soon consider may also include provisions designed to ensure that enhanced disclosure about a firm's ratings performance affords other credit rating agencies, including newly recognized NRSROs, an opportunity to identify flaws or opportunities for improvement on their competitor's approach, or to demonstrate to investors that their credit ratings perform better.

The Commission is also reconsidering its extensive reliance on, and reference to, NRSRO credit ratings in its own rules. The Commission's intent is to promote greater due diligence by market participants. Investors would use NRSRO ratings that they deemed to be credible, along with other information, in conducting their due diligence. This could induce greater competition among rating agencies to produce the highest quality, most reliable ratings.

Finally, the Commission may soon consider ways to enhance competition through rules designed to ensure that all NRSROs have access to the information underlying credit ratings. Thus, regardless of whether the NRSRO follows the "issuer pays" or the subscriber-based approach, there would be no competitive disadvantage based on lack of access to the information on the assets underlying the structured credit product. To the extent both models were to flourish in a competitive marketplace, each could act as a healthy competitive check on the other. In addition, given the dominance of the "issuer pays" model currently, such rules could create an equal opportunity for NRSROs that were not paid by issuers to rate securities to issue their own unsolicited ratings – and, thereby, to develop a track record for rating these products. Of course, because this planned proposed rulemaking is ongoing, there could and undoubtedly will be other subjects covered in the draft rules that the staff will present to the Commission for its consideration.

In closing, Mr. Chairman, I want to emphasize that the Commission is very much open to ideas from the Congress, as well as the general public, on this proposed rulemaking, given the salience of this topic for you and all of your constituents. We especially welcome ideas from this committee, as you are the authors of the Credit Rating Agency Act, and it is your intent in writing the law that the Commission is working to fulfill. I appreciate this opportunity to provide the Committee with this update on the Commission's new oversight and regulatory responsibility for the NRSROs, and 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 United States Senate Committee on Banking, Housing and Urban Affairs
April 22, 2008

**"TURMOIL IN THE U.S. CREDIT MARKETS:
THE ROLE OF THE CREDIT RATING AGENCIES"**

Chairman Dodd, Ranking Member Shelby, and Fellow Senators:

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

I. What We Have Long Known About Ratings Agencies

For some time, we have known that the credit rating agencies were different than the other "gatekeepers" on whom investors necessarily rely for certification and verification services (e.g., auditors, investment banks, attorneys and securities analysts). The most obvious differences include:[1]

(1) An Oligopolistic Market. Until very recently, the reality was that only three credit rating agencies were recognized by the SEC as "NRSROs" ("Nationally Recognized Statistical Ratings Organizations"). Moreover, because the long-standing convention has been that an issuer must obtain two ratings on its debt securities, competition was even weaker than this number would indicate. In turn, weak competition implied that the credit rating agencies needed to worry less about preserving their "reputational capital" than in other markets where involvement in a major scandal could stigmatize or destroy a firm.

(2) Immunity From Liability. Other gatekeepers – accountants, law firms, and investment banks – are regularly sued by investors, but credit rating agencies have been singularly immune from liability to investors. This is partly the consequence of their "First Amendment" defense under which they assert that they are simply the publishers of financial information and partly the result of the high pleading standards imposed by the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which requires that a

[1] For a fuller elaboration of these points, see John C. Coffee, Jr., GATEKEEPERS: The Professions and Corporate Governance (Oxford University Press 2006).

plaintiff plead facts with particularity giving rise to a strong inference of fraud before it can obtain discovery. Put simply, if credit rating agencies do not have to fear liability to investors, they have less incentive to be diligent or prudent.

(3) "Regulatory Licenses". Unlike other gatekeepers, credit rating agencies do not simply provide information or verifications; rather, their investment grade rating is a necessary condition before many institutional investors can buy debt securities. Thus, even if their views were not respected or their ratings were known to be inflated, they would still be retained to grant "regulatory licenses."

(4) The Built-In Conflict of the "Issuer Pays" Model. Beginning in the 1970s, credit rating agencies shifted their business model from a subscription-funded business and began to receive the vast majority of their fees from issuers. Professor Frank Partnoy estimates that approximately 90% of the revenues of rating agencies come from issuers paying for ratings.[2] This means that the agencies are a watchdog paid by the persons they are to watch. In contrast, securities analysts are not compensated in this fashion; indeed, since the Sarbanes-Oxley era reforms, securities analysts are walled off within investment banking firms from underwriting personnel who might wish to pressure them to support the firm's clients. Although accountants are also paid by the clients that they audit, accounting firms face potentially bankrupting liabilities if they acquiesce in their clients' demands for favorable treatment. No one else is in the position of the rating agency with a built-in conflict and no real exposure to liability.

The inherent conflict facing the credit rating agency has been aggravated by their recent marketing of advisory and consulting services to their clients. Today, the rating

[2] See Frank Partnoy, "How and Why Credit Rating Agencies Are Not Like Other Gatekeepers" (http://ssrn.com/abstract=900257) (May 2006).

agencies receives one fee to consult with a client, explain its model, and indicate the likely outcome of the rating process; then, it receives a second fee to actually deliver the rating (if the client wishes to go forward once it has learned the likely outcome). The result is that the client can decide not to seek the rating if it learns that it would be less favorable than it desires; the result is a loss of transparency to the market.

(5) Weak Incentives to Provide Current Information or Update. Ratings agencies are paid to issue a rating and to consult with the issuer about the impact of possible transactions. They are not paid to update that rating. Hence, downgrades tend to be infrequent (because they antagonize the client while they earn no income for the agency). As a result, ratings are often stale, meaning that investors are relying on out of date ratings that the agency might not issue today, either because of changed facts or changed methodologies.

II. What Have We Recently Learned About Ratings Agencies

The recent credit crisis, beginning with the subprime mortgage market and now extending well beyond, has taught us some new truths about the credit rating agencies, including:

1. Although Credit Rating Agencies Are Good at Judging the Firm-Specific Risk Associated With Individual Companies, They Have Proven Relatively Poor At Estimating the Risk Associated With Structured Finance Products. For roughly a century, credit rating agencies have demonstrated their ability to accurately predict defaults on corporate bonds. But corporate bond ratings are based largely on publicly available data (such as audited financial statements). The process is very different in the case of structured finance products. The data used in such cases comes principally from the

issuer or underwriter and is not independently verified by the rating agency or anyone else.

The analytical process is also very different. The rating agency evaluating collateralized debt obligations (or "CDOs") must employ quantitative models that seek to assess the likely cash flows from portfolios of correlated assets. In hindsight, it is now evident that the models used by the ratings agencies to estimate the risk of loss on structured finance products (especially CDOs) were flawed and inaccurate. Possibly, their greatest deficiency was their blindness to the "default dependence" among the similar assets in the portfolio. The possibility of "default contagion" in real estate markets – namely the prospect that a default by one or more borrowers would increases the likelihood that other borrowers would also default – was either missed or egregiously underestimated.

Besides overlooking "contagion risk," the ratings agencies erred in at least two other important ways. First, the investment grade status given to senior tranches of CDOs was largely based on the subordination of junior tranches to that senior tranche. If cash flows were less than expected, junior tranches were to bear the loss and senior tranches were to receive full payment. But the rating agencies appear to have seriously underestimated how much of the portfolio had to be placed in the junior tranche and subordinated in order to adequately secure the senior tranche. Secondly, the rating agencies relied much too confidently on credit enhancement provided by monoline insurers who wrote credit default swaps to "insure" investors against default. Both the size of the obligations underwritten by these monolines and their own heavy investment in structured finance products have today made them effectively insolvent. Nonetheless, the rating agencies blithely ignored this problem without downgrading the monolines until long after their predicament was headline news.

In principle, debt securities that are given the same rating (for example, "AAA") should have the same default risk. But the recent disparity between Moody's default rates on corporate bonds and CDOs is extraordinary. Looking at the default rate on Moody's lowest investment grade rating ("Baa"), two financial economists have 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 rate between 1994 and 2005 on CDOs with a Baa rating was 24% – a more than ten to one disparity![3]

All this leads up to the critical question: Were the inflated ratings given by the ratings agencies to structured finance products simply an innocent mistake, attributable to the meteoric rise of structured finance and the agencies' reliance on unproven quantitative models that had not been thoroughly tested? Or, was it the product of conflicts of interest, as the agencies blinked at developments and warnings that should have alerted them to danger because structured finance have proven miraculously profitable for them causing their own profits and stock prices to soar in the period after 2000? In a provocative recent article, The Wall Street Journal recently suggested that Moody's desire to become a larger player in the structured finance field (where it had been a late entrant) led it to be more generous in its ratings and to defer to managements and promoters.[4] That same article noted that Moody's earnings rose 375% over the last

[3] See Charles Calomiris and Joseph Mason, "Reclaim Power from the Rating Agencies," Financial Times, August 24, 2007 at 11.
[4] See Aaron Lucchetti, "Rating's Game: As Housing Boomed, Moody's Opened Up," The Wall Street Journal, April 11, 2001 at p. A-1.

six years, fueled largely by structured finance's rise, and Professor Frank Partnoy has similarly pointed out that Moody's net income rose from $159 million in 2000 to $425 million in 2004, while its stock price increased by 300% between 2001 and 2006 – again, as a direct result of the rise of structured finance.[5] Today, structured finance is believed to account for 43% of Moody's revenues, whereas a few years ago its contribution fell in the single digit range. At the least, the motive for grade inflation seems clear and present.

Equally important, the rise of structured finance seriously aggravated the existing conflict of interest problem. No individual corporate issuer accounts for a significant share of the revenues of any ratings agency (Standard & Poors estimated in 2003 that no one issuer or corporate group accounted for 2% of its revenues). But in the case of structured finance the key player is the investment bank, and it may have packaged together a different CDO offering on a nearly monthly basis during 2005 and 2006. Because only a limited number of investment banks did such deals, they thus held economic leverage over the rating agencies that individual corporate issuers did not have.

Ultimately, it is still premature to estimate the impact of conflict of interest on ratings inflation. But it played a role and thus precautionary reforms are appropriate if they do not impose high costs.

2. <u>Rating Agencies Were Tardy At Adjusting Their Models to New Developments and At Revising Ratings In Accordance With Their Revised Models</u>. Let me briefly review the major economic developments in the housing industry over the last few years.[6] Prior to 2005, subprime mortgage loans represented roughly 10% of outstanding mortgage loans. By 2006, the origination of subprime mortgages rose to account for 20%

[5] See Partnoy, supra note 2.
[6] This discussion relies on Michael Crouhy and Stuart M. Turnbull, "The Subprime Crisis of 07," (http://ssrn.com/abstract=1112467) (March 2008).

of new residential mortgages (compared to an historical average of 8%). Traditionally, lenders required the mortgage borrower to make at least an 80% downpayment on the purchase price of the home. Beginning around 2005, subprime borrowers were offered "80/20" mortgage loans – consisting of an 80% first mortgage and a 20% second mortgage – to finance 100% of the home. Many of these mortgages also had a "short reset" provision which provided for a below market initial interest rate that would later be reset to a typically higher market rate. In effect, the initial interest rate was a marketing teaser. Add to this picture the factors that short-term interest rates began to rise from mid-2004 on (from near record low levels) and that housing prices had either stalled or already begun to sink, and the stage was set for disaster as adjustable rate mortgages began to reset upward.

More generally, spurred by the worldwide insatiable demand of institution investors for investment grade rated structured finance products, underwriting standards on mortgage loans began to deteriorate. The loosening of mortgage loan standards was first noted by the Office of the Comptroller of the Currency in its 2005 "Survey of Credit Underwriting Practices." Not only were lenders requiring little or no equity investment, but to increase "affordability," they came to require less and less documentation of income. Such undocumented loans – known popularly as "liar loans" – rose to account for 40 percent of subprime mortgage loans in 2006, up from 25 percent in 2001. By early 2007, journalists had begun to give prominent attention to these problems. See P. Coy, "Why Subprime Lenders Are in Trouble," Business Week, March 2, 2007.

Obviously, for a borrower having no equity stake in his or her home (as a result of 100% financing) and facing rising interest rates and declining housing prices, default becomes rational. This is especially the case in state jurisdictions which bar any deficiency judgment – so that foreclosure and loss of the home is the only penalty for default. Indeed, once housing prices begin to fall, it becomes increasingly hard to justify paying back a mortgage at an increasing interest rate to own a home with a current market value lower than the total non-recourse mortgage debt.

None of these obvious facts were lost on the ratings agencies, which began to issue warnings about the deteriorating state of the subprime market in mid-2006. By the end of 2006, Moody's publicly announced that the documentation problems on subprime mortgages was becoming more serious.

But major downgrades did not come until July 2007, when S&P downgraded some $7.3 billion of CDO securities sold in 2005 and 2006. Shortly thereafter, Moody's downgraded some 691 issues from 2006, with an original value of $19.4 billion, including some 78 bonds which Moody's had originally rate Aaa. In October 2007, S&P lowered its ratings on RMBS securities with a par value of $22 billion. In November 2007, Moody's downgraded 16 SIV issuers with approximately $33 billion in debt and followed that with further downgrades on another $14 billion in December (at which time it also placed under $105 billion under credit review).

In short, these downgrades came more than a year after the Comptroller of the Currency first publicly called attention to the deteriorating conditions in the subprime market and many months after the agencies themselves first noted problems in the market. And they came in a series of massive waves, further suggesting that individual ratings were not being reviewed on a case-by-case basis.

3. <u>Because Due Diligence Was Not Performed on Structured Finance Products, Ratings Were Awarded Based on Biased or At Least Selectively Disclosed Information</u>. As representatives of both Moody's and S&P testified before this Committee in September, 2007, the credit rating agencies do not perform due diligence; that is, they accept the representations and data provided by issuers, loan originators, and underwriters at face value and without undertaking any real effort to verify. Although this absence of verification also applies to corporate bonds, the two contexts are dramatically different. In the case of corporate bonds, the issuer has released audited financial statements, is usually a "reporting" company making regular, periodic filings with the SEC, and typically has other securities traded in deep and efficient public markets (with the result that the prices on those traded securities supply useful information). But in the case of structured finance products, there is only a pool of financial assets, and the quality of the collateral underlying it may range considerably. To be sure, ratings agencies do request and receive information, but they do not audit, verify or even sample it. Put simply, this is the equivalent of an auditor accepting an issuer's statements about its revenues, costs, inventories and contingent liabilities at face value.

Absent some efforts at verification, it is doubtful that the ratings on structured finance will ever again be credible to much of the debt market. In the past, underwriters did make efforts to perform some due diligence (in part because of their strict statutory liability under §11 of the Securities Act of 1933, which holds them liable for a misstatement or omission unless they could show that they had conducted a "reasonable investigation"). Typically, underwriters hired "due diligence" firms (of which Clayton Holdings, Inc. is probably the largest). Such firms did sample the collateral in the portfolio, reviewing a percentage they considered adequate of the total mortgage loans in the CDO. But recent press reports have suggested that an investigation by New York State Attorney General Cuomo has found that even when the "due diligence" firm warned the underwriter that a substantial percentage of the loans in a portfolio were "exception loans" – that is, loans outside the investment bank's normal underwriter criteria –, the underwriter did nothing.

Why did the underwriter not respond? Perhaps, the demand of the market for more and more CDO offerings was too attractive for it to resist. Perhaps, short-term focused investment bankers, concerned more about their annual bonuses, did not worry about litigation years away (and litigation over debt offerings had been rare). Perhaps, the investment bank just assumed that real estate values would continue to rise so that foreclosures would not truly injure the collateral. Perhaps finally, the investment banker assumed that its lawyers could solve any disclosure problem that arose with boilerplate warnings in the prospectus or offering memorandum. Whatever the reason, critical information did not reach either the market or the rating agencies even when it was gathered.

Summary: More problems could be discussed, but the basic picture that emerges is one in which (1) the rating agencies were using largely untested quantitative models that were very different from the judgment-based methodologies that they used to assess default risk at individual issuers, (2) the rating agencies were tardy in their response to new information of which they were aware; and (3) they relied on untested, unverified factual information submitted by loan originators who knew how to influence the agencies' models and had considerable incentive to do so by withholding adverse information.

III. What Should Be Done?: An Agenda for Rating Agency Reform

Reform efforts should have three distinct goals: (1) to increase the reliability of ratings on structured finance products; (2) to promote competition within a highly concentrated, indeed oligopolistic market; and (3) to enhance market transparency. These goals, of course, overlap. For example, reducing or better managing conflicts of interest might help realize all three.

A. Improving Reliability. Of all the problems associated with rating inflation on structured finance products, the most serious may be the unverified nature of the information relied upon. Only those who believe in Santa Claus can fail to recognize that the information provided by loan originators is likely to be biased. For a variety of reasons, loan originators face only a very low risk that a class action can be certified against them; hence, they are underdeterred and may even believe (possibly correctly) that the underwriter does not want to learn about the problematic quality of the collateral.

Conceivably, rating agencies could be required to conduct due diligence. At present, however, they lack the staff to do so. Rating agencies rate an extraordinary number of products. Even before structure finance grew meteorically to its present size, Moody's was rating over 21,000 issuers a decade ago in 1997. The staff required to verify basic financial information on those securities would be sizable.

What then is feasible? Mandatory verification (at least through a sampling approach) can be achieved by other means. Specialized due diligence firms (such as Clayton Holdings) exist and could provide the same information to the rating agency that they currently provide to the underwriter. The premise here is that it is more likely that the rating agency will respond to negative information than that the underwriter will. To make this proposal more specific, consider a hypothetical rule that required loan originators and underwriters to provide the rating agency with any information that was given them by a third party firm. To make such a rule even more mandatory, one might also require that no investment grade ratings would be given on a structured finance product by an NRSRO rating agency unless it had received a report from an independent third party – i.e., one not controlled by the loan originator or underwriter – that addressed the quality of the loan collateral and set forth its conclusions based on a sampling of the collateral that it deemed reasonably sufficient for purposes of its conclusions. The exact contents of such a certification need not be set forth in this testimony. For example, it might assure the rating agency that not more than 10% of the credit scores for the borrower in the mortgage pool fell outside specified levels or that not more than 10% of the borrowers in the pool appeared to have a minimum equity investment of less than 20% in their homes.

The real purpose and point of this proposal is to supplement the quantitative model of the rating agency with some minimal auditing (or at least sampling) that tests the quality of the information that the rating agency is relying upon. Otherwise, the oldest rule about quantitative models is "GIGO" – garbage in, garbage out. In effect, this proposal seeks to invent a new gatekeeper to complement the role of the rating agency because, in the world of structured finance, the rating agency is flying blind. Worse yet, because rating agencies commonly provide issuers and underwriters with their quantitative models, the latter know precisely how to "game the model" with only slightly misleading information to produce the desired result.

Several criticisms of this proposal can be anticipated. First, if the proposed rule only required the underwriter to give the rating agency any advice or reports that it received as to the nature or quality of the loan collateral, this might chill the underwriter's incentive to commission such reports. One response here might be to use disclosure to embarrass the underwriter by requiring both it and the rating agency to disclose prominently the absence of such reports or information and any reasons therefor. But the better answer is to mandate that the NRSRO issue not give an investment grade rating when it is in effect "flying blind" in the absence of some independent sampling of the collateral.

A possible objection to such a mandatory rule is that it would be unconstitutional as an interference with the financial publisher's First Amendment rights. Certainly, the Government could not tell The Wall Street Journal what it must do before it recommended a particular security to its readers. But if the Government cannot regulate the speech of alleged "financial publishers" (i.e., the term that the ratings agencies like to use for themselves), it can regulate the behavior of NRSROs. Thus, the rule would not prohibit speech but would instead condition the ratings agency's continued status as an NRSRO on its compliance with a rule requiring it to receive some certification as to quality of the collateral before giving an "investment grade" rating. Ultimately, this is little different than the SEC's longstanding rule (which dates back to 1933) requiring an issuer that sells securities to the public to provide audited financial information. In both contexts, some certification by independent professionals should be necessary. Some rating agencies might abandon their NRSRO statuses, but that is not necessarily undesirable.

Mandatory certification by a "due diligence" expert would not necessarily be resisted by the industry. Although it does have a cost, underwriters already use such experts. The investment banking industry understands that use of such an expert reduces its own liability. The "due diligence" expert may face §11 liability in the case of registered public offerings (but so does the auditor), and the investigation to be required of such an expert would fall far short of an audit and more closely resemble the auditor's traditional "cold comfort" letter.

Other proposals to increase the reliability of ratings can also be imagined that do not involve great cost or high liability. In prior testimony before this committee, I suggested that the NRSRO status should be forfeited (at least for a defined period and at least for a class of products) if the default rate experienced by the rating agency exceeded some specified level. Because the major rating agencies face little liability to investors and are not yet subject to significant competition from new entrants, a high rate of error has lower costs to them than it does for other professionals. Some sanction is needed. NRSRO forfeiture would not prevent the rating agency from issuing ratings, but it would deny them the NRSRO designation that converts their rating into a "regulatory license" that enables many classes of investors to buy the security.

B. Improving Transparency. Two critical problems stand out: (1) Staleness and (2) Forum Shopping. More generally, fee disclosure needs to be enhanced.

1. Staleness. From a transparency perspective, the gravest problem today may be the staleness of debt ratings. As noted earlier, issuer-paid rating agencies earn no

revenues from downgrades and may jeopardize their relationships with both issuers, investment banks, and many institutional investors (who must today typically write down the value of downgraded debt). As a result, downgrades occur infrequently and generally on the brink of disaster (such as the now legendary downgrading of Enron four days before its bankruptcy filing).

Moreover, even when a ratings agency changes its model or its approach to rating a class of products, it may not revise outstanding ratings on previously issued securities, (even though it would clearly award a lower rating today to the same securities if they were currently being rated). The result is "stale" ratings that mislead investors.

The best answer to this problem is to impose a requirement for periodic review and re-affirmation of a rating by the rating agency. If the rating agency did not wish to re-affirm its prior rating, it could withdraw its rating, but it should not be permitted to maintain a stale rating that misleads investors.

Not only should there be a requirement of periodic review (probably annually), but there should be an obligation to review all ratings promptly whenever the rating agency's basic model or methodology is materially changed. For example, if the rating agency were hypothetically to decide to revise its model to give greater weight to the geographic concentration of the mortgages in the pool, it should be required to downgrade (or at least withdraw) all ratings that were inconsistent with its revised model within some reasonable period (say, 90 days).

Periodically updating one's ratings or evaluation is standard practice among securities analysts, who are the functional equivalents of credit rating agencies for the equity markets. Admittedly, such a periodic review will add a cost to the ratings process.

To address this, the rating agency might enter into a three or four year prepaid contract with the issuer under which it agreed to review its rating at least annually. Although the cost for such a periodic review would be higher, the one advantage of a highly concentrated market is that the rating agency has the leverage to pass this cost onto the issuer and the underwriter. Indeed, to the extent that NRSRO ratings are regarded as "regulatory licenses" because many investors can only legally buy securities having such a rating, there is little prospect that issuers or underwriters will dispense with ratings.

2. Forum Shopping. As noted earlier, issuers pay advisory and consulting fees to rating agencies before they seek a formal rating and often never request a rating if they are advised that they are unlikely to get the desired rating. This can produce forum shopping (while still being profitable to the rating agency which receives the advisory fee but not the rating fee). This should be a special focus of disclosure with a requirement being placed both on the issuer and the rating agency to disclose payments made and received where no rating was issued by the rating agency.

3. Fee Disclosure. Ratings agencies should disclose the total fees that they have received from an issuer and/or underwriter over a defined period (say, two years) in connection with any disclosure that they make of their rating. This responds to the problem of the currently invisible "advisory" fee.

4. Forfeiture of NRSRO Status. Another means towards improving transparency would be to require disclosure of the default rates of each rating agency for each generic class of product. Some rating agencies (most notably, Moody's) already go part way in this direction, but there is a need for standardization. Default rates can be calculated in different ways (for example, if an interest payment is delayed for six months and then

paid, is this a default?). The SEC should define what "default" or "impaired" means so as to include delayed payments, then calculate these rates over five year cumulative periods, and publish its results on its own website. This would enable consumers to engage in a simple, one stop comparison. For smaller institutions (e.g., small pension funds, or college endowments), the in-house financial staff is often thin and only a simplified comparison will enable them to shop effectively.

C. Improving Competition. After decades of resisting new entrants into the small select club of NRSRO members, the SEC has changed its position and recently admitted new members into the NRSRO club in the wake of Congress's clear instructions in the Credit Rating Agency Reform Act of 2006. But there are still significant barriers to entry, as "reputational capital" is not easily acquired. Moreover, some new entrants work on a "subscriber pays" model that issuers and underwriters may fear (because such a more independent rating agency may be more critical of issuers).

Against this backdrop, both to enhance market transparency and competition, two proposals, clearly within the SEC's jurisdiction, make sense:

1. An SEC Sponsored Web Site. This web site would should display the ratings for each security on which multiple ratings were issued by NRSRO agencies. The net result would be to inform consumers of the multiplicity of ratings and the possible divergences in view.

The SEC's core function has always been disclosure, and this proposal does nothing more than reduce the costs to consumers of learning multiple opinions. Many potential consumers may not be aware of the existence of "subscriber paid" rating agencies or that the SEC had approved them as NRSROs whose opinions carried legal weight for institutions needing an "investment grade" rating. Obviously, this proposal dovetails with the earlier suggestion that the SEC disclose on the same web site the five year default rates for each NRSRO for each generic class of product. Sunlight is the best disinfectant (as the SEC has long known), and this proposal places no cost on issuers or underwriters.

2. Equal Access to Proprietary Data Made Available to Any NRSRO. Selective disclosure is today disfavored, at least since the adoption of Regulation FD in 2000, but it persists in one special context: credit ratings. Issuers may not wish to deal with new credit rating agencies, even though the SEC has found them qualified. The issuer may deny them access to non-public information that it makes available to the traditional "issuer-paid" agencies for precisely the same reasons that public companies formerly withheld data from securities analysts who had been critical of them: either to punish them or to preclude them from issuing critical reports. Today, because of a special exemption in Regulation Fair Disclosure ("Regulation FD") for credit rating agencies, the issuer can selectively give information to favored rating agencies, but withhold the same data from other NRSROs. This is a barrier to competition that should be eliminated. Any such mandated disclosure of issuer data could 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 transparency to be achieved and for competition to work in this special context, meaningful steps must be taken because the status quo has not and will not result in either. The foregoing proposals are intended to work in unison: (1) a certification requirement that would require the critical information about the quality of the collateral to be verified (or at least sampled) by an independent expert; (2) an SEC clearinghouse that would exhibit both ratings and default rate data by rating grade and product for each rating agency; and (3) a periodic review and re-assessment requirement to curb the persistence of stale ratings. All these steps are within the existing power of the SEC to implement without new legislation. Other proposals (such as forfeiture of NRSRO status) may, however, require legislation.

TESTIMONY OF VICKIE A. TILLMAN
EXECUTIVE VICE PRESIDENT
STANDARD & POOR'S CREDIT RATING SERVICES

BEFORE

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

APRIL 22, 2008

Mr. Chairman, Mr. Ranking Member, Members of the Committee, good morning. I am Vickie A. Tillman, Executive Vice President of Standard & Poor's ("S&P") Credit Rating Services. I commend you for holding hearings to review important topics related to our increasingly complex financial system and appreciate the opportunity to appear before you today. I especially welcome the chance to highlight some of the actions that we at Standard & Poor's are implementing to enhance our ratings process. We have been listening hard to your views and those of various market participants, investors, other policy makers and external critics in the United States and globally, and we have been learning from current market events. Most importantly, we have made it our priority to take proactive steps to address the feedback received and issues raised.

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

- The actions we are implementing to enhance our processes and promote confidence in our ratings; and
- The current regulatory situation both here in the United States and globally.

S&P's Actions To Enhance the Ratings Process and Promote Confidence

At Standard & Poor's, a core value of our company and key principle of our business is a constant commitment to improvement. Over the past several months, rating agencies have been the object of significant focus, including much critical attention. We have listened to, and reflected on, the numerous comments and concerns and have focused our efforts to enhance our ratings process, provide better and more information to investors, and promote confidence in our ratings. The result has been a series of actions -- announced in February of this year. The actions focus on raising transparency — providing the market with greater insight and understanding of the analytics and information supporting the ratings so investors can make better informed investment decisions — as well as Standard and Poor's rating practices and processes. I have attached to my testimony a detailed description of those actions that includes an update we published earlier this month outlining the significant progress we have made in implementing the actions and our plans for further implementation going-forward. Many of these initiatives are either already underway or scheduled for roll-out this year.

In total, our actions include 27 different initiatives, which fall into four broad categories:

1) Governance — The first category of actions relates to our governance procedures and controls. These actions are designed to enhance the integrity of our ratings process and to safeguard against factors that could challenge that process. Among other things, they include:

- Establishing an "Office of the Ombudsman" to address concerns related to, for instance, potential conflicts of interest, including potential conflicts that may arise from the fact that we are paid by issuers. The Ombudsman will be independent of the business, reporting to the Audit committee of The McGraw-Hill Companies' Board of Directors and the public.

- Requiring periodic reviews of our compliance and governance processes by an independent external firm.

- Establishing an independent "Risk Assessment Oversight Committee" responsible for analyzing risks that might affect the ratings process as well as assessing the feasibility of rating new types of securities.

- Implementing "look back" reviews when analysts leave to work for an issuer. This review is designed as a safeguard against undue influence by issuers in the ratings process.

- Implementing periodic rotations for lead analysts. The purpose of this policy is to help prevent long-standing professional or personal relationships from affecting ratings.

2) Analytics — The second category of actions focuses on the substantive analysis we do in arriving at our ratings opinions. These actions are designed to enhance the quality of our ratings analysis. Among other things, they include:

- Enhancing our surveillance process through increased resources, ongoing separation from new rating and rating surveillance activities in Structured Finance, expanded use of search and market based tools, and other measures.

- Establishing an independent "Model Oversight Committee" to assess and validate the quality of models used in our analysis.

- Increasing annual analyst training and certification requirements.

- Complementing traditional credit ratings analysis by highlighting non-default risk factors that can influence the valuation and performance of rated securities and portfolios of rated securities, such as market liquidity, volatility, correlation and recovery.

3) Information — The third category of actions addresses the information we use in our analysis and the information we provide to the public. These are designed to provide greater insight to market participants. Among other things, they include:

- Presenting "what if" scenario analysis in rating reports to explain key rating assumptions and the potential impact of positive or negative events on the rating.
- Working with market participants to improve disclosure of information regarding collateral underlying structured finance securities.

- Implementing procedures to collect more information about the processes used by issuers and originators to assess the accuracy and integrity of their data and their fraud detection measures so that we can better understand their data quality capabilities.

- More broadly disseminating ratings-related data, including default statistics. S&P has long made available — for free — detailed transition and default studies about our ratings. The studies cover our ratings across sectors, from corporate ratings to structured finance to public finance. This initiative is designed to promote broader dissemination of that information to the markets. For example, on March 31, 2008, we distributed free of charge a multimedia videocast addressing our most recent annual corporate default and transition study to roughly 30,000 institutional investors and other market participants.

- Developing an identifier to the ratings of securitizations that will highlight to the market when: (a) a rating is on a securitization, and (b) a rating is on a new type of structure or securitization;

- Making available a report of "Landmark Deals" which summarizes new structures and major issues, and distributing the report widely to investors, intermediaries, issuers, regulators and media;

- Developing an early warning indicator to investors that a key credit quality attribute (*e.g.*, delinquencies or losses) of an issue or issuer differs from our expectations and has or may trigger a full review by S&P surveillance.

4) Education — The fourth category of actions relates to our efforts to educate the market about ratings, their role, and their limitations. The goal of these actions is to increase understanding in the marketplace about credit ratings and rated securities. Among other things, they include:

- Publishing a *Credit Ratings User Manual & Investor Guidelines* to promote better understanding of the ratings process and the role of ratings in the financial markets.

- Launching a market outreach program to promote better understanding of complex securities that S&P may rate.

- Establishing an "Advisory Council" with membership that includes risk managers, academics and former government officials to provide guidance on addressing complex issues and set topics for market education.

- Working with other NRSROs to promote ratings quality through the introduction of best practices and issuer disclosure standards.

As we have discussed with Members of this Committee, we have been working aggressively to implement these actions and have been meeting with legislators, regulators, and market participants in the United States and globally to gather feedback. I would also emphasize that these actions are in addition to the practices and polices we have in place to address the integrity and quality of ratings. While we believe these address the concerns we have heard from this Committee, we welcome further suggestions as to how we can enhance market confidence and continue our tradition of quality ratings that offer opinions on creditworthiness to the market.

U.S. and Global Regulatory Situation

As the Committee is aware, Standard & Poor's and other NRSROs operate in a global financial market, and just as we have engaged with market participants and government authorities here at home, we have also reached out to similar groups around the world. Many of the concerns raised globally reflect those in the United States, and I would like to briefly review for the Committee the status of some of these efforts.

First, here in the United States, the SEC has been working on two fronts since passage of the *Credit Rating Agency Reform Act of 2006* (CRARA). As the Committee is aware, the regulatory regime established under that law was the product of several years of consideration and, in our view, reflects a judicious balance between oversight and analytical independence. The SEC's implementing rules for CRARA took effect on June 26, 2007, less that one year ago, and the first SEC examination under the new regime started in late 2007. That examination is still in progress. Its scope is extensive and the SEC staff has been extremely active and thorough in their work. The SEC exam is focusing on the very issues that have been at the heart of the concerns expressed by market participants and policy makers, and we look forward to the SEC's completion of its work. We are committed to addressing any recommendations that the Commission may have following its review process.

Another important development on the policy front was the March 10th release of the *Policy Statement on Financial Market Developments* by the President's Working Group on Financial Markets (PWG). That report addresses a number of potential measures or reforms in the financial industry, including some relating to credit ratings. A good number of the PWG recommendations are consistent with our announced actions. S&P fully supports the Working Group's efforts to bring greater transparency, stability and confidence to the capital markets and we look forward to working with the PWG to help drive the effective functioning of the credit markets.

On the international front, the International Organization of Securities Commissions (IOSCO) has undertaken a review of its *Code of Conduct Fundamentals for Credit Rating Agencies*. Just this past March, IOSCO published for comment a series of possible proposed changes to its model Code, after extensive consultation among IOSCO members, credit rating agencies (CRAs), representatives of the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, issuers, and the public at large. We are reviewing the IOSCO proposals currently and will be submitting our comments in the coming days.

In Europe, the Committee of European Securities Regulators (CESR) released a consultation report in February of this year, entitled *The Role of Credit Rating Agencies in Structured Finance*. The consultation report sought comments on some of the results of CESR's market survey. The consultation report also sought views regarding the regulatory regime in Europe. Among the areas covered in the report are: transparency of rating processes and methodologies; monitoring of rating performance; CRA staff resourcing; and conflicts of interest.

S&P is also considering the recommendations made by the Financial Stability Forum (FSF) in its recent report. S&P has been engaged with FSF members and we will continue our dialogue on their suggestions. As with other international initiatives, we look forward to working with the FSF on consistent global approaches to key issues.

Both on its own, and as part of an informal industry working group of participating CRAs, S&P is committed to remaining engaged in these processes — just as we have been in response to our U.S. policy makers. We expect that, in the next eight weeks, IOSCO will finalize its proposed amendments to the IOSCO Code and CESR will present its recommendations to the European Commission. The report issued by FSF indicates that the Forum will consider further steps mid-year. Once these recommendations are finalized, we will review them carefully and move swiftly to re-assess our processes and procedures and adopt, as appropriate, additional measures to conform with the final recommendations of those organizations.

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 going forward. 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 affecting the subprime market. I would be happy to answer any questions you may have.

The McGraw-Hill Companies

April 10, 20(

STANDARD
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Progress Update

S&P's steps to further manage potential conflicts of interest, strengthen the ratings process, and better serve the markets

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GOVERNANCE: Ensuring Integrity of the Ratings Process

Establish an *Office of the Ombudsman* that will address concerns related to potential conflicts of interest and analytical and governance processes that may be raised by issuers, investors, employees and other market participants across S&P's businesses. The Ombudsman will have oversight of the handling of all issues, with authority to escalate any unresolved matters, as necessary, to the CEO of The McGraw-Hill Companies and the Audit Committee of the Board of Directors.

- We have begun a search for candidates and will appoint an Ombudsman by year-end.

Engage an external firm to periodically conduct an independent review of S&P Ratings' compliance and governance processes and issue a public opinion that addresses whether S&P is effectively managing potential conflicts of interest and maintaining the independence of our ratings.

- We are finalizing and implementing relevant policies and are in the process of identifying a firm to conduct the independent review. We anticipate engaging a firm for this review by the end of next year.

Hold periodic reviews with the Audit Committee of the McGraw-Hill Board to discuss S&P Rating's overall governance and compliance functions. The reviews will include: (1) key business measures of ratings quality and compliance effectiveness, (2) the concerns and resolution of issues addressed by the Office of the Ombudsman, and (3) results of the independent reviews, by an external firm, of S&P Ratings' overall governance and compliance processes.

- Review meetings have begun. Meetings will be held three times a year with the McGraw-Hill Audit Committee and once a year with the full Board. Additional meetings or follow-up will be scheduled as requested or necessary.

Formalize functions with responsibility for policy governance, compliance, criteria management and quality assurance of the ratings and make them separate and independent from the ratings business units.

- We have established an independent Policy Governance Group (PGG) with the mandate to develop and approve all new Ratings' policies and procedures. This group is also responsible for the maintenance of policies that are clear, measurable and maintain our standards of quality. PGG membership includes representation from legal and compliance teams as well as the Analytical Policy Board.

- We continue building out our compliance department with additional staff and resources to implement risk-based monitoring of key policies that manage potential conflicts of interests, and enhance compliance training.

- We have reorganized the criteria and quality review functions, increased staffing dedicated to these functions, and have made them independent from the ratings business units. Guidelines for the activities and reporting of the criteria quality review function and process were enhanced. Training has been initiated on new criteria review processes.

Establish an enterprise-wide *Risk Assessment Oversight Committee* that operates separately and independently of the ratings business. The Committee will assess all risks that could impact the ratings process. This committee will also assess the feasibility of rating new types of securities.

- Established the Standard & Poor's Enterprise Risk Oversight Committee ("SPEROC"). SPEROC has the responsibility to provide critical risk assessment of business strategies and plans, employ appropriate assessment and monitoring of existing and emerging risks, and evaluate risk policies and controls. Regularly scheduled meetings have begun.

Implement "look back" reviews to ensure the integrity of prior ratings, whenever an analyst leaves to work for an issuer.

- We have developed a framework for look back review procedures. The reviews are expected to begin by mid-year 2008.

Institute periodic rotations for lead analysts.

- We have commenced a rotation program for our analysts. Additionally, the Structured Finance practice will be limiting lead analysts' exposure to specific arrangers, and potentially issuers, based on a number of factors that may include: (i) a maximum time period for lead analysts who handle a given arranger or issuer relationship, (ii) a maximum number of ratings assignments per period involving the same arranger or issuer, or (iii) a maximum number of consecutive ratings assignments involving the same arranger or issuer.

Increase the level of existing employee training to ensure compliance with policies.

- We've improved access to key Ratings' policies and Codes of Conduct by adding an icon to analysts' desktops.

- We are enhancing our global compliance training, which is scheduled for completion in Q3 2008.

- We are developing new modules that enhance our on-line training courses and reinforce key policies for analysts. The new modules will available to analysts in Q3 2008.

ANALYTICS: Enhancing Quality of Ratings Analysis and Opinions

Improve the surveillance process through: (a) additional resources and ongoing separation of new rating and rating surveillance functions in Structured Finance (b) strengthen surveillance in Corporates & Governments through the expanded use of search and market based tools and through oversight of surveillance separate from the business, and (c) regular adding of surveillance tools to make the surveillance process more timely and effective.

- In Structured Finance Ratings, we:
  - Have increased our RMBS Surveillance staff
  - Are integrating RMBS loan specific data into our credit and cash flow models
  - Are incorporating new capabilities gained as part of acquisition of iMake, a leading global provider of structured cash flow models and data.

- For Corporate & Government Ratings, we:
  - Have developed a market pricing monitor to alert analyst to credits trading outside our expected range
  - Have deployed text-based search tools for U.S. corporate issuers' filings.

- We continue to identify and evaluate additional methods of improving surveillance and will update the market as they are implemented.

Establish a *Model Oversight Committee* within the Quantitative Analytics Group, which will be separate from and independent of the business unit, to assess and validate the quality of data and models used in our analytical processes.

- We have hired a Senior Director of Model Quality and have staffed and established the group.

Increase annual analyst training requirements, enhance training programs and establish an analyst certification program.

- We have developed an enhanced training curriculum and increased our annual analyst training requirements by 25%.

- We are evaluating third-party firms to establish an independent credit analyst certification program. We expect development of this program to begin by year-end 2008.

Complement traditional credit ratings analysis by highlighting non-default risk factors such as liquidity, volatility, correlation and recovery, that can influence the valuation and performance of rated securities and portfolios of these securities.

- We have identified a list of non-default risk factors and will begin market validation in Q2 2008. We have requested feedback from market participants by mid-year and will commence research coverage by year-end 2008.

INFORMATION: Providing Greater Transparency and Insight to Market Participants

Simplify and provide broader market access to ratings criteria, underlying models and analytical tools.

- We are improving users' ability to search our free public website for S&P criteria documents. This enhancement will be available by mid-year 2008.

Include "what if" scenario analysis in rating reports to explain key rating assumptions and the potential impact of positive or negative events on the rating.

- We are developing a framework for including "what if" scenario analysis in all of our initial ratings reports. We anticipate including this information in all CMBS, CLO, U.S. RMBS, and U.S. Auto Loan reports by year-end.

- We have already included this analysis in the following reports:

  - The Potential Effect Of Rate Freezes On S&P-Rated U.S. First-Lien Subprime RMBS
  - Ford Credit Auto Owner Trust 2008-A
  - Reviewing The Impact Of Rate Freezes On Rated U.S. First-Lien Subprime RMBS Under Two Scenarios
  - U.S. Credit Card ABS Is Expected To Withstand Higher Losses in a Recession

Improve the quality and integrity of information by working with market participants to improve disclosure of information on collateral underlying structured securities. In addition, implement procedures to collect more information about the processes used by issuers and originators to assess the accuracy and integrity of their data and their fraud detection measures so that we can better understand their data quality capabilities.

- On transactions closing after May 1, 2008, we are requesting updated loan level performance data from issuers on a monthly basis, consistent with data customarily sent to Trustees and third party data vendors in the U.S. RMBS market.

- We are in the process of revamping criteria for assigning overall mortgage originator rankings based on operational process and procedures. New criteria will be established by mid-year 2008.

- We are evaluating various fraud tools and detection policies used by originators for improved data integrity and will be incorporating these evaluations in the criteria to be established by mid-year 2008.

- We continue to identify other actions and will notify the market as they are implemented.

More broadly disseminate long- and short-term rating performance data.

- We have broadened distribution of this data to regulators, legislators and other market participants.
    - For example, we have produced a multimedia videocast, discussing the key highlights of S&P's most recent annual corporate default and transition study. The videocast and study were distributed free of charge on March 31 to roughly 30,000 institutional investors and other market participants.

Better explain the comparability of ratings across asset classes/issuer types (structured vs. corporate vs. government).

- Our goal is to continue to provide credit ratings that are reasonably comparable measures of creditworthiness across all major sectors and their sub-sectors. S&P uses the same rating scale across the structured finance, corporate and government sectors, including public finance to express our rating opinions. We will continue to publish data and articles on the subject of ratings comparability.

Make available a Landmark Deal Report which summarizes new structures and major issues, and distribute the report widely to investors, intermediaries, issuers, regulators and media.

- We will begin publishing Landmark Deal Reports in Q3 2008.

Enhance access to S&P's code of ethics and disclosures through a link to the Global Regulatory Affairs section of www.standardandpoors.com.

- We are designing a new link on our website to more easily access important regulatory information. The link should be available by mid-year 2008.

Establish greater minimum portfolio disclosure criteria for structured securities servicers (e.g. ABCP and SIVS).

- By mid-year 2008, we will publish new, key data items about the portfolio of every ABCP conduit and SIV we agree to rate. This increased disclosure will provide investors additional insight into the investments and risks of these entities and a better understanding of what assets underlie their investments. This will include asset metrics such as sector concentrations, key ratings dependencies such as credit support and liquidity providers, and liability metrics with regard to outstanding liabilities of the issuer.

Develop an early warning indicator to investors that a key credit quality attribute (e.g. delinquencies; losses) of an issue or issuer differs from our expectations and has or may trigger a full review by S&P surveillance.

- We have introduced new early warning indicators.
  - We are publishing Synthetic Rating Over-Collateralization (SROC) monthly for all synthetic collateralized debt obligations. SROC is a key indicator of potential rating change.
  - We have launched the Ratings Review Triggers product for European RMBS.

- We will continue to look for additional methods of improving transparency and update the market on our actions.

Develop an identifier to the ratings of securitizations that will highlight to the market that: (a) the rating is on a securitization, and (b) the rating is on a new type of rating structure or securitization.

- We have developed a proposal for the identification of securitized ratings. We will publish a request for comment by mid-year asking for feedback. An update on next steps will be provided by Q3 2008.

EDUCATION: More Effectively Educating the Marketplace about Credit Ratings and Rated Securities

Publish a *Credit Ratings User Manual and Investor Guidelines* to promote better understanding of the ratings process and the role of ratings in the financial markets.

- S&P plans to distribute on its website a Ratings User Manual and Investor Guidelines in Q3 2008.

Broaden distribution of analysis and opinions via web and other media.

- We have broadened distribution of this data to include regulators, legislators and other market participants.
  - For example, we have produced a multimedia videocast, discussing the key highlights of S&P's most recent annual corporate default and transition study. The videocast and study were distributed free of charge on March 31 to roughly 30,000 institutional investors and other market participants.

  - We are improving users' ability to search for our criteria on our website. We are on schedule to release this enhancement by mid-year 2008.

- Released new RMBS Product Distribution Platform (available via https://www.sp.sfproducttools.com/sfdist/), which includes all of S&P's publicly available Residential Mortgage Backed Securities models

- Launched update of CDO Interface (available via https://www.sp.cdointerface.com/CdoOnlineWeb/login.htm), which provides greater transparency through increased reporting functionality and improved access to European and Asia/Pacific deal research

▪ We will continue to look for additional methods of broadening the distribution of our analysis and opinions and update the market on our actions.

Launch market outreach program to promote better understanding of complex securities S&P rates.

▪ We have recently begun meeting with Chief Investment Officers at top investment firms to discuss ways in which we can provide greater transparency on the complex securities we rate.

▪ In addition, S&P has recently expanded the production and distribution of its free podcasts and videocasts to provide broader market access to the perspectives of S&P's analytical staff.

▪ We will continue to look for additional methods to promote a better understanding of the complex securities we rate.

Establish an Advisory Council with membership that includes risk managers, academics and former government officials to provide guidance on addressing complex issues and establish topics for market education.

▪ We are identifying and recruiting members for an Advisory Council. We will begin meetings by year-end 2008.

Work with other NRSROs to promote ratings quality through the introduction of industry best practices and issuer disclosure standards.

▪ Standard & Poor's is part of a working group, together with other SEC-registered NRSROs who choose to participate. This group is responding to matters of regulatory concern, as appropriate, and implementing industry-wide proposals to help restore confidence in the credit rating industry.

▪ S&P is also working with the American Securitization Forum and other trade groups and industry organizations to establish best practices for disclosure in securitizations.

Moody's Investors Service

Testimony of Claire Robinson
Senior Managing Director
Moody's Investors Service

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

April 22, 2008

Hearing on Turmoil in U.S. Credit Markets: The Role of Credit Rating Agencies

I. INTRODUCTION

Good morning Chairman Dodd and members of the Committee. I am Claire Robinson. I am a Senior Managing Director at Moody's Investors Service ("Moody's") and have responsibility for our Asset Finance and Commercial Real Estate rating groups. On behalf of my colleagues at Moody's, I would like to thank the Committee for the opportunity to participate in today's hearing and to share our views on some of the recent developments and initiatives in the credit markets, our industry and at Moody's.

Difficulties in the U.S. housing sector have had considerable consequences in global credit markets. While most market participants today recognize that there were unprecedented forces driving U.S. mortgage delinquencies (including the deterioration in mortgage underwriting processes, misrepresentations in the mortgage application process, the steep decline in home prices and sharp contraction in credit available for refinancing) there is no question that, regardless of the underlying reasons, there has been a more general loss of confidence in the credit markets, and in particular within the structured finance sector. As a direct result of this loss of confidence, over the past several months various global authorities, policy makers and market participants have coordinated their activities and worked together to recommend a number of initiatives involving various market participants, including credit rating agencies. If implemented, we believe these various initiatives will help to restore confidence to the global markets.

Moody's strongly supports this coordinated global activity and welcomes the opportunity to work with Congress, regulators and other market participants to achieve this goal. Indeed, Moody's has been working constructively with other rating agencies, regulatory authorities and trade associations to develop various measures that could: reinforce the independence of the credit rating process; improve the transparency around the assumptions used in our analysis; and more clearly articulate the attributes and limitations of credit ratings.

Throughout its history, Moody's has taken pride in our commitment to continuously improve our analytical capabilities. Consistent with this history, and in light of recent events, we have undertaken several significant initiatives to enhance the quality of our analysis, address concerns in the marketplace, and further improve the usefulness of our credit ratings to investors. These measures include steps to:

- Enhance our analytical methodologies;
- Enhance our review of the due diligence process conducted by originators and underwriters;
- Provide more clarity about the credit characteristics of structured finance ratings;
- Promote objective measurement of ratings performance;
- Continue effectively managing potential conflicts of interest; and

- Enhance investors' understanding of the attributes and limitations of our ratings.

Finally, Moody's also believes that examination of the credit rating industry – including the review currently underway by the Securities and Exchange Commission ("SEC") – is helpful to encourage best practices and support the integrity and effectiveness of the industry, and we welcome and are eager to participate in the constructive evaluations of the industry.

II. BACKGROUND ON MOODY'S INVESTORS SERVICE

Credit rating agencies serve a narrow but important role in the investment information industry. Our role is to disseminate information about the relative creditworthiness of, among other things, financial obligations of corporations, banks, governmental entities, and 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 used sources for credit ratings, research and risk analysis. Our ratings and analysis track debt covering more than 100 sovereign nations, 11,000 corporate issuers, 26,000 public finance issuers, and 110,000 structured finance obligations. In addition, Moody's publishes credit opinions, transaction research, and commentary serving more than 3,000 clients around the globe.

Moody's credit ratings are forward-looking opinions that address just one characteristic of fixed income securities – their creditworthiness. Ratings are not statements of fact about past occurrences or guarantees of future performance and they do not constitute a recommendation to buy, sell, or hold a security. Ratings are designed exclusively for the purpose of ranking bonds according to their relative credit risk and do not take into consideration factors such as the direction of future market prices, an investor's investment objectives, or an investor's risk parameters. Ratings are not static and we will change our rating opinions if the fundamental creditworthiness of an issuer changes.

Our long-term debt ratings are expressed according to a simple system of letters and numbers, on a scale that has 21 categories ranging from Aaa to C. Bonds with the lowest relative credit risk are rated at the Aaa level, those with a higher relative credit risk are rated at the Aa level, those with an even higher relative credit risk are rated at the A level, and so on down through the rating scale. A Moody's rating is not a "pass-fail" grade; rather, Moody's ratings are a relative ranking system.

Moody's credit ratings are widely and publicly available at no cost to investors and the general public. We publicly disseminate our credit ratings through press releases and also make them available on our website. They are made 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 enhance 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.

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 probabilities 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. They are not designed to address any risk other than credit risk and should not be used for any other purpose.

The predictive content of Moody's ratings is demonstrated in our annual default studies and ratings performance reports, which are posted on our website, www.moodys.com. These reports demonstrate that both our corporate and structured finance ratings have been remarkably consistent and reliable predictors of default over many years and across many economic cycles.

There will always be unanticipated developments in some markets that impact the credit risk of securities – as we have seen over the past year. Indeed, because of shocks to different sectors, which cannot 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. (Over the past 15 years, however, investment-grade structured finance securities have had somewhat lower credit losses on average than investment-grade corporate securities.) Moody's success depends on our reputation for issuing objective and accurate ratings – and we are proud of the strong performance over time of the ratings we have issued on hundreds of thousands of securities.

III. CURRENT TURMOIL IN GLOBAL CREDIT MARKETS

The turmoil in the global credit markets has been driven, in part, by difficulties in the U.S. housing sector and the high levels of U.S. mortgage delinquencies, especially in the subprime market. Those difficulties grew out of an unprecedented confluence of factors, including the sharp deterioration in mortgage underwriting processes, misrepresentations in the mortgage application process, the steep decline in home prices and sharp contraction in credit available for refinancing.

Moody's provided early warnings on the weakness in the subprime market, and beginning in 2003 repeatedly published reports in which we pointedly commented on the deterioration in origination standards and rising housing prices. 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 by approximately 30% from 2003 to 2006. As soon as we saw that deterioration in the subprime market exceeded even those levels, we took prompt and deliberate rating actions on those transactions with heightened risk.

While Moody's did see and published about the increasing riskiness in subprime lending, neither we – nor most other market participants, observers, or regulators – fully anticipated the severity or speed of deterioration in subprime mortgage lending or the rapidity of credit tightening. As the higher than expected level of delinquencies on the 2006 subprime loans became apparent, the resulting volatility in the capital markets was further exacerbated by the short positions taken by some hedge funds and the lack of transparency regarding who holds many of these structured finance products.

The rating agencies are one of many players with historically well-defined roles in the credit and structured finance markets. We believe that addressing the current challenges in the credit markets – including the general loss of confidence among many individuals and institutions – will require action on the part of all market participants, and we are eager to work with the Congress, regulators and other market participants to this end.

IV. MOODY'S SUPPORT FOR COORDINATED GLOBAL POLICY INITIATIVES

While Moody's has taken steps to adopt changes in policies and procedures that we believe can contribute to enhanced confidence in the global credit markets, we also believe that coordinated global activity by a wide range of market participants and the regulatory authorities that oversee them is required to institute all necessary reforms. Accordingly, we have been cooperating fully to support the work of various regulatory authorities around the globe who are examining these issues.

In the U.S., the Credit Rating Agency Reform Act was passed into law in September 2006. It created a voluntary registration process for any credit rating agency wishing to be designated as a nationally recognized statistical rating organization ("NRSRO"). The Reform Act provides the SEC with ongoing authority to oversee NRSROs. The SEC's final rules implementing the Reform Act came into effect in June 2007 and Moody's applied to become registered as an NRSRO in the same month. We were registered by the SEC as an NRSRO in September 2007 and are subject to the SEC's regulatory oversight.[1] The SEC has been examining NRSROs, including Moody's, that were active in rating residential mortgage backed securities ("RMBS") and collateralized debt obligations ("CDOs"). Moody's has been cooperating fully with the SEC. The examination process has been extensive and it is continuing. In addition, the President's Working Group on Financial Markets has been examining the role of various market players in the recent turmoil and has published a series of thoughtful recommendations to help restore confidence. Finally, we have been working with this and other Congressional Committees who are engaged in studying the underlying causes of the developing financial market stress.

Globally, the role of the credit rating industry in the structured finance market has been the subject of review by the Financial Stability Forum ("FSF") – a working group of authorities responsible for global financial stability. In October 2007, the FSF was directed by the G-7 Finance Ministers and central bank Governors to undertake an analysis of the current market turmoil and to make recommendations for enhancing the resilience of the markets and financial institutions. Moody's worked with and provided input to the FSF process throughout the review period. The FSF's final report was delivered to the G-7 Finance Ministers and central bank Governors at their meeting on April 11, 2008 in Washington, D.C., at which meeting the G-7 agreed to adopt the proposals and asked the FSF to report on the implementation of the various

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1 As required by the SEC's rules, Moody's has posted its initial application to become an NRSRO on Moodys.com, as well as its Annual Certification of Form NRSRO.

recommendations at the G-7's June meeting. With respect to the credit rating industry, the FSF made the following general recommendations:

- Credit rating agencies should improve the quality of the rating process and manage conflicts of interest in rating structured finance products.
- Credit rating agencies should somehow distinguish ratings on structured finance products from those on corporate ratings[2] and expand the initial and ongoing information provided on the risk characteristics of structured products.
- Credit rating agencies should enhance their review of the quality of the data input and of the due diligence performed on underlying assets by originators, arrangers and issuers involved in structured finance products.
- Investors should address their over-reliance on ratings, and investor associations should consider developing standards of due diligence and credit analysis for investing in structured products. In addition, relevant authorities should review the use of credit ratings in the regulatory and supervisory framework to ensure investors make independent judgment of risks and perform their own due diligence

Moody's supports the recommendations of this international body. We believe that implementation of these measures globally can have a positive impact in helping to address some of the current issues in the credit markets. We already have begun to adopt many of these recommendations and will continue to support these and other efforts.

V. MOODY'S INITIATIVES TO ENHANCE THE QUALITY, INDEPENDENCE AND TRANSPARENCY OF OUR CREDIT RATING PROCESSES

While we believe coordinated global action is required, we also have undertaken a series of substantial initiatives at Moody's to:

- Enhance our analytical methodologies
- Enhance our review of the due diligence process conducted by originators and underwriters
- Provide more clarity about the credit characteristics of structured finance ratings
- Promote objective measurement of ratings performance
- Continue effectively managing potential conflicts of interest
- Enhance investors' understanding of the attributes and limitations of our ratings

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[2] For purposes of this testimony, the term "corporate ratings" encompasses ratings on industrial, utility, and financial institution companies.

a) Enhance Moody's Analytical Methodologies

Over the past year, as sectors of the U.S. housing market have seen unprecedented forces driving mortgage delinquencies, Moody's has made a number of changes to the analytical methodologies used in our U.S. structured finance ratings process. These changes, which have been made incrementally over time, allow us to incorporate newly available information to better inform our view of the credit risk characteristics of a given sector. Examples of such changes for our RMBS sector are as follows.

- Increasing the average loss estimates, and therefore credit enhancement levels, for subprime RMBS that Moody's rates.
- Expanding the mortgage loan-level data we request from the issuers to include depth and breadth of a borrower's credit history, presence of escrow for taxes and insurance and presence and level of cash reserves.
- Updating our mortgage default model. The new approach will look at home prices in individual metropolitan areas, thus allowing for a more detailed geographic analysis of a given pool of mortgages. It will also allow Moody's analysts to more easily conduct "what if" scenarios by inputting values for various economic variables.
- Increasing the depth and breadth of our operations reviews of loan originators. We currently have a detailed protocol for assessing the capabilities and procedures of loan servicers. We will develop a similar approach for assessing the credit and quality control processes of loan originators.

Moody's recently issued a special report summarizing these and other modifications to our analytical approach, entitled "Updates to Moody's U.S. Structured Finance Rating Methodologies".

b) Enhance Our Review of the Due Diligence Process Conducted by Originators and Underwriters

The quality of any credit analysis necessarily relies on the quality of the underlying data, and Moody's supports efforts to improve the quality of that data. To that end, Moody's has proposed the following enhancements to improve transparency, data integrity and accountability in U.S. residential mortgage securitizations:

- Stronger representations and warranties;
- Independent third-party pre-securitization review of underlying mortgage loans;
- Standardized post-securitization forensic review;
- Expanded loan-level data reporting of initial mortgage pool and ongoing loan performance; and
- More comprehensive originator assessments.

These five enhancements are intended to work together to provide more standard and reliable information on RMBS transactions than is currently available. Moody's ability to rate a particular RMBS or assign a high or investment grade rating will depend in part upon the degree to which issuers incorporate these enhancements.

These proposals were made in a Request for Comment (RFC), "Moody's Proposed Enhancements to U.S. Residential Mortgage Securitizations: Call for Comments", published by Moody's in March 2008. Our RFC closed on April 11, and we are analyzing the responses received. We will publish the results and our next steps in the near future.

c) Provide More Clarity About the Credit Characteristics of Structured Finance Ratings

Over the past six to nine months, a debate has emerged about the appropriateness of a single rating scale for both structured and non-structured securities. In particular, some market participants, including public authorities, have asked credit rating agencies to consider:

- Distinguishing ratings assigned to structured products from those assigned to corporate and government-related issuers, and/or
- Providing information content about financial performance attributes of structured products other than credit risk.

Moody's is committed to developing the most effective possible rating scale to serve the needs of market participants. To this end, Moody's, in February 2008, issued an RFC "Should Moody's Consider Differentiating Structured Finance and Corporate Ratings?" soliciting views from market participants on whether we should assign ratings on structured securities using an alternative to the current scale and what alternative they would find most effective. Our proposal offered five alternatives for changing the rating scale, including:

- Moving to a completely new rating scale.
- Adding a modifier to ratings on the existing scale to identify them as structured finance.
- Adding a suffix to the existing rating scale to indicate rating volatility risk.
- Using the existing rating scale combined with a second scale indicating such risks.
- Making no changes, but providing additional commentary.

Our goal in laying out these various alternatives was to encourage a broad dialogue with market participants that would help ensure we considered the full range of ratings-related alternatives and perspectives, and that we adopt the most effective scale.

Over 200 market participants provided us with their views through submissions to an electronic survey; emails sent to Moody's Credit Policy Group; and comments made directly to us during meetings with market participants. We are analyzing the extensive feedback we have received and intend to publish the results in the coming month.

d) Promote Objective Measurement of Ratings Performance

Moody's has led the ratings industry in subjecting its ratings performance to objective measurement. Moody's measures a range of attributes associated with our ratings – for example: accuracy, stability, rating transitions, default rates within one year of holding an investment-grade rating, and rating-reversal rates (downgrades followed by an upgrade, or vice versa) within one year. We compile these measurements in a number of periodic ratings performance studies including:

- Annual corporate default and loss studies (which we have conducted since 1989)
- Annual structured finance rating transition studies (which we have conducted since 1995)
- Annual structured finance default and loss studies (which we have conducted since 2003)
- Quarterly corporate ratings performance studies (which we have conducted since 2003)
- Semi-annual structured finance ratings performance studies (which we have conducted since 2005)

Measurements are calculated on a periodic basis for the purposes of making ratings performance comparisons over time and, where data permit, comparisons of Moody's ratings performance against alternative credit risk indicators.

e) Continue Effectively Managing Potential Conflicts of Interest

To foster and demonstrate objectivity, Moody's has adopted and publicly disclosed important fundamental principles for managing Moody's ratings process. For example, among other steps:

- Ratings decisions are made by a rating committee, not by an individual analyst.
- Analysts participating in a committee are required to be fully independent from the companies they rate.
- Analyst compensation is unconnected to either ratings or fees of the securities they rate.
- Analysts have standards by which they are required to conduct themselves with issuers and investors.
- An independent and separate surveillance team reviews the performance of most structured finance transactions on an ongoing basis.
- Our ratings methodologies are transparent and publicly disclosed.

These and other measures protect the integrity of Moody's rating opinions and allow us to manage any potential conflicts of interest. They are described in our Code of Professional Conduct, which is available on our Regulatory Affairs home page at www.moodys.com.

While we believe these safeguards are robust and transparent, we continue to work to enhance protections against potential conflicts. We have recently implemented, or are in the process of implementing, several other measures to further demonstrate the independence of our rating process:

- Formalize the Separation of Ratings-Related Businesses: Moody's recently reorganized its operating businesses to formalize the separation of our ratings-related and non-rating activities into two different business units.
- Enhance the Credit Policy Function: The Credit Policy function at Moody's has long been independent from those parts of the rating agency with revenue-generating responsibility, and we have taken steps to further separate this function. The Chairman of Credit Policy now has a reporting responsibility directly to the Moody's Board of Directors. The performance incentives for Credit Policy personnel are based exclusively on the effectiveness of the rating process and the analytical quality of their oversight. And, the measurement of the unit's performance is wholly independent of the financial performance of the company or any business unit.
- Codify the Existing Policies About Analyst Communication With Issuers: In order to enhance market confidence in the appropriateness of communications between Moody's analysts and issuers or advisors, we are codifying our existing practice that such communications are limited to communications about credit issues.
- Implement "Look-back" Reviews to Confirm Integrity of Analysis: Moody's has adopted a new policy related to employees who leave Moody's to work for another market participant. When we learn that an issuer or a financial intermediary representing the issuer has hired a Moody's employee who has served as lead analyst for that issuer, we will now review the analyst's work related to the issuer and its securities over a six-month "look-back" period to confirm the integrity and rigor of that analyst's work.

f) Enhance Investors' Understanding of the Attributes and Limitations of our Ratings

While capital market participants are often highly sensitive to Moody's ratings and rating actions, we note that misunderstandings remain about the objectives and performance of our ratings. We have undertaken numerous steps to improve the understanding of our ratings, including frequent publications,[3] extensive distribution of

[3] 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

information on these topics, and hundreds of face to face meetings with investors. We intend to continue these efforts and hope to work with other market participants to improve market understanding about what our ratings do and do not measure. We believe this can help ensure more appropriate use of our credit ratings going forward.

VI. Conclusion

Recent events show that markets can change rapidly and dramatically. Such change should teach important lessons. The opportunity to improve market practices, including credit analysis and credit-ratings processes, must be pursued vigorously and transparently if confidence in, and the healthy operation of, credit markets are to be restored.

We are firmly committed to the integrity of our rating methodologies and policies and the transparency of our performance metrics. In this regard, we look forward to continuing our dialogue with authorities and market participants to help strengthen confidence in the financial markets.

I am happy to respond to any questions.

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

ANNEX I

Guide to Moody's Key Rating Methodologies, Ratings System Management Policies and Ratings Performance Studies

Moody's methodologies, policies and performance studies all appear on our website, www.moodys.com, and can be located by navigating the Credit Policy and Regulatory Affairs Web pages, both of which have direct links from Moody's homepage.

Rating Methodologies. Within the corporate and the sovereign/subsovereign sectors, individual reports are available that detail our rating approach for each major industry or sector. These reports are organized in a simple outline structure on the Web page entitled "Fundamental Rating Methodologies Index". Structured finance rating methodologies for all sectors can also be found at www.moodys.com. The easiest way to find structured finance methodologies is to search the "Index of Special Reports."

Rating System Management Policies. Moody's rating policies and procedures can be found on its Regulatory Affairs homepage. The document, entitled "Moody's Investors Service Disclosures," discusses and contains links to Moody's Codes of Professional and Business Conduct, Policy with Respect to Non-Rating Services, Core Principals for the Conduct of Rating Committees, Designating Issuers that Do Not Participate in the Ratings Process, Designating and Unsolicited Ratings. A wide variety of additional ratings policy documents are posted on the Credit Policy page of the Moody's website. For a useful overview of how Moody's manages its ratings system, see "Understanding Moody's Corporate Bond Ratings and Rating Process," Special Comment, May 2002.

Ratings Performance Studies. Moody's rating performance is measured by the Credit Policy Research Group, which reports to the Credit Policy Chair, who reports administratively to the President of Moody's Investors Service and has a periodic reporting responsibility to the Moody's Corporation Board of Directors.

Moody's outlined its general approach to measuring ratings performance in April 2003 in a Special Comment titled, "Measuring the Performance of Moody's Corporate Ratings." The paper discusses the dual objectives – accuracy and stability – of the rating system; the greater importance placed on relative ratings accuracy compared to cardinal ratings accuracy; and the tools available to measure these various aspects of performance. The key metrics include accuracy ratios, rating action (volatility) rates, and investment-grade default rates. In addition to measuring changes in performance over time, Moody's compares the performance of its ratings to "ratings" inferred from bond prices, credit default swaps spreads, equity prices, and financial accounting ratio models.

Moody's has been since 2003 updating these performance measures for its corporate ratings on a quarterly basis, with the most recent report entitled, "The Performance of Moody's Corporate Bond Ratings: December 2007 Quarterly Update." Similar metrics have also been applied to Moody's structured finance ratings on a semi-annual basis since 2005, with the most recent report entitled, "The Performance of Structured Finance Ratings: Full-Year 2006 Report."

In addition, Moody's publishes detailed annual studies of default, transition, and loss rates for corporate ratings, transition rates for structured finance ratings, and material impairment and loss rates for structured finance ratings. The most recent versions of these reports are titled:

- "Corporate Default and Recovery Rates, 1920-2007,"
- "Structured Finance Rating Transitions: 1983-2007," and
- "Default & Loss Rates of Structured Finance Securities: 1993-2006."

Lastly, the Credit Policy Research Group produces a wide variety of special research reports on ratings performance within sectors and of broad interest to market participants, regulators and academics. These reports are indexed at www.moodys.com and are listed in a Special Comment entitled, "Guide to Moody's Default Research," which is updated every few months.

FitchRatings

Statement of
Stephen W. Joynt
President and Chief Executive Officer
Fitch, Inc.
To
United States Senate
Committee on Banking, Housing and Urban Affairs

Turmoil in U.S. Credit Markets: The Role of the Credit Rating Agencies

April 22, 2008

Introduction

Fitch Ratings traces it roots to the Fitch Publishing Company established in 1913. In the 1920s, Fitch introduced the now familiar "AAA" to "D" rating scale. Fitch was one of the three rating agencies (together with Standard & Poor's ("S&P") and Moody's Investors Service ("Moody's") first recognized as a nationally recognized statistical rating organization (a so-called "NRSRO") by the Securities and Exchanges Commission (the "Commission") in 1975.

Since 1989 when a new management team recapitalized Fitch, the company has experienced dramatic growth. In 1997, Fitch merged with IBCA Limited, another NRSRO headquartered in London, and became owned by Fimalac, a holding company that acquired IBCA in 1992. The merger of Fitch and IBCA represented our first step to respond to investors' needs for an alternative global, full-service rating agency capable of successfully competing with Moody's and S&P across all products and market segments.

Our next step in building Fitch into a global competitor was our acquisition in April 2000 of Duff & Phelps Credit Rating Co., an NRSRO headquartered in Chicago, followed by the acquisition later that year of the rating business of Thomson BankWatch. These acquisitions especially strengthened our coverage in the insurance industry.

Fitch currently covers 6,000 banks, insurance companies and other financial institutions, 1,700 corporations, 105 sovereigns and 94,000 municipal offerings in the United States. In addition, we cover over 9,000 structured finance securities.

Testimony

The past ten months have seen continuing deterioration in first the U.S. and then global fixed income markets. Severe asset quality deterioration in the U.S. subprime market and related CDO securities initially caused large market price declines that required revaluations of those securities by financial institutions because ultimate credit losses are now expected to be far greater than anyone had anticipated. Today's market stresses, however, have become more broad based and emanate from a global reassessment of the degree of leverage and appropriateness of short-term financing techniques inherent in today's regulated and unregulated financial companies. Deleveraging is dramatically reducing liquidity and contributing to price volatility. Many financial market participants are seeking ways to enhance stability.

Fitch's contribution to a better functioning market requires a reassessment of the changed risk environment, rating changes that reflect the changes in risk, ratings that are more stable and reliable, an improvement in our analysis and modeling techniques and full transparency so investors and all market participants can understand and use our ratings to supplement their own risk analysis and decision making.

Like all of the major rating agencies, our structured finance ratings have not performed well and have been too volatile. We have downgraded large numbers of structured finance securities, particularly in the subprime mortgage and CDO areas, in many cases by multiple rating notches. While we still expect almost all AAA securities to pay off, we have downgraded many, and some previously highly rated securities are at a high risk of incurring losses in the future.

While we were aware of, and accounted for, the many risks posed by subprime mortgages and the rapidly changing underwriting environment in the U.S. housing market, we did not foresee the magnitude or velocity of the decline in the U.S. housing market nor the dramatic shift in borrower behavior brought on by the changing practices in the market. We also did not foresee and are surprised by the far-reaching impact the subprime crisis has had on markets throughout the world.

Understandably, the rating agencies have lost some confidence of the market for which I am very disappointed. I think it will be a long and difficult road to win back market confidence. We have, however, aggressively started down that road and believe that we are making progress, albeit slowly.

To win back investor confidence we simply must do a better job with our structured finance and other ratings. Our structured finance ratings must be more predictive and stable. Our research and analysis must be more insightful and forward-looking. We must tell the investor about what might happen tomorrow instead of what has happened yesterday. We of course remain committed to ensure that our work is of the highest integrity and objectivity.

We have reevaluated our ratings across all areas of structured finance and the financial services industry as the credit turmoil has progressed. We are working hard to anticipate what may be next and to address any issues as quickly as we can while maintaining a balanced perspective and avoiding overreaction to these trying times.

Fitch has also been busy reassessing our structured finance criteria and models - changing them to reflect what we have observed in this turmoil. It has been our belief that we will best serve the market by concentrating our efforts on improving our ratings, our criteria and our models before anything else. As we conduct this work, we have decided to stop rating new issues in some structured finance markets that have experienced some of the greatest turmoil, such as CDOs. We will remain out of these markets until we can assure the market and ourselves that we have adequately updated our models and criteria to reflect what we have observed through the turmoil.

The world's financial infrastructure has become intricately interconnected and it seems as a result that credit ratings have become increasingly important to many market participants. Unfortunately, we have come to learn that ratings have been used by some as a proxy to measure liquidity and market risk, which ratings were never designed to address. Accordingly, we must do a better job at providing ratings and additional tools that allow investors to better assess risk in this increasingly complicated environment.

We have also been busy working with the other rating agencies, including Moody's and S&P, to increase the transparency and quality of ratings and to address the various concerns of regulators and market participants throughout the world. As an industry, the rating agencies have been in active dialogue with world regulators and trade groups about improving what we do.

Here in the U.S., we have been cooperating with the SEC in their extensive examination of our practices and procedures. The SEC began a formal examination of Fitch in September and a staff of SEC examiners has been working with our staff during the past seven months as they work to complete their examination. The SEC staff is conducting their examination under the oversight authority granted to them by the Credit Agency Reform Act of 2006. I believe that the market and the rating agencies will benefit from the oversight authority that the Reform Act gave to the SEC.

The examination process has been thorough and will prove to be very constructive to the SEC as it undertakes the important work of considering new rules about credit ratings and the credit rating agencies. We support their efforts to improve the transparency, integrity and quality of ratings and we believe their work will aid us in our efforts to win back investor confidence.

Fitch also has been actively meeting with the staff of this Committee and the staff of the House Financial Services Committee, both of which have taken leadership roles in understanding the market turmoil and introducing measures to help alleviate the turmoil. Since last spring, we have been meeting regularly with the staff of the Treasury Department, the various Federal bank regulators, state insurance commissioners, state and local officials and investors, both large and small, to share our perspective with them, and to gain insight from them, on the variety of ways the turmoil has affected the market.

We will continue to engage in these dialogues and we stand ready to adopt the various proposals of such groups as the Financial Stability Forum and other international regulatory bodies that are designed to improve the independence, transparency and quality of Fitch's credit rating process.

I thank you for the opportunity to testify and look forward to answering your questions.

Testimony of

Arturo Cifuentes, Ph.D.

Managing Director

Structured Finance Department

R.W. Pressprich & Co.

New York, NY

Before the Senate Committee on Banking, Housing and Urban Affairs

TURMOIL IN U.S. CREDIT MARKETS:

THE ROLE OF THE CREDIT RATING AGENCIES

U.S. Senate

Washington, D.C.

April 22, 2008

NOTE: The opinions and views expressed in this document are those of Dr. Cifuentes, who is appearing before the Committee on his own behalf and as a private citizen, and are not intended to represent the views or opinions of any organization.

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

My name is Arturo Cifuentes and I am an investment banker based in New York City. I am pleased to be here today and honored to be invited to testify. Thank you for the opportunity.

My professional background is described in the **APPENDIX** to this document. I just want to point out that I seem to be one of the few professionals who (not because of any personal virtue, but rather as a result of chance) has worked in all the industries that are relevant in the context of the current discussion: rating agency; monoline (re-insurance company); hedge fund (asset management), and investment banking (in two capacities, research and origination/structuring). I hope my experience can be useful to illuminate our debate.

The issue at hand is serious, so I will get to the point right away. Once again, just to be clear: these are my personal opinions; I am here in my capacity as a private citizen and not on behalf on any organization.

I have expressed some of these views elsewhere in a more elaborated fashion (please see the **REFERENCES** cited at the end of this statement [1, 2, …, 19]) so I will just try to summarize the key ideas.

BACKGROUND

There is a widespread belief that the U.S. economy is experiencing something that euphemistically has been labeled as "credit crunch," "subprime crisis," or "credit turmoil." The reality, unfortunately, is far more serious. This crisis represents the collapse of the alternative banking system.

Alternative banking system refers to the financial system that was created using securitization techniques and credit derivatives during the past twenty years. This system (several US$ trillions in size) has been an engine of growth for the U.S. economy. Its power relied on the fact that it offered efficient financing to many borrowers that, for whatever reasons, were not welcomed by the traditional banking system. It also permitted, when used prudently, a more efficient risk management.

Sad to say, at the present time this system is broken.

Much has been said about the possible causes behind this crisis. But whatever one's preferred diagnosis, a fact remains: from a ratings' point of view this has been the worst disaster in the history of the fixed income markets. One telling example: As of this writing more than 120 collateralized debt obligations (CDOs, see Figure 1) appear to be "insolvent" (have reached a so-called event-of-default status). In addition, the number of AAA-rated CDO-tranches that have been downgraded (or defaulted) is alarming.

In essence, the rating agencies failed not once, but twice. First, they failed when they misrated a huge number of subprime securitizations or Residential Mortgage-Backed Securities (RMBS); and a second time, when they misrated the so-called CDOs of ABS (CDOs of Asset-Backed Securities), that is, re-securitizations that used RMBS-tranches as assets (See Figure 2.) CDOs of ABS accounted for more than 90% of the U.S. CDOs downgraded in 2007.

And to cap it all: they all failed together, that is, all the rating agencies made – broadly speaking— the same mistakes at the same time which, incidentally, raises a disturbing concern: to what extent are these ratings independent?

Consequently, at the heart of this crisis there is a painful truth: market participants do not believe in the rating agencies anymore. One of the keys to ending this crisis is restoration of confidence in the agencies and their methods of analyses.

In what follows, I will offer my views in terms of what I think should be done. I do not profess to have the ultimate and perfect solution for this difficult problem. My goal is rather to highlight certain critical issues that I think should be discussed in depth and have been overlooked or neglected so far.

THE CONCEPTUAL PROBLEM

The First Problem. The rating agencies were created with one goal in mind: to provide investors with useful information regarding credit risk. They called this information credit ratings and they chose to convey it using an alpha-numeric rating system (AAA to C).

Much later, regulators decided (since ratings already "existed") to use them as a basis to dictate rules in terms of capital requirements, what certain institutions could and could not buy, etc.

Inadvertently, this seemingly innocuous decision may have created a serious problem that has only now become apparent: Are the needs of these two constituencies (the regulator and the investor) the same? More to the point: Is a rating *useful* for the investor necessarily also *useful* for the regulator? The answer is not obvious and it needs to be explored. Granted, it is hard to claim that these two groups have opposite interests, but it is not clear that they are one-hundred per cent aligned either. For instance, one could make the case that an investor who trades these securities would benefit more from a timely change in ratings, that is, a more "dynamic" rating. On the other hand, somebody who looks at ratings to determine capital reserves may prefer a more stable (or "static") rating.

In other words: Did the regulators, by forcing the rating agencies to satisfy the needs of two masters, put them in a difficult position (where they would be ultimately doomed to fail both)? Something to think about.

The Second Problem. This issue is more subtle but equally relevant. At this point most people are already familiar with the rating symbols: AAA, AA, A, BBB, BB,B, CCC,CC, and C. In short, the assortment of letters that go from AAA all the way to C and denote different levels of credit risk. AAA means extremely safe (foolproof) whereas C means the asset is in default. That's the theory.

Actually, the letters themselves are irrelevant: what matters is that we have a scale with nine levels. (For simplicity I have left aside the fact that Moody's uses an equivalent but slightly different set of symbols: Aaa instead of AAA, Baa instead of BBB, etc; additionally, each of these categories can be broken down into three sub-levels, such as A1, A2 and A3, but this is not important now.)

What is important is that regulators, in the U.S. and overseas, have taken these symbols as if they were absolute standards based on well-known (and identifiable) parameters and used them to enact rules.

An example will clarify this problem. There is a regulation that states that an insurance company cannot hold on its books an asset whose rating is below investment grade (i.e. below BBB). It seems reasonable. Unfortunately, the regulator has not specified what BBB means. That power was given to an external agent: the rating agency. Not only that, the agency can change the BBB definition at will.

This situation is conceptually untenable. Who, in his right mind, would enact a law stating—for example—that in Washington, D.C. you cannot build a "tall building," and then, give a private company the right to specify what "tall building" means? A five-story building? A ten-story building? Who knows?

To sum up: regulators have given the rating agencies three powers. Let us use the BBB category as an example but the same holds for any other rating category.

- First, there is the power to define what a BBB-rating means and the ability to change that definition anytime.

- Second, the rating agency has the right to establish the method to determine if a given bond satisfies the BBB-rating definition; again, the agency can change this method at will.
- And third, they—and only they—have the right to use this method to decide if a bond meets the BBB-rating definition.

Triple-power seems like too much power.

THE MISCONCEPTIONS

The Fee Issue. The conventional view is that in a securitization the banker pays the rating fee and therefore this creates a conflict of interest. The reality is quite different. The banker raises some capital and when the securitization bonds are issued, simultaneously, a small fraction of this capital is used to pay all the parties involved in the transaction (rating agencies, law firms, accountants, trustee, bankers, etc.) Therefore, the alleged link between the rating agency fee and the banker is weak at best, not to mention that the same could be said about the fees of all the other parties.

The Agency-as-Architect Issue. There is the misguided notion that frequently the rating agencies design the transactions they rate by providing "excessive" guidance to the bankers. This is nonsense. The interaction between the bankers and the agencies is the normal give-and-take that one sees in any business where approval is needed to go ahead with a project.

The misguided insistence on focusing on these two non-issues is a dangerous waste of time that deviates the attention from the relevant problems.

THE MUST-DO (NOW) THINGS

The Chinese Wall. There is a far more serious conflict of interest than is commonly believed at the root of the current rating agency business model. Mark Froeba, a former Moody's analyst, has suggested separating the rating *business* from the rating *analysis*. It is an interesting idea. In fact, one could make the case that whenever a rating analyst is supervised by a manager whose compensation is determined by market share or revenue growth (rather than ratings accuracy) the objectivity of ratings is compromised. Interestingly, nobody has focused on this issue. But to the extent that rating analysts are not protected by Chinese walls the potential to exert undue influence on them is real.

Additionally, rating analyst's promotions, salary increases, and bonuses should not be tied to revenue increase or, market share metrics: ratings accuracy should be the only yardstick. Under the prevailing *modus operandi* (no Chinese wall to protect the analysts) this is impossible to implement.

It is worth remembering that a similar situation motivated the 2003 Global Research Analyst settlement. (Before the settlement, *research* pieces were routinely written under inappropriate influence and ended up being nothing but propaganda dressed as *independent advice.*)

Incidentally, this kind of healthy separation is common in other businesses. For example, it would be unconceivable in a newspaper to have a manager with advertising growth responsibilities in charge of supervising an investigative reporter.

The Real Fee Issue. There is indeed a fee issue, but it's different from the one people have generally focused on. When rating a transaction the agencies get paid a significant upfront fee and a fairly minor (monitoring) fee over the life of the deal. Investors would be better served (and their interests would be more aligned with those of the agencies) if the rating fees were distributed more evenly over time. Additionally, they should be contingent on the accuracy of the ratings assigned to the investment-grade notes.

To be clear: a fraction of the total rating fee (for example, 30%) could be paid upfront. The remaining 70% (which should be paid over the life of the transaction) must be subordinated to the AAA-tranche payments (or the investment-grade tranches' payments). In other words, if the AAA-investor does not get its money, the agency does not get it either. There are, of course, variations of this idea but the goal is the same: align the interest of both, investors and agencies.

The Global Database. A major obstacle for a potential agency to enter the ratings market is the lack of historic data (past performance of previously rated instruments). Moody's and S&P already "have" a large amount of data on which they can rely. I have intentionally used the word "have" as opposed to "own" because I am not sure who owns the data. It seems to me, anyway, that if the ratings were paid for by the bankers (or the participants in a transaction) a case can be made that the data are not "owned" by the agencies. Or perhaps it should be made available (for a reasonable fee) to third parties. This is analogous to what happened with telephone companies. Eventually, the established companies were forced to permit new entrants to use their lines for a fee. Anyhow, making the ratings information available through a centralized global database would facilitate the entrance of new agencies. It would also facilitate a comparison between the agencies performance.

The Use of Black Boxes. The use of black boxes as part of the rating process must be eliminated. A black box is a computer program that receives a specific input and produces a given output (in this case a rating or a piece of information to be used in the rating process), but nothing or little is known about the method that the computer program uses. Rating methods should be disclosed in full so that market participants can build their own computer programs to replicate the agencies methodologies. The use of black boxes leaves everybody with a big disadvantage since the rules (structure of the black box) can be changed anytime and worse, not knowing what parameters drive the output, makes it very difficult for investors to interpret the meaning of the ratings.

Accountability and Barriers to Entry. In the face of what is the most egregious ratings disaster ever, market participants continue to ask themselves: If, with this dismal performance, the three rating agencies are still allowed to rate structured products, what else would it take to have them suspended?

That's why the thought of expediting the process to approve new agencies should be revisited. I am not a fan of the three-consecutive years in operation requirement (established by the Credit Rating Agency Reform Act of 2006). In fact, the current mess indicates that this requirement did little to help the already established agencies. Additionally, under the present circumstances regulators might be tempted to be forgiving with the existing agencies (and overlook their faulty performance) for the fear of creating a dangerous void.

TOPICS TO DISCUSS

Global Regulation. The fixed income market, and more specifically, the structured products market, is global in nature. It is not uncommon for a transaction to involve multiple jurisdictions as investors, asset originators, portfolio managers, trusts (SPVs), swap counterparties, etc. can be domiciled in different countries. This market does not lend itself to a fragmented (country-driven) regulatory framework. Geography, in the traditional sense of the term, is meaningless in this context.

If U.S. regulators do not move quickly and in a coordinated fashion with other counterparties to restore confidence there is a danger that other (European, U.K., etc.) entities could move on their own to enact local regulations. This situation could result in a set of multiple, but disconnected rules that will damage the efficiency of the fixed income market.

Independence. In principle, the rating agencies use different methods to assess credit risk and use different targets (or standards) to determine if a given instrument meets the target required to be AAA/Aaa, AA/Aa, etc. Therefore, and since the agencies are independent from one another, one would expect that at least, every now and then, they should produce different "results" (ratings). A study should be conducted by an independent internationally-recognized statistical consulting organization (there are well-established mathematical methods to conduct this type of analysis) to see if the ratings have been "independent." Take, for example, all the CDO ratings given in a specific time period by Moody's and S&P (to the same transactions) and compare them to see if they are "statistically different" or not. This is a much needed exercise.

I am not trying to suggest in any way that the existing agencies cooperated in any illegal fashion to produce the same ratings. What I am trying to point out is something different: that the present system seems to encourage a "race-to-the-bottom" type of environment which could have produced, as a byproduct, an undesirable "consistency" of ratings.

Rating Models. Much has been said about RMBS, but the most pronounced rating errors appear to have occurred in relation to the ratings of CDOs of ABS (or re-securitizations). Again, see Figure 2.

It is interesting to notice that Moody's introduced in 1996 a method called The Binomial (see **REFERENCES** [20, 21]) to rate CDOs. To this day, Moody's has used this method (or minor variations of it) to rate CDOs supported by corporate bonds, emerging market debt, and bank loans (collateralized loan obligations or CLOs). It seems that The Binomial method has done a decent job. It has "survived" two credit cycles and even now, under very stressful market conditions, CLOs analyzed with The Binomial approach seem to have performed satisfactorily.

On the contrary, CDOs of ABS, which apparently were analyzed with a different mathematical method (Monte Carlo simulations/Gaussian Copula), have exhibited a fairly bad performance. This new approach was introduced in the early 2000s. An approximate back-of-the-envelope calculation gives the impression that the so-called default probability and correlation assumptions used with this new (Monte

Carlo/Gaussian Copula) approach were more "relaxed" than the assumptions used with The Binomial method.

Although this observation is by no means conclusive, it points to the necessity to look into this issue more carefully. This might be the reason behind the abysmal performance of CDOs of ABS.

Other Topics. Some market participants have proposed certain ideas that are worth discussing: (1) the creation of a professional organization, independent of the rating agencies, to which rating analysts must belong and which sets forth ethical, educational, and professional standards; and (2) the modification of antitrust laws so the agencies can cooperate on establishing minimum standards.

CONCLUDING REMARKS

As the country appears to be entering what it seems to be the worst recession of the last fifty years, we must keep the following in mind:

- The banks have been badly damaged and will end up losing probably between US$ 300 to US$ 500 billion. Unless they are re-capitalized quickly their ability to lend will be severely curtailed.
- The alternative banking system, which, among other things, used to absorb more than 70% of the bank loans, is semi-paralyzed.
- Market participants do not seem to believe in the ratings anymore. The paralysis that is affecting certain markets is one undeniable indicator; the CDS (credit default swaps) spreads and bond yields observed in other markets –totally at odds with what ratings indicate—is another undisputable piece of evidence.

The combined effect of these three factors has the potential to make the upcoming recession even more serious.

With this sorry state of affairs, it is imperative that the confidence in the rating agencies is restored rapidly. Whether the agencies are guilty of incompetence (they tried to do the right thing, but they got it wrong) or something worse (they knew what they were doing, but seeking market share proved to be a more compelling driver than ratings accuracy) is immaterial at this point. The fact that matters is that they got too much too wrong, and the financial system is broken.

The U.S. capital markets are the envy of the free world: big, vigorous, creative, innovative, resilient and –above all— they benefit from a wide perception of transparency and honesty. In short, people trust them. But that trust has now been damaged. Specifically, the trust that American and foreign investors, once put on the rating agencies is now gone. The question is whether it will be gone forever or for a short time.

That is difficult to answer. But one thing is for sure: not taking a radical action to address this issue now could have a devastating effect on the U.S. capital markets. Once trust is lost, not much is left to lose. And after that, there is only room for regrets about what once was but it is no more. Let us not get there.

APPENDIX

Arturo Cifuentes

Professional Background

Dr. Cifuentes has worked in the fixed income sector for almost twelve years. He was a Senior Vice-President at Moody's (1996-1999) where he rated more than fifty CDOs; worked at Ambac in 1999/2000 as Managing Director in the Structured Products (CDO) department; managed a hedge fund that invested in CDOs for almost three years (Triton Partners, 2000-2003); and then became an investment banker (he was the Global Head of CDO Research at Wachovia and later joined R.W. Pressprich & Co. to focus on structuring and origination).

He has contributed to the development of many analytical techniques that are currently used in the structured finance arena; and he has lectured and consulted extensively on many financial topics in the U.S. and overseas. Most recently, he has advised the U.S. Treasury/OCC (several times); the State of Connecticut Insurance Department; and BCI (a Chilean bank). He has written extensively on financial topics in the international press, trade publications, and academic journals.

Before switching to the financial arena Dr. Cifuentes held scientific and engineering positions at the IBM T. J. Watson Research Center in New York and The MacNeal-Schwendler Corp., an engineering software firm based in Los Angeles. He has also held faculty positions at the University of Southern California, California State University and the University of Chile.

Dr. Cifuentes received a Ph.D. in applied mechanics and an M.S. in civil engineering from the California Institute of Technology (Caltech); an MBA in finance (Stern Scholar Award) from New York University; and a degree in civil engineering from the University of Chile.

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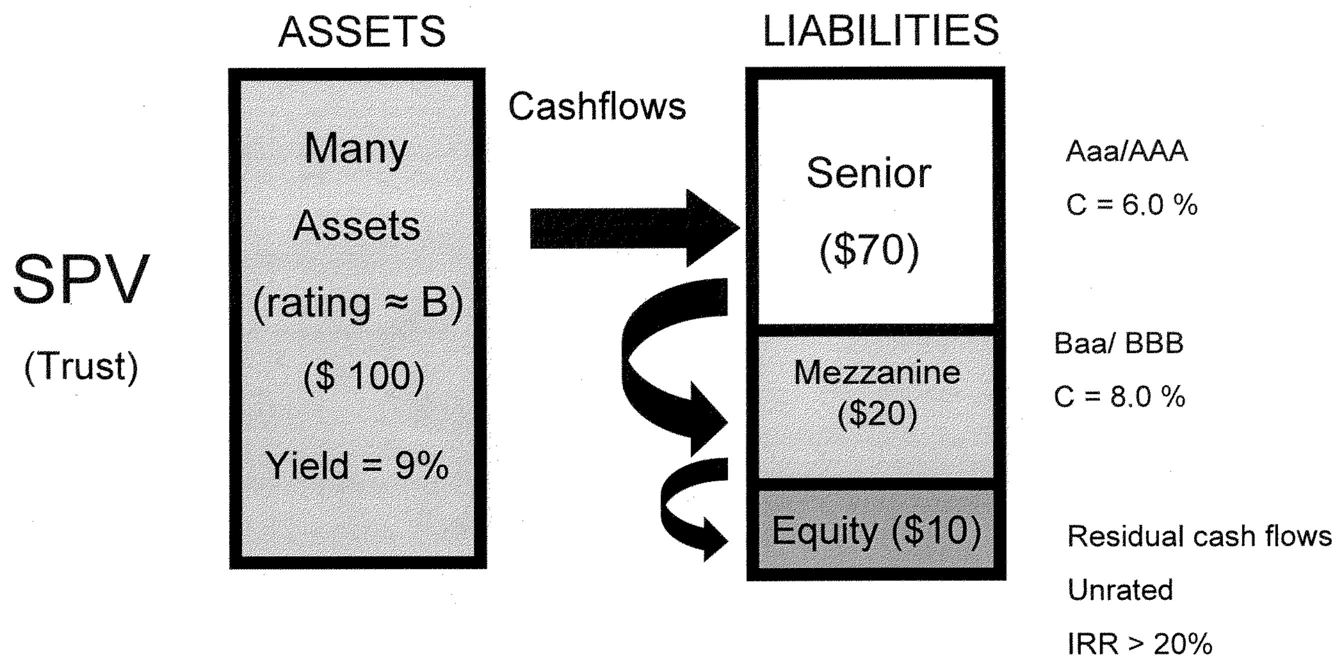
FIGURE 1: Mechanics of a CDO



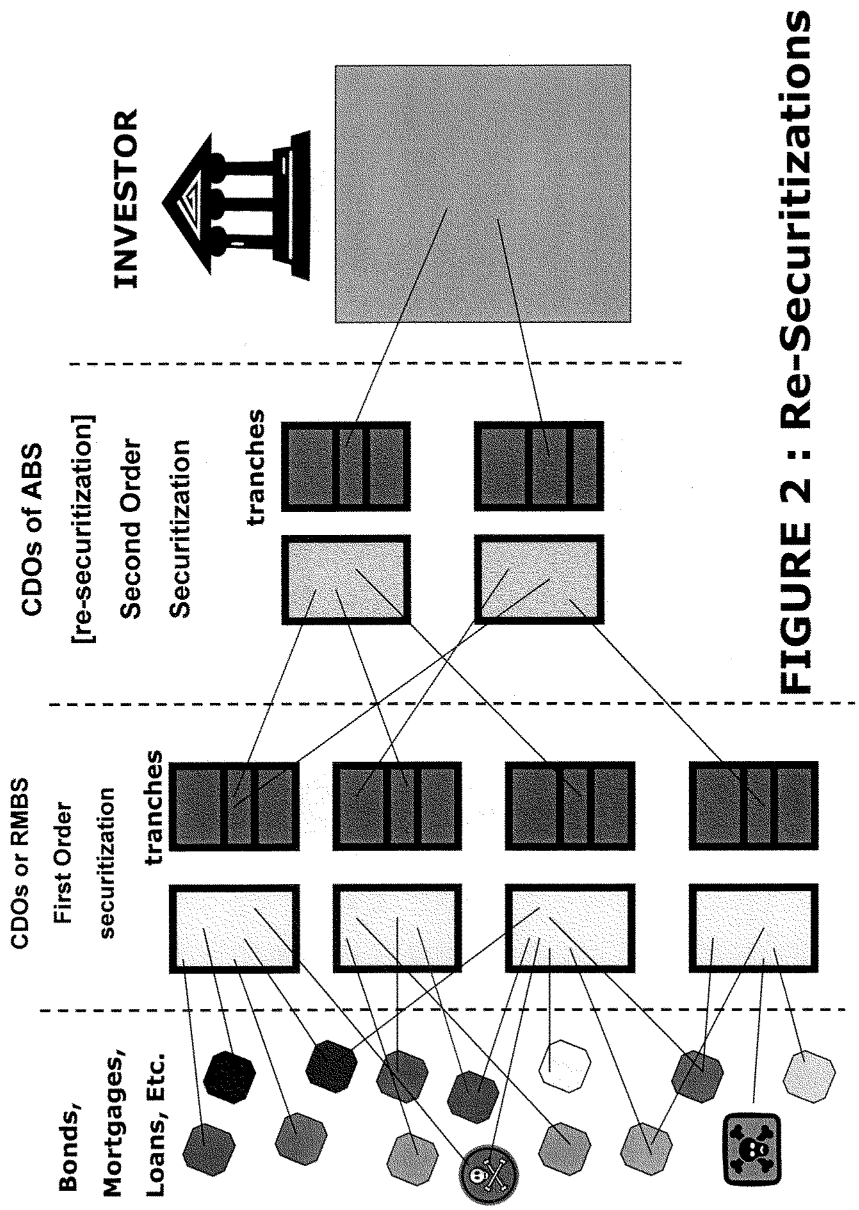


FIGURE 2 : Re-Securitizations

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM CHRISTOPHER COX

Q.1. Conflicts—Separate Analysts from Business? Dr. Cifuentes' testimony contains a recommendation by Mr. Mark Froeba that a rating agency be required to separate its rating business function from its rating analysis function. Has the Commission considered whether a significant conflict exists in this area and whether it should be addressed by regulation?

A.1. Yes. The Commission recently proposed rule amendments that would prohibit issuance of a credit rating if the NRSRO or an affiliate of the NRSRO made recommendations to the obligor or the issuer, underwriter, or sponsor of the security about the corporate or legal structure, assets, liabilities, or activities of the obligor or issuer of the security. The amendments would also prohibit a person within a NRSRO who participates in determining credit ratings, or in developing or approving procedures or methodologies used, from participating in any fee discussions or arrangements.

Q.2. Timeliness of Updates of Ratings. Professor Coffee's written testimony states "the gravest problem today may be the staleness of debt ratings." What standards should NRSROs observe in updating ratings and in withdrawing obsolete ratings for the benefit of investors and the integrity of markets?

A.2. The Commission believes credit ratings should reflect current assessments of the credit worthiness of an obligor or debt security. Consequently, NRSROs should have policies and procedures for monitoring and reviewing existing credit ratings. Furthermore, the Commission recently proposed new rules and rule amendments to require greater disclosure about the NRSROs' procedures and methodologies for monitoring existing ratings, including how frequently ratings are reviewed and whether different models are used in the initial rating and monitoring processes. This proposal is designed to provide the market with sufficient information on the surveillance processes of the NRSROs to allow for comparisons with respect to how actively they monitor and review existing ratings.

Q.3. Due Diligence. You testified that "The Commission's intent is to promote greater due diligence by market participants." Would the quality of ratings improve if NRSROs themselves performed some form of checking or due diligence on the data they receive before issuing ratings?

A.3. Because of the sheer volume of securities they rate, credit rating agencies may be less suited to performing due diligence than issuers and underwriters. But this should not relieve credit rating agencies of the responsibility to ensure that their ratings are based on reliable information, even if the due diligence is performed by others. The Commission recently proposed new rules and rule amendments that would require disclosure as to the level of verification performed by issuers and underwriters and NRSROs, and how the NRSROs take that verification into account when determining credit ratings.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM CHRISTOPHER COX

Chairman Cox, in his written testimony, Professor Coffee notes that because only a limited number of investment banks underwrite structured finance products, they have leverage over the rating agencies. If they don't like the ratings they get from one rating agency, they can go to another rating agency that has lower standards. Since a few investment banks control which ratings agencies receive the large revenues that come from rating structured finance products, rating agencies may be compelled to lower their ratings to remain competitive.

Q.1.a. Do you agree with Professor Coffee about the market power of investment banks over rating agencies?

A.1.a. This is one of the issues the Commission is reviewing as part of its examination of the role of credit rating agencies in the credit market turmoil. The Credit Rating Agency Reform Act and our proposed new rules recognize that this could happen, and therefore provide broadened competition and transparency as a remedy. At this date, the Commission has not reached any final conclusions as to whether investment banks unduly influenced the rating process.

Q.1.b. Has the SEC's investigation of the rating agencies revealed evidence that (1) the rating agencies compromised the integrity of their ratings in order to increase their profits, (2) there is a relationship between securities that have been downgraded and the investment banks that underwrote them or the credit rating agency that rated them, or (3) investment banks actively steered business to the rating agencies with lower standards?

A.1.b. The Commission will be making a formal report to you of its examination findings on this question very soon. (1) Preliminary observations suggest the credit rating agencies were in fact focused on how the ratings they issued influenced their market share. (2) The staff's preliminary evaluations have not found any significant relationship between the securities whose ratings were downgraded and the investment banks that issued those securities. In addition, examiners have not found a link between the downgraded securities and certain credit rating agencies. (3) The ongoing reviews have not found indications that investment banks actively steered business to the rating agencies with lower standards.

Chairman Cox, many institutional investors can purchase only securities rated by the rating agencies listed in the investment guidelines that govern their funds. Because S&P and Moody's have historically dominated the ratings market, the investment guidelines for many investment firms list only one or both of those firms. It has been suggested that the fact that investors do not regularly update or re-consider which rating agencies are specified in their investment guidelines places new rating agencies at a competitive disadvantage. Even if a new firm produces better ratings than S&P and Moody's, investors may still have to use S&P and Moody's ratings due to the requirements of their investment guidelines.

Q.2.a. As matter of good business practice, should institutional investors regularly review their investment guidelines and conduct due diligence to determine which credit rating agencies' ratings their guidelines should require?

A.2.a. Yes. As with any number of institutional investors' screening methods and evaluation criteria, it is prudent for those investors to periodically review their guidelines that incorporate credit ratings. In conducting a review, institutional investors should consider the reliability of the agencies on whose ratings they may rely and consider available alternative rating firms. Moreover, for many institutional investors, a security's rating likely would operate only as a starting point in a reasonable due diligence process. Further, where modeling is a significant part of the rating process, institutional investors should develop an understanding of the credit rating agencies' models. For example, that understanding could include the various risks those models seek and do not seek to capture.

Q.2.b. If institutional investors reviewed more regularly the rating agencies listed in their investment guidelines, would it provide an additional incentive for rating agencies to produce high quality ratings?

A.2.b. Yes. To the extent they do not do so today, institutional investors' periodic review of the efficacy and adequacy of their investment guidelines, including the reliability of credit ratings and the firms that issue them, could provide an additional incentive for credit rating agencies to provide higher quality ratings. In addition, it would be useful if issuers seeking ratings and the rating agencies themselves were fully aware of investors' perceptions of, and perspectives on, both those agencies and the ratings they issue.

Chairman Cox, S&P, Moody's, and Fitch indicated in their testimony that they are taking steps to make it easier for investors to understand the methodologies used in rating different types of securities. However, they have stopped short of proposing that different symbols be used to distinguish ratings on corporate, structured finance, and municipal securities.

Q.3. Would having different ratings symbols for each rating category provide investors with useful information about the nature of those ratings?

A.3. Yes. However, there are also questions about the costs of such a requirement, which the Commission is carefully evaluating. Given the reliance of some investors on ratings of subprime securities, the Commission has proposed requiring NRSROs to provide investors and other users of credit ratings with more useful information about credit ratings and processes used by credit rating agencies to determine credit ratings. An amendment proposed by the Commission would require a NRSRO to attach a report each time it publishes a credit rating for a structured finance product that describes the rating methodology used to determine the credit rating and how it differs from the determination of a rating for any other type of obligor or debt security, and how the credit risk characteristics associated with a structured finance product differ from those of any other type of obligor or debt security. A NRSRO would not be required to attach that report if the rating symbol identifies the credit rating as relating to a structured finance product as distinct from a credit rating for any other type of obligor or debt security. Recognizing that market participants have a range of views on the symbology approach and whether it would be effective, particularly from a cost-benefit analysis, the Commission looks forward to the public's comments on this proposal.

Q.4. Chairman Cox, presently if an investor wants to compare the accuracy of the ratings of different rating agencies, could an investor easily obtain the necessary information? How would the proposals you outlined in your testimony, if adopted, make it easier for investors, analysts, and scholars to analyze the accuracy of ratings?

A.4. Currently making comparisons across NRSROs is difficult. For that reason, the Commission recently proposed new disclosure requirements designed to assist investors and others in comparing the performance of NRSROs. Under the proposed new rules a NRSRO would need to provide transition statistics for each asset class of credit ratings for which an applicant is seeking registration broken out over 1, 3, and 10 year periods. Both upgrades and downgrades would have to be included in these statistics. In addition, default statistics would show defaults relative to the initial rating and incorporate defaults that occur after a credit rating is withdrawn. These new rules would make it easier for academics, investors, and others to compare how different NRSROs initially rated a security, and whether they subsequently changed the rating.

Q.5.a. Chairman Cox, during our last hearing on rating agencies, this Committee heard testimony that the use of ratings by NRSROs in financial regulation creates artificial demand for NRSRO ratings. Because financial institutions must obtain NRSRO ratings to satisfy regulatory requirements, there is a demand for ratings even if they are inaccurate. Does demand for NRSRO ratings for regulatory purposes reduce the incentive for credit rating agencies to produce accurate ratings?

A.5.a. Not necessarily, but it could reduce the incentives of investors to be critical users of the ratings. Of course, ratings are used for a variety of purposes. One of the major uses of ratings is by issuers to give confidence to buyers that the debt instrument offered for sale is of high quality. The reputation of the rating agency is critical for that purpose. The Commission staff does not have any evidence to suggest that the coincident use of ratings for regulatory purposes reduces the NRSROs' incentive to protect their reputations by producing accurate ratings. To deal with the problem of regulatory over-reliance on credit ratings as a shorthand for achieving other regulatory objectives, we will soon consider a rule proposal to provide alternative means of meeting those objectives.

Q.5.b. Should steps be taken to eliminate or reduce the use of NRSROs in financial regulation? If so, how could this be accomplished?

A.5.b. Yes. Financial regulators, including the SEC, should consider the extent to which the use of ratings for regulatory purposes induces investors to over-rely on ratings. The Commission is currently reconsidering the use of NRSRO ratings in its own rules. The Commission proposed new rules on June 25 designed to ensure that the role assigned to ratings in Commission rules is consistent with the objective of having investors make an independent judgment of risks and of making it clear to investors the limits and purposes of credit ratings for structured products.

Q.6. Chairman Cox, NRSRO ratings are widely embedded in our economy. We heard testimony at the hearing about the great weight investors and regulators place on ratings. Do investors and regulators overly rely on ratings by NRSROs? Has over-reliance on ratings reduced the amount of due diligence and risk assessment undertaken in our economy?

A.6. The fallout from the credit market turmoil indicates some investors relied too heavily on credit ratings for structured products rather than conducting their own assessment of the credit quality of the product. While, many of the financial institutions impacted in the turmoil had devoted substantial resources to establishing internal risk assessment functions (some of which ultimately failed to protect them), there is no question that there is a connection between over-reliance on ratings and the level of due diligence and risk assessment. The Commission proposed new rules on June 25 designed to ensure that the role assigned to ratings in Commission rules is consistent with the objective of having investors make an independent judgment of risks and of making it clear to investors the limits and purposes of credit ratings for structured products.

Q.7. Chairman Cox, the use of NRSRO ratings for financial regulation appears to multiply the impact inaccurate ratings can have on our economy. For example, NRSRO ratings are used in capital requirements and the SEC's money market rules. This means inaccurate ratings can allow financial institutions to hold too little capital, or force them to sell assets that no longer satisfy regulatory requirements. The need for financial institutions to raise more capital or re-allocate assets following large scale ratings downgrades could significantly affect the economy. If our financial regulatory system had relied less on NRSRO ratings, would our economy have been better prepared to weather the impact of the recent large scale ratings downgrades?

A.7. Yes, because the ratings for subprime-related securities were categorically wrong due to a variety of methodological factors that the agencies have since acknowledged. The large number of subsequent credit rating downgrades played a role in the credit market turmoil. However, as noted previously, issuers purchase credit ratings to make their securities marketable and many of the investors demanding that securities be rated are not subject to regulations that use credit ratings. The link between the use of credit ratings in Commission rules and investor over-reliance on credit ratings is difficult to quantify with precision.

Chairman Cox, the Credit Rating Agency Reform Act of 2006 sought to increase competition among rating agencies by making it easier for new firms to become NRSROs. The Act favors no particular business model. Two firms that use an "investor pays" model have registered as NRSROs. Some have argued that the "investor pays" model has fewer conflicts of interest than the "issuer pays" model because it makes the rating agency directly accountable to investors.

Q.8.a. How do we go about fostering innovation and further reducing the conflicts of interest in the credit rating industry?

A.8.a. The Rating Agency Reform Act of 2006 was designed to achieve these goals through requirements that promote accountability, transparency and competition in the credit rating agency industry. The Commission recently proposed new rules and rule amendments that are designed to further these goals in the context of structured finance, including by requiring more comparable performance statistics, the disclosure of ratings history, and greater disclosure of the assets underlying structured finance products and the methodologies used to determine and monitor structured finance ratings. The goal is to make it easier for the market to assess the quality of NRSRO ratings.

Q.8.b. What competitive barriers still entrench S&P and Moody's in their dominant market positions?

A.8.b. In the past, S&P and Moody's widespread market acceptance has given them an advantage because issuers and investors were familiar with their rating record and reputation. Issuers were inclined to use their services because they helped issuers sell their securities. Following the enactment of the Credit Rating Agency Act, it will be easier for competitor firms to become NRSROs and for the users of credit ratings to become comfortable with NRSROs other than S&P and Moody's. Ultimately, the test of their quality and value in the marketplace will be whether users are willing to pay for ratings from these other organizations. At the same time, S&P, Moody's, and the other NRSROs will need to provide significantly more information to the public to demonstrate the quality of their ratings and ratings processes. The Commission recently proposed new rules and rule amendments designed to require NRSROs to provide more information with which investors and other market participants could evaluate the NRSROs' performance record.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM CHRISTOPHER COX

RATING SHOPPING

Without a doubt, one of the most worrisome practices that undercuts the accuracy and reliability of ratings is rating shopping. I am pleased to hear your proposal include improvements to disclosure, but I am concerned that it doesn't go far enough to ensure rating shopping cannot occur.

Q.1.a. Would the proposed rules eliminate rating shopping?

A.1.a. This is exactly what the proposed rules are intended to do. Specifically, the proposed new rules and rule amendments are designed to target the problem of rating shopping by making it easier to track the ratings of NRSROs, and by making it easier for competitor NRSROs to issue unsolicited ratings for structured products that would allow investors to compare these ratings. Currently, the information necessary to determine an initial rating for structured products typically is not made widely available. If this information were made available to all NRSROs, those that are not hired to determine the credit rating could nonetheless issue a credit rating. This approach is designed to eliminate the potential harm of rating shopping by promoting unbiased ratings.

Q.1.b. The fundamental problem is that people can still get a preliminary rating and then decide to go elsewhere. Would issuers have to disclose if they received a preliminary rating?

A.1.b. The agreement recently reached between the three largest NRSROs and the New York Attorney General to change the payment structure in the industry attacks this problem in a slightly different way, by ending the practice of free preliminary ratings. Now, issuers will have to pay even if they do not obtain a rating. The Commission staff believes this will also avoid the problem that arises if issuers forego approaching NRSROs in order to defeat a disclosure requirement.

Q.1.c. On the disclosure proposals you outlined—are you going to require issuers to share material non-public information with all NRSROs if they provided the same information to one NRSRO? Can you describe in detail the proposal for disclosure?

A.1.c. The Commission recently proposed new rules and rule amendments to require the disclosure of information about the assets underlying a structured finance product that are used by an NRSRO to determine a rating. The goal is to provide information to NRSROs that were not hired to determine the credit rating so they would have an opportunity to issue a credit rating. The details of this proposal are described in the attached rule release.

BEAR STEARNS

The Bear Stearns collapse signaled a few problems in our system, one of which was that we seemed to have no idea how faulty Bear's assets were until it was too late.

Q.2.a. In the days and weeks leading up to Bear Stearns' collapse, it appears we received no signals from the ratings, which to my knowledge were unchanged until after the collapse. What does this say to you about the reliability of these ratings? Is this an example of a broader problem, in your mind?

A.2.a. Credit ratings issued by the NRSROs are intended to be an indicator of the credit risk associated with particular instruments or issuers. The extremely rapid deterioration of the financial position of Bear Stearns highlights the limitations of credit ratings and demonstrates the importance of considering the total mix of facts and circumstances in evaluating a firm, rather than relying on any single indicator of firm health.

Q.2.b. Shouldn't we be able to use the ratings as some sort of guide about the overall health and the risk of a firm's assets? Would you say that in the case of Bear, the ratings failed? Even if this was under extraordinary circumstances, shouldn't the ratings better reflect the actual risk at hand?

A.2.b. While the NRSROs would argue their definitions of credit risk reflected by their ratings accurately described the case of Bear Stearns even though it approached bankruptcy, you are right that users implicitly expect a correlation between ratings and performance. While the Credit Rating Agency Reform Act of 2006 prohibits the Commission from regulating the substance of credit ratings, our proposed new rules are intended to increase the accuracy of ratings through better disclosure, transparency, and competition. As noted previously, the events at Bear Stearns demonstrate the importance of considering the full range of information about a firm and broader market conditions in making judgments about the health of any firm.

Q.2.c. Is the SEC looking at the credit rating history for Bear Stearns, specifically the relationships between Bear Stearns and the rating agencies?

A.2.c. Yes, one of several areas covered by our examination of the three largest credit rating agencies is the relationship between issuers and the rating agencies. As a matter of enforcement policy, the Commission does not confirm or deny the existence of any ongoing enforcement investigation.

UPDATING RATINGS

Q.3.a. I'd like you to comment on a proposal by Professor Coffee for the rating agencies to periodically update ratings, as is done by securities analysts. Is this feasible? Do you think the SEC could require this within its existing authority?

A.3.a. The NRSROs generally have policies and procedures in place to monitor each rating and update it as necessary. The Commission has proposed new rules and rule amendments that would require greater disclosure about the NRSROs' procedures and methodologies for monitoring existing ratings including how frequently ratings are reviewed and whether different models are used in the initial rating and monitoring processes.

Q.3.b. Do you think the issue of ratings becoming "stale" is a concern? Could we argue that the ratings on Bear were in fact "stale"?

A.3.b. Yes, this is a concern. The Commission believes credit ratings should reflect current assessments of the credit worthiness of an obligor or debt security. As described above, our proposed new rules tackle this problem through new disclosure requirements. And although the Commission is statutorily prohibited from second guessing credit rating decisions made by the NRSROs, the Commission may evaluate whether an NRSRO followed its stated methodologies. We intend to do this through regular examinations.

Q.3.c. Will the proposed rules provide sufficient assurance to the markets that the ratings are current?

A.3.c. The proposed new rules that require greater disclosure about the NRSROs' procedures and methodologies for monitoring existing ratings such as how frequently ratings are reviewed and whether different models are used in the initial rating and monitoring processes are designed to provide the market with sufficient information on the surveillance processes of the NRSROs to allow for comparisons with respect to how frequently and actively they monitor and review existing ratings.

Q.3.d. Is the SEC looking at providing additional interpretation regarding what it means for a credit rating agency's ratings to be "current assessments"? Is this an area the Commission should be looking at, in your opinion?

A.3.d. Yes. As part of the notice and comment process for our proposed new rules, we expect to receive useful information on this question. The Commission believes credit ratings should reflect current assessments of the credit worthiness of an obligor or debt security, and we will continue to explore ways to effectuate this principle. The Credit Rating Agency Act of 2006 defines a "credit rating" as "an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments." Under this definition an "assessment" must reflect the NRSRO's current view of creditworthiness of the obligor or debt security.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM CHRISTOPHER COX

Q.1. Should Reg FD be amended to give all investors access to the same information that the rating agencies have so as to be able to judge for themselves whether the agency's opinions are valuable?

A.1. This is the purpose of the proposed new rules that would require the disclosure of information about the assets underlying the structured finance products that the NRSROs rate. This would allow market participants to better analyze the assets underlying structured securities, and reach their own conclusions about their creditworthiness. However, these new rules are not an amendment to Reg FD, which was designed to address the problem of issuers making selective disclosures of material nonpublic information to persons who were likely to use that information to their advantage in securities trading.

Q.2. Should Reg FD be amended to allow all NRSROs the same access to information if any NRSRO gets access to that information?

A.2. While not styled as an amendment to Reg FD, this is the purpose of the Commission's recently proposed new rules to require the disclosure of information about the assets underlying the structured finance products that the NRSROs rate. This data availability could particularly benefit subscriber-based NRSROs, who could use it to perform independent assessments of the validity of the ratings by their competitors who use the "issuer pays" model.

Q.3. If issuers pay the rating agencies for the ratings, how should investors be protected from rating shopping? Wouldn't it be better if the users of the ratings paid for them so that rating agencies that did a bad job and issued inflated ratings would be punished by the users in the form of lost market share? Doesn't the current structure reward the softest graders with increased business?

A.3. The issuer-pay and subscriber-pay models are subject to different types of potential conflicts. Consequently, I believe the users of credit ratings are served by having NRSROs that operate under both models as they serve as a check on the other. In addition, the Commission recently proposed new rules and rule amendments that would make it easier for NRSROs to provide unsolicited ratings for structured products. The goal is to create a mechanism to expose whether an NRSRO is employing less conservative methodologies than other NRSROs to determine ratings in order to increase market share.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM JOHN C. COFFEE, JR.

Q.1. If these reports are true, what duties would investment banks have violated under the securities laws?

A.1. In the case of an offering registered under the Securities Act of 1933, any investment banks that ignored warnings from their agents (*i.e.*, the due diligence firms) would almost certainly face private liability under Sections 11 and 12 of the Securities Act of 1933 (plus, of course, liability in SEC enforcement actions based on Section 17 of that Act and Rule 10b–5). The provisions of Section 11 entitle investors who purchased in the offering to sue for any material omission, unless the underwriter can establish its due diligence defense under Section 11(b)(3) that it "had, after a reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." (Similar provisions are also found in Section 12(a)(2) with only modest differences). I seriously doubt that either affirmative defense could be satisfied if the investment were on notice that a significant percentage of the loans in the structured finance product were outside usual lending guidelines and these facts were not clearly and specifically disclosed.

In the case of offerings done by means of a private placement or other exemption from registration, the above sections will not apply, but the investment banks would still face liability under Rule 10b–5 if they made a materially false statement or omitted to make a statement necessary to be made in order to make the statement made, in light of the circumstances under which they were made, not misleading. Again, I think the investment banks who withheld material information will face a high risk of liability (but a variety of legal defenses are possible).

Q.2. Should credit rating agencies, as gatekeepers responsible for monitoring the quality of securities offered in our markets, conduct an independent assessment of asset-backed structured finance markets?

A.2. Ideally, yes, because this is what gatekeepers normally do. But logistically, it may be very difficult for the major ratings agencies to gear up to take such a step. Thus, a second-best alternative would be to require that "NRSRO" rating agencies not confer an "investment grade" rating on a structured finance product in the absence of receipt of a verification from an independent expert that the latter had conducted an investigation, using such sampling or similar procedures as the rating agency deemed reasonable for these purposes, and had reached specified conclusions about the quality of the collateral underlying the security. These specified conclusions might include that not more than a defined percentage of the loans were outside traditional lending criteria (i.e., such as that the borrower had an equity stake of at least [20] percent in the home).

The point of this alternative is that the underwriters (and not the rating agency) could bear the cost of this "due diligence" investigation, but the rating agency would get an independent certification from an expert firm (which should have both civil and criminal liability for fraud for any knowing misstatements). Other techniques can also be imagined by which the rating agencies receive verification from parties other than the loan originators (and that is what is important—not that the rating agencies do it themselves).

Q.3. How often should ratings be reviewed and, if needed, updated by rating agencies?

A.3. All other gatekeepers on whom investors rely for evaluations—*e.g.*, securities analysts and auditors—do regularly update their evaluators. With credit rating agencies, updates are the exception, not the rule. I would suggest two principles:

First, debt ratings should be reviewed and updated at least annually. The rating agency could at this periodic moment re-affirm, change or simply withdraw its rating. But such a withdrawal would be public and would alert investors not to continue to rely on a "stale" rating.

Second, whenever the rating agency either (a) updates its model or methodology or (b) realizes that there has been an error in its model, it should promptly inform the market of the change that the new model (or the discovery of the error) would produce. Recent press reports have suggested that Moody's discovered a computer error in some ratings on European offerings that resulted in ratings that were three levels too high—and it did nothing! That is the kind of culpable omission that should be impermissible.

Q.4. If ratings were required to be updated more frequently, would it significantly increase the cost of ratings?

A.4. There would be an increase in the cost, which would be largely passed onto the issuer in all likelihood (given the weak level of competition in the ratings industry). But the costs of updating should not approach the cost of the original rating. In the typical case, the rating agency would already have developed its methodology and the issue would be largely whether any information input had changed (for example, had the default rate on mortgages in a particular location risen materially?). These will be relatively exceptional events. Where the agency changes its model, it should be able to generate all the implications for prior ratings in a single computer run (using the new methodology). Thus, while I acknowledge that there would be some cost increases, I do not believe they would approach the cost increases that Sarbanes-Oxley imposed (justifiably) on the accounting profession.

Q.5. Would you please comment on Chairman Cox's testimony about the areas of rulemaking that the SEC is considering?

A.5. It is difficult to comment (and possibly unfair to do so) until proposed regulations are released. I did hear Chairman Cox testify that he favored rules restricting the currently pervasive conflicts of interest in this field, and that is desirable.

Nonetheless, I do not yet believe that the SEC is considering rules to require increased verification of information in the rating process or to address the staleness problems. No "solution" can be adequate until these problems are addressed. Complex and sophisticated as any computer model may be, the first rule in this field is: "GIGO: garbage in, garbage out." If loan originators are not subject to close scrutiny in terms of the data they provide, the process will inevitably produce distorted and optimistically biased conclusions.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM VICKIE A. TILLMAN

Q.1. Ratings Scoreboard. What are your views on the recommendation that has been made for the creation of a central website which investors could access and on which they could compare the accuracy of past ratings by the different NRSROs for the same types of securities?

A.1. We agree that rating agencies should work towards greater transparency and disclosure. At S&P, we are regularly considering new ways to do so. In our experience, the most effective way to measure ratings performance is through historical measures such as default and transition studies. These studies can demonstrate effectively the existence (or lack) of a correlation between ratings assigned by an NRSRO and the likelihood of default. At the same time, it is important to note the broad disparities in rating definitions, criteria and methodologies used by various rating agencies that help foster competition in the industry. Meaningful differences exist among rating agencies, not only in the way ratings are defined, but also in the way defaults and other relevant credit events are determined and measured, all of which can affect reported results. We would not object to having each rating agency make available—in a central repository—information about its performance history but would caution that such a repository must note these differentiations among rating agencies. Investors can then judge ratings performance and determine for themselves the value to them of a particular rating agency's opinions.

Q.2. Due Diligence. Did S&P undertake to verify the information it used to decide ratings on the structured finance products that were subsequently downgraded? In recent years, there has been widespread awareness, through the press and otherwise, about the proliferation of so-called "liar loans"—mortgage loans with little or no documentation required and on which borrowers ultimately have stopped paying. Do you feel that NRSROs should have performed some investigation or due diligence on structured debt that contained these "liar loans"?—Are there circumstances under which NRSROs should be required to perform some form of due diligence before issuing a rating?

A.2. The information concerning the collateral for the securitizations that we rate typically comes from the participants in the transaction being rated: the issuers and underwriters. S&P is very specific about the data it requires in its rating process. For example, with respect to U.S. Residential Mortgage-Backed Securities ("RMBS"), S&P publishes a detailed list of approximately 70 data points that it requires issuers to submit with respect to each loan in each pool that it is asked to rate. We also publish a detailed glossary of definitions that the issuer must utilize when providing data to S&P.

S&P does not go on-site to review individual loan files held by originators and servicers, or perform an independent verification of the information provided to it in connection with its ratings analysis. As others at the hearing noted, we are not auditors and are generally not in the position to verify underlying data. The participants in the transactions we rate understand that S&P relies upon them for the accuracy of the data they provide. These participants issue representations and warranties in the operating documents for the transaction we are asked to rate with respect to the loan level data, regulatory compliance, and other issues and make disclosures about the collateral in the prospectus.

However, in light of recent events, we determined that S&P can take steps on our own to improve disclosure of information on collateral underlying structured securities, and as I testified, S&P has announced and is implementing a comprehensive set of new measures designed to improve the ratings process. In addition, S&P has begun to implement procedures to collect more information about the processes used by issuers and originators to assess the accuracy and integrity of their data and their fraud detection measures so that we can better understand their data quality capabilities.

Q.3. Timeliness of Updates of Ratings. Professor Coffee in his testimony pointed out that major downgrades of CDO securities "came more than a year after the Comptroller of the Currency first publicly called attention to the deteriorating conditions in the subprime market and many months after the agencies themselves first noted problems in the markets." His testimony also states "the gravest problem today may be the staleness of debt ratings." What is S&P doing to update ratings in a timely manner and eliminate stale ratings? What standards should NRSROs observe?

A.3. S&P continually strives to balance the twin goals of updating its ratings in a timely fashion while also adhering to its criteria and taking action when and only when it has the data to support a change in its rating opinion. In response to recent events, we have increased the frequency of our reviews of rated transactions. As part of our recently announced Actions (discussed at greater length in my testimony), we have undertaken several additional steps to improve the effectiveness and speed of our surveillance process. These include:

- increasing resources dedicated to surveillance;
- continuing to separate our new rating and rating surveillance functions;
- expanding our use of search and market based tools;
- incorporating new capabilities we have gained as part of our acquisition of iMake, a leading global provider of structured cash flow models and data; and
- developing an early warning indicator to investors that a key credit quality attribute (*e.g.*, delinquencies or losses) of an

issue or issuer differs from our expectations and has or may trigger a full review by S&P surveillance.

We believe strongly that these steps will improve our surveillance process and help provide the market with timely and appropriate ratings updates.

Q.4. Separate Ratings from Business? Dr. Cifuentes' testimony contains a recommendation that a rating agency separate its rating business function from its rating analysis function. What are your views on how NRSROs should address this analyst independence concern?

A.4. S&P shares Dr. Cifuentes' belief in the importance of analyst independence and has long sought to protect the integrity of its ratings analysis and opinions through policies and procedures designed to promote that independence. For example, analysts are not involved in negotiating fees. Nor can S&P personnel who are responsible for negotiating fees vote in ratings committees. Additionally, we specifically structure our analysts' compensation so that it is not dependent on the revenue generated by the ratings they assign. Moreover, S&P's Analytic Firewalls Policy imposes numerous requirements and responsibilities on both ratings analysts and other employees of S&P and the McGraw-Hill Companies in order to ensure that ratings analysts "have the freedom to express their respective opinions free from the improper influence of other Standard & Poor's/McGraw-Hill employees and free from the influence of the commercial relationships between Standard & Poor's/McGraw-Hill and third parties."

Additionally:

- ratings analysts are prohibited from participating in consulting or advisory services;
- ratings analysts are prohibited from cross-selling of credit ratings or ancillary ratings products and services with any other S&P or McGraw-Hill product or service; and
- ratings employees are prohibited from joint selling or calling ratings customers with other S&P or McGraw-Hill employees.

Q.5. Ratings Shopping. We have heard concerns about "ratings shopping," where an underwriter or an issuer goes to the NRSRO that it feels will give it the highest rating, even if it is not necessarily the most accurate. Is ratings shopping a problem? How should the negative aspects of it be addressed?

A.5. We believe that ratings shopping is an issue to be considered by the markets as a whole. One suggested measure to address the concern is to require structured finance issuers to disclose whether they have approached rating agencies other than the ones providing a rating on the applicable transaction.

Q.6. Professional Analyst Organization. Dr. Cifuentes' testimony suggests "the creation of a professional organization, independent of the rating agencies, to which ratings analysts must belong and which sets forth ethical, educational and professional standards." Please share your thoughts on the potential merits of such an organization.

A.6. At S&P, we believe that all rating agencies should have systematic procedures to help ensure that their analysts are able to identify, understand, and analyze information relevant to the issues and issuers they rate. In assessing the competence of analysts, S&P considers their level of education; experience within sectors, industries and geographic regions; experience with particular transactions and asset classes and other specialty areas; analytical ability; decision making; professionalism; time management ability; leadership; teamwork; and their written and verbal communication skills. S&P has adopted and continues to enhance policies and procedures designed to ensure that its analysts receive sufficient training and support to facilitate the generation of independent, objective and credible rating opinions. A major emphasis of the action plan that S&P announced in February is strengthening analyst training.

However, given the importance of rating agency independence and the value of having a diversity of opinions in the market, we do not believe that Congress or the SEC should impose minimum standards for analyst training, background, experience, or other characteristics. Standards along these lines would replace independent judgments with those of the government. The result would be more homogeneity, and less innovation.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM VICKIE A. TILLMAN

Q.1. Ms. Robinson, Ms. Tillman, and Mr. Joynt, do you think that it is easy for investors to compare the accuracy of the ratings of the different credit rating agencies? If not, do S&P, Moody's, and Fitch favor the SEC issuing rules to require enhanced disclosure of ratings performance as Chairman Cox outlined in his testimony?

A.1. We have a long-standing tradition at Standard & Poor's ("S&P") of publishing significant amounts of information about the default and transition history of our ratings. We believe the studies we publish assist issuers and investors in their evaluation of the quality of our rating opinions. And we are always open to considering new ways to inform the public about what we do and the excellent track record of S&P's ratings.

We would support having each rating agency make available—in a central repository—information about its performance history. Investors can then judge that performance and determine for themselves the value, to them, of a particular rating agency's views. I will note, however, that our rating opinions represent an analytic judgment based on a wide range of factors, many of which are assessments of future developments. Rating agencies employ different definitions of ratings and have different criteria. We believe that although this diversity of approaches is beneficial to the markets, it makes an "apples to apples" comparison of ratings difficult.

Q.2. Ms. Robinson, Ms. Tillman, and Mr. Joynt, would you please explain the process by which you obtain the information you use to rate structured finance securities?

How much of the information is from issuers, underwriters, or other sources?

Do you ever seek to verify the accuracy of the information you receive?

A.2. The information concerning the collateral for the securitizations that we rate typically comes from the participants in the transaction being rated: the issuers and underwriters. S&P is very specific about the data it requires in its rating process. For example, with respect to U.S. Residential Mortgage-Backed Securities ("RMBS"), S&P publishes a detailed list of approximately 70 data points that it requires issuers to submit with respect to each loan in each pool that it is asked to rate. We also publish a detailed glossary of definitions that the issuer must utilize when providing data to S&P.

We at S&P are not auditors and are generally not in the position to verify underlying data. Currently, the participants in the transactions we rate understand that S&P relies upon them for the accuracy of the data they provide. These participants issue representations and warranties in the operating documents for the transaction with respect to the loan level data, regulatory compliance, and other issues and make disclosures about the collateral in the prospectus.

As I testified, S&P has announced and is implementing a comprehensive set of new measures designed to further strengthen the ratings process, including steps to improve the quality and integrity of information we collect. We are working with market participants to improve disclosure of information on collateral underlying structured securities. Specifically:

On transactions closing after May 1, 2008, we are requesting updated loan level performance data from issuers on a monthly basis, consistent with data customarily sent to Trustees and third party data vendors in the U.S. RMBS market.

We are in the process of revamping criteria for assigning overall mortgage originator rankings based on operational process and procedures. New criteria should be established by mid-2008.

We are evaluating various fraud tools and detection policies used by originators for improved data integrity and will be incorporating these evaluations in the criteria to be established by mid-2008.

Q.3. Do you have any reason to believe that inaccurate or fraudulent data contributed to the poor performance of your ratings on structured finance securities over the last few years? If yes, please provide supporting evidence.

A.3. Published reports indicate that data quality and fraud are among the factors that may have impacted loan performance for the vintages that have seen worse-than-expected performance, as well as a host of other potential factors. Certain published reports also suggest a significant increase in fraud with respect to recent vintages. For example, the Mortgage Asset Research Institute, commissioned by the Mortgage Bankers Association to conduct a mortgage fraud study in 2006, reported "findings of fraud were in excess of previous industry highs." It noted that key risk variables that have historically influenced default patterns, such as FICO, LTV and ownership status were proving less predictive.

Ms. Robinson, Ms. Tillman, and Mr. Joynt, according to testimony provided by Chairman Cox, Moody's has downgraded 53 percent and 39 percent of all its 2006 and 2007 subprime tranches; S&P has downgraded 44 percent of the subprime tranches it rated between the first quarter of 2005 and the third quarter of 2007; and Fitch has downgraded approximately 34% of the subprime tranches it rated in 2006 and the first quarter of 2007.

Q.4. What steps have each of your companies taken during the past three years to hold accountable its executives and analysts for the poor performance of its ratings? Has your company dismissed or otherwise disciplined any of the executives or analysts responsible for overseeing or producing its ratings of structured finance products? Please provide a complete list of disciplinary actions.

A.4. Ratings transitions, even significant transitions, do not reflect errors in our initial analysis as they could be caused by a multitude of unforeseen factors such as the unprecedented market conditions we are currently experiencing. Moreover, the downgrades of our 2006 and 2007 subprime tranches do highlight the success of our surveillance procedures in place at S&P as we adapt to turbulent market conditions.

Additionally, S&P considers personnel actions to be confidential and does not—as a rule—discuss publicly reasons for promotions/demotions/dismissals.

We have been listening to and learning from the concerns and criticisms raised about our industry. We take very seriously our responsibility to implement whatever measures we can to improve the way we do business consistent with our role in the financial markets. As a result of our ongoing commitment to improve our rating process, we recently announced that we are adopting wide-ranging set of new measures to increase responsiveness and accountability at S&P from top to bottom.

Among these numerous initiatives, we are increasing the annual training requirements for our analysts, expanding the scope and the course offerings of our training programs, including increasing our focus on policy requirements and compliance, and are establishing an analyst certification program in partnership with an academic institution. We also recently created and filled two new executive positions in the areas of risk oversight, criteria management and quality assurance. These changes add strength and depth to our ratings leadership and capabilities, and demonstrate S&P's commitment to serving the broad and growing needs of the global credit markets. Among other things, we named a new Executive Managing Director of Ratings Risk Management, who will be responsible for identifying, assessing and mitigating potential internal and external risk exposures in our ratings business. Also we split Quality and Criteria governance responsibilities into two separate functions to further strengthen their respective independence and effectiveness.

Consistent with these Actions and with our ongoing efforts to do what is best both for our company and the financial markets we serve, we will continue to evaluate the performance of all of our employees and take action where we believe it to be appropriate.

Q.5.a. Ms. Robinson, Ms. Tillman, and Mr. Joynt, during the last 3 years, did your firm notice a decline in underwriting standards for mortgages being used to create residential mortgage-backed securities? If so, did you alter your ratings process in anyway to account for this decline in underwriting standards? Did you disclose to investors that there was a decline in underwriting standards?

A.5.a. S&P repeatedly and publicly voiced concerns about the subprime market and the deteriorating credit quality of RMBS transactions as far back as April 2005. These warnings included discussion of the various "affordability" mortgage products employed in the subprime market and the risks they entailed, including the risk of loosening underwriting standards. For example:

In an April 4, 2005 article entitled S&P Comments On Risk In Newer Mortgage Products, As Discussed At Industry Event, we noted that "there is growing concern around the increased usage of [interest-only, negative amortization, and 40-year amortization] mortgages in new RMBS securitization, which may pose significant credit risk. . . . [S]ome of the inherent risks that may arise include payment shock due to interest rate increases, coupled with the addition of principal repayment, undercollaterlization with regard to negative amortization, and home price depreciation."

In an April 20, 2005 article entitled Subprime Lenders: Basking in the Glow of a Still-Benign Economy, But Clouds Forming on the Horizon, we stated that we "remain concerned about how these subprime lenders will perform in a prolonged rising interest rate environment." We observed that increased competition among subprime lenders threatened a relaxation in underwriting standards and warned that the growing popularity of "affordability" mortgage products "suggests that Standard & Poor's concerns are justified." We singled out interest-only mortgages as "[e]specially worrisome," noting that "these loans are more likely to feature adjustable rates . . . setting borrowers up for potential problems should mortgage rates rise dramatically."

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 identified "mortgage delinquencies" as a "potential hot button," and noted that such delinquencies "may become a greater concern for lenders and servicers."

On February 14, 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.

In a February 28, 2007 article entitled RMBS Trends: U.S. Subprime Market Continues Correction As Issuers Strengthen Underwriting Standards, we observed that: "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. Lenders have reported tightened underwriting standards during the industry consolidation, with weaker players exiting the origination business or being acquired by larger entities, most prominently investment banks. Although evidence of improved underwriting standards has been represented in loan documentation data, other measures such as LTV have not fully supported the reports. However, as there is a lag between loan origination and securitization, we may begin to see more evidence in the coming quarters."

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."

In a July 25, 2007 teleconference, we observed that the "poor performance" in U.S. RMBS "results from a combination of factors including but not limited to an environment of loose underwriting standards, pressure on home prices, speculative borrowing behavior, risk layering, very high combined loan to value, financial pressure on borrowers resulting from payment increases on first-lien mortgages and questionable data quality."

Q.5.b. Did you alter your ratings processes in any way to account for this decline in underwriting standards?

A.5.b. In response to deterioration in the sub prime mortgage market, which was attributable to a number of factors, we tightened our criteria through changes in our LEVELS® model targeted to increase the credit enhancement requirements for pools with subprime loans. As noted above, in February 2007, we also took the unprecedented step of placing on CreditWatch negative (and ultimately downgrading) transactions that had closed as recently as 2006. We continued taking downward action through as recently as this week. 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 (collateral) 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.

Q.6. Ms. Robinson, Ms. Tillman, and Mr. Joynt, when each of your companies tries to attract new customers, how do you distinguish your ratings from the ratings of other rating agencies?

Do you have empirical data that demonstrates that your ratings are better than the ratings of other companies? If yes, please provide documentation supporting your answer.

Do you compete more on price or ratings accuracy? Please provide documentation supporting your answer.

A.6. S&P began its credit rating activities 90 years ago, and today is a global leader in the field of credit ratings and credit risk analysis. We vigorously protect our reputation and we believe—recent criticism notwithstanding—that our excellent historical track record of providing the market with independent and rigorous rating opinions and information is widely recognized in the market. Investors attach value to our ratings because of this track record, and this is and of itself diminishes any leverage that underwriters may be perceived to have over the process. It is also this track record, along with our commitment to innovation and improvement, that we sometimes discuss with potential new customers. We believe, as well, that S&P's proven role as a market leader will continue to distinguish us from our competitors even as the credit rating industry expands.

Q.7. Ms. Robinson, Ms. Tillman, and Mr. Joynt, what are the idealized default rates for each of your ratings?

A.7. There are no idealized default rates for our ratings, since ratings are not mapped to particular expected default rates. Instead, we arrive at our rating opinions by applying our published assumptions, methodologies and criteria to the best available information in our possession.

Over the last 30 years (through May 16, 2008), S&P's cumulative default rate by original rating class for all structured finance ratings has been as follows:

Initial rating	Percent of default
AAA	0.14
AA	0.60
A	1.46
BBB	3.53
BB	5.21
B	4.78

Q.8. Ms. Robinson, Ms. Tillman, and Mr. Joynt, in his written testimony, Professor Coffee notes that because only a limited number of investment banks underwrite structured finance products, they have leverage over the rating agencies. If they don't like the ratings they get from one agency, they can go to another with lower standards.

Has your firm ever felt pressure to lower your rating standards in order to attract business?

How do you attract customers if your ratings use the most stringent standards? Will issuers and underwriters simply go to other firms with less demanding standards?

A.8. At S&P, we do not permit issuers to dictate any aspect of our analytical process. Our analytics are driven by our criteria, and we do not compromise that criteria to meet a particular issuer's needs or agenda. We have refused to rate whole categories of transactions that do not meet our criteria and we believe that we have lost numerous RMBS deals for this reason.

As noted, we believe our reputation and integrity are our most valuable long-term assets. It would be contrary to our best interests to sacrifice these qualities by providing anything other than what we believe to be our best opinion of creditworthiness. In some instances, this may mean that an issuer will take its business elsewhere, but that is a risk we are willing to take in order to preserve the far more valuable asset that is our reputation for independence.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM VICKIE A. TILLMAN

Q.1. During the hearing, I asked you for specifics on the ratings your agency provided on Bear Stearns in the months leading up to the collapse. Please provide the Committee with a detailed explanation of the ratings for Bear Stearns from November 2007 and March 2008. In addition, please answer the following questions.

A.1. On November 15, 2007, S&P downgraded the Bear Stearns Companies' ("Bear") long-term counterparty credit rating from "A+" to "A" and affirmed the short-term rating of "A–1".

This action followed our decision on August 3, 2007 to revise our outlook on Bear from stable to negative based in part on the reputational harm suffered by Bear in the wake of problems with its managed hedge funds, as well as its material exposure to holdings of mortgages and MBS, the valuations of which, we said, remained under "severe pressure." We further noted on August 3 that Bear had exposure to debt it had taken up as a result of unsuccessful leveraged finance underwritings and had significant further underwriting commitments. We observed that Bear had a relatively high degree of reliance on the U.S. mortgage and leveraged finance sectors, and its revenues and profitability would be especially affected if there were an extended downturn in those markets. We continued this negative outlook in our November 15 rating action.

The November 15 rating action followed Bear's announcement that it would take a fourth-quarter writedown on its CDO and subprime exposure of $1.2 billion. We considered the writedown to be comparatively less than that of its peers, particularly given Bear's substantial business concentration in the U.S. mortgage market. We noted that the potential for further writedowns remained given continued dislocation in the mortgage market but considered the company's remaining CDO and subprime exposure to be manageable. Nevertheless, we warned that additional writedowns could further impair the company's future earnings performance, particularly in light of Bear's relatively greater revenue reliance on fixed income markets, which were experiencing a general slowdown.

The negative outlook on the ratings reflected our continuing concern that the general slowdown in Bear's core fixed income businesses could have a negative impact on its earnings performance in the near to medium term. We also remained concerned that long-term lingering effects (including litigation) of the widely publicized problems in the company's managed hedge funds would have a negative impact on performance in the company's asset management unit. We noted that the ratings could be lowered if earnings failed to stabilize at a satisfactory level beyond the next few quarters, which we expected to be difficult ones for the firm. We observed that in contrast, if Bear were able to overcome current challenges and affect a more rapid earnings recovery than we currently anticipated, the outlook could be revised to stable.

On March 14, 2008, S&P downgraded Bear's long-term counterparty credit rating from "A" with negative outlook to "BBB" and its short-term rating from "A–1" to "A–3". At the same time, we placed the long- and short-term ratings on CreditWatch with negative implications.

This rating action followed Bear's announcement that its liquidity position had substantially deteriorated in the two days prior to the rating action. The severe impairment of Bear's liquidity had resulted in the negotiation of a 28-day, Fed-backed secured loan facility with JP Morgan Chase ("JPMC") that was designed to ease Bear's liquidity pressures until it could implement a longer term funding structure.

We noted that Bear had been experiencing significant stress during the week of March 10 because of concerns regarding its liquidity position. Although the firm's liquidity at the beginning of the week had held steady with excess cash of $18 billion, ongoing pressure and anxiety in the markets resulted in significant cash outflows toward the week's end, leaving Bear with a significantly deteriorated liquidity position at end of business on Thursday, March 13, 2008.

We observed that our ratings were based on our expectation that Bear would find an orderly solution to its funding problems. We noted, however, that although we viewed the liquidity support to Bear as positive, we considered it a short-term solution to a longer term issue that did not remediate Bear's confidence crisis. We also remained concerned about Bear's ability to generate sustainable revenues in an ongoing volatile market environment.

Finally, we stated that we expected to resolve the CreditWatch in the coming weeks, as more concrete, longer term solutions to Bear's liquidity and confidence crisis were fleshed out. We warned that the ratings could be lowered further if there were a failure to stabilize liquidity or to achieve a satisfactory longer term funding structure.

On March 17, 2008, we placed our "BBB" long- and "A–3" short-term counterparty credit ratings on Bear on CreditWatch with developing implications.

This rating action followed the announcement that JPMC had agreed to acquire Bear in an all-stock transaction.

We noted that we considered the acquisition of Bear by JPMC as positive, as it would permit Bear to meet its obligations through funding sources obtained directly from its new parent. We observed that we expected that JPMC would assume all of Bear's obligations when the transaction closed. We stated that we would resolve the CreditWatch placement when details about the integration of Bear's activities became tangible.

We warned that if the acquisition by JMPC were not to close as expected, the ratings on Bear would come under renewed pressure. Conversely, if the acquisition was to proceed as expected and Bear's businesses were successfully integrated into JPMC, the ratings on Bear could be equalized with those on its new parent.

On March 24, 2008, we raised the counterparty credit ratings on Bear to "AA–/A–1+" and removed them from CreditWatch Developing where they had been placed on March 17. We determined that the outlook for the ratings was stable.

This rating action recognized the strengthened immediate guarantee by JPMC of all of Bear's counterparty obligations. We noted that JPMC was also to assume Bear's debt obligations upon completion of the acquisition.

We observed that in our view, the price increase for the transaction and the anticipated increase in the amount of shares controlled by JPMC raised the probability that the deal would be completed. We warned that on its own, Bear's viability was uncertain, and that if the deal were to be amended in any way, we would review the circumstances at that time.

We stated that we expected the acquisition by JPMC to be completed under the revised terms by mid-May. In light of the guaranty and our expectation that Bear's debt would be assumed by JPMC, we believed that Bear's creditors benefited from JPMC's creditworthiness and participated in the outlook for JPMC. Therefore we equalized the ratings and outlook with those on JPMC.

Our press releases for each of these ratings actions are attached.

Q.2. Were any of the ratings downgraded between December 2007 and March 14, 2008?

A.2. As noted, on November 15, 2007, S&P downgraded Bear's long-term counterparty credit rating from "A+" to "A," which followed our decision in August 2007 to change our outlook on Bear from stable to negative.

On March 14, 2008, S&P downgraded Bear's long-term counterparty credit rating from "A" with negative outlook to "BBB" and its short-term rating from "A–1" to "A–3." At the same time, we placed the long- and short-term ratings on CreditWatch with negative implications.

Q.3. Were any of the ratings downgraded during the week of the collapse (March 10–14)?

A.3. As noted, on March 14, 2008, S&P downgraded Bear's long-term counterparty credit rating from "A" with negative outlook to "BBB" and its short-term rating from "A–1" to "A–3." We also placed Bear's long- and short-term ratings on CreditWatch with negative implications.

Q.4. Can you explain from your agency's point of view how Bear's collapse unfolded and the role the ratings may have played?

A.4. While we are continuing to review the factors that led to the sudden and severe weakening of Bear's liquidity situation, a number of factors are clear at this time. As noted in our published reports, Bear faced (i) material exposure to CDOs and subprime investments, as well as the general slowdown in its fixed income businesses; (ii) significant dislocation in the mortgage market; and (iii) severe, ongoing reputational harm that eventually led to a crisis in confidence. The damage to Bear was hastened, in our view, by its inability to effect a rapid earnings recovery in the face of these challenges.

As noted, Bear's situation deteriorated rapidly in March 2008 when it announced that its liquidity position had substantially and rapidly deteriorated over a two-day period, which resulted in part from significant cash outflows, as well as ongoing pressure and anxiety in the markets. It was also reported that some hedge funds suddenly withdrew billions of dollars in assets from Bear, which was unexpected and would have contributed to the bank's rapid decline. The sudden loss in confidence in Bear was critical in our view, and was widely unexpected. It became clear that Bear required a long term solution to its liquidity problems, which eventually arose in the form of JPMC's announced acquisition.

We do not believe that S&P's ratings had a role in causing these events to occur. Rather, consistent with our long-standing reputation for independence and objectivity, our ratings simply reflected our current opinion of the creditworthiness of Bear based on the best facts available to us at the time.

Q.5. Do you think the lack of changes to the Bear Stearns' ratings is an example of a unique event in the markets or an indication of larger flaws in the structure of the ratings?

A.5. We believe the speed with which Bear deteriorated was a unique event in the market and broadly unanticipated.

Q.6. Under ideal circumstances, would you agree that the ratings should have been downgraded to more accurately reflect Bear's risk?

A.6. As with all of our ratings, we downgraded Bear's rating when we concluded that the data available supported such a move. It is always easy in hindsight to look back and question whether certain ratings should have or could have been different if we knew then what we know now. That, however, is different than the reality of our work, which is to take the information available to us at the time and try as best we can to project what is likely to happen in the future. That is what we did with our ratings on Bear.

Q.7. What lessons do you think we should take from the Bear Stearns collapse as it relates to the credit ratings?

A.7. As noted, our rating on Bear was based on the best information available to us at the time, including statements by management and regulatory filings. We had concerns about Bear's exposure to CDOs and subprime investments, as well as the consequences of continued harm to its reputation, among other things, and made those concerns public. Of course, we are always looking for ways to refine our analytical processes and, in this case, are continuing to assess the factors that led to Bear's rapid decline.

Q.8. What are your thoughts on a proposal Professor Coffee discussed at the hearing for rating agencies to periodically update ratings?

A.8. At S&P we believe that timely monitoring of our rating opinions is a key component of the value we bring to investors and the market. We are constantly looking for ways to enhance our surveillance process and have made improvements—including increasing the frequency of our reviews of rated transactions and the amount of resources dedicated to the process—response to recent events.

While we believe that credit ratings should be "current" assessments of creditworthiness, we do not believe a mandated fixed schedule of periodic reviews in the manner that Professor Coffee suggests would improve the surveillance process. Ratings are subjective in nature and are typically formulated and disseminated after deliberation of whatever duration is appropriate to assess the particular issue or issuer being considered. The necessary frequency and scope of any ratings review may vary considerably based on issue and issuer-specific factors as well as the original method of analysis. Any rule attempting to impose a specific, fixed period during which ratings must be updated would divert attention away from surveillance based on risk identification and assessment, and would by its nature be arbitrary, burdensome and, we believe, ineffective.

STANDARD
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August 3, 2007

Research Update:

Bear Stearns Cos. Inc. Outlook Revised To Negative; 'A+/A-1' Rating Affirmed

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Research Update:

Bear Stearns Cos. Inc. Outlook Revised To Negative; 'A+/A-1' Rating Affirmed

Rationale

On Aug. 3, 2007, Standard & Poor's Ratings Services revised its outlook on Bear Stearns Cos. Inc. to negative from stable. At the same time, Standard & Poor's affirmed its 'A+/A-1' issuer credit rating on Bear Stearns as well as its ratings on various Bear Stearns affiliates (see list).

Notwithstanding the challenges it faces, Bear Stearns' liquidity is strong. Still, the negative outlook reflects our concerns about recent developments and their potential to hurt Bear Stearns' performance for an extended period. We believe Bear Stearns' reputation has suffered from the widely publicized problems of its managed hedge funds, leaving the company a potential target of litigation from investors who have suffered substantial losses.

Bear Stearns has material exposure to holdings of mortgages and MBS, the valuations of which remain under severe pressure. It also has exposure to debt it has taken up as a result of unsuccessful leveraged finance underwritings, and it has significant further underwriting commitments. Broadly, we believe these direct balance-sheet exposures are not proportionately larger than those of Bear Stearns' peers. Also, even with these exposures, we expect Bear Stearns to be profitable in the current quarter. However, Bear Stearns has a relatively high degree of reliance on the U.S. mortgage and leveraged finance sectors, and its revenues and profitability would be especially affected if there were an extended downturn in those markets.

The ratings continue to reflect Bear Stearns' strong competitive positions in such areas as MBS, CMBS, ABS, and CDO/CLO underwriting and market making; prime brokerage; and clearing services. The firm's relatively small capital base, high degree of operating risk, and concentrations in fixed-income products and in the U.S. market partially offset these strengths.

Bear Stearns' liquidity is strong, and we expect it to remain so. The company has reduced it reliance on CP from former levels. Holdings of cash and unencumbered securities, available secured and unsecured committed credit facilities, and other sources of funding should be more than sufficient to meet near-term funding requirements, even if--contrary to our expectations--there were to be a sustained period of disrupted capital markets access.

Outlook

The ratings could be lowered if large losses were to be incurred over the next few quarters or if earnings failed to stabilize at a satisfactory level beyond the next few quarters, which we expect will be--at best--difficult ones for the company. On the other hand, if Bear Stearns can overcome current challenges and effect a more rapid recovery than we currently anticipate, the rating outlook could be revised back to stable.

Ratings List

Ratings Affirmed

Bear Stearns Cos. Inc. (The)	
Senior Unsecured	
Foreign Currency	A+
Local Currency	A+/A-1
Preferred Stock	
Local Currency	BBB+
Short-Term Debt	
Local Currency	A-1
Certificate Of Deposit	
Local Currency	A+
Commercial Paper	
Local Currency	A-1
Bear Stearns Capital Trust I	
Bear Stearns Capital Trust II	
Preferred Stock	
Local Currency	BBB+
Bear Stearns Finance LLC	
Preferred Stock	
Foreign Currency	BBB+

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Bear Stearns Cos. Inc. (The)		
Counterparty Credit Rating	A+/Negative/A-1	A+/Stable/A-1
Bear Stearns Securities Corp.		
Counterparty Credit Rating	AA-/Negative/A-1+	AA-/Stable/A-1+

Complete ratings information is available to subscribers of RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; select Ratings in the left navigation bar, then Credit Ratings Search.

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November 15, 2007

Research Update:

Bear Stearns Cos. Inc. L-T Rating Lowered To 'A'; 'A-1' S-T Rating Affirmed; Outlook Negative

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Research Update:

Bear Stearns Cos. Inc. L-T Rating Lowered To 'A'; 'A-1' S-T Rating Affirmed; Outlook Negative

Rationale

On Nov. 15, 2007, Standard & Poor's Ratings Services lowered its long-term counterparty credit rating on The Bear Stearns Cos. Inc. (Bear Stearns) to 'A' from 'A+'. At the same time, the 'A-1' short-term rating was affirmed. The outlook is negative.

The rating action follows Bear Stearns' announcement that it would take a fourth-quarter writedown on its CDO and subprime exposure of $1.2 billion, which will result in the company's first quarterly loss in its history. We consider the writedown to be comparatively less than that of peers', particularly given Bear Stearns' substantial business concentration in the U.S. mortgage market. However, the expected net loss brings to light the extent to which the company is concentrated in fixed income businesses, which we believe is an underlying structural weakness in revenue generation. While there remains potential for further writedowns, given continued dislocation in the mortgage market, we consider the company's remaining CDO and subprime exposure ($884 million, net of hedges) to be manageable. Nevertheless, additional writedowns could further impair the company's future earnings performance particularly in light of Bear Stearns' relatively greater revenue reliance on fixed income markets, which are currently experiencing a general slowdown.

On a full-year basis, Bear Stearns remains profitable in 2007 based on sound performance in the first two quarters of the fiscal year, and modest profitability in the third quarter after $700 million in writedowns on mortgage--and leveraged loan-related exposures. Fourth-quarter revenues, however, have been negatively affected by the general slowdown in fixed income sales and trading and, to a lesser extent, a decline in client balances in the company's global clearing business. While Bear Stearns remains on track to post strong performance in its equities business in the fourth quarter, this is insufficient in offsetting the revenue loss in other core fixed income businesses, particularly if current market conditions persist. Given this, we expect that any near-term boost to profitability will necessarily have to come from the expense side. We understand that Bear Stearns is actively pursuing "significant steps" to contain costs, but we believe that meaningful expense reductions may be hampered by the company's need to remain competitive in terms of compensation.

Outlook

The negative outlook on the ratings reflects our concern that the general slowdown in Bear Stearns' core fixed income businesses could have a negative impact on its earnings performance in the near to medium term. Moreover, we remain concerned that long-term lingering effects (including litigation) of the widely publicized problems this past summer in the company's managed hedge funds will have a negative impact on performance in the company's asset management unit. The ratings could be lowered if earnings fail to stabilize at a satisfactory level beyond the next few quarters, which we expect to be difficult ones for the firm. In contrast, if Bear Stearns is able to overcome current challenges and effect a more rapid earnings recovery than we currently anticipate, the outlook could be revised to stable.

Ratings List

	To	From
Counterparty credit rating		
	A/Negative/A-1	A+/Negative/A-1

NB: This list does not include all ratings affected.

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Ratings information is available to subscribers of RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at www.ratingsdirect.com. It can also be found on Standard & Poor's public Web site at www.standardandpoors.com; select your preferred country or region, then Ratings in the left navigation bar, followed by Credit Ratings Search. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office Hotline (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow (7) 495-783-4017. Members of the media may also contact the European Press Office via e-mail on: media_europe@standardandpoors.com.

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Ratings Services receives compensation for its ratings. Such compensation is normally paid either by the issuers of such securities or third parties participating in marketing the securities. While Standard & Poor's reserves the right to disseminate the rating, it receives no payment for doing so, except for subscriptions to its publications. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

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March 14, 2008

Research Update:

The Bear Stearns Cos. Inc. Ratings Lowered And Placed On CreditWatch Negative

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Research Update:

The Bear Stearns Cos. Inc. Ratings Lowered And Placed On CreditWatch Negative

Rationale

On March 14, 2008, Standard & Poor's Ratings Services lowered its long-term counterparty credit rating on The Bear Stearns Cos. Inc. (Bear) to 'BBB' from 'A' and its short-term rating to 'A-3' from 'A-1'. At the same time, we placed the long- and short-term ratings on CreditWatch with negative implications.

The rating action follows Bear's announcement that its liquidity position has substantially deteriorated in the past 48 hours. The severe impairment of Bear's liquidity has resulted in the negotiation of a 28-day, Fed-backed secured loan facility with JP Morgan Chase that is designed to ease Bear's liquidity pressures until it can implement a longer term funding structure.

Bear has been experiencing significant stress in the past week because of concerns regarding its liquidity position. Although the firm's liquidity, at the beginning of the week, held steady with excess cash of $18 billion, ongoing pressure and anxiety in the markets resulted in significant cash outflows toward the week's end, leaving Bear with a significantly deteriorated liquidity position at end of business on Thursday, March 13, 2008.

The ratings are based on our expectation that Bear will find an orderly solution to its funding problems. However, although we view the liquidity support to Bear as positive, we consider it a short-term solution to a longer term issue that does not entirely affect Bear's confidence crisis. We also remain concerned about Bear's ability to generate sustainable revenues in an ongoing volatile market environment.

We expect to resolve the CreditWatch in the coming weeks, as more concrete, longer term solutions to Bear's liquidity and confidence crisis are fleshed out. The ratings could be lowered further if there is a failure to stabilize liquidity or to achieve a satisfactory longer term funding structure.

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Bear Stearns Cos. Inc. (The)		
Counterparty Credit Rating	BBB/Watch Neg/A-3	A/Negative/A-1
Senior Unsecured		
Foreign Currency	BBB/Watch Neg	A
Local Currency	BBB/Watch Neg	A
Subordinated	BBB-/Watch Neg	A-
Preferred Stock		
Local Currency	BB+/Watch Neg	BBB+
Short-Term Debt		

Local Currency	A-3/Watch Neg	A-1
Certificate Of Deposit		
Local Currency	BBB/Watch Neg/A-3	A/A-1
Commercial Paper		
Local Currency	A-3/Watch Neg	A-1
Bear Stearns Capital Trust III		
Preferred Stock		
Local Currency	BB+/Watch Neg	BBB+
Bear Stearns Securities Corp.		
Counterparty Credit Rating	BBB+/Watch Neg/A-2	A+/Negative/A-1

Complete ratings information is available to subscribers of RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; select your preferred country or region, then Ratings in the left navigation bar, followed by Credit Ratings Search.

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March 17, 2008

Research Update:

Bear Stearns Cos. 'BBB/A-3' Ratings Placed On Watch Dev; JPMorgan Chase Ratings Affirmed

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Research Update:

Bear Stearns Cos. 'BBB/A-3' Ratings Placed On Watch Dev; JPMorgan Chase Ratings Affirmed

Rationale

On March 17, 2008, Standard & Poor's Ratings Services placed its 'BBB' long- and 'A-3' short-term counterparty credit ratings on The Bear Stearns Cos. Inc. (Bear) on CreditWatch with developing implications. The ratings had been placed on CreditWatch with negative implications on March 14, 2008. At the same time, Standard & Poor's affirmed its 'AA-' long- and 'A-1+' short-term counterparty credit ratings on JPMorgan Chase & Co. (JPMC). The outlook is stable.

The rating actions follow the recent announcement that JPMC has agreed to acquire Bear in an all-stock transaction. The transaction remains subject to shareholder approval.

JPMC's acquisition of Bear comes after the banking group agreed, on March 14, to provide the securities firm with a 28-day secured loan facility that would permit Bear to continue to meet its short-term obligations until a more permanent financing structure could be implemented. On the back of market rumors regarding Bear's liquidity that led to significant cash outflows, the firm's liquidity position had substantially deteriorated by the end of last week, resulting in the need to seek emergency aid to stay afloat.

We consider the acquisition of Bear by JPMC as positive, as it will permit Bear to meet its obligations through funding sources obtained directly from its new parent. As part of the transaction, JPMC will benefit from nonrecourse financing from the Federal Reserve of up to $30 billion to support Bear's less liquid assets, in addition to the financing that the Federal Reserve provides through its discount window. We also expect that JPMC will assume all of Bear's obligations when the transaction closes, which is expected within 90 days. We will resolve the CreditWatch placement as and when details with regard to the integration of Bear's activities become tangible. In the event the acquisition by JPMC does not close as expected, the ratings on Bear will come under renewed pressure. Conversely, if the acquisition proceeds as expected and Bear's businesses are successfully integrated into JPMC, the ratings on Bear could be equalized with those on its new parent.

The ratings on JPMC reflect our expectation that the bank's post-acquisition capital and leverage metrics will remain satisfactory. JPMC is acquiring some valuable businesses, such as Bear's prime brokerage and clearing operations, which we do not expect will add much risk to its balance sheet. We assume that the integration of these businesses will be smooth, given JPMC's great familiarity with these activities, and our expectation that the bank will have free rein to act quickly in assuming management oversight. In the longer term, we expect that JPMC will benefit from the incremental income that the acquisition of Bear's activities will provide.

Ratings List

	To	From
The Bear Stearns Cos. Inc.		
Counterparty credit rating		
	BBB/Watch Dev/A-3	BBB/Watch Neg/A-3
Commercial paper		
	A-3/Watch Dev	A-3/Watch Neg
JPMorgan Chase & Co.		
Counterparty credit rating		
	AA-/Stable/A-1+	AA-/Stable/A-1+
Commercial paper		
	A-1+	A-1+

NB: This list does not include all ratings affected.

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Ratings information is available to subscribers of RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at www.ratingsdirect.com. It can also be found on Standard & Poor's public Web site at www.standardandpoors.com; select your preferred country or region, then Ratings in the left navigation bar, followed by Credit Ratings Search. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office Hotline (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow (7) 495-783-4017. Members of the media may also contact the European Press Office via e-mail on: media_europe@standardandpoors.com.

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March 24, 2008

Research Update:

The Bear Stearns Cos. Inc. Ratings Raised, Removed From CreditWatch; Outlook Stable

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Research Update:

The Bear Stearns Cos. Inc. Ratings Raised, Removed From CreditWatch; Outlook Stable

Rationale

On March 24, 2008, Standard & Poor's Ratings Services raised its debt and counterparty credit ratings on Bear Stearns to 'AA-/A-1+' and removed them from CreditWatch Developing where they were placed on March 17, 2008. The outlook is stable.

The rating action recognizes the strengthened immediate guarantee by JPMorgan Chase & Co. of all of Bear Stearns' counterparty obligations. JPMorgan will also assume Bear Stearns' debt obligations upon completion of the acquisition.

In our view, the price increase and the anticipated increase in the amount of shares controlled by JPMorgan raise the probability that the deal will be completed. On its own, Bear Stearns' viability is uncertain. If the deal is amended in any way, we would review the circumstances at that time.

Outlook

We expect the acquisition by JPMorgan to be completed under the revised terms in mid-May. In light of the guaranty and our expectation that the debt will be assumed by JPMorgan, we believe that Bear Stearns' creditors benefit from JPMorgan's creditworthiness and participate in the outlook for JPMorgan. Therefore we have equalized the ratings and outlook with those on JPMorgan.

Ratings List

Upgraded; CreditWatch/Outlook Action

	To	From
Bear Stearns Cos. Inc. (The)		
Counterparty Credit Rating	AA-/Stable/A-1+	BBB/Watch Dev/A-3
Senior Unsecured		
Foreign Currency	AA-	BBB/Watch Dev
Local Currency	AA-/A-1+	BBB/Watch Dev
Subordinated		
Local Currency	A+	BBB-/Watch Dev
Preferred Stock		
Local Currency	A	BB+/Watch Dev
Short-Term Debt		
Local Currency	A-1+	A-3/Watch Dev
Certificate Of Deposit		
Local Currency	AA-	BBB/Watch Dev
Commercial Paper		
Local Currency	A-1+	A-3/Watch Dev

Bear Stearns Capital Trust III		
Preferred Stock		
Local Currency	A	BB+/Watch Dev
Bear Stearns Securities Corp.		
Counterparty Credit Rating	AA-/Stable/A-1+	BBB+/Watch Dev/A-2

Complete ratings information is available to subscribers of RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; select your preferred country or region, then Ratings in the left navigation bar, followed by Credit Ratings Search.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM CLAIRE ROBINSON

Q.1. Ratings Scoreboard. What are your views on the recommendation that has been made for the creation of a central website which investors could access and on which they could compare the accuracy of past ratings by the different NRSROs for the same types of securities?

A.1. Moody's would support the establishment of a centralized repository, such as an industry portal, for rating performance studies. Indeed, we believe such a repository could enhance the ability of users of credit ratings to compare and contrast rating agency performance in a more efficient manner. We also would support a centralized repository that lists the ratings of each NRSRO for a particular security, so long as such requirements do not intrude on our rating methodologies or the content of our ratings.

Q.2. Timeliness of Updates of Ratings. Professor Coffee in his testimony pointed out that major downgrades of CDO securities "came more than a year after the Comptroller of the Currency first publicly called attention to the deteriorating conditions in the subprime market and many months after the agencies themselves first noted problems in the markets." His testimony also states "the gravest problem today may be the staleness of debt ratings." What is Moody's doing to update ratings in a timely manner and eliminate stale ratings? What standards should NRSROs observe?

A.2. Our initial ratings on these securities reflected our expectation of the asset performance in the pools. As always, we monitored our published ratings and took rating actions accordingly and when warranted by performance data and when our expectation of future performance changed due to changes in market conditions.

Professor Coffee's comments seem to suggest that rating actions on a security should be taken as soon as any significant changes in market conditions are observed. Based on our ongoing conversations with investors, issuers and regulators, many market participants have a strong preference for credit ratings that are not only accurate but stable. They want ratings to reflect enduring changes in credit risk because rating changes have real consequences—due primarily to ratings-based portfolio governance rules and rating triggers—that are costly to reverse. Market participants, moreover, do not want ratings that simply track market-based measures of credit risk. Rather, ratings should reflect independent analytical judgments that provide counterpoint to often volatile market-based assessments.

However, we do believe that there are additional steps that can be taken to enhance the quality and efficiency of our surveillance activities. For example:

- Further enhancing our surveillance function: We are continuing to expand the resources allocated to wholly separate monitoring teams within our Structured Finance Group. This initiative began before the RMBS and CDO downgrades. More recently, as part of our commitment to enhancing surveillance, Moody's created and filled the position of Global Structured Finance Surveillance Coordinator. The executive in this role is working with the surveillance managers and departmental heads throughout our global Structured Finance Department to enhance our surveillance processes and make them more efficient.

- Enhancing the automated review of data: Moody's has also been implementing a number of automated processes and systems, including proprietary applications, to routinely sift through entire databases of transactions, updating performance statistics and flagging rating outliers. The rollout of these initiatives began before the RMBS and CDO downgrades.
- Enhancing market communication: Moody's has allocated more resources to the function of communicating our monitoring activities to the market.
- Enhancing review of internal process and market trends: As part of the CRA industry initiative, Moody's has committed to evaluating our internal processes and market trends regularly so that we maintain the operational flexibility to enable us to dedicate the resources needed to monitor existing ratings and conduct reviews on a timely basis.

Q.3. Separate Ratings from Business? Dr. Cifuentes' testimony contains a recommendation that a rating agency separate its rating business function from its rating analysis function. What are your views on how NRSROs should address this analyst independence concern?

A.3. Moody's would not object to a clearer distinction between the business arm of a credit rating agency and the analytical work that it conducts. For our part, Moody's Code sets forth our policies that govern the roles and responsibilities of our rating agency employees, with the primary goal of ensuring that our analytical activities remain appropriately distanced from the commercial management of our business. In particular, the following provisions are relevant:

2.11 Reporting lines for Employees and their compensation arrangements will be organized to eliminate or effectively manage actual or potential conflicts of interest. Analysts will not be compensated or evaluated on the basis of the amount of revenue that [Moody's] derives from Issuers that the Analyst rates or with which the Analyst regularly interacts.

2.12 [Moody's] will not have analysts who are directly involved in the rating process initiate, or participate in, discussions regarding fees or payments with any entity they rate.

Implementation of these and other standards in the Moody's Code is subject to oversight by our internal Compliance Department as well as external examination by authorities such as the SEC.

Furthermore, while we believe that we operate with a high degree of independence and clarity around analytical remuneration, greater clarity regarding our policies and practices to protect analysts' independence may be beneficial for the market. We recently have implemented, or are in the process of implementing, several other measures to further demonstrate the independence of our rating process. These include:

- Formalizing the separation of ratings-related businesses: Moody's recently reorganized its operating businesses to formalize the separation of our ratings-related and non-rating activities into two different business units.
- Enhancing the Credit Policy function: The Credit Policy function at Moody's has long been independent from those parts of the rating agency with revenue-generating responsibility, and we have taken steps to further separate this function. The Chairman of Credit Policy now has a reporting responsibility to the President of Moody's. The performance incentives for Credit Policy personnel are based exclusively on the effectiveness of the rating process and the analytical quality of their oversight. The measurement of the unit's performance is wholly independent of the financial performance of the company or any business unit.
- Codifying the existing policies about analyst communication with issuers: In order to enhance market confidence in the appropriateness of communications between Moody's analysts and issuers or advisors, we are codifying our existing practice that such communications are limited to communications about credit issues.
- Implementing "look-back" reviews to confirm integrity of analysis: Moody's has adopted a new policy related to employees who leave Moody's to work for another market participant. When we learn that an issuer or a financial intermediary representing the issuer has hired a Moody's employee who has served as lead analyst for that issuer, we will now review the analyst's work related to the issuer and its securities over a six-month "look-back" period to confirm the integrity and rigor of that analyst's work.

Also, as part of the CRA industry initiative, we have committed to conduct formal and periodic, internal reviews of compensation policies and practices for analysts and other employees who participate in rating committees to ensure that these policies do not compromise the rating process.

Q.4. 4. Ratings Shopping. We have heard concerns about "ratings shopping," where an underwriter or an issuer goes to the NRSRO that it feels will give it the highest rating, even if it is not necessarily the most accurate. Is ratings shopping a problem? How should the negative aspects of it be addressed?

A.4. Ratings shopping occurs in the structured finance market because there is relatively little information available publicly about the transactions prior to their issuance. Arguably, market disciplinary forces and transparency around NRSRO methodologies already operate to some extent to address the negative aspects of rating shopping. For example, because rating methodologies are published, market participants can compare various CRA's different approaches to the same sectors or asset classes. A potential user of an NRSRO's credit ratings can decide for itself whether or not the NRSRO's methodology is more or less stringent than another NRSRO's methodologies and take this into account in deciding whether to attach any weight to the NRSRO's ratings. On the other hand, this same transparency allows issuers to assess the conservatism of a particular NRSRO and ratings shop at the outset of the rating process.

We believe that the appropriate way to deal with the negative aspects of ratings shopping in the structured finance market is to have issuers publicly disclose in a comprehensive and standardized manner:

- the characteristics of each asset in the asset pool;
- the structure of the transaction and performance data for each asset in the asset pool;
- the validation process used to verify the quality of the information provided and all pertinent representations and warranties; and
- Servicer and Trustee reports prepared after the issuance of the transaction.

Presently, because of the generally limited data in the public market about structured securities prior to their issuance, neither investors nor CRAs that have not had sufficient contact with the issuer are able to formulate an informed opinion on the securities. However, if robust information about structured finance products were publicly available once the details of the transaction had been finalized,[10] both the investors and credit rating agencies could form higher quality opinions, regardless of whether or not an issuer has directly contacted them. As a result, in many circumstances market participants would have the benefit of multiple and potentially diverse opinions about the same transaction. Finally, and most importantly, having the underlying data published by the issuers or originators would allow investors to form their own opinions about the strengths and weaknesses of a particular transaction, which could support authorities' efforts to discourage the use of ratings for purposes other than an objective opinion about relative credit risk.

Some policymakers and market commentators have suggested that ratings shopping can be addressed by requiring CRAs to disclose the names of issuers who provide data to a credit rating agency and ask for a preliminary assessment but then choose to publish the rating of another credit rating agency. We believe that such a solution would be unworkable and likely would fail to resolve concerns about the practice because:

- The CRA would not necessarily know if the issuer contracted with another CRA for a final rating of the same structure.

Even if the CRA tried to monitor the conduct of an issuer, the CRA could not know with certainty that it had identified all cases requiring disclosure under such a provision because it might not have access to all relevant information. Moody's believes it is inappropriate to impose a disclosure obligation on an entity that cannot, as a practical matter, control the means by which it acquires information that triggers that obligation.

[10] Given their complex and mutable nature, structured finance products may not lend themselves to unsolicited ratings before that time.

- Ratings shopping would simply occur at an earlier point in time.

Moody's believes that requiring credit rating agencies to disclose cases of ratings shopping might change the nature of the practice but would not eliminate it. Some originators, underwriters and sponsors of structured securities who wished to avoid being identified by CRAs as ratings shoppers likely would get around the disclosure trigger by withdrawing earlier in the process. Others might simply refrain from approaching CRAs that were believed to have more conservative methodologies or were less-well established, and whose methodologies were not well-understood or well-tested in the market.

Q.5. Professional Analyst Organization. Dr. Cifuentes in his testimony suggested "the creation of a professional organization, independent of the rating agencies, to which ratings analysts must belong and which sets forth ethical, educational and professional standards." Please share your thoughts on the potential merits of such an organization.

A.5. In evaluating the necessity of a "professional analyst organization", we believe the following points should be considered.

- We believe that a rigorous credit ratings process involves the expertise of a combination of professionals—including lawyers, MBAs, accountants and others—who bring their respective and possibly divergent points of view to bear upon an analysis. Consequently, establishing a single body that establishes one set of standards for credit analysts, in our view, may diminish some of the advantage of having employees with different educational and professional credentials.
- Many of our professionals already belong to professional organizations, such as state bars. These organizations impose continuing education requirements and ethical standards. Establishing yet another professional organization may be overly burdensome on the analysts.
- Moody's Code already has extensive provisions dealing with, among other things, the quality, integrity and independence of the rating process. There are provisions directed specifically to analysts.
- Moody's also has an extensive professional development and training program that has been designed to enhance the quality of Moody's rating analysis and analysts' understanding of relevant policies and procedures, including those relating to ethics. Moody's analysts are required to meet annual continuing education requirements by completing Moody's courses or approved, external courses.
- As part of the CRA industry initiative, we intend to incorporate into the Moody's Code an explicit commitment to adopt and maintain a continuing education program appropriate to the nature of our business. Doing so will make our policies and practices in this area subject to monitoring by the SEC.

Annex I

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 Markets	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 each other's markets to maintain or increase their*

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		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)

Annex II

Moody's Reports on the State of the U.S. Subprime Mortgage Market

- U.S. Subprime Mortgage Market Update, November 2007
- U.S. Subprime Mortgage Market Update, October 2007
- U.S. Subprime Mortgage Market Update, September 2007
- U.S. Subprime Mortgage Market Update, August 2007
- U.S. Subprime Mortgage Market Update, July 2007
- U.S. Subprime Mortgage Market Update, June 2007
- U.S. Subprime Mortgage Market Update, April 2007
- Challenging Times for the US Subprime Mortgage Market, March 2007
- Early Defaults Rise in Mortgage Securitizations, January 2007

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Annex III

Other Publications Referenced in Moody's Investors Service's Response of May 30, 2008

- Moody's Proposed Enhancements to U.S. Residential Mortgage Securitizations: Call for Comments, March 2008
- Guide to Moody's Default Research, March 2008 Update
- Moody's Code of Professional Conduct, October 2007 [updated from the original publication in June 2005]
- Report on the Code of Professional Conduct, December 2007
- Report on the Code of Professional Conduct, April 2006

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM CLAIRE ROBINSON

Q.1. Ms. Robinson, Ms. Tillman, and Mr. Joynt, do you think that it is easy for investors to compare the accuracy of the ratings of the different credit rating agencies? If not, do S&P, Moody's, and Fitch favor the SEC issuing rules to require enhanced disclosure of ratings performance as Chairman Cox outlined in his testimony?

A.1. We agree that new "requirements for enhanced disclosures about ratings performance" is an important area for consideration as the Securities and Exchange Commission ("SEC") contemplates new rules for our industry. We believe that consideration of ratings performance data would create objective criteria for assessing whether a credit rating agency's ("CRA's") ratings are suitable for use in regulation.

For Moody's part, we publish and make freely available a wealth of data on ratings performance so that users of our ratings, as well as regulators, can judge the performance of our ratings. For your information, we have provided in this packet our "Guide to Moody's Default Research: March 2008 Update", which lists our performance, default, transition and loss severity research reports in reverse chronological order and broken down by topic. Moody's believes there is substantial value in encouraging agencies to present their analysis of their ratings performance in the ways they believe to be most relevant, since there is no single agreed upon approach.

One reason why there is no unique way to measure ratings performance is that different users of ratings place different value on different characteristics of the relationship between ratings and credit risk and as such different rating agencies seek to measure different attributes. For example, users may be concerned with one or more of the following:

- the relationship between ratings and defaults;
- the relationship between ratings and expected credit losses (which are the product of default probabilities and loss severity rates in the event of default);
- ratings stability;
- the relationship between ratings and "mark-to market" risk;
- the information in rating outlooks rather than just the ratings alone;
- the ability of ratings to rank relative credit risk at a point of time; and
- the ability of ratings to rank relative credit risk over time.

We agree in concept that presenting data in a standardized format would facilitate ratings performance comparisons. We believe, however, that such a standard may be difficult to implement in practice for a number of reasons, including:

- There may be differences of opinion on the most meaningful way to present the data. Any given presentation may advantage or disadvantage one rating agency compared with another.
- Rating agencies do not all define their ratings in the same way, which may result in standardized performance reports

not being perfectly comparable. For example, Moody's ratings are intended to be opinions of expected loss whereas some other rating agencies may intend their ratings to measure other indicators of credit risk, such as just probability of default. Therefore, a standardized format that focuses on default experience alone may not effectively capture the overall predictive content of a Moody's rating.

- Rating agencies have different approaches to dating defaults on structured finance securities because events of default are more subjective in structured finance than in corporate finance. In particular, many securitizations are structured as pass-through securities and, as such, are not at risk of payment defaults in a strict contractual sense until they reach their legal final maturity dates (in perhaps 30 years) even though cash flows to investors may cease many years prior to maturity.

Q.2. Ms. Robinson, Ms. Tillman, and Mr. Joynt, would you please explain the process by which you obtain the information you use to rate structured finance securities?

A.2. At Moody's, the analyst or analysts assigned to a particular structured finance transaction begin the credit analysis by assembling relevant information on the transaction. Information about the specific transaction may come from the originator or a market intermediary in meetings or other communications with the analyst(s). Our analysts compare this transaction-specific information with data we have regarding past transactions, deals effected by other market participants, thematic research generated by Moody's analysts regarding industry trends, credit research generated in other rating departments (e.g., regarding the creditworthiness of the financial institutions participating in the securitization) and macro-economic trend research generated by Moody's Analytics.[1]

We have provided in this packet the Moody's Investors Service Code of Professional Conduct ("Moody's Code"), which presents the various policies that we have in place to address issues of (1) quality and integrity of the rating process; (2) independence and management of conflicts of interest; (3) responsibilities to investors and issuers; and (4) enforcement and disclosure of the Code of Professional Conduct and communication with market participants. Of particular relevance to this question is the following provision:

1.4 Credit Ratings will be determined by rating committees and not by any individual Analyst. Credit Ratings will reflect consideration of all information known, and believed to be relevant, by the applicable [Moody's] Analyst and rating committee, in a manner generally consistent with [Moody's] published methodologies. In formulating Credit Ratings, [Moody's] will employ Analysts who, individually or collectively, have appropriate knowledge and experience in developing a rating opinion for the type of credit being analyzed.

[1] Moody's Analytics is a subsidiary of our corporate parent, Moody's Corporation. It is legally and operationally separate from Moody's Investors Service, the rating agency, and is a provider of research, data, analytic tools and related services that are distinct from credit ratings.

Our primary contact for transaction-specific information is typically the intermediary ("Arranger" "Underwriter" or "Investment Banker") that chooses the assets to be included in the transaction and sets up the structure of the transaction, divides the structure into different classes of securities ("tranches") and markets the tranches. We may also deal with and obtain information from:

- one or more "Originators", which either originate the underlying assets in the course of their regular business activities or source them in the open market;
- the "Servicer", which collects payments and may track pool performance;
- in managed transactions, an "Asset Manager", which may assemble the initial pool and may subsequently buy and sell assets in the transaction; q
- the "Trustee", who oversees cash distributions to investors and monitors compliance with transaction documentation;
- a "Financial Guarantor", who may provide guarantees on principal and/or interest payments to, or may sell credit default swaps on, particular tranches; and
- in asset-backed commercial paper ("ABCP") programs, an "Administrator" of the ABCP conduit that funds several asset pools.

In addition, it is not unusual for the Arranger to ask us to communicate directly with the transaction lawyer in order for us to get a better understanding of the transaction structure.

Q.2.a. How much of the information is from issuers, underwriters, or other sources?

A.2.a. The relative proportions of the information we obtain from the different sources vary depending on the asset class and the transaction in question. In general terms, our primary source of transaction-specific information is the Arranger (or its agents). As noted above, however, our analysts compare this transaction-specific information with data we have regarding past transactions, deals effected by other market participants, thematic research generated by Moody's analysts regarding industry trends, credit research generated in other rating departments (e.g. regarding the creditworthiness of the financial institutions participating in the securitization) and macro-economic trend research generated by Moody's Analytics.

Q.2.b. Do you ever seek to verify the accuracy of the information you receive?

A.2.b. Our analysis takes into consideration and compares data from a variety of sources. Moody's Code of Professional Conduct Provision 1.7 states:

1.7 [Moody's] will invest resources sufficient to carry out high-quality credit assessments of Issuers or obligations. When deciding whether to rate or continue rating an obligation or Issuer, [Moody's] will assess whether it is able to devote sufficient personnel with appropriate skills to make a proper rating assessment, and whether its personnel likely will have access to sufficient information needed in order to make such an assessment.

When rating a corporate issuer, we receive audited financial data and regulatory filings. When rating a structured finance product, the Originator and/or Arranger of the structured product make representations and warranties to the other parties in the transaction as to the quality of the loan level data describing the collateral. With respect to the publicly offered securities in the structured finance market, the prospectus also contains information that must be provided to investors in accordance with U.S. securities laws. The named underwriter performs due diligence on the security being issued to help verify the accuracy of information in the prospectus. These underwriters frequently hire a due diligence firm to examine the underlying loans. Accounting firms also are frequently hired by underwriters to verify that the summary information about the loan pools matches the information in the related loan files.

As part of the credit rating process, we do consider, among other factors:

(a) the source of the data we receive;

(b) the track record of the source in providing quality data;

(c) the predictive powers associated with the data; and

(d) whether or not the data (such as financial information) has been subject to review by a third party.

In addition, as noted in our response to the preceding question, we also assess the transaction-specific information in the context of the much broader and deeper data sets and other information we possess as a result of our credit rating and credit-related research activities. However, others in the market (e.g. auditors, issuers and underwriters) are far better positioned—given their expertise and resources—to certify the accuracy of data.

Our experience over the decades that we have been rating structured securities has been that most of the issuers operated in good faith and provided reliable information to us, and we have relied upon them to do so. Nevertheless, our analysts seek to exercise skepticism in our analysis of information provided to us. Furthermore, if we believe we have inadequate information to provide an informed credit opinion to the market, we will exercise our editorial discretion and either refrain from publishing an opinion or withdraw our published credit rating.

In light of recent market difficulties, we believe that the due diligence process conducted by the parties who originate, arrange, and/or service residential mortgage backed securities ("RMBS") needs to be further strengthened. We have proposed a series of measures to improve transparency, data integrity and accountability in U.S. residential mortgage securitizations, including [2]:

- Stronger representations and warranties;
- Independent third-party pre-securitization review of underlying mortgage loans;

[2] For more information, please see the enclosed "Moody's Proposed Enhancements to U.S. Residential Mortgage Securitizations: Call for Comments".

- Standardized post-securitization forensic review;
- Expanded loan-level data reporting of initial mortgage pool and ongoing loan performance; and
- More comprehensive originator assessments.

We believe that these measures taken together will provide more standard and reliable information on RMBS transactions than currently available.

Q.3. Do you have any reason to believe that inaccurate or fraudulent data contributed to the poor performance of your ratings on structured finance securities over the last few years? If yes, please provide supporting evidence.

A.3. While the sharp decline in home prices and contraction of mortgage credit availability across the U.S. have been key factors contributing to the current market turmoil, numerous market sources have identified certain market practices—including lenient lending practices by mortgage originators and misrepresentations by certain mortgage brokers, appraisers and some borrowers themselves—as also contributing to the unexpectedly poor payment performance of recent subprime mortgage loans. This is why we are supporting the strengthened due diligence measures noted in our response to question 2a above.

Q.4. Ms. Robinson, Ms. Tillman, and Mr. Joynt, according to testimony provided by Chairman Cox's testimony, Moody's has downgraded 53 percent and 39 percent of all its 2006 and 2007 subprime tranches; S&P has downgraded 44 percent of the subprime tranches it rated between the first quarter of 2005 and the third quarter of 2007; and Fitch has downgraded approximately 34% of the subprime tranches it rated in 2006 and the first quarter of 2007.

What steps have each of your companies taken during the past three years to hold accountable its executives and analysts for the poor performance of its ratings? Has your company dismissed or otherwise disciplined any of the executives or analysts responsible for overseeing or producing its ratings of structured finance products? Please provide a complete list of disciplinary actions.

A.4. Moody's is committed to providing the most accurate, objective and independent credit assessments available in the global credit markets. As in any company, Moody's regularly evaluates the performance of its employees, including its executives and analysts. The assessment of the performance of each employee, which is measured by the ability of the employee to perform his/her job function, is an assessment that is distinct from ratings performance. Moody's does make disciplinary decisions, including employment termination decisions, based on poor performance in a job function. Moody's individual personnel decisions, however, are confidential and the Company is therefore not in a position to provide more detailed information on specific personnel actions.

Also, as you know, the Securities and Exchange Commission ("SEC") has been conducting a non-public examination of certain NRSORs, including Moody's. Under the Credit Rating Agency Reform Act of 2006 ("Reform Act") and related rules the SEC is entitled to inspect Moody's books and records, including those relating to Moody's compliance function, credit policy function and human resources function. Moody's has been cooperating fully with this extensive examination.

We recognize that the unprecedented financial turmoil that has developed in the past year has caused a great deal of anxiety and uncertainty in the markets. While examination of the root causes of the situation reveals multiple points of market failure, we believe the speed and extent of rating downgrades have been one contributor to the loss of confidence in the credit markets and undermined the credibility of credit rating agencies.

For Moody's part, we have been and will continue working hard to respond quickly 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 can and must always strive to improve the quality of our work. Lessons from the recent market turmoil highlight opportunities for improvements in assessing the quality of information used in our rating process, the modeling and explanation of risk factors, and the application of multi-disciplinary analysis to even the most highly specialized instruments.

Q.5. Ms. Robinson, Ms. Tillman, and Mr. Joynt, during the last 3 years, did your firm notice a decline in underwriting standards for mortgages being used to create residential mortgage-backed securities? If so, did you alter your ratings process in any way to account for this decline in underwriting standards?

A.5. Yes. Beginning in 2003, Moody's observed an increase in the risk profile of subprime mortgage portfolios that we were asked to review prior to assigning ratings and adjusted our ratings standards accordingly. Our response to these increased risks can be categorized into three broad sets of actions:

(1) We began warning the market starting in 2003.

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 frequently published reports on these issues starting in July 2003 and throughout 2004, 2005 and 2006.[3] In January 2007, we published a special report highlighting the rising defaults on the 2006 vintage subprime mortgages[4] and we have continued to publish on similar trends in the market.[5]

(2) We tightened our ratings criteria.

in the riskiness of loans made during the last few years and the changing economic environment, Moody's steadily increased its loss projections and levels of credit protection for each rating level we looked for on pools of subprime loans. Our loss projections and credit protection (or "enhancement") levels rose by about 30% over the 2003 to 2006 time period, and as a result, bonds issued in 2006

[3] Please see Annex I, which sets out in a table excerpts from our publications on this issue. We have also provided you with all of the documents referenced in Annex I.

[4] Please see "Early Defaults Rise in Mortgage Securitization," Moody's Special Report, January 18, 2007. We have included this document in Annex II, which also provides a list of the updates we provided to the market as well as the actual published research for your information.

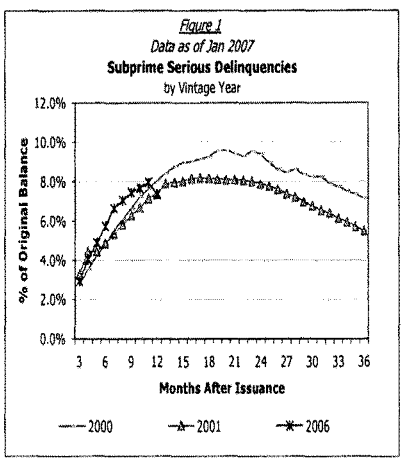
[5] Please see Annex II.

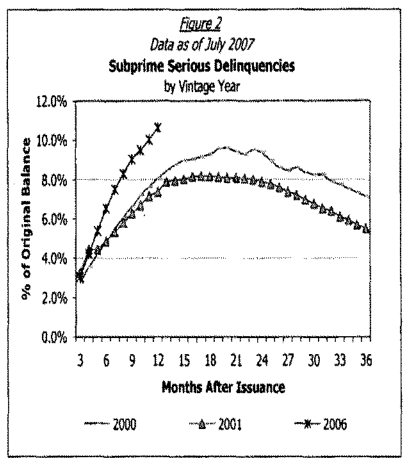
and rated by Moody's had significantly more credit protection than bonds issued in earlier years.

(3) We took rating actions as soon as warranted by the performance data.

As illustrated by Figure 1, 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.

Figure 2 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 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), the rapid transition to restrictive lending that subsequently occurred or the virtually unprecedented national decline in home prices.

Q.5.a. Did you disclose to investors that there was a decline in underwriting standards?

A.5.a. Yes. Please see Annex I, including in particular, the excerpts quoted from the following publications:

(1) 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 TO 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)

(2) 2004 Review and 2005 Outlook: Home Equity ABS (January 18, 2005); and

- "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)

(3) 2005 Review and 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)

Q.6. Ms. Robinson, Ms. Tillman, and Mr. Joynt, when each of your companies tries to attract new customers, how do you distinguish your ratings from the ratings of other rating agencies?

A.6. When endeavoring to attract new customers for our credit rating services, Moody's seeks to distinguish our rating services from those of other CRAs on the basis of a number of factors, including the following:

- Moody's overall reputation for trustworthiness and credibility in the market place, based on the aggregate performance of our ratings over time, our objectivity and independence, the depth and breadth of our research and ratings coverage, transparency and the quality of services.
- The analytical capabilities of the rating teams that cover the particular sector or asset class in question.
- The transparency and analytical rigor of our rating methodologies for the sectors or asset classes in question.
- The depth and breadth of our research and ratings coverage for the particular sector, geographic region and/or asset class in question.
- The quality of the services we provide to users of our credit ratings, as well as to issuers and their agents in the credit rating process. We believe that both users of our credit ratings and issuers and their agents appreciate the efficiency, effectiveness, accessibility, and courtesy of our rating teams, issuer relations teams and investor services teams.
- The ability of Moody's analysts to access and use the research, data and analytic tools produced by Moody's Analytics, an operationally and legally separate business unit within Moody's Corporation.
- Moody's credit ratings seek to opine on "expected loss", which reflects an assessment of both probability of default and loss given default. This approach is a distinctive feature of our credit ratings and differs from our competitors.

Q.6.a. Do you have empirical data that demonstrates that your ratings are better than the ratings of other companies? If yes, please provide documentation supporting your answer.

A.6.a. No. We do not possess the comprehensive, comparative ratings data histories for each CRA that would be needed to undertake such analyses. Moreover, we believe performance comparisons should be made by others, not the ratings agencies themselves, because ratings agencies naturally have an interest in the subject matter of such comparisons. However, if we were to become aware of performance comparisons made by others that we believed were incorrect or subject to misinterpretation, we would try to correct the resulting misunderstandings.

Having said that, we would also note that credit default studies show that our ratings have been remarkably consistent and reliable predictors of default over many years and across many economic cycles. The predictive quality of credit ratings is empirically verifiable and has been evaluated by Moody's and independent third parties. We would refer you to our Guide to Default Research, which is attached. Examples of rating performance reports that we publish include:

- Quarterly global and regional reports on corporate bond rating performance, both with respect to rating accuracy and rating stability.
- Semi-annual reports on global structured finance rating performance, both in the aggregate and disaggregated by asset class sub-sectors.
- Annual reports on corporate and structured finance default rates, loss given default rates and rating transitions.
- Periodic reports on default and loss characteristics of bonds, bank loans and preferred stocks for specific company sectors and regions.

In addition to publishing issuer or obligation-specific rating actions and credit opinions, Moody's also publishes our rating methodologies and various studies relating to the historical, aggregate performance of our credit ratings. These and other publications facilitate the assessment of our ratings' relevance and usefulness by potential users of our credit ratings as well as other third parties.

As noted in question 6 above, however, our credit ratings seek to offer an opinion on expected loss, which differs from what some of our competitors attempt to address, which consequently makes direct comparison difficult. We believe that we serve users of our credit ratings best by being as transparent as possible about our rating methodologies, the reasoning in support of our credit opinions and the aggregate performance of our ratings.

Q.6.b. Do you compete more on price or ratings accuracy? Please provide documentation supporting your answer.

A.6.b. Moody's seeks to compete on the basis of the quality of our products (including credit ratings and related research), the trustworthiness of our reputation, and the quality of the services we provide to users of credit ratings and the people and firms with which we interact as part of the credit rating process. We believe that the aggregate performance of our credit ratings over time is a very important factor in the assessment of the quality of our work. In this regard, we refer you to our Guide to Default Research.

Q.7 Ms. Robinson, Ms. Tillman, and Mr. Joynt, what are the idealized default rates for each of your ratings?

A.7 Moody's does not target specific default or loss rates for its ratings.[6] That is to say, Moody's credit rating scale does not measure

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[6] Moody's primary objective for its ratings is to provide an informative ordinal ranking of credit risk at each point in time. As such, in our view the most appropriate measure of Moody's accuracy is the "power" of its ratings, the information content of their rank orderings at specific points in time with respect to expected credit losses (the product of default probability and expected loss severity) as realized over a long horizon. Credits that have low ratings today should on average prove to be more risky than credits that have high ratings today.

In addition to a relative ranking of risk at a point in time, some investors desire a consistent relative ranking of credits across time, so that the riskiness of a credit today can be compared to similarly rated debt instruments in the past. To measure the accuracy of Moody's ratings across time, the most appropriate metric is the "power" of a pool of ratings assigned to multiple credits, and possibly even the same credits, observed at different points over time.

Continued

"absolute" credit risk; rather it provides an ordinal ranking of credit risk.

When, however, we need to associate specific default or loss rates with ratings for quantitative modeling purposes, we refer to a table of idealized expected credit loss rates. (Expected credit loss rates are the products of default probabilities and expected amounts of loss suffered if defaults occur.) These idealized loss rates are broadly consistent with the long-term average historical loss rates of securities that carry the same ratings and are used for associating modeled expected losses of both structured and corporate securities with corresponding ratings.

Some models require default rates, rather than expected loss rates, as inputs. In those cases, we are able to derive idealized default rates from the idealized loss rates simply by dividing every value in the idealized loss table by an appropriate expected loss severity rate. To derive an idealized default rate for senior unsecured corporate bonds, for example, we could assume an average expected loss severity of 55%. For secured bonds and loans, we would typically assume a lower severity rate, and for subordinated bonds a higher severity rate. For structured securities, expected loss severity rates (and hence idealized default rates) have varied by asset class and potentially other features of the security.

Since Moody's first began rating municipal securities in 1920, municipal securities have been rated on a separate scale that places greater weight on default risk than expected loss severity. This rating scale has been associated with lower overall credit risk by rating category than comparably rated corporate and structured securities. For municipal securities, we have developed a similar idealized default rate table that is sometimes used to model expected portfolio defaults on a pool of municipal securities. Given the very limited number of defaults in the municipal sector and secular changes in credit risk profiles in the sector, the derivation of this table is less closely tied to historical data and is more likely to be reviewed from time to time.

Moody's believes that as a consequence of its relative rating approach, the meaning of its ratings should be highly consistent over time. Since the relative creditworthiness of bond issuers does not, on average, change rapidly, there should not generally be any need to change average rating levels sharply over time. As a practical matter, therefore, Moody's does not manage its ratings to achieve cardinal accuracy or to maintain constant default rates by rating category. Doing so would require Moody's to change its ratings en masse in response to changes in cyclical conditions. Rather, ratings are changed "one-at-a-time" as needed in order to improve the current rank ordering of credit risk.

Moody's Idealized Expected Loss Rate* Table

Rating	Time Horizon (in Years)									
	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year
Aaa	0.0000%	0.0001%	0.0004%	0.0010%	0.0016%	0.0022%	0.0029%	0.0036%	0.0045%	0.0055%
Aa1	0.0003%	0.0017%	0.0055%	0.0116%	0.0171%	0.0231%	0.0297%	0.0369%	0.0451%	0.0550%
Aa2	0.0007%	0.0044%	0.0143%	0.0259%	0.0374%	0.0490%	0.0611%	0.0743%	0.0902%	0.1100%
Aa3	0.0017%	0.0105%	0.0325%	0.0556%	0.0781%	0.1007%	0.1249%	0.1496%	0.1799%	0.2200%
A1	0.0032%	0.0204%	0.0644%	0.1040%	0.1436%	0.1815%	0.2233%	0.2640%	0.3152%	0.3850%
A2	0.0060%	0.0385%	0.1221%	0.1898%	0.2569%	0.3207%	0.3905%	0.4560%	0.5401%	0.6600%
A3	0.0214%	0.0825%	0.1980%	0.2970%	0.4015%	0.5005%	0.6105%	0.7150%	0.8360%	0.9900%
Baa1	0.0495%	0.1540%	0.3080%	0.4565%	0.6050%	0.7535%	0.9185%	1.0835%	1.2485%	1.4300%
Baa2	0.0935%	0.2585%	0.4565%	0.6600%	0.8690%	1.0835%	1.3255%	1.5675%	1.7820%	1.9800%
Baa3	0.2310%	0.5775%	0.9405%	1.3090%	1.6775%	2.0350%	2.3815%	2.7335%	3.0635%	3.3550%
Ba1	0.4785%	1.1110%	1.7215%	2.3100%	2.9040%	3.4375%	3.8830%	4.3395%	4.7795%	5.1700%
Ba2	0.8580%	1.9085%	2.8490%	3.7400%	4.6255%	5.3735%	5.8850%	6.4130%	6.9575%	7.4250%
Ba3	1.5455%	3.0305%	4.3285%	5.3845%	6.5230%	7.4195%	8.0410%	8.6405%	9.1905%	9.7130%
B1	2.5740%	4.6090%	6.3690%	7.6175%	8.8660%	9.8395%	10.5215%	11.1265%	11.6820%	12.2100%
B2	3.9380%	6.4185%	8.5525%	9.9715%	11.3905%	12.4575%	13.2055%	13.8325%	14.4210%	14.9600%
B3	6.3910%	9.1355%	11.5665%	13.2220%	14.8775%	16.0600%	17.0500%	17.9190%	18.5790%	19.1950%
Caa1	9.5599%	12.7788%	15.7512%	17.8634%	19.9726%	21.4317%	22.7620%	24.0113%	25.1195%	26.2350%
Caa2	14.3000%	17.8750%	21.4500%	24.1340%	26.8125%	28.6000%	30.3875%	32.1750%	33.9625%	35.7500%
Caa3	28.0446%	31.3548%	34.3475%	36.4331%	38.4017%	39.6611%	40.8817%	42.0663%	43.2196%	44.3850%

Moody's Municipal Idealized 10-Year Cumulative Probability of Default (PD) Rates

Rating	Time Horizon (in Years)									
	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year
Aaa	0.0001%	0.0002%	0.0007%	0.0018%	0.0029%	0.0040%	0.0052%	0.0066%	0.0082%	0.0100%
Aa1	0.0002%	0.0011%	0.0035%	0.0074%	0.0109%	0.0147%	0.0189%	0.0235%	0.0287%	0.0350%
Aa2	0.0005%	0.0027%	0.0086%	0.0156%	0.0226%	0.0296%	0.0369%	0.0449%	0.0545%	0.0665%
Aa3	0.0009%	0.0058%	0.0181%	0.0311%	0.0437%	0.0563%	0.0698%	0.0837%	0.1006%	0.1230%
A1	0.0018%	0.0117%	0.0370%	0.0598%	0.0826%	0.1044%	0.1284%	0.1518%	0.1813%	0.2214%
A2	0.0035%	0.0226%	0.0717%	0.1114%	0.1508%	0.1883%	0.2293%	0.2677%	0.3171%	0.3875%
A3	0.0142%	0.0549%	0.1318%	0.1976%	0.2672%	0.3331%	0.4063%	0.4758%	0.5563%	0.6588%
Baa1	0.0365%	0.1135%	0.2270%	0.3365%	0.4460%	0.5554%	0.6770%	0.7987%	0.9203%	1.0541%
Baa2	0.0772%	0.2133%	0.3767%	0.5446%	0.7171%	0.8941%	1.0938%	1.2934%	1.4704%	1.6338%
Baa3	0.1687%	0.4218%	0.6870%	0.9562%	1.2254%	1.4865%	1.7396%	1.9967%	2.2378%	2.4507%
Ba1	0.3402%	0.7900%	1.2241%	1.6425%	2.0649%	2.4442%	2.7610%	3.0856%	3.3984%	3.6761%
Ba2	0.6372%	1.4173%	2.1158%	2.7775%	3.4351%	3.9906%	4.3705%	4.7626%	5.1670%	5.5141%
Ba3	1.3161%	2.5807%	3.6860%	4.5852%	5.5547%	6.3182%	6.8474%	7.3579%	7.8263%	8.2712%
B1	2.6155%	4.6833%	6.4717%	7.7403%	9.0089%	9.9981%	10.6911%	11.3059%	11.8703%	12.4068%
B2	4.8989%	7.9846%	10.6393%	12.4045%	14.1698%	15.4971%	16.4276%	17.2076%	17.9397%	18.6102%
B3	9.2945%	13.2858%	16.8212%	19.2288%	21.6364%	23.3561%	24.7959%	26.0597%	27.0195%	27.9154%
Caa1	14.2411%	19.0362%	23.4642%	26.6105%	29.7525%	31.9261%	33.9078%	35.7690%	37.4198%	39.0815%
Caa2	21.8856%	27.3571%	32.8285%	36.9362%	41.0356%	43.7713%	46.5070%	49.2427%	51.9784%	54.7141%
Caa3	48.3995%	54.1123%	59.2770%	62.8763%	66.2737%	68.4472%	70.5537%	72.5992%	74.5886%	76.5998%

Q.8. Ms. Robinson, Ms. Tillman, and Mr. Joynt, in his written testimony, Professor Coffee notes that because only a limited number of investment banks underwrite structured finance products, they have leverage over the rating agencies. If they don't like the ratings they get from one agency, they can go to another with lower standards.

Has your firm ever felt pressure to lower your rating standards in order to attract business?

A.8. Issuers, arrangers, underwriters, investors and other users of credit ratings naturally have strong incentives to try to influence CRAs' credit rating analysis and decisions, both when a credit rating is first issued and over the lifetime of the securities in question. It is not surprising, therefore, that from time to time, various members of these groups try to exert pressure on us, e.g. to: (a) change our methodologies, models or assumptions; (b) reach a decision on a rating that favors their interests; and/or (c) make a rating decision faster or slower than we consider appropriate in light of the information available. Since various market participants and users of credit ratings often have diverging interests, we are accustomed to our actions being unpopular with one group or another.

However, Moody's reputation and long-term success are critically dependent on the market's confidence in our ethics, objectivity and credit judgments. Consequently, we have long had in place strong policies and procedures to ensure the independence and objectivity of our ratings. (For a more detailed descriptions in Section 2 of Moody's Code and our annual reports on implementation of the Moody's Code.[7]) For example:

- ratings are decided on by committees, not individuals;
- analyst compensation is unconnected to either ratings or fees;
- a separate surveillance team reviews the performance of most structured transactions;
- a separate and independent credit policy group within Moody's is responsible for reviewing and vetting methodologies and models; and,
- perhaps most significantly, our methodologies, models and processes are publicly available and transparent so all market participants can assess our integrity and rigor.

Q.8.a. How do you attract customers if your ratings use the most stringent standards? Will issuers and underwriters simply go to other firms with less demanding standards?

A.8.a. In our view, the best mechanism to discourage rating-shopping is investor confidence in our ratings. If investors believe that our ratings are thoughtful opinions about the credit quality of a security, they ultimately will demand that issuers seek our ratings. Alternately, if investors believe that the models, assumptions and methodologies from Moody's or another CRA are inappropriately conservative or lax and therefore fail to produce predictive ratings, over time, we believe investors, issuers and their agents will prefer the ratings of another CRA whose ratings appear to be better predictors of credit quality.

[7] We make these documents publicly available on the Regulatory Affairs webpage at moodys.com and have included them in Annex III to this response.

As noted above, Moody's long-term success is critically dependent on the market's confidence in our ethics, objectivity and credit judgments.

Q.9. Ms. Robinson, in your written testimony you stated that Moody's tracks debt for more than 11,000 corporate issuers, 26,000 public finance issuers, and 110,000 structured finance obligations.

How often does Moody's review and, if necessary, update each rating?

A.9. The frequency with which Moody's periodically reviews the creditworthiness of issuers and obligations varies across sectors and asset classes based on the unique characteristics of each.[8] In very general terms, the frequency of our regular, periodic reviews typically is associated with the frequency with which new information about the issuer or obligation is made available. (Ratings may also be reviewed between these regular, periodic reviews when information indicates that the creditworthiness of a security could be materially affected.)

For example, the frequency of our regular, periodic reviews for structured finance securities typically is determined by the scheduled payment dates for the rated securities. This is the case for two reasons. First, the receipt of transaction underlying asset performance information from the Trustee or the Servicer is driven by these payment dates. Second, until the performance information is received, it will not be clear whether there has been any deterioration in underlying asset performance and thus whether a rating adjustment needs to be considered. Consequently, Moody's structured finance monitoring process typically occurs either monthly or quarterly, depending on the frequency with which the trustees or servicers generate and provide information to us. If we receive performance data or other information between scheduled payment dates that indicates material deterioration or improvement in the creditworthiness of securities, we would take appropriate action. The transaction performance data is further informed by Moody's analysis of macroeconomic conditions.

With corporations and financial institutions, analysts for the issuer in question typically conduct periodic reviews that are timed to coincide with the publication of financial statements and other key, periodic filings with authorities (e.g. on a quarterly, semiannual or annual basis, depending on the filing and jurisdiction in question). They may also listen to investor briefings organized by the issuer, monitor the business and specialized industry press and relevant authorities' websites. In addition, if they identify information from the issuer or other sources that would indicate material

[8] See Moody's Code of Professional Conduct. Provision 1.9 states our policy regarding monitoring of credit ratings:

"Except for Credit Ratings that clearly indicate that they do not entail ongoing surveillance, once a Credit Rating is published, Moody's will monitor the Credit Rating on an ongoing basis and update it by:

1.9.1 periodically reviewing the creditworthiness of the Issuer or other relevant entity or debt or debt-like securities;

1.9.2 initiating a review of the status of the Credit Rating upon becoming aware of any information that might reasonably be expected to result in a Credit Rating action (including termination of a Credit Rating), consistent with the applicable rating methodology; and

1.9.3 updating on a timely basis the Credit Rating, as appropriate, based on the results of such review.

deterioration or improvement in the creditworthiness of securities, they take appropriate action at that time. Furthermore, rating teams conduct regular (e.g. annual) portfolio reviews. In a portfolio review, all of the analysts involved in rating issuers or securities belonging to a particular sector, together with their supervisors, credit officers for the sector and possibly related sectors, and relevant specialists (e.g. corporate governance, accounting and risk management analysts) are invited to participate in a meeting where the credit ratings of all issuers in a sub-sector are considered relative to each other and in light of Moody's methodology for the sector and outlook for the industry as a whole.

Within a given sector or sub-sector, there can be differences in the frequency with which issuers are brought to a committee for review. For example, all things being equal, an issuer whose ratings are under review for possible upgrade or downgrade likely will be brought to a rating committee within a shorter period of time than an issuer to whom Moody's has assigned a "stable" outlook.

Q.9.a. Does Moody's review municipal ratings as often as it reviews corporate and structured finance ratings?

A.9.a. As indicated above, the frequency of our review will depend upon the specific characteristics of each sector and asset class. In our public finance group the level of issuance activity in a particular sector, the level of issuance activity by a particular issuer, the rating level of a particular issuer (lower rated credits are reviewed more frequently) and the overall volatility in that issuer's sector are important factors in determining the frequency of reviews. There are certain issuers in the public finance sector who are very active in the debt market, who are not highly rated and who are in a more credit-sensitive sector. These issuers generally will have their ratings reviewed on a more frequent basis than those who, in contrast, are small issuers in less volatile sectors who access the market very infrequently and whose credit characteristics are not as complex as some of the larger issuers.

Consequently, the frequency of our review is directly linked to the complexity of the credit, the volatility of the sector, and the susceptibility of the credit to change.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM CLAIRE ROBINSON

Q.1. During the hearing, I asked you for specifics on the ratings your agency provided on Bear Stearns in the months leading up to the collapse. Please provide the Committee with a detailed explanation of the ratings for Bear Stearns from November 2007 and March 2008.

A.1.

- *November 14, 2007:* Moody's placed the long-term ratings of The Bear Stearns Companies Inc. ("Bear") and its subsidiaries on review for possible downgrade. This rating action was taken in response to Bear's announcement that it expected to post a net loss in the fourth quarter of 2007, resulting from $1.2 billion in net market valuation losses on its exposures to subprime mortgage-related assets and CDOs. The loss also followed weak third quarter 2007 earnings. Moody's stated in its rating action that it "expected that on a go-forward basis, Bear's exposure to these specific assets would pose only modest downside risk but that during its review Moody's would evaluate Bear's firm-wide exposures and valuations in other asset classes." Moody's also expressed the opinion that Bear's performance through the market inflection and dislocation was more challenged than some competitors, which reflected not only tough markets, but certain risk and strategic decisions made by the firm. Specifically, we stated that "[A]lthough Bear had improved its earnings diversification over the past five years, its level and scale of product and geographic diversification still lagged that of its peers and had not provided a sufficient buffer to offset write-downs in mortgages and leveraged lending."

- *December 20, 2007:* Moody's lowered the long-term senior debt rating of Bear to A2 from A1 and changed the rating outlook to stable, "concluding the review for downgrade that was initiated on November 14, 2007" (see above). Factors considered included the sizeable write-downs on its mortgage and CDO portfolios, Bear's elevated risk appetite at the time, and Moody's ongoing concern regarding Bear's corporate governance, including board oversight of management's strategic risk decisions and leadership succession planning. The A2 rating and stable outlook factored in Moody's expectations at that time for the future risk of loss posed by Bear's net exposures, as well as Moody's expectations for a reduced, but acceptable, level of operating profitability in 2008. Moody's also indicated that Bear's ratings benefited from an ample capital position and strong liquidity profile. Bear had recently announced a partnership agreement with CITIC Securities Co. Ltd., which included a $1 billion preferred stock investment in Bear, further bolstering its capital position.
- *March 14, 2008:* Moody's lowered the long-term senior debt rating of Bear two notches to Baa1 from A2 and its short-term ratings to Prime–2 from Prime–1, and placed the company's long-term and short-term ratings on continued review for a possible downgrade. The rating action was in response to the rapidly deteriorating liquidity position of Bear, which necessitated an emergency secured funding line from JPMorgan Chase & Co. ("JPMorgan") back-stopped by the Federal Reserve Bank of New York. The 28-day funding facility represented a temporary liquidity respite for Bear as it looked to identify a long-term resolution to its liquidity problems.

The rating action reflected Moody's opinion that Bear's customer franchise had been hurt by the crisis, and would continue to erode if a long-term stabilizing solution was not quickly achieved. The review would focus on the financial and strategic alternatives under consideration by Bear and the likelihood for a timely resolution.

Given the fluidity of the situation, Moody's stated that it would re-address its ratings within 7–10 days. Importantly, Moody's indicated that Bear had a number of attractive franchises that could facilitate a strategic solution.

- *On March 17, 2008:* Moody's placed Bear's ratings on review for possible upgrade in response to the announcement by JPMorgan that it would acquire Bear with assistance from the Federal Reserve.
- *March 28, 2008:* Moody's announced it was continuing its review for possible upgrade of Bear's Baa1 ratings and those of its rated subsidiaries. This rating action followed revisions to the original March 16, 2008 merger agreement and operating guaranty from JPMorgan.

In addition, please answer the following questions.

Q.1.a. Were any of the ratings downgraded between December 2007 and March 14, 2008?

A.1.a. Response: Yes.

- *December 20, 2007:* Moody's downgraded the following ratings of Bear Stearns and its subsidiaries:
  - — long-term senior unsecured debt to A2 from A1
  - — issuer rating to A2 from A1
  - — subordinated debt to A3 from A2
  - — trust preferred stock to A3 from A2
  - — preferred stock to Baa1 from A3
- *March 14, 2008:* Moody's downgraded the following ratings of Bear Stearns and its subsidiaries, and placed the ratings on review for possible further downgrade:
  - — long-term senior unsecured debt to Baa1 from A2
  - — commercial paper to Prime–2 from Prime–1
  - — issuer rating to Baa1 from A2
  - — subordinated debt to Baa2 from A3
  - — trust preferred stock to Baa2 from A3
  - — preferred stock to Ba1 from Baa1

Q.1.b. Were any of the ratings downgraded during the week of the collapse (March 10–14)?

A.1.b. Yes. Please see our response to the above question. On March 14, 2008, Moody's lowered Bear's long-term senior debt rating two notches to Baa1 from A2, and placed the company on review for further downgrade. We expressed the opinion that the liquidity crisis was the result of sudden diminishing market confidence in Bear by its counterparties and customers, compounded by persistently negative market conditions. The downgrade also reflected our opinion that Bear's franchise had been hurt by the liquidity crisis and would continue to erode if a long-term, stabilizing solution was not quickly achieved. Moody's also noted that Bear had a number of attractive franchises that could facilitate a strategic solution—which is what ultimately occurred.

Q.1.c. Can you explain from your agency's point of view how Bear's collapse unfolded and the role the ratings may have played?

A.1.c. During the week of March 10, 2008, the market was flooded with rumors about liquidity problems at Bear. Although Bear did not face any sizeable net writedowns or credit losses, and the bulk of its franchises were intact, rampant rumors about its liquidity position, compounded by persistently negative market conditions, further eroded confidence in Bear by its counterparties and customers. Investor concerns over the impact that the failure of the Peloton and Carlyle hedge funds would have on Bear added to the pressure.

Because market participants value both accuracy and stability in credit ratings, Moody's manages its ratings so that they are changed only in response to changes in relative credit risk that we believe will endure, rather than in response to market rumors, transitory events or shifts in market sentiment. We recognize, however, that rumors about liquidity problems at a financial institution can, in and of themselves, contribute to liquidity problems and that liquidity problems for such an institution can have an enduring impact on creditworthiness. Consequently, Moody's analysts were actively reviewing Bear's evolving liquidity position on a daily basis throughout the week.

It is our understanding that Bear's liquidity situation declined precipitously between March 12 and March 14, 2008. What was originally market perception and rumors had become reality. This sudden erosion in liquidity severely constrained Bear's financial and operating flexibility. Prime brokerage clients pulled cash and investment balances out of the firm, haircut requirements rose on Bear's short-term collateralized funding and an increasing amount of short-term collateralized funding failed to roll at maturity. As a result, Bear's liquidity pool, which had started the week at about $18 billion, rapidly declined to around $5 billion by the end of Thursday, March 13. On March 14, we downgraded Bear's long-term senior unsecured debt ratings from A2 to Baa1 and short-term debt ratings from Prime–1 to Prime–2 and left those ratings on review for further downgrade. We expressed the opinion that the liquidity crisis was the result of diminishing market confidence in Bear by its counterparties and customers, compounded by persistently negative market conditions. The downgrade also reflected our opinion that Bear's franchise had been hurt by the liquidity crisis and would continue to erode if a long-term, stabilizing solution was not quickly achieved. Moody's also noted that Bear had a number of attractive franchises that could facilitate a strategic solution—which is what ultimately occurred.

Q.1.d. Do you think the lack of changes to the Bear Stearns' ratings is an example of a unique event in the markets or an indication of larger flaws in the structure of the ratings?

A.1.d. Moody's believes that our credit ratings of Bear and its securities were appropriate in light of the information available to us throughout the relevant time period. Moreover, although the company's equity suffered a dramatic loss in value as a result of this crisis, Moody's maintained our credit rating on Bear's debt at investment grade, in part because Bear had a number of attractive franchises that could facilitate a strategic solution—which is what ultimately occurred. As noted earlier, Moody's ratings speak to whether a debt investor who holds the securities to maturity will be made whole, and not whether a company's equity will retain its value.

Ultimately, the issue with Bear was a severe and extreme crisis of confidence based on a liquidity problem that arose suddenly and materialized in a matter of days. This crisis of confidence denied Bear's access to short-term secured financing, even when the collateral consisted of agency securities with a market value in excess of the funds to be borrowed. Confidence sensitivity was expected to be less of an issue in the secured funding markets, particularly where franchise impairment was limited. (Notably, Bear had survived prior crises utilizing many of the same tools that were at its disposal this time.) However, access to the secured funding markets, which had operated smoothly throughout many previous market crises, evaporated over the span of week. The market dislocation was so extreme that Bear could not borrow against high-grade collateral. This is a situation that Bear—or any other securities firm—would find difficult to protect against, and as a result the Federal Reserve was prompted on March 16, 2008 to provide liquidity to the securities firms.[9]

Our analysis suggested that Bear was more vulnerable than the other major securities firms because it had slightly weaker liquidity, was less diversified and had concentrations in stressed asset classes. Bear's long-term ratings were lower than those of its peers, reflecting this risk. However, it also appears to us that a high degree of risk avoidance by market participants (due to persistently negative market conditions and market-wide opacity with respect to counterparty exposures) may have led to the very unusual situation where market participants refused to accept high-grade collateral at any haircut. In addition, during the week of March 10 the departure of client balances that had financed prime brokerage lending contributed to Bear's liquidity difficulties.

Q.1.e. Under ideal circumstances, would you agree that the ratings should have been downgraded to more accurately reflect Bear's risk?

A.1.e. We believe that our credit ratings of Bear and its securities appropriately reflected the credit risks of which we were aware in light of the information available to us at the time. It is important to note that while Bear Stearns suffered a severe crisis of confidence, it has not defaulted on any of its debt instruments, and its ratings are currently on review for upgrade in connection with its pending acquisition by JPMorgan. In hindsight, a lower rating on such instruments would have overstated the risk of default.

Q.1.f. What lessons do you think we should take from the Bear Stearns collapse as it relates to the credit ratings?

A.1.f. Moody's credit ratings intend to offer an opinion on the risk of default and severity of loss in the event of default. As stated above, we believe that our credit ratings of Bear and its securities appropriately reflected the risks of which we were aware given the information available to us at the time. We also believe that, more generally, Moody's long-term credit ratings strike the appropriate balance between accuracy and stability. Our conversations with investors, issuers and regulators have led us to conclude that they have a strong preference for credit ratings that are both accurate

[9] Specifically, by the implementing the primary dealer credit facility.

and stable. They want ratings to reflect enduring changes in credit risk because rating changes have real consequences—due primarily to ratings-based portfolio governance rules and rating triggers—that are costly to reverse. Market participants, however, do not want us to provide ratings that simply track market-based measures of credit risk (although such measures can be a useful supplementary source of information in the investment decision-making process). They want our credit ratings to reflect independent analytical judgments that provide a counterpoint to often volatile market-based assumptions.

Having said that, the recent market turmoil has highlighted a vulnerability of securities firms, namely the loss of access by a solvent firm to secured funding, even when secured by high quality collateral. This scenario had not previously occurred in the history of the industry. The SEC is also now more focused on this vulnerability, as SEC Chairman Cox recently noted: "We are discussing with each of the firms various stress scenarios that include not only impairment of unsecured funding but also of secured funding. We now live in a post Bear Stearns reality." (Reuters, May 26) In addition, the increased complexity of these firms and of the financial instruments in which they deal have elevated the analytic challenge. Moody's is and will continue to evaluate the appropriateness of our rating methodology for securities firms in light of the recent events.

Q.1.g. What are your thoughts on a proposal Professor Coffee discussed at the hearing for rating agencies to periodically update ratings?

A.1.g. Moody's believes that credit rating announcements should be made when the credit rating agency has new or relevant information to share with the market. Generally, these instances are either: a change in rating (the rating opinion has changed); or a rating affirmation (there is a significant event in the market and investors are unsure whether the rating remains unchanged).

Moody's does not believe that publishing rating announcements according to a prescribed timetable or schedule would prevent mass downgrades or improve the appropriateness of existing ratings for the following reasons:

- Ratings are already monitored on an ongoing basis and Moody's changes our ratings when our opinion about the fundamental creditworthiness of the obligation changes.
- A requirement to announce on a quarterly, semi-annual or annual basis that our rating has not changed would saturate the market with redundant and potentially confusing or obfuscating information.
- Arbitrary review dates could inappropriately focus investor and issuer attention on those dates, rather than on credit-relevant events and thereby inadvertently conceal significant rating actions.
- Paradoxically, publishing more information could reduce the usefulness of the rating and impair transparency.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM STEPHEN W. JOYNT

Q.1. *Ratings Scoreboard.* What are your views on the recommendation that has been made for the creation of a central website which investors could access and on which they could compare the accuracy of past ratings by the different NRSROs for the same types of securities?

A.1. In our Joint Response to the Technical Committee of the International Organization of Securities Commissions' ("IOSCO") Consultation Report on the Role of Credit Rating Agencies in Structured Finance Markets, dated April 25, 2008, the participating rating agencies (Fitch, AM Best, DBRS, Moody's and Standard & Poor's) stated our commitment to create a centralized, industry portal to house our ratings performance studies and other relevant data.

I note that the SEC will soon publish its recently announced proposed rules (the "Proposed Rules"), which will include a requirement that certain performance statistics be made publicly available to facilitate comparisons among rating agencies. Fitch looks forward to working with the SEC in the context of the Proposed Rules to enhance the availability of performance data for users of ratings.

Q.2. *Due Diligence.* Did Fitch undertake to verify the information it used to decide ratings on the structured finance products that were subsequently downgraded? In recent years, there has been widespread awareness, through the press and otherwise, about the proliferation of so-called "liar loans"—mortgage loans with little or no documentation required and on which borrowers ultimately have stopped paying. Do you feel that NRSROs should have performed some investigation or due diligence on structured debt that contained these "liar loans"? Are there circumstances under which NRSROs should be required to perform some form of due diligence before issuing a rating?

A.2. The principal contacts at the initial stages of the rating process are with the originator, the issuer and/or the arranger. Fitch will also receive information and documentation from the transaction lawyers. These parties will typically provide an overview of the transaction and the originator, as well as a detailed term sheet setting out the main features of the legal and financial structure. The arranger often acts as the conduit between Fitch and the originator for information on the underlying assets and their historic performance. It may also act as a conduit for outside opinions from other experts, such as accountants.

Where relevant, Fitch will meet the originator to conduct an onsite servicer review, the purpose of which is to understand the asset origination process, the way the assets are administered and what steps are undertaken in the event of non-performance (e.g., of individual loans within a consumer loan portfolio). This also represents an opportunity for Fitch to resolve any outstanding questions about the data that it has already received. Following this review any further questions on the origination, underwriting or administration process are addressed directly to the originator or via the arranger.

Fitch's own lawyers (internal or external) may discuss legal and structural aspects of the transaction with transaction counsel, to better understand the transaction and whether and how legal risks relevant to our credit analysis have been mitigated. However, in all cases, these reviews are not designed to supplant or replace the legal analysis performed by transaction counsel, and are instead undertaken simply to understand the legal analysis provided by transaction counsel. In cases where Fitch receives reports and information from other external advisors or experts, such as auditors, actuaries and consultants, we may discuss these reports and information with such third parties to understand their impact on our credit analysis. Fitch also utilizes data gathered from servicers, trustees and data services in the course of monitoring existing transactions to evaluate new transactions.

As part of this process, we consider, among other factors, (a) the source of the data we receive; (b) the track record of that source in providing quality data; (c) the predictive powers associated with any one piece of data; and (d) whether or not the data (such as financial information) has been subject to review by a third party.

However, as we make clear in our Code of Conduct and other documents and publications, Fitch does not audit or verify the truth or accuracy of any information provided or available to it. This responsibility is not one which it is feasible or appropriate for rating agencies to discharge, and one that, in a clear, statutory context, already exists for other parties. We do agree with the SEC's position, in the Proposed Rules, that it would be very helpful to users of our ratings for us to disclose the extent to which we rely on the due diligence of others to verify the assets underlying structured products. In addition, we will be amending our Code of Conduct, in line with IOSCO's recently amended Code of Conduct Fundamentals for Credit Rating Agencies, to state that we will adopt reasonable steps to assess that the information provided to us for use in ratings is of sufficient quality to support credible ratings.

Indeed, we have already introduced additional measures aimed at reviewing the plausibility of data used in the rating process. In November 2007, we announced a reassessment of the risk management processes of originators, conduits and/or issuers for product being securitized going forward. Beginning in January 2008, our RMBS rating process has incorporated a more extensive review of mortgage origination/acquisition practices, including a review of originator/conduit/issuer due diligence reports, and a sample of mortgage origination files. Additionally, Fitch is studying how a more robust system of representation and warranty repurchases could help to provide more stable RMBS performance. Fitch will not rate subprime RMBS without completion of the review process.

Q.3. *Timeliness of Updates of Ratings.* Professor Coffee in his testimony pointed out that major downgrades of CDO securities "came more than a year after the Comptroller of the Currency first publicly called attention to the deteriorating conditions in the subprime market and many months after the agencies themselves first noted problems in the markets." His testimony also states "the gravest problem today may be the staleness of debt ratings." What is Fitch doing to update ratings in a timely manner and eliminate stale ratings? What standards should NRSROs observe?

A.3. We believe that a number of recent steps will improve our timeliness.

In order to better signal concerns about potential ratings pressure, Fitch is rolling out the use of Rating Outlooks for all structured finance securities. Outlooks indicate those securities for which the risk of rating actions is heightened, but has not yet reached the level of Rating Watch.

Additionally, Fitch has made substantial investments in automation to provide for more frequent in-depth analysis of the large portfolios of rated RMBS, CDO and other structured products. This allows for the ability to more quickly communicate the impact of fast-moving events on large portfolios.

More broadly, as with many other market participants, we have learned lessons from the precipitous changes in performance and environment for several asset classes and are adding additional review steps to the process by which criteria assumptions are determined. These will not guarantee that future assumptions will always be replicated in actual events—no process could realistically assure this—but they will incorporate recent experience regarding origination standards, product correlation and risk-layering.

We have introduced structural changes to a number of groups, from senior management rotation down to increased resources devoted to dedicated surveillance work. We have also added Credit/Risk Officers to each of the ratings groups, to bring enhanced analytical oversight, experience and training to these groups. The Credit and Risk Officers will work with each group to identify important trends and to ensure that Fitch's analytical process is both rigorous and balanced.

At the same time, we are conscious of the need to manage expectations of the degree to which the timing of rating actions will ever meet universal acclaim. Ratings are a "single-point" representation which inevitably will be subject to change as different risks crystallise and others recede. Particularly when market conditions are volatile, rating efficacy can also be measured in terms of the swiftness with which the ratings are revised to reflect a change in circumstances, rather than their absolute ability to have predicted a series of unexpected events. It is in this spirit that we continue to place significant focus on the timeliness of our continued surveillance.

Q.4. *Separate Ratings from Business?* Dr. Cifuentes' testimony contains a recommendation that a rating agency separate its rating business function from its rating analysis function. What are your views on how NRSROs should address this analyst independence concern?

A.4. Fitch acknowledges and addresses the potential conflicts of being an issuer-paid rating agency in four primary ways. One, we have separated business development from credit analysis, to keep each group focused on its core task. Two, we have relocated all of our non-rating operations into a separate division, Fitch Solutions, which operates behind a firewall. Three, we have established and enforce a Code of Conduct and related policies to address these conflicts. Four, no analyst or group of analysts is directly compensated on the revenues related to their ratings. To that end, we are in agreement with the SEC's Proposed Rule that would prohibit anyone who participates in determining a rating from negotiating the fee that is paid for such rating.

Q.5. *Ratings Shopping*. We have heard concerns about "ratings shopping," where an underwriter or an issuer goes to the NRSRO that it feels will give it the highest rating, even if it is not necessarily the most accurate. Is ratings shopping a problem? How should the negative aspects of it be addressed?

A.5. We understand the concerns surrounding "rating shopping", which have arisen most recently in the context of structured finance ratings. To address these concerns, Fitch has consistently advocated greater transparency regarding transaction data.

As it stands today, generally there is limited data in the public market about structured securities prior to their issuance such that neither investors nor rating agencies who lack direct contact with the issuer are able to formulate an informed opinion on structured securities. However, if robust information about structured finance products were publicly available once the details of the transaction had been finalized, agencies could provide ratings, regardless of whether or not an issuer requested a preliminary rating.

The dissemination of unsolicited ratings, where possible, likely would reduce the frequency of rating shopping, since rating opinions could be disseminated into the market regardless of whether the issuer specifically contracted with the agency or not. As a result, in many circumstances market participants would have the benefit of multiple and potentially diverse opinions about the same transaction.

Additionally, and most importantly, as mentioned above under Response I, having the underlying data published by the issuers or originators would allow investors to form their own opinions about the strengths and weaknesses of a particular transaction, which could support authorities' efforts to discourage the use of ratings for purposes other than an objective measure of relative credit risk. Voluntary efforts currently in progress being coordinated by the American Securitization Forum will potentially provide much more standardized data to all participants in the U.S. RMBS market.

Q.6. Professional Analyst Organization. Dr. Cifuentes in his testimony suggested "the creation of a professional organization, independent of the rating agencies, to which ratings analysts must belong and which sets forth ethical, educational and professional standards." Please share your thoughts on the potential merits of such an organization.

A.6. Fitch typically is sympathetic to any industry initiative which seeks to support analysts from rating agencies, and other institutions, in their professional development. At the same time, we note that recent market feedback to the Committee of European Securities Regulators ("CESR"), with which CESR concurred,[1] was that there was no need to impose educational and professional qualifications upon the staff of rating agencies.

[1] Paragraph 165 of CESR's Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and The role of credit rating agencies in structured finance, May 2008.

Membership of such an organization would also have to be voluntary—it is unlikely we could compel membership by our employees. Equally, it would be important for operational, compliance, and regulatory reasons that the formal, mandatory policies of each individual agency, including our policies on the management of conflicts of interest, be understood as the standard by which employee behavior is judged.

RESPONSE TO WRITTEN QUESTIONS OF SENATORS SHELBY FROM STEPHEN W. JOYNT

Q.1. Ms. Robinson, Ms. Tillman, and Mr. Joynt, do you think that it is easy for investors to compare the accuracy of the ratings of the different credit rating agencies? If not, do S&P, Moody's, and Fitch favor the SEC issuing rules to require enhanced disclosure of ratings performance as Chairman Cox outlined in his testimony?

A.1. In our Joint Response to the Technical Committee of the International Organization of Securities Commissions' ("IOSCO") Consultation Report on the Role of Credit Rating Agencies in Structured Finance Markets, dated April 25, 2008, the participating rating agencies (Fitch, AM Best, DBRS, Moody's and Standard & Poor's) stated our commitment to create a centralized, industry portal to house our ratings performance studies and other relevant data.

I note that the SEC will soon publish its recently announced proposed rules (the "Proposed Rules"), which will include a requirement that certain performance statistics be made publicly available to facilitate comparisons among rating agencies. Fitch looks forward to working with the SEC in the context of the Proposed Rules to enhance the availability of performance data for users of ratings.

Q.2. Ms. Robinson, Ms. Tillman, and Mr. Joynt, would you please explain the process by which you obtain the information you use to rate structured finance securities?

- How much of the information is from issuers, underwriters, or other sources?
- Do you ever seek to verify the accuracy of the information you receive?

A.2. The principal contacts at the initial stages of the rating process are with the originator, the issuer and/or the arranger. Fitch will also receive information and documentation from the transaction lawyers. These parties will typically provide an overview of the transaction and the originator, as well as a detailed term sheet setting out the main features of the legal and financial structure. The arranger often acts as the conduit between Fitch and the originator for information on the underlying assets and their historic performance. It may also act as a conduit for outside opinions from other experts, such as accountants.

Where relevant, Fitch will meet the originator to conduct an onsite servicer review, the purpose of which is to understand the asset origination process, the way the assets are administered and what steps are undertaken in the event of non-performance (e.g., of individual loans within a consumer loan portfolio). This also represents an opportunity for Fitch to resolve any outstanding questions about the data that it has already received. Following this review any further questions on the origination, underwriting or administration process are addressed directly to the originator or via the arranger.

Fitch's own lawyers (internal or external) may discuss legal and structural aspects of the transaction with transaction counsel, to better understand the transaction and whether and how legal risks relevant to our credit analysis have been mitigated. However, in all cases, these reviews are not designed to supplant or replace the legal analysis performed by transaction counsel, and are instead undertaken simply to understand the legal analysis provided by transaction counsel. In cases where Fitch receives reports and information from other external advisors or experts, such as auditors, actuaries and consultants, we may discuss these reports and information with such third parties to understand their impact on our credit analysis. Fitch also utilizes data gathered from servicers, trustees and data services in the course of monitoring existing transactions to evaluate new transactions.

As part of this process, we consider, among other factors, (a) the source of the data we receive; (b) the track record of that source in providing quality data; (c) the predictive powers associated with any one piece of data; and (d) whether or not the data (such as financial information) has been subject to review by a third party. However, as we make clear in our Code of Conduct and other documents and publications, Fitch does not audit or verify the truth or accuracy of any information provided or available to it. This responsibility is not one which it is feasible or appropriate for rating agencies to discharge, and one that, in a clear, statutory context, already exists for other parties. We do agree with the SEC's position, in the Proposed Rules, that it would be very helpful to users of our ratings for us to disclose the extent to which we rely on the due diligence of others to verify the assets underlying structured products. In addition, we will be amending our Code of Conduct, in line with IOSCO's recently amended Code of Conduct Fundamentals for Credit Rating Agencies, to state that we will adopt reasonable steps to assess that the information provided to us for use in ratings is of sufficient quality to support credible ratings.

Indeed, we have already introduced additional measures aimed at reviewing the plausibility of data used in the rating process. In November 2007, we announced a reassessment of the risk management processes of originators, conduits and/or issuers for product being securitized going forward. Beginning in January 2008, our RMBS rating process has incorporated a more extensive review of mortgage origination/acquisition practices, including a review of originator/conduit/issuer due diligence reports, and a sample of mortgage origination files. Additionally, Fitch is studying how a more robust system of representation and warranty repurchases could help to provide more stable RMBS performance. Fitch will not rate subprime RMBS without completion of the review process.

Q.3. Do you have any reason to believe that inaccurate or fraudulent data contributed to the poor performance of your ratings on structured finance securities over the last few years? If yes, please provide supporting evidence.

A.3. The very high delinquency and default performance of recent vintage subprime RMBS and Alternative-A RMBS has a variety of causes, including declining home prices and the prevalence of high-risk mortgage products such as stated-income loans and 100% combined-loan-to-value loans. However, as indicated in your question, these factors do not fully account for the large number of early defaults that are occurring. Many industry observers have noted that poor underwriting, together with borrower/broker fraud, also appear to be playing a role in high defaults.

For example, for an origination program that relies on owner occupancy to offset other risk factors, a borrower fraudulently stating intent to occupy will dramatically alter the probability of the loan defaulting. When this scenario happens with a borrower who purchased the property as a short-term investment, based on the anticipation that the value would increase, the layering of risk is greatly multiplied. If the same borrower also misrepresented his income, and cannot afford to make the payments, the loan will almost certainly default and result in a loss, as there is no type of loss mitigation, including modification, which can rectify these issues.

It is not possible to confidently make a broad statement of how pervasive these problems are across the range of originators and issuers in Fitch's rated portfolio. However, given the combination of our review of historical loan performance, the level of problems identified in recent Fitch studies and the findings of third-party reviews, Fitch believes that poor underwriting quality and fraud may account for as much as one-quarter of the underperformance of recent vintage subprime RMBS. More details on this can be found in our November 28, 2007 report "The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance", a copy of which is attached to this letter.

Q.4. Ms. Robinson, Ms. Tillman, and Mr. Joynt, according to testimony provided by Chairman Cox's testimony, Moody's has downgraded 53 percent and 39 percent of all its 2006 and 2007 subprime tranches; S&P has downgraded 44 percent of the subprime tranches it rated between the first quarter of 2005 and the third quarter of 2007; and Fitch has downgraded approximately 34% of the subprime tranches it rated in 2006 and the first quarter of 2007.

What steps have each of your companies taken during the past three years to hold accountable its executives and analysts for the poor performance of its ratings? Has your company dismissed or otherwise disciplined any of the executives or analysts responsible for overseeing or producing its ratings of structured finance products? Please provide a complete list of disciplinary actions.

A.4. Like all of the major rating agencies, our structured finance ratings have not performed well and have been too volatile, but we have found no evidence of violations of our policies or procedures which would indicate disciplinary action is either warranted or appropriate.

We have, however, seen merit in making a number of changes to the senior management team to introduce additional perspectives into the work of our structured finance groups. On January

22, 2008, Fitch appointed successors to the positions of Global Head of Structured Finance Ratings, responsible for all structured finance ratings globally, and Global Head of Structured Credit Ratings, responsible for all CDO ratings globally. In making these and other appointments, we have reflected a belief that adding senior managers with experience of corporate and financial sector assets is an important addition to the robustness of the rating process.

Q.5. Ms. Robinson, Ms. Tillman, and Mr. Joynt, during the last 3 years, did your firm notice a decline in underwriting standards for mortgages being used to create residential mortgage-backed securities? If so, did you alter your ratings process in any way to account for this decline in underwriting standards?

Did you disclose to investors that there was a decline in underwriting standards?

A.5. Some degree of decline was apparent in the migration to higher risk products such as "no-money-down" and "no documentation" loans. The rating process accounted for these factors by assuming higher default and loss rates for these mortgages than for other, less risky mortgages. We described to investors the risks of various mortgage products in our criteria reports, and we discussed the trends to higher risk products in numerous investor presentations and special reports, e.g., the 2006 and 2007 Global Structured Finance Outlook reports.

Fitch did not change the rating process until it became apparent that not only the underwriting standards, but the underwriting processes and controls, had become so weak that RMBS became exposed to very high-risk loans, in many instances exhibiting evidence of borrower and broker fraud. In response to these developments Fitch announced an enhanced originator review process described in Response B above.

Q.6. Ms. Robinson, Ms. Tillman, and Mr. Joynt, when each of your companies tries to attract new customers, how do you distinguish your ratings from the ratings of other rating agencies?

- Do you have empirical data that demonstrates that your ratings are better than the ratings of other companies? If yes, please provide documentation supporting your answer.
- Do you compete more on price or ratings accuracy? Please provide documentation supporting your answer.

A.6. While we can point to occasions where we believe our methodologies and rating actions have demonstrated greater prescience than those of our competitors, at a very high level, it is difficult to argue conclusively that one set of ratings is demonstrably "better" than another. Our aim has always been to provide a valid, independent opinion that investors can use as one additional data point to include in their own analysis, and that can be judged on its own merits, based on the quality of our rating commentary, accompanying research and the published performance data.

The decision by an entity as to which CRA to approach is based on a variety of factors, including the efficiency of the rating process, the quality of the analysis and the accompanying research reports, the relative cost and, most importantly, the reputation of the agency with investors. Ultimately, the long-term success or failure of an agency is measured in terms of the latter, which, in Fitch's case, has resulted in investors—voluntarily and at their own initiative—incorporating Fitch in their investment guidelines over the past five years, on an equal footing with the two larger agencies. This greater recognition—based on the quality of our work and not the level of our ratings—has been the greatest spur to increased business opportunities for our agency.

Q.7. Ms. Robinson, Ms. Tillman, and Mr. Joynt, what are the idealized default rates for each of your ratings?

A.7. Given the ordinal nature of ratings—that is, ratings are a relative ranking, rather than a specific percentage prediction—Fitch has not historically benchmarked individual ratings to cardinal default expectations. In our public transition and default studies, we have measured our performance using a variety of traditional measures, including comparisons of cumulative default rates, Gini coefficients and Lorenz curves.

Q.8. Ms. Robinson, Ms. Tillman, and Mr. Joynt, in his written testimony, Professor Coffee notes that because only a limited number of investment banks underwrite structured finance products, they have leverage over the rating agencies. If they do not like the ratings they get from one agency, they can go to another with lower standards.

- Has your firm ever felt pressure to lower your rating standards in order to attract business?
- How do you attract customers if your ratings use the most stringent standards? Will issuers and underwriters simply go to other firms with less demanding standards?

A.8. We do not view the nominal concentration of investment banks active in the capital markets as representing increased leverage such as to threaten the objectivity of our work. The banks in question operate across multiple asset classes, in dozens of geographies. In this work, the decision on which rating agency to approach and ultimately to engage is not steered centrally by any one individual, or any one group of individuals within any of the banks. The decision to hire or not hire a given agency is based on the variety of factors outlined above in Response F, rather than a narrow consideration of the treatment of that bank's prior transaction.

Where the level of credit enhancement is also used by banks as a determining factor, we believe that our track record amply demonstrates many segments where our market share was lower in part because of the credit view which Fitch took. We understand this as a natural part of the business of being an independent rating agency, and believe, as noted above in Response F, that ultimately the long-term success or failure of our agency will be measured relative to our reputation with investors, not short-term gains in market share.

Q.9. Mr. Joynt, Chairman Cox outlined in his testimony the rulemaking areas the SEC is considering.

The outline contains several ideas for improving competition in the ratings industry.

Are there any additional measures the SEC should consider to foster competition?

A.9. Fitch supports competition in the marketplace and has been working diligently to provide an alternative global, full-service rating agency capable of successfully competing with Moody's and S&P across all products and market segments. We believe that one of the Proposed Rules—requiring the public disclosure of the information a rating agency uses to determine a rating on a structured product—would be very constructive in furthering competition. Such disclosure would also have the added benefit of assisting investors in conducting their own investment analysis process. However, it may be most practical that this disclosure requirement should apply to the sources of the information—i.e., originators, arrangers and issuers—rather than the receivers of the information.

Q.10. Mr. Joynt, Chairman Cox indicated in his testimony that the SEC may consider rules that would require all NRSROs to have access to the information underlying credit ratings.

Would this make it easier for your company and the other smaller rating agencies to compete against S&P and Moody's?

A.10. Fitch supports competition in the marketplace and has been working diligently to provide an alternative global, full-service rating agency capable of successfully competing with Moody's and S&P across all products and market segments. We believe that one of the Proposed Rules—requiring the public disclosure of the information a rating agency uses to determine a rating on a structured product—would be very constructive in furthering competition. Such disclosure would also have the added benefit of assisting investors in conducting their own investment analysis process. However, it may be most practical that this disclosure requirement should apply to the sources of the information—i.e., originators, arrangers and issuers—rather than the receivers of the information.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM STEPHEN W. JOYNT

Q.1. During the hearing, I asked you for specifics on the ratings your agency provided on Bear Stearns in the months leading up to the collapse. Please provide the Committee with a detailed explanation of the ratings for Bear Stearns from November 2007 and March 2008. In addition, please answer the following questions.

- Were any of the ratings downgraded between December 2007 and March 14, 2008?
- Were any of the ratings downgraded during the week of the collapse (March 10–14)?
- Can you explain from your agency's point of view how Bear's collapse unfolded and the role the ratings may have played?
- Do you think the lack of changes to the Bear Stearns' ratings is an example of a unique event in the markets or an indication of larger flaws in the structure of the ratings?
- Under ideal circumstances, would you agree that the ratings should have been downgraded to more accurately reflect Bear's risk?
- What lessons do you think we should take from the Bear Stearns collapse as it relates to the credit ratings?

- What are your thoughts on a proposal Professor Coffee discussed at the hearing for rating agencies to periodically update ratings?

A.1. The "A+" long-term Issuer Default and senior debt ratings reflected Fitch's view that Bear Stearns' capacity for payment of financial commitments was strong, but more vulnerable to changes in circumstance or economic conditions than higher rated obligors. Positive rating considerations included leading franchises in clearing and securities settlement and fixed income and equities securities sales and trading. The company had a conservative market and credit risk culture as regards proprietary trading and investment banking relative to peers. Senior executives at Bear Stearns had established a culture of no surprises and accountability which had served them well, demonstrated by a very long history of good and steady profits. There was minimal turnover at high ranks and material employee ownership indicated a degree of alignment of the firm's interests with those of its customers.

Fitch analysts meet with broker dealer issuers several times a year to assess business risk and strategies as well as review principal ratings factors already listed above. We also maintain an open dialogue through regular conversations, pre-earnings calls and regular information requests on business and balance sheet conditions.

Fitch published a special analysis on liquidity in August 2007, following market liquidity pressures in July and August. Information requests also increased once the volatile markets began in earnest in August 2007. Bear Stearns and other issuers provide us with updates on exposures and commitments to leveraged loans, commercial real estate, ABS CDOs, mortgage inventory, counterparty credit relationships to financial guarantors and hedge funds. We also obtain regular updates on liquidity and market volatility trends.

Bear Stearns' funding structure was similar to peers although net adjusted leverage was slightly lower. Bear Stearns assumed significant operational and reputation risk from its global clearing and prime brokerage business but had managed this risk very well historically. Strategic expansion was thoughtful and carefully balanced against its expenses resulting in reduced revenue diversification as compared to peers. Product expansion typically lagged industry trends. Diversification was limited by this both geographically and on the product side. The firm had more limited revenues outside the U.S. The firm had recently been investing in its asset management business to build higher fee revenues often seen as ballast against trading results. Its support of a managed hedge fund in June 2007 was a marked departure for Bear Stearns.

On November 14, 2007, Fitch downgraded a number of Bear Stearns' ratings. Full rating histories are attached. At the parent company level, the Short-term Issuer Default Rating of BSC was lowered to "F1" and the Individual rating (a measure of standalone financial strength) was lowered to "B/C". Additionally, the rating outlook was revised to "Negative" from "Stable". The downgrades reflected Fitch's view that Bear Stearns' near term profitability was expected to be weak, pressured by its exposure to the U.S. mortgage market as a whole. Its global clearing and equities businesses were performing well, however; Fitch believed financial performance in 2008 would remain challenging given the scale of Bear Stearns' fixed income business and more limited international scope. Liquidity had been managed well and remained adequate but deteriorating conditions in the capital markets were considered a potential threat to Bear Stearns' financial flexibility. Fitch highlighted that future downgrades could result from declines in earnings, severe negative valuation adjustments, an increased risk profile, diminished liquidity, rising leverage and/or tangible equity erosion.

In December, Fitch continued the Negative Outlook following Bear Stearns' earnings release of FY07 results in a published press release. Bear Stearns posted its first quarterly loss in its history and was mildly profitable for FY07. The firm took $1.9 billion in mortgage inventory write-downs. Liquidity measures had improved during the last half of 2007. Ratings were not downgraded further during the period March 10–13, 2008.

On March 14, 2008, Fitch lowered all ratings on Bear Stearns and its subsidiaries rated by Fitch. The parent company Long-term Issuer Default Rating was lowered to "BBB" from "A+" and the Short-term Issuer Default Rating was lowered to "F3" from "F1". The Individual rating was lowered to "C/D" from "B/C". All issue ratings were also placed on Rating Watch Negative. The Support rating was raised from "5" to "3", reflecting the secured loan agreement concluded with JP Morgan Chase.

Bear Stearns suffered a rapid decline in liquidity over a 24-hour period. In February and early March, there was unprecedented spread widening in all credit and particularly in mortgage products as the failure of several high profile hedge funds pressured prices. Liquidity had dried up in almost the entirety of the domestic mortgage-backed securities market, including unprecedented credit spread widening in "AAA"-rated US Agency paper.

Bear Stearns had a capital base that was the smallest of the bulge bracket and had the highest percentage of its securities inventory in mortgage based assets. It was the lowest rated broker dealer at Fitch. As indicated above, Fitch had downgraded its Short-term ratings to "F1" in November and the Negative Outlook indicated a probability that its rating may face further downgrades. Bear Stearns also possessed a high market share in providing financing to fixed income hedge funds. Fitch believes these factors all led to increasing reluctance by investors to hold its paper, particularly as their quarter end was approaching.

Fitch believes that market conditions were highly volatile for several weeks preceding the Bear Stearns' failure. Unique elements include the unprecedented spread widening in products that had been highly liquid for years and through multiple stress scenarios. While similarities can be drawn between this period and market conditions in the fall of 1998, there are numerous unique elements including the turmoil in domestic RMBS markets, the absence of Fannie Mae and Freddie Mac in active purchases of mortgages due to portfolio caps, the existence of the mortgage-based ABX indexes allowing greater speculation and accumulation of short positions, and the increase in hedge fund and statistically-based program trading in fixed income and equities. Fitch believes these market conditions likely resulted in the acceleration of the rate of deterioration.

It is very difficult to attribute "what if" scenarios to the operations of financial markets since human reaction can be so unpredictable. Ratings consider the diversification of sources, tenor and types of unsecured funding as well as its reliance and ability to withstand periods of illiquidity. Treasury management is an integral part of the culture and management of these firms and risk mitigation takes multiple forms including short term limits to rollover risk, investor concentrations and availability of unencumbered assets. Contingency funding plans are detailed and make various assumptions on the firm's ability to shift from an unsecured to a secured environment.

Fitch noted a shift in industry trends since 1998. The industry and Bear Stearns, in particular, reduced reliance on unsecured credit sources, emphasizing the extension of long-term funds, the use of bank charters to support certain businesses and increased reliance on secured bank funding agreements to support the growing inventory of illiquid assets.

Bear Stearns' liquidity ratios were on target with peers. Its funding coverage of less liquid assets was the strongest of peers having limited credit granted to investment banking clients, merchant bank and private equity funds and generally conservative posture in expanding its balance sheet. It also maintained a relatively conservative capital structure with minimal levels of hybrid capital issuances versus peers.

While we strive to incorporate a prospective view in our ratings, Fitch believes that the evolving credit stress has elements of great severity and rapidity not previously foreseen. We are evaluating this scenario, as well as the recent programs modified by the U.S. Federal Reserve in the ongoing ratings assessment of the other U.S. based brokers. Three of the remaining four are presently assigned a Rating Outlook of Negative.

Our ratings are subject to continuous review, other than where expressly disclosed as point-in-time in nature. This means that any material event can cause a rating action for any rating at any time. Fitch is staffed to ensure that sufficient analysts of appropriate experience are available to attend whenever committees need to be called.

The topic of "bunching" actual rating actions to meet pre-determined dates has also recently been discussed in the context of regulatory consultations in Europe, and we understand that the overwhelming majority of rating users do not see a benefit in such an idea.

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US Residential Mortgage
Special Report

The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance

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Related Research
- "Drivers of 2006 Subprime Vintage Performance," dated Nov. 13, 2007.
- "Resilogic: US Residential Mortgage Loss Model — Amended," dated Aug. 14, 2007.

November 28, 2007

■ Summary

Residential mortgage-backed securities (RMBS) issued in 2006 and 2007, backed by pools of subprime mortgages, are substantially underperforming initial performance expectations, resulting in ratings downgrades and heightened risk of principal loss. As anticipated in Fitch's rating criteria, falling home prices are a fundamental source of poor performance. However, the 2006 subprime vintage performance is remarkable for the magnitude of early mortgage defaults. Fitch attributes a significant portion of this early default performance to the rapid growth in high-risk "affordability" features in subprime mortgages. The interaction of home price declines and high risk products in 2006 vintage subprime performance is analyzed in Fitch's special report "Drivers of 2006 Subprime Vintage Performance," dated Nov. 13, 2007. In addition to the inherent risk of these products, evidence is mounting that in many instances these risks were not controlled through sound underwriting practices. Moreover, in the absence of effective underwriting, products such as "no money down" and "stated income" mortgages appear to have become vehicles for misrepresentation or fraud by participants throughout the origination process.

Fitch believes that much of the poor underwriting and fraud associated with the increases in affordability products was masked by the ability of the borrower to refinance or quickly re-sell the property prior to the loan defaulting, due to rapidly rising home prices. With home prices now falling in many regions of the country, many loans that would have paid off in prior years remain in the pool and are more likely to default. BasePoint Analytics LLC, a recognized fraud analytics and consulting firm, analyzed over 3 million loans originated between 1997 and 2006 (the majority being 2005–2006 vintage), including 16,000 examples of non-performing loans that had evidence of fraudulent misrepresentation in the original applications. Their research found that as much as 70% of early payment default loans contained fraud misrepresentations on the application.[1] For additional information on measuring fraud within the industry, refer to Appendix A on page 9.

As Fitch sought to explain the poor performance of this vintage, we examined the impact of high risk collateral characteristics and rapidly declining home values. The underperformance was not fully explained by these factors, suggesting that other factors such as fraud might be playing a significant role. This was supported by the results of a file review conducted by Fitch on a small sample (45 loans) of early defaults from 2006 Fitch-rated subprime RMBS, many of which had apparently strong credit characteristics such as high FICOs, as outlined in the Characterics table on page 2.

Fitch's review of these files indicated that these loans suffered in many instances from poor lending decisions and misrepresentations by borrowers, brokers and other parties in the origination process. High risk products, which require sound underwriting and which are easy targets for fraud, account for some of the largest variances to expected default rates. It is not possible to confidently make a broad statement of how pervasive these problems are across the range of originators and issuers in Fitch's rated portfolio based on such a small sample of loans. However, given the combination of our review of historical loan performance, the pervasive problems indicated in the file review, and the findings of third-party reviews, Fitch believes that poor underwriting quality and fraud may account for as much as one-quarter of the underperformance of recent vintage subprime RMBS.

Characteristics of Small File Sample

# of Loans	45
Average FICO	686
Average Combined LTV Ratio	93
% California Properties	49
% Low/No Doc	69
% 2nd Lien	60

LTV – Loan-to-value. Source: Fitch.

In order to better understand the nature and impact of poor underwriting and fraud on subprime RMBS performance, Fitch analyzed a targeted sample of early defaults from 2006 Fitch-rated subprime RMBS. Fitch's findings from this review include:

- Apparent fraud in the form of "occupancy misrepresentation." The borrower's stated intent was to occupy the property, but there is evidence in the loan files that this did not occur, and that it is likely that occupancy was never the true intent of the borrower.
- Poor or lack of underwriting relating to suspicious items on credit reports. The loan files of borrowers with very high FICO scores showed little evidence of a sound credit history but rather the borrowers appeared as "authorized" users of someone else's credit.
- Incorrect calculation of debt-to-income ratios.
- Poor underwriting of "stated" income loans for reasonability of the indicated income.
- Substantial numbers of first-time homebuyers with questionable credit/income.
- In one instance, acknowledgement by the borrower of being the "straw buyer" in a property flipping scheme.

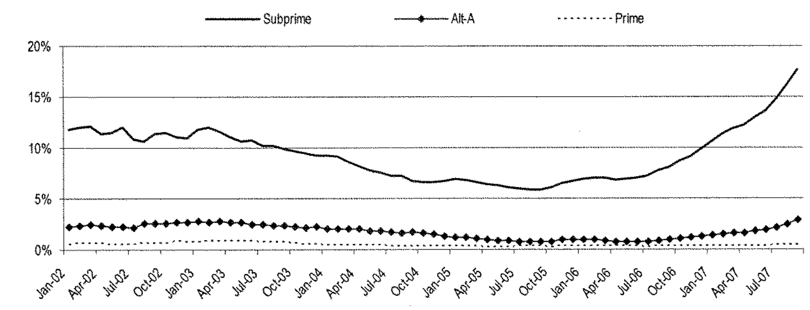
Fitch recognizes that, even in good quality pools, there will be some loans that default. However, when some pools of subprime mortgages have very high projected default rates, it is important to understand the impact that loans originated with poor underwriting practices and fraud can have. Moreover, Fitch intends to utilize the insights from its review to improve the RMBS rating process. Fitch believes that conducting a more extensive originator review process, including incorporating a direct review by Fitch of mortgage origination files, can enhance the accuracy of ratings and mitigate risk to RMBS investors. Fitch will be publishing its proposed criteria enhancements shortly. Additionally, a more robust system of representation and warranty repurchases may be desirable.

In order to better detect and prevent poor underwriting and fraud, a combination of technology and basic risk management is needed before, during and after the origination of the loan. In this report, Fitch discusses some of the more obvious examples of evidence of fraud found in loan files, along with some of the steps that could identify the fraud at the earliest possible stage, ideally before the loan is funded. There are several effective fraud indication tools available today to the originator/issuer and servicer; however, it is important to acknowledge that no process or tool can identify all instances of misrepresentation or fraud.

■ Lack of Disciplined Underwriting Increases Defaults and Allows Fraud

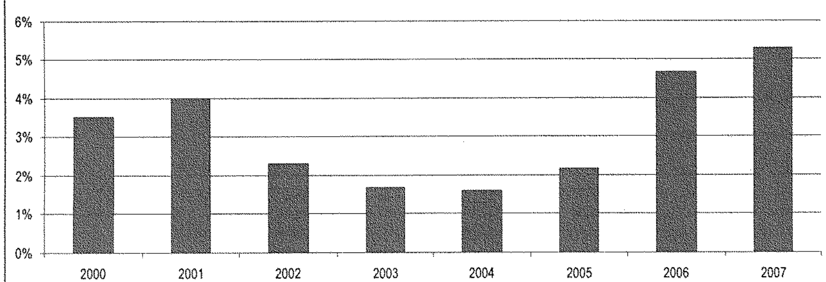
Increased risk caused by operational weaknesses oftentimes is not apparent in the collateral characteristics, but rather, manifests itself in the pool performance. As detailed in Fitch's criteria report, "ResiLogic: US Residential Mortgage Loss Model — Amended" dated Aug. 14, 2007, Fitch derives base frequency of foreclosure and loss severity, and therefore expected base case loss amounts, using each loan's disclosed risk attributes. These attributes include loan-to-value (LTV), combined loan-to-value (CLTV) and FICO scores, which are historically the primary drivers of default risk, with loan purpose and occupancy as secondary drivers of default risk. However, additional risk caused by inaccurate data and/or fraudulent or misrepresented factors could materially affect the performance of

60+ Delinquency By As Of Date
(As Percentage of Outstanding Balance)



Source: Fitch Ratings: Loan Performance.

Percentage of Securitized Pool Balance 90 Days Delinquent Before Age 6 Months (EPDs)



Source: Fitch Ratings: Loan Performance.

pools. Losses are more likely to be low if the originator consistently applies underwriting policies and guidelines, and has adequate quality control procedures, sufficient technology, and/or has risk management processes that are well developed and applied. For example, an inadequate appraisal quality review program is a significant risk factor since the valuation determines LTV. In most cases, the lack of an appropriate valuation at origination may not be evident until the borrower defaults on the loan or attempts to sell/refinance the property.

There is a distinction between inaccurate data provided by the originator/issuer to investors, and others who rely on the data, including Fitch, and data, which is technically accurate, but does not actually reflect the true credit risk due to poor underwriting, quality control, or property valuation. Fitch believes that data, which is correct but inaccurately reflects the credit risk (e.g., stated income was not reasonable), is a larger component of underperformance than data integrity issues (e.g., debt-to-income ratios [DTI] were incorrectly stated on tape). Therefore, increasing data reverification on securitized transactions, while potentially beneficial, will not address the more material risk and will result in increased costs and reduced efficiencies for consumers and securitizations. Fitch believes that the rating agencies could add value by assessing the rigor and integrity of underwriting and valuation processes and controls, as part of their originator/issuer reviews.

There has been a significant increase in the defaults and EPDs in 2006 and 2007 vintage subprime securitizations as outlined in the two charts on page 3. In Fitch's research to determine the causes for high defaults in recent vintage pools, several factors began to emerge which indicated that the underlying loans did not perform consistently with their reported risk characteristics. To gain a better understanding of the situation, Fitch selected a sample of 45 subprime loans, targeting high CLTV, stated documentation loans, including many with early missed payments. In particular, we selected loans that were primarily purchase transactions having a higher range of FICO scores (650 to 770), because high FICO scores and purchase transactions are historically attributes which generally reduce the risk of default. Fitch's analysts conducted an independent analysis of these files with the benefit of the full origination and servicing files. The result of the analysis was disconcerting at best, as there was the appearance of fraud or misrepresentation in almost every file.

While we realize this was a very limited sample, Fitch believes that the findings are indicative of the types and magnitude of issues, such as poor underwriting and fraud, which are prevalent in the high delinquencies of recent subprime vintages. In addition, although the sample was adversely selected based on payment patterns and high risk factors, the files indicated that fraud was not only present, but, in most cases, could have been identified with adequate underwriting, quality control and fraud prevention tools prior to the loan funding. Fitch believes that this targeted sampling of files was sufficient to determine that inadequate underwriting controls and, therefore, fraud is a factor in the defaults and losses on recent vintage pools. Additionally, Fitch continues to attempt to expand its loan sample to provide further validation of its findings and will provide additional commentary as applicable.

In light of our findings, Fitch believes that it is important to reassess the risk management processes of originators and/or issuers for product being securitized going forward.

While prime originators are not immune to fraud schemes, the subprime sector has exhibited the most vulnerability to them. Undoubtedly, flat or declining home prices and the loosening of program guidelines remain the main drivers of defaults and therefore losses within the subprime sector. However, Fitch believes that poor underwriting processes did not identify and prevent and, therefore, in effect, allowed willful misrepresentation by parties to the transactions, which has exacerbated the effects of declining home prices and lax program guidelines. For example, for an origination program that relies on owner occupancy to offset other risk factors, a borrower fraudulently stating its intent to occupy will dramatically alter the probability of the loan defaulting. When this scenario happens with a borrower who purchased the property as a short-term investment, based on the anticipation that the value would increase, the layering of risk is greatly multiplied. If the same borrower also misrepresented his income, and cannot afford to pay the loan unless he successfully sells the property, the loan will almost certainly default and result in a loss, as there is no type of loss mitigation, including modification, which can rectify these issues.

■ Research Results

The files reviewed by Fitch's analysts contained common features that Fitch believes contributed to default on these loans. Although the loan programs under which these loans were underwritten allowed for several high risk features, the files indicated a lack of underwriting review for basic reasonableness and credibility. It is important to note that while most of these issues could have been noted and investigated at the time of origination, others, such as occupancy and property condition, only became obvious as the servicer performed its functions.

Some general examples of these findings are below.

- Borrower balance sheet and assets did not support income as stated
  - No indication in file of reasonableness test or attempt to obtain additional information.
  - Some verbal employment checks provided by borrower (self-employed) or related individual (spouse).
- DTI ranged from 44%–57%
  - Some exceptions were made to programs, but for many the amounts used for calculation did not include other debts and/or tax/insurance/homeowners' association (HOA) dues which could have been determined from information within the files.
- Credit Reports

- FICO scores based on "authorized" accounts or joint accounts, where the borrower is utilizing someone else's credit.
- No notation as to research on fraud or other alerts shown on credit reports.
- No notation as to research on inconsistent social security numbers, date or birth, or AKAs from application to credit reports.
- No research in the files on reported unresolved derogatory credit, including judgments, liens, etc.

- Seller concessions and other closing items
  - No indication of review performed on HUD-1 Settlement Statement for consistency with contract in file, allowable amounts paid for borrower, or funds to borrower (including purchase transactions).
  - No indication in file of review of borrower identification or signature.
- No consideration for payment shock, NSFs, or overdrafts
  - No indication in file of review of borrower's ability to sustain materially higher payments (assets or deposits did not indicate borrower had excess liquidity).
  - No notation as to research on NSFs, or overdrafts shown in bank statements.
- Incomplete documentation
  - Occupancy form signed by borrower but box declaring occupancy rarely checked.
  - Missing "final" version of closing documents.

Characteristics by percentage of the 45 files reviewed included (loans may appear in more than one finding):

66%	Occupancy fraud (stated owner occupied — never occupied), based on information provided by borrower or field inspector
51%	Property value or condition issues — Materially different from original appraisal, or original appraisal contained conflicting information or items outside of typically accepted parameters
48%	First Time Homebuyer — Some applications indicated no other property, but credit report showed mortgage information
44%	Payment Shock (defined as greater than 100% increase) — Some greater than 200% increase
44%	Questionable stated income or employment — Often in conflict with information on credit report and indicated to be outside "reasonableness" test
22%	Hawk Alert — Fraud alert noted on credit report
18%	Credit Report — Questionable ownership of accounts (name or social security numbers do not match)
17%	Seller Concessions (outside allowed parameters)
16%	Credit Report — Based on "authorized" user accounts
16%	Strawbuyer/Flip scheme indicated based on evidence in servicing file
16%	Identity theft indicated
10%	Signature fraud indicated
6%	Non-arms length transaction indicated

Fraud has grown significantly over the past few years in volume and complexity. Fitch believes that there are many things that originators/issuers could do to prevent misrepresentation and fraud, as discussed below.

■ Originator's/Issuer's Role in Identifying Fraud and High Risk Loans

As the mortgage lending industry continues to make the mortgage process faster and less expensive, the occurrences of fraud continue to grow. For example, advances in personal computer capabilities enable individuals to produce documents to support fraudulent data, which are often hard to distinguish from true originals. In addition, access to databases has enabled perpetrators to alter pertinent loan documentation and information or create falsified loans where there is no borrower or property.

In many instances, misrepresentations and altered documentation are evident in the physical files, and most lenders provide underwriters and other personnel with training to identify red flags that may indicate fraud. Many lenders have an individual or group to research and resolve situations where fraud is suspected. Often, loans containing misrepresentations have multiple problems that can be detected through a strong validation and reverification process.

Mortgage fraud has increased in recent years to an extent that The Federal Bureau of Investigation (FBI) has reported the cost to the mortgage lending industry is between $946 million and $4.3 billion in 2006 alone.[2] Because fraud is becoming so prevalent, Fitch expects lenders to aggressively monitor for fraud, research and resolve suspected cases, and take appropriate actions against the source(s) of the problem. This includes the repurchase of loans by third parties, the removal of these parties from further business dealings, the dismissal of employees involved and, where appropriate, legal action.

Some of the primary areas of mortgage fraud are discussed below, along with the originators' actions which could identity these situations. It is important to keep in mind that for several of the situations mentioned here, there are widely available tools that can be purchased which increase the originators' ability to quickly identify potential problem loans.

Broker-Originated Loans

Broker-originated loans have consistently shown a higher occurrence of misrepresentation and fraud than direct or retail origination. In most instances, the broker will be the only direct contact with the borrower, and often is in the position of gathering most, if not all, required information on the borrower, including in some cases the selection of the appraiser. In this role, they have the ability, if inclined, to adjust or amend the stated facts, with or without the borrower's knowledge, to allow the loan request to fit within the parameters of lender guidelines.

Certainly not all brokers would engage in these activities; however, it is imperative that lenders actively research the identity and history of individuals applying for inclusion in lending programs, as well as maintain a regular update on all brokers. Lenders are expected to actively monitor the approval/reject record, repeat/amended submissions, and performance/default record for loans from each broker. In addition, if problems are detected, the lender is expected to aggressively research the cause, and if misrepresentation or fraud is indicated, to withdraw the broker's approval and, if appropriate, pursue legal actions. Finally, to prevent a repeat of this activity, the lender can provide the broker's name and identification information to The Mortgage Banker's Association's (MBA) Mortgage Asset Research Institute (MARI), which maintains a list of reported brokers that may be accessed by other lenders.

Stated Income

Stated income programs were initially reserved for high net worth individuals, who were self-employed and did not want to disclose all their business dealings but had assets that supported the income stated and strong credit profiles and credit scores. As the mortgage industry grew, originators expanded their programs to include salaried borrowers, and then on to the subprime sector.

Lenders who use reasonableness tests for income during the underwriting process, as well as initiate further research if the stated amounts appear inflated, can mitigate the risk inherent in stated income products. If the borrower profile does not support the income levels indicated, either by assets or liquidity (bank or savings accounts), the reasonable assumption would be that the income could be inflated. In addition, if lender guidelines require a verbal statement of employment, care should be exercised to determine that the individual providing the statement is an unrelated, independent source.

Originators often use the Internet to help confirm employment and the reasonableness of the income based on job title and geographic location. Most lenders know and have the ability to use the various sites and programs which provide this type of "reasonableness" check, and when stated income falls outside these parameters by an established variance, further research would be warranted.

FICO Inflation

FICOs present a consistent statistical assessment of the borrower's creditworthiness and risk profile; however, credit scoring is limited by the accuracy of the data contained within the credit bureau file. The confidence that originators place in FICOs may be diminished, and the perceived risk of the loan may be altered, when information provided within the report is not taken into consideration. Therefore, if the credit report provides conflicting information regarding Social Security Numbers, birth dates, addresses, indications of the use of multiple names, fraud alerts (known as HAWK Alert), etc., the lender should perform additional research.

Another concern with FICO score accuracy involves companies, typically Internet-based, who sell a means to artificially inflate a borrower's FICO. It has been estimated, as well as claimed by these services, that the use of a single "borrowed" account from a good consumer, reflected on the credit report as an "authorized user" account, will increase a FICO score by 50 to 75 points. Multiple authorized user accounts have the possibility of inflating a poor credit borrower's FICO by as much as 200 points. While this practice is not technically illegal for the service provider, many feel that the borrower who utilizes another person's good credit to inflate their score for the purpose of misleading a lender is committing fraud.

However, the industry is starting to limit the use of authorized user accounts or "piggyback credit." For example, Fair Isaac Corp. indicated that it was taking steps to ensure credit scores are not artificially enhanced by using borrowed credit by modifying the formula for its FICO score. The newest FICO model (version FICO 08) will ignore authorized user accounts. In addition, TransUnion LLC expanded its offerings to help the financial industry by identifying consumers who may have added authorized user relationships to their credit files to artificially enhance their credit standing.

Because of the effect of authorized users and other credit "improvement" schemes available today, lenders who review all information on a proposed borrower's credit report will be able to better determine the full indication of a borrower's credit risk profile. Specifically, if a lender uses a "high" FICO as a compensating factor for layered risk or risk outside stated program guidelines, the need to determine the accuracy of this tool is materially increased.

Property Valuation Accuracy

Risks associated with appraisals are varied and costly. Based on the past unprecedented home price appreciation in some markets and recent regulatory investigations, there is widespread concern regarding the number and severity of inflated valuations used to determine LTV. The availability of stated value refinances, inappropriate use of alternative valuations, and high production volume pressures on appraisers contributed to this problem. The effect of flat or declining home values, currently evident on a national scale, is most sharply felt in some of the same markets affected by the most inflated valuations, making current assessments of appropriate valuations more difficult. As a result, lenders are expected to exercise additional caution when determining values, and therefore LTVs to use in their risk assessments.

Fitch believes that a comprehensive valuation program uses a combination of full appraisals, automated valuation models (AVMs), and review appraisals. AVMs can be used to check and verify the appropriate valuations of appraisals at a relatively low cost. They are especially useful in the selection of properties for re-appraisal or appraisal review as part of a comprehensive quality control program. In addition, most lenders have procedures for reviewing appraisals referred by underwriting or quality control that use either in-house certified review appraisers or adequately monitored third-party review appraisers.

Lack of Underwriting

The high volume of mortgage applications over the past few years, coupled with the consumer's demand for more rapid responses to those applications, led to use of automation via Automated Underwriting Systems (AUS) and the use of validators to ease heavy underwriter workload. The borrower application information, often provided by the broker, is typically subject only to a cursory validation process. The cost savings benefit of using less experienced employees must be offset by controls to mitigate the likelihood that critical data points or red flags that could materially affect the underwriting decision or pricing may be overlooked.

Policies should address how the lender is evaluating risk layering, disposable income and payment shock. In addition, compensating factors are often used to override or offset loan characteristics that do not meet stated program guidelines. However, typically a single compensating factor would not offset multiple layers of risk. Therefore, to determine acceptable and predictive levels of risk, exceptions, upgrades, and overrides to established underwriting and loan programs should be carefully documented, monitored and disclosed.

Audits and Quality Control

To mitigate and control the extensive risks associated with originations, a lender needs an active, dynamic, and systemic quality control and internal audit program. An independent quality control program can provide an objective assessment of credit risk and compliance to the company's loan product and underwriting guidelines, as well as identify deteriorating asset quality. Pre- and post-funding quality control programs assess the underwriting decision, re-verify documentation, and provide constructive feedback to management.

■ Representations and Warranties (Reps & Warranties) in RMBS

In RMBS transactions, reps and warranties are given by the originator, issuer or other appropriate party, covering several areas, including the legality of the mortgage loan, the lien status, and condition of the property. In addition, some of the reps and warranties address compliance with the originator's underwriting standards and a smaller number of transactions have specific reps and warranties for fraud. However, there are several challenges to relying on reps and warranties to remove loans from RMBS deals for a breach due to underwriting or misrepresentation/fraud.

For many subprime loans, the program guidelines allowed the originator to base qualification on features such as stated income. Assuming that the originator's underwriting standards did not require the verification through another means, or that a "reasonableness test" be conducted, the failure to perform these steps would not be an exception to their underwriting standards. Therefore, if the borrower or broker misrepresented the actual income, it is fraud on their part, but is it a breach of the reps and warranties? The same question would apply to borrowers who have artificially enhanced their FICO.

Most pooling and servicing agreements that Fitch reviewed indicate that any party to the transaction (typically, the issuer, servicer, master servicer, or trustee) who becomes aware of a suspected breach to the reps and warranties should provide notice to the trustee (or in some all other parties). However, unless there is a reason that research is conducted to specifically look for a breach, finding potential breach situations typically requires an awareness and identification by the servicer while conducting their functions. Directions as to the process after notification are somewhat varied, but in general, if a breach is determined, the trustee will facilitate the request for repurchase of the loan from the transaction. Fitch believes that risk management firms that track potential repurchase candidates and monitor the repurchase process can enhance the effectiveness of representations and warranties. However, in today's environment, one of the situations which could occur would be that the original provider of the reps and warranties is no longer in existence or has filed bankruptcy.

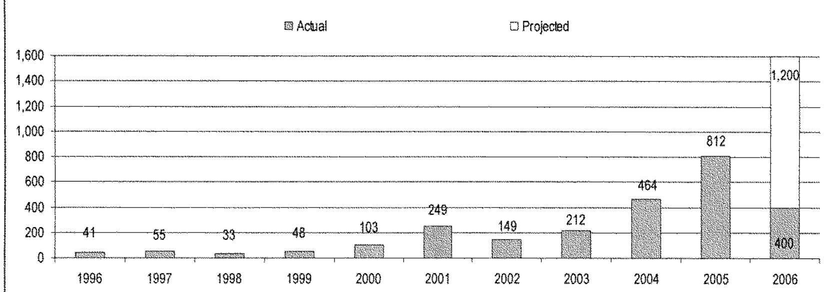
Appendix — Measuring Fraud Within the Industry

Difficulties in Measuring and Reporting Fraud

Although most information available today on mortgage fraud indicates a strong increase in the amount and complexity of fraud in the industry, there is not a clear mechanism in place today to adequately identity and track these instances.

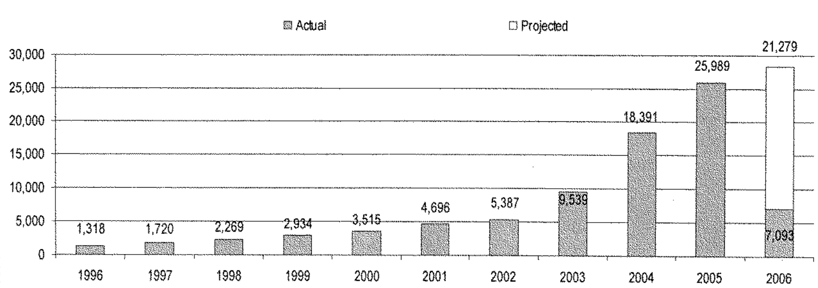
One source for this information is the US Department of the Treasury, Office of Inspector General's Financial Crimes Enforcement Network (FinCEN), which was established in 2001 to advise and make recommendations on matters relating to financial intelligence and criminal activities, including mortgage loan fraud. In the most recent Suspicious Activity Report (SAR) dated November 2006, the bureau reported a 14-fold rise in mortgage fraud-related suspicious activity reported between 1997 and 2005.[3] However, the first quarter of 2006 is the most recent data available currently.

SAR Narrative Reports of Strawbuyers in Suspected Mortgage Loan Fraud



Source: Financial Crimes Enforcement Network Regulator Policy and Programs Division: Mortgage Loan Fraud; an Industry Assessment based upon Suspicious Activity Report Analysis, November 2006.

Mortgage Loan Fraud Reporting Trend



Source: Financial Crimes Enforcement Network Regulator Policy and Programs Division: Mortgage Loan Fraud; An Industry Assessment based upon Suspicious Activity Report Analysis, November 2006.

It is important to realize that the SARa are typically only filed by federally chartered or federally insured institutions. Since the majority of the subprime mortgage loans are originated by entities that are not federally chartered or insured, the number of potential fraud instances could easily be multiplied two to three times.

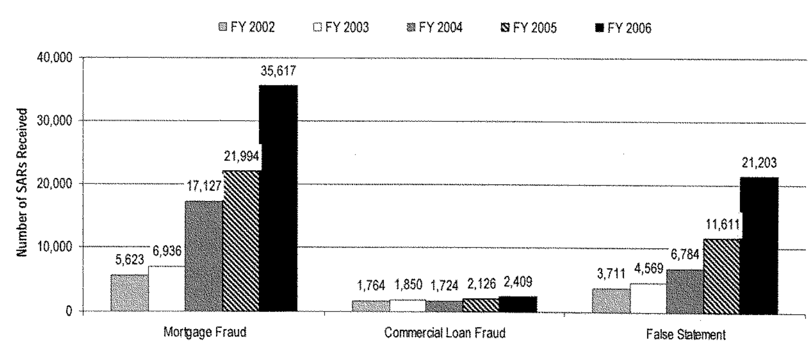
Another widely acknowledged source for mortgage fraud information, MARI provides an annual report on mortgage fraud activity. Although the MBA has access to a wider range of information from its membership, the information is provided as an index for the states and metropolitan areas, and without access to the raw data behind the indexes, comparison and trending is limited. However, MARI has indicated that its records show a 30% increase in loans with suspected mortgage fraud in 2006, with the most common type of fraud being employment history and claimed income. The report went on to show that while 55% of overall fraud incidents reported to MARI were application fraud, the percentage of subprime loans with application fraud was higher at 65%. In addition, for appraisal/valuation fraud the overall was 11%, with subprime at 14%. The report also makes a projection with regard to the cases of fraud in subprime, indicating that it will likely take three to five years to uncover most of the fraud and misrepresentation in the 2006 book of business.[4]

The FBI reports the actual number of convictions for mortgage fraud has increased 131% from 2001 to 2006. As shown in its report for 2006, the FBI investigated 818 cases and obtained 263 indictments and 204 convictions of mortgage fraud criminals. The agency also reports that in 2006, for mortgage fraud, it accomplished $388.9 million in restitutions, $1.4 million in recoveries, and $231 million in fines.[5]

However, the timing of reported fraud cases must be considered when attempting to determine the increasing trend of occurrence within the FBI numbers. While some fraud cases can be identified at the time of origination, most will not be noted until later in the servicing process. This may occur when the servicer notes a first or early payment default; a borrower cannot be contacted or traced; inspection of the property identifies vacancy, tenants, or conditions that are not as noted on the appraisal; or possibly when, during contact with the borrower or other parties in the transaction, there is an admission of misrepresentation. Also, with regard to the FBI reported convictions, it should be noted that there may be a considerable span of time from the identification and investigation phase of these cases to pending and final conviction. This delay, combined with the difficulty in identifying the vintage of loan origination, makes specific trending using this data complicated at best.

There are providers of advanced technology tools to identify fraud or misrepresentation available in the industry today. Some of these providers also report their findings in summary or on certain features of fraud. This

Number of Violations of Mortgage-Related Fraud SARs



Source: FBI Financial Crimes Report to the Public Fiscal Year 2006 information is helpful to the industry; however, the information provided by these vendors will be limited to the data provided to them from their clients. Notwithstanding this limitation, because these companies are typically actively looking for fraud in new production files, the statistics they provide may well be the most up to date information available upon which to monitor trends.

Endnotes

[1]White Paper, "Early Payment Default – Links to Fraud and Impact on Mortgage Lenders and Investment Banks," 2007 BasePoint Analytics LLC.

[2]Federal Bureau of Investigation, "Mortgage Fraud: New Partnership to Combat Problem: March 9, 2007."

[3]Mortgage Loan Fraud, An Industry Assessment based upon Suspicious Activity Report Analysis, November 2006, Financial Crimes Enforcement Network, Regulatory Polity and Programs Division, Office of Regulatory Analysis, US Department of the Treasury.

[4]Ninth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association, April 2007, Mortgage Asset Research Institute, LLC., a ChoicePoint Service.

[5]"Financial Crimes Report to the Public Fiscal Year 2006, October 1, 2005 – September 30, 2006," Federal Bureau of Investigation.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ARTURO CIFUENTES, PH.D.

Q.1. Dr. Cifuentes, in your testimony you point out that rating agencies were originally created to provide investors with information about credit risk. Later, ratings were used by regulators for a variety of other purposes including determining capital requirements and establishing investment guidelines for financial institutions.

Would you please elaborate on your view that ratings that are useful for investors may not be necessarily as useful for regulators?

A.1. A regulator is mostly concerned with the soundness (solvency) of financial institutions; to be precise, whether a financial institution has enough capital. In that sense, a regulator prefers conservative ratings (that is, ratings that err in the direction of "safety") and stability (that is, ratings that do not change frequently for nobody wants to check the solvency of an institution on a daily basis).

An investor or portfolio manager, on the contrary, benefits from accurate (that is, neither conservative not aggressive) and unbiased ratings. Moreover, to the extent that investors trade securities, they would benefit from timely changes in ratings. These objectives lend themselves to ratings that should be more "dynamic" (change more frequently).

Therefore, the needs of these two constituencies (stable versus dynamic ratings; conservative versus accurate and unbiased ratings) are not one-hundred per cent aligned.

A final observation: Some naïve commentators think that the ratings agencies secretly welcome the use of ratings by regulators because this would help the agencies to secure a reliable and steady source of revenue. Actually, the opposite is true. In fact, T. J. McGuire, a former Moody's Executive Vice President, gave a speech to the SEC in 1995 in which he expressed the view that this practice would eventually erode the integrity and objectivity of the ratings system. (See T. J. McGuire speech delivered on April, 1995 at the Fifth Annual International Institute for Securities Market Development, U.S. Securities and Exchange Commission, available from *www.Moodys.com*.)

Q.2. Dr. Cifuentes, the credit rating industry is highly concentrated with S&P and Moody's each rating more than 90 percent of rated corporate bonds. Fitch is the only other firm that has significant market share. Chairman Cox has indicated that the SEC is considering rules to require disclosure about the performance of the ratings of each rating agency.

Do you believe that disclosure of ratings performance data would help new credit rating agencies compete with more established firms?

A.2. No. I don't think so. Ratings performance data are available already and have done little to help potential new agencies to compete with the existing ones.

In my opinion, the most significant obstacles faced by a new agency are a bit different: (i) the three-year "waiting" period (essentially, they need to survive for three years while selling ratings that are not accepted by regulators: an incredibly tough barrier to entry); (ii) the fact that the existing rating agencies have not been sanctioned for their bad performance; and (iii) the fact that the new agencies do not have access to historical data (bond default frequencies, recovery values for defaulted securities, etc.) that Moody's and S&P have.

Q.3. Would this disclosure also make rating agencies more accountable to investors?

A.3. I don't believe so. Rating agencies, to the extent that they can protect themselves under the First Amendment, are accountable to nobody. And worse, whether they are accountable to investors or not, it is in a sense an academic issue: being approved by the SEC is the only thing that matters.

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

AS HOUSING BOOMED, MOODY'S OPENED UP

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By AARON LUCCHETTI

Bond-rating agency Moody's Investors Service used to be an ivory tower of finance. Analysts were discouraged from having a drink with a client. Phone calls from bankers went unanswered if they rang during intense, almost academic debates about credit ratings.

A decade ago, as the housing market was just beginning to take off, Moody's was a small player in analyzing complex securities based on home mortgages. Then, Moody's joined Wall Street and many investors in partaking of the punch bowl.

A firm once known for a bookish culture began to focus on the market share that affected its own revenue and profit. The rating firm became willing, on occasion, to switch analysts if clients complained. An executive overseeing mortgage ratings went skydiving with a client. By the height of the mortgage-securities frenzy in 2006, Moody's had pulled even with its largest competitor, rating nine out of every 10 dollars raised in these instruments. It gave many of the bonds its coveted triple-A rating.

Profits at the 99-year-old firm, which John Moody started to rate railroad bonds, rose 375 percent in six years. The share price quintupled.

Now, Moody's and the other two major rating firms, the Standard & Poor's unit of McGraw-Hill Cos. and the Fitch Ratings unit of Fimalac SA, are under fire for putting top ratings on securities that ultimately collapsed in value. Investors, many of whom relied on ratings to signal which securities were safe to buy, have lost more than $100 billion in market value. The credibility of the ratings system is in tatters as new downgrades of mortgage securities come almost weekly. Investigators from Congress, the Securities and Exchange Commission and several state attorneys general are examining the rating firms' practices.

Moody's acknowledges it sometimes got things wrong in judging mortgage bonds, but says these were honest mistakes and not the result of efforts to garner market share. It says it has maintained its rigor and objectivity in a rating process that is still adversarial toward big investment banks.

Of the three big rating agencies, Moody's underwent the deepest cultural change amid the housing boom. At the heart of the firm's gradual transformation into a player in the mortgage game was Brian Clarkson, 51 years old, who joined the company as an analyst in 1991 and became president last August. Mr. Clarkson maintains that his focus on making Moody's friendlier to Wall Street was what the company needed early this decade. "We're in a service business," he says. "I don't apologize for that."

When Mr. Clarkson first joined Moody's, the agency was known as a place where analysts often didn't even promptly pick up their phones, much less talk extensively to companies whose bonds they were rating. A magazine story in the mid '90s attempted to answer the question "Why Everyone Hates Moody's."

Mr. Clarkson himself had dealt with Moody's as an outsider, and been frustrated with its manner. As he began to rise within the firm, he set out to make it more client-friendly and focused on market share. Firms like Moody's are hired by companies, governments and other organizations that seek to sell bonds. The firms rate bonds based on the likelihood they'll default and, in Moody's case, also based on how much of their principal bondholders are likely to get back.

Top-rated triple-A bonds rarely miss payments, and even if they do, investors can expect to get nearly all of their money back. Bonds rated B and C are more likely to lose money for their owners. To compensate for the added risk, they pay higher interest rates. Bond buyers depend heavily on the ratings, and conservative investors often buy only triple-A bonds.

Bond issuers, knowing that a higher rating means they pay a lower interest rate, have an incentive to shop around among rating agencies. And they have clout as they shop: They're the ones paying the bill. Moody's toughness gave issuers reason to go elsewhere, and back in the mid-1990s, Fitch and S&P were both rating more mortgage bonds than Moody's, in large part because their standards were considered easier. For instance, in commercial mortgage-backed securities, Moody's trailed its two main competitors by 30 percentage points in market coverage in 1996.

That year, Mr. Clarkson took over the group at Moody's that analyzed such securities. The firm added new analysts and overhauled its ratings approach, allowing for higher ratings in the area. Within a year, Moody's moved ahead of both Fitch and S&P in the sector. Rivals said Moody's had cut its standards. Mr. Clarkson was quoted as calling this "sour grapes." He says now that the change in the ratings approach was the right call.

In 1999 Mr. Clarkson took over the part of the firm's "structured finance" business that oversaw bonds and complex securities based on home mortgages. Moody's rated just 14 percent of high-quality "prime" bonds in that area in the year before he took over, compared with 51 percent that Fitch rated and 89 percent that S&P rated, as calculated by the publication Asset-Backed Alert. (The same bond often gets a rating from two different firms.)

Moody's top home-mortgage analyst at the time, Mark Adelson, took a cautious approach that resulted in fewer triple-A ratings. Mr. Clarkson shook things up, firing or reassigning about two dozen analysts and hiring new ones who started giving higher grades under a new methodology. Mr. Adelson left for an investment bank. In 2001, Moody's market coverage was up to 64 percent. Mr. Adelson says "the world thought differently than I did" about mortgage bonds in 1998 and 1999. He isn't critical of Mr. Clarkson's management. Mr. Clarkson "is what Moody's needs," Mr. Adelson says. "He's very smart, capable and driven."

By 2001, Moody's was an independent company. It had long been tucked inside financial publisher Dun & Bradstreet Corp., but D&B spun it off as a new public company in 2000. Just before it did so, Warren Buffett saw the growth and profitability of Moody's business and had his Berkshire Hathaway Inc. raise its stake in D&B. Berkshire is now Moody's biggest shareholder, with a 19 percent interest. In some areas, Moody's continued to make it hard to get a high rating, with the result that it didn't do much business in those areas; these areas included the riskier part of home-mortgage bonds and products known as net-interest margin securities.

Mr. Clarkson encouraged his people to be more responsive picking up the phone when in the office and to find ways deals could get done within Moody's methodologies. Customer-service coaches gave sessions on improving relationships with bond issuers and investors.

"Brian (Clarkson) created a dialogue between Moody's and the Street that was good," says Paul Stevenson, a former Moody's executive who now works at BMO Financial Group. But "the most recent problem," he says, "is that the rating process became a negotiation."

Consider a Bank of America mortgage deal in early 2001. As in most such deals, the vast majority of the securities based on the pool of mortgages would be rated triple-A. The question was how big a chunk would be rated lower paying a higher interest rate and bearing the brunt of any defaults that occurred.

A rating committee at Moody's voted to require that the issuer put about 4.25 percent of the deal's value in the lower-rated section, to provide extra protection for buyers of the top-rated section. But after Bank of America complained and said it might go with a different rating firm, Moody's reduced the size of the lower-rated chunk slightly saving the issuer some interest costs according to people with knowledge of the matter.

Linda Stesney, a Moody's managing director who was then co-head of mortgage-backed securities, says she doesn't recall the deal. She says Moody's reconsidered its view on deals when issuers presented new information affecting credit quality. She adds that Moody's mortgage ratings at the time held up well.

In 2002, Mr. Clarkson's realm extended to the fast-growing business of CDOs. In this complex product, already-sliced-up bonds are further sliced into new pieces, based on risk and potential return. Moody's was already rating 90 percent of the dollar value of CDOs. Mr. Clarkson told an analyst he didn't want bad service to cause that to slip, say people familiar with the matter.

"There was never an explicit directive to subordinate rating quality to market share," says Mark Froeba, a former Moody's analyst who recently started a bond valuation company that may compete with rating firms.

"There was, rather, a palpable erosion of institutional support for rating analysis that threatened market share." An example would be raising too many legal issues on deals, slowing them down unnecessarily.

Mr. Clarkson says the goal was maintaining consistency about the issues Moody's raised on deals. "I have no problem losing deals for the right reasons," he says. "We don't change methodology to garner market share."

Some supporters say that while Mr. Clarkson cared about market share, he cared more about the quality of Moody's ratings. Bill May, a Moody's managing director, recalls Mr. Clarkson warning him in 2002 about the things that could get a managing director fired. He says inaccurate ratings topped the list, followed by "arrogant or rude" behavior toward market participants.

On occasion, Moody's agreed to switch analysts on deals after bankers complained. Among banks that requested that a different analyst look at their deals were Credit Suisse Group, UBS AG and Goldman Sachs Group Inc., according to a person familiar with the matter. The banks declined to comment. Mr. May says analysts were switched on "rare" occasions to accommodate such a request.

Mr. Clarkson stressed relationships, in a break with tradition at the firm, whose office in Lower Manhattan is adorned with sepia-toned pictures of its founder. John Bohn, Moody's president from 1989 to 1996, says he used to tell recruits that Moody's was a "special business" where "you can't go out for beers" with friends who worked for investment banks.

Mr. Clarkson's view is that "it's important to socialize." The onetime mountain climber and recreational weightlifter met with investment-bank officials and gave speeches at industry conferences peppered with movie quotes and references to television shows like "Survivor."

When Moody's sought to rate more deals for GMAC's residential-finance unit in the late 1990s, Moody's officials traveled to the company's Minneapolis offices several times. Mr. Clarkson and several others from Moody's accepted an invitation to go skydiving with officials of the GMAC unit. "We paid our own way," Mr. Clarkson recalls.

Some analysts say they occasionally would attend the dinners that celebrated the launch of a new CDO Moody's had just rated. Moody's says it has rules to prevent conflicts, including a $50 limit on gifts, and that building better relationships with Wall Street officials was part of its effort to be more transparent in its rating methodologies.

As Moody's staff grew to accommodate the surging mortgage market, Mr. Clarkson arranged off-site meetings for employees to get to know each other better. At one, he sung as a Blues Brother, while at another, two Moody's executives entertained by wrestling in fat suits.

Mr. Clarkson's structured-finance group grew to account for about 43 percent of Moody's revenue in 2006, up from 28 percent in 1998. By 2006, the firm had more revenue from structured finance $881 million than its entire revenue had been in 2001.

Employees, though paid a fraction of what they could earn on Wall Street, sometimes grew wealthy from Moody's surging share price and their stock options. According to a regulatory filing, Mr. Clarkson's compensation totaled $3.8 million in 2006. The firm's chief executive, Raymond McDaniel, earned $8.2 million that year, more than twice what his predecessor made in 2000. Moody's says the rise in their compensation reflected growth in the overall business, not just the mortgage area, and that much of the rise came from the increasing value of stock options that had been granted years before.

By early 2007, some Moody's analysts were growing worried about the market for securities backed by subprime mortgages. But Mr. McDaniel told a group of investors in May 2007: "The good-news story for us" includes "very strong growth coming out of our largest business, which is the structured-finance business. It is both large and a significant growth engine for the company."

Despite some analysts' concerns, Moody's rated about 94 percent of the $190 billion in mortgage-related and other structured-finance CDOs issued in 2007, the second busiest year ever. Many of those CDOs have since been downgraded, some from triple-A to levels that suggest investors will have significant losses. Moody's says some bonds it rated were backed by fraudulent loans. It also notes that it wasn't alone in being surprised by the depth of the housing decline. "We were preparing for a rainstorm and it was a tsunami," Mr. Clarkson says.

Since becoming Moody's president in August, he is spending up to half of some weeks dealing with regulators. "They want the same things we do," he says. Some options that Moody's is considering to improve its process such as adding new labels to structured-finance ratings to convey the products' unique attributes and risks were earlier raised by regulators.

Mr. Clarkson says analysts have kept their "adversarial" approach, but adds, "One of the things we have to do going forward is be more skeptical."