CREDIT RATING AGENCIES AND THE NEXT FINANCIAL CRISIS

HEARING

BEFORE THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

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CREDIT RATING AGENCIES AND THE NEXT FINANCIAL CRISIS

WEDNESDAY, SEPTEMBER 30, 2009

HOUSE OF REPRESENTATIVES,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The committee met, pursuant to notice, at 10:01 a.m. in room 2154, Rayburn House Office Building, Hon. Edolphus Towns (chairman of the committee) presiding.

Present: Representatives Towns, Issa, Chaffetz, Clay, Connolly, Cuellar, Cummings, Foster, Jordan, Kanjorski, Kaptur, Kucinich, Luetkemeyer, Lynch, McHenry, Mica, Murphy, Norton, Quigley, Souder, Speier, Tierney, and Welch.

Staff present: John Arlington, chief counsel—investigations; Brian Eiler and Neema Guliani, investigative counsels; Linda Good, deputy chief clerk; Jean Gosa, clerk; Katherine Graham, investigator; Adam Hodge, deputy press secretary; Carla Hultberg, chief clerk; Phyllis Love, Ryshelle McCadney, and Alex Wolf, professional staff members; Mike McCarthy, deputy staff director; Ophelia Rivas, assistant clerk; Jenny Rosenberg, director of communications; Ron Stroman, staff director; Lawrence Brady, minority staff director; Rob Borden, minority general counsel; Jennifer Safavian, minority chief counsel for oversight and investigations; Frederick Hill, minority director of communications; Adam Fromm, minority chief clerk and Member liaison; Kurt Bardella, minority press secretary; Benjamin Cole, minority deputy press secretary; Christopher Hixon, minority senior counsel; Brien Beattie, minority professional staff member.

Chairman TOWNS. The committee will come to order.

Today, the committee continues its investigation of the credit rating agencies, companies at the heart of the last financial collapse, companies that will be at the heart of the next financial collapse.

The average American has probably never heard of credit rating agencies, but these companies play a powerful role in our economy and they played a starring role in the collapse of the financial system last year.

The main mission of credit rating agencies is to tell investors how risky bonds and other debt securities are. Pension plans, banks, insurance companies, and other investors depend on these ratings to help them decide where to invest their funds.

Unfortunately, for the past decade, the credit rating system has not worked well at all. A year ago, this committee learned that ratings did not capture the true risk of many deals because the rating agencies were more concerned with their own bottom line than anything else.

As one rating agency official said in an internal e-mail, “We rate every deal. It could be structured by a group of cows and we would rate it.” The result was a marketplace flooded with toxic debt, so-called structured securities, such as CDOs and other complicated securitizations backed by risk mortgages and propped up by inflated ratings.

More and more money was funneled into bonds and other debts that were destined to fail. Predatory lending flourished, which families got in over their heads buying houses they could not afford. Investors were left holding bonds and other securities that were dramatically over-valued. When the housing bubble finally burst, we wound up in the deepest recession since the Great Depression. A year after the collapse of Lehman Brothers and the massive government bailout of AIG, Bank of America and others, it looks like not much has really changed.

Today, we will hear testimony from Eric Kolchinsky, until recently an insider at Moody’s, one of the largest credit rating agencies. We have obtained a memo written by Mr. Kolchinsky to his superiors at Moody’s detailing very serious allegations about Moody’s rating practices. If true, these allegations indicate troubling behavior in the credit rating industry. According to Mr. Kolchinsky, they continue to use inaccurate and outdated models. They continue to have conflicts of interest, and they continue to rate novel securities with little historical data that no one really understands.

He was not alone in having concerns about the new way Moody’s operates. We will also have testimony from Mr. Scott McCleskey who was senior vice president of compliance at Moody’s, until he rocked the boat too hard. Mr. McCleskey’s job was to ensure compliance with SEC regulations and other requirements. In theory, he was a senior executive with important responsibilities. In practice, he got the old mushroom treatment: keep him in the dark and bury him in fertilizer.

In short, it looks like not much has changed since the crash of 2008. We ignore this situation at our peril. In the next financial crisis, will the credit rating agencies be part of the problem or part of the solution?

Both the House and the Senate are drafting legislation to rein in these types of abusive practices by credit rating agencies. Our second panel of witnesses will provide suggestions on how to accomplish this.

One other note, I would particularly like to thank my good friend, Senator Alfonse D’Amato, the former chairman of the Senate Banking Committee, for being here today as well; also Floyd Adams, another well known and highly regarded New Yorker.

And let me conclude by saying I look forward to hearing from the witnesses.

At this time, I yield to the gentleman from California, Congressman Issa, the ranking member of this committee.

[The prepared statement of Chairman Edolphus Towns follows:]

OPENING STATEMENT

CHAIRMAN EDOLPHUS TOWNS

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HEARING: CREDIT RATING AGENCIES AND THE NEXT FINANCIAL CRISIS

September 30, 2009

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Today, the Committee continues its investigation of credit rating agencies—companies at the heart of the last financial collapse. Companies that will be at the heart of the next financial collapse.

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But these companies play a powerful role in our economy. And they played a starring role in the collapse of the financial system last year.

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Unfortunately, for the past decade, the credit rating system has not worked well at all. A year ago this committee learned that ratings did not capture the true risk of many deals, because the rating agencies were more concerned with their own bottom lines.

As one ratings agency official said in an internal email, "We rate every deal. It could be structured by cows, and we would rate it."

The result was a marketplace flooded with toxic debt: so-called "structured securities" such as CDO's and other complicated securitizations, backed by risky mortgages, and propped up by inflated ratings.

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Today we will hear testimony from Mr. Eric Kolchinsky, until recently, an insider at Moody's, one of the largest credit rating agencies.

We have obtained a memo written by Mr. Kolchinsky to his superiors at Moody's detailing very serious allegations about Moody's rating practices.

If true, these allegations indicate troubling behavior in the credit rating industry. According to Mr. Kolchinsky, they continue to use inaccurate and outdated models; they continue to have conflicts of interest; and they continue to rate novel securities with little historical data, that no one really understands.

He was not alone in having concerns about the way Moody's operates. We will also have testimony from Mr. Scott McCleskey, who was Senior Vice President for Compliance at Moody's – until he rocked the boat too hard.

Mr. McCleskey's job was to ensure compliance with SEC regulations and other requirements. In theory he was a senior executive with important responsibilities. In practice, he got the old mushroom treatment: keep him in the dark and bury him in fertilizer. In short, it looks like not much has changed since the Crash of 2008.

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One other note: I would particularly like to thank my good friend Senator Al D'Amato, the former Chairman of the Senate Banking Committee, for being here today. Also, Floyd Abrams, another well known and highly regarded New Yorker.

With that, I look forward to the testimony today.

# # #

Mr. ISSA. Thank you, Mr. Chairman, and thank you for holding this hearing today.

I strongly suspect that the gentleman from Pennsylvania to my left, Mr. Kanjorski, would rightfully so say, aren't we coming dreadfully close to overstepping the bounds of this committee and going into the territory well held by the Financial Services Committee.

And I would agree with him up to a point. I would differ with him in one sense. Although the oversight of this party of the financial community clearly belongs to the Financial Services Committee, as does the SEC, transparency in government and transparency for the people who live under that government clearly falls within the jurisdiction of this committee.

So as we review the failures in the financial crisis, I would say to my friend, the gentleman from New York, that in fact this committee must look beyond the failures of the private sector in this case, look to the public sector which we have direct jurisdiction over, and essentially we have the power today, which we didn't have back in the 1930's when the New Deal came about and in the Depression, post-collapse era, the Federal Government began outsourcing the oversight and regulation and rating of credit instruments.

Today, we have technology like XBRL and other standards which we, the Federal Government, can insist allow for full transparency, not by the select few that we dribble and drabble out the ability to rate for pay, but in fact we have the ability today to insist that every instrument made available to the American people can be transparent to the American people directly.

We have the ability that instead of standing in line at your broker, you can go online and look at every element of that. That allows, of course, not every private citizen to necessarily do his own analysis. They don't do that on every stock or mutual fund. But it does allow literally thousands of educated people to scrutinize credit products and, on a continuous basis, evaluate the underlying risk that happens.

In my own State of California, it is very clear, if you bought a bond 2 years ago, it is not the same bond it was today. You shouldn't have to wait for a credit agency to tell you California is in a financial meltdown in order to see a daily change. And you shouldn't have to do it if it is G.E. paper or anyone else's.

So I would hope to work with the chairman in insisting on a real change in reporting, one that eliminates these credit agencies as monopolies, duopolies, triopolies or whatever a quadopoly is, and in fact opens it up to all the people of America.

Additionally, as I said, this committee has broad jurisdiction, and I would hope that as the chairman said this morning on CNBC, we would use it. I cannot agree more with the chairman for what he said today. He said, "People are now suffering." But Mr. Chairman, why are they suffering? When you said we are going to look at the whole financial meltdown across the board, why is it we left Freddie and Fannie out? Why is it Franklin Raines, who apparently committed perjury before this committee, has not been brought back before this committee or referred for prosecution?

Why is it that in fact Bank of America still holds vital documents showing 28,000 loans, mixed in with them are hundreds or thousands of loans to government officials throughout the country, from the top to the bottom, from Republican to Democrat to Independent, who were clearly given what amounts to a bribe of government by a man who was brought before this committee because he made too much money while Countrywide stock was dropping, but has not been brought before this committee once we discovered that the Friends of Angelo Program in fact was designed to influence Members of Congress, key staff, and people throughout the government.

That is not a small scandal. That is the crux of this scandal. If the trillions of dollars that the American people are on the hook for at Freddie and Fannie as GSEs are in fact because Countrywide had a cozy relationship bought and paid for that allowed them to unload not all, but much of these bad debts, and in fact allowed for the promotion of subprime and other risky instruments, then in fact, Mr. Chairman, that is the heart of the financial meltdown.

The financial meltdown is not about the failure of the SEC. It is not even about Bernie Madoff and the billions that in fact he did opaquely without proper supervision. That is important and we need to deal with it, along with the Financial Services Committee. But the very underpinnings of good government require that government officials when they take an oath to their city, their State or our country, in fact operate without an agenda bought and paid for by public or private money. It is clear that is not the case here. It is clear that the distortions in the market go back years and they go back to government officials, quasi-government officials and private sector, including obviously the Friends of Angelo Program.

So Mr. Chairman, I challenge you today either to issue a subpoena to Bank of America to get those records, or allow this committee to have an open vote so the people of America can understand that in fact this is an important issue. It is not a side issue. It is at the crux of this very investigation.

And I might note that when we began looking at this problem, when we had Angelo Mozilo in front of us, there were tapes, digital copies of every single conversation between Members of Congress, members of the administration, postal workers, Freddie and Fannie, even Franklin Raines that were held so we could hear them. Today, I am told they may have been destroyed. When I hear they may have been destroyed, I realize we have been lax in our duties. That chair was held by Mr. Waxman and we had a crook in front of us that Mr. Waxman called a crook, said in fact that he was hurting the American people. Now we know in fact he bought and paid for what hurt the American people.

Mr. Chairman, I call on you today to issue that subpoena. It is that important that I bring it up at this hearing, and I call for you, if you cannot do it, to step aside and allow the committee to have a vote.

And I yield back.

Chairman TOWNS. Let me just respond to the gentleman. I see he is sort of worked up over that issue.

Mr. ISSA. Yes, Mr. Chairman, I am worked up because we need to protect the American people. We won't do it if we don't investigate this corruption.

Chairman TOWNS. Let me respond to you by saying, No. 1, the Justice Department is looking at it.

Mr. ISSA. Mr. Chairman, that is what the chairman of this committee said previously as an excuse. It turns out they didn't. It turns out the Senate Ethics Committee has failed to act and said in fact there was no ethical violation. We are beyond ethics here. We are at a point where the American people at least should know who they gave money to or benefit to, how they did it, and so on.

We have ignored that paper. I have never seen this committee refuse to at least ask to see documents before deciding to ignore them.

Chairman TOWNS. Before we go to our witness, let me just say to you that I did not say the Senate Ethics Committee was looking at it. I said the Justice Department. As you know, there is a difference.

Mr. ISSA. Mr. Chairman, if the Justice Department had subpoenaed the audiotapes, they would have them. They didn't. It appears as though Bank of America allowed them to become destroyed or they were destroyed in the last days of Countrywide. But more important, those documents, as we have been told, have not, in fact, been subpoenaed. The Justice Department does not have the boxes of documents that Bank of America has gathered, but will not turn over without a subpoena for reasons of privacy.

If you tell me today you are referring it, because you have enough information, to the Justice Department for prosecution or investigation, fine. But today, we don't know what we don't know. What we do know is there is a level of intended corruption by Countrywide that clearly had an effect on government decisions for years, and we are ignoring it.

We cannot really understand the failure of government if we don't understand the failure of government officials led by, in fact, an attempt to bribe them.

Chairman TOWNS. The gentleman's time has expired.

Mr. ISSA. Thank you, Mr. Chairman.

[The prepared statement of Hon. Darrell E. Issa follows:]

EDOLPHUS TOWNS, NEW YORK
CHAIRMAN

DARRELL E. ISSA, CALIFORNIA
RANKING MINORITY MEMBER

ONE HUNDRED ELEVENTH CONGRESS

Congress of the United States

House of Representatives

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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Statement of Rep. Darrell Issa, Ranking Member

Credit Rating Agencies and the Next Financial Crisis

September, 24 2009

Mr. Chairman, thank you for holding this important hearing on role of the credit rating agencies in the financial crisis.

Risky subprime mortgages were packaged into mortgage-backed securities and CDOs by lenders and investment banks and sold to investors. A crucial step in the process of creating these toxic assets was for the party putting the deal together to obtain a credit rating on the proposed bond from one of the Big Three credit rating agencies -- Moody's, S&P and Fitch.

As we now know, the rating agencies were overly optimistic in their ratings. By September 2008, Moody's and S&P alone had downgraded over 75% of the AAA-rated CDOs issued since 2006. These massive downgrades accelerated the turmoil in financial markets, spooking investors and forcing collateral calls that increased the pressure on firms like AIG.

I dare say most Members in this body think the current system is broken, but there are two competing approaches to reform. Many of my friends on the other side of the aisle advocate what I would call a "tinkering" approach. The Obama Administration and various Members of Congress advocate tinkering with the existing regulations, doing things like getting the SEC more heavily involved in the credit rating process.

Two thoughts come to mind about this tinkering approach. First, I would point out that the SEC is the same agency that missed the Madoff scandal, the biggest Ponzi scheme in the history of the world. Second, we ought to consider that the financial crisis originated in perhaps the most heavily regulated sector of the economy. Tinkering with the existing regulations will not achieve the kind of fundamental reform we need.

I would like to propose an alternative approach to this problem, which is to throw open the windows and let the fresh air of competition transform the rating agency business for the first time since the New Deal. Back in the 1930s, the federal government began outsourcing its regulatory responsibilities to these three companies and requiring every investor in the marketplace to use their ratings in order to satisfy their regulatory capital requirements. Federal and state regulators essentially handed the Big Three credit rating agencies a protected oligopoly status and granted their ratings the force of law, requiring investors to use their product and no one else's. Is it any wonder the Big Three credit rating agencies got lazy and allowed their rating procedures to become outdated or corrupted?

We ought to be encouraging the application of 21st century solutions to the problem of evaluating credit risk and this can best be achieved by opening up this market to new and innovative players. Combined with real transparency reforms such as implementing XBRL reporting, we can achieve a new standard for transparency and accountability. That won't happen if we just tinker at the margins by adding new regulations like the Administration has proposed. We need a bold new approach and I would like to work with the Chairman and my colleagues to make that happen.

Thank you Mr. Chairman.

Chairman TOWNS. Let's move forward.

We will now turn to our first panel of witnesses. It is committee policy that all witnesses are sworn in, so please stand and raise your right hands as I administer the oath.

[Witnesses sworn.]

Chairman TOWNS. You may be seated. Let the record reflect that they answered in the affirmative.

Mr. Eric Kolchinsky is a former managing director at Moody's Corp. He has worked in structured finance for over 12 years, 8 of which were at Moody's. While at the rating agency, Mr. Kolchinsky focused on rating collateral debt obligations [CDOs]. He has also worked at Lehman Brothers, Merrill Lynch and MBIA in the CDO groups.

We welcome you this morning.

We would also like to introduce Mr. Scott McCleskey. He was a senior vice president for compliance at Moody's Investors Service from April 2006 until September 2008. In this role, he was responsible for the organization's compliance with rules and regulations established by the SEC and other regulators. Prior to joining Moody's, Mr. McCleskey spent approximately 15 years in the financial services industry in both compliance and regulatory positions in the United States and in the European Union.

Mr. McCleskey is currently managing editor for a firm providing news analysis and compliance solutions for the financial industry.

We welcome you as well.

Mr. Richard Cantor serves as the chief risk officer for Moody's Corp., and as the chief credit officer for Moody's Investors Service. In his role as chief credit officer, Mr. Cantor heads the Credit Policy Group and chairs the Credit Policy Committee, both of which are responsible for the review and approval of rating methodologies.

Mr. Cantor's Policy Group also works with the rating group at Moody's to promote consistent rating practices and improved rating quality.

Let me welcome you as well.

At this time, I ask that each witness deliver their testimony within 5 minutes. The yellow light means you have 1 minute remaining, and the red light means stop. Everywhere in America red light means stop.

And then, of course, we will have time to raise questions with you and seek the answers.

So we would like to start with you, Mr. Kolchinsky, and then come right down the line.

STATEMENTS OF ILYA ERIC KOLCHINSKY, FORMER MANAGING DIRECTOR, MOODY'S INVESTORS SERVICE; SCOTT MCCLESKEY, FORMER SENIOR VICE PRESIDENT FOR COMPLIANCE, MOODY'S CORP.; AND RICHARD CANTOR, CHIEF RISK OFFICER, MOODY'S CORP., AND CHIEF CREDIT OFFICER, MOODY'S INVESTORS SERVICE

STATEMENT OF ILYA ERIC KOLCHINSKY

Mr. KOLCHINSKY. Good morning. I want to thank Chairman Towns, Ranking Member Issa and all the members of the committee for giving me an opportunity to speak this morning.

My name is Eric Kolchinsky and during the majority of 2007, I was the managing director in charge of the business line which rated subprime-backed CDOs for Moody's Investors Service. More recently, I was suspended by Moody's as a result of a warning I sent to the compliance group regarding what I believed to be a violation of securities laws within the rating agency.

I am grateful for the opportunity to speak in front of you on the need of rating agency and financial markets reform. Despite the circumstances of my separation, I still believe that Moody's is a good company and the vast majority of analysts there are smart, capable, and want to do a good job of rating financial products.

Unfortunately, these ingredients are not sufficient to produce quality ratings or to safeguard the financial system. While I do not believe that the rating agencies were the main cause of the credit crisis, there are other parties that were far more responsible, there are still unresolved problems which will lead to poor ratings performance.

No. 1, conflicts of interest. The conflicts of interest which ail the rating industry remain unmanaged. Senior management still favors revenue generation over ratings quality and is willing to dismiss or silence those employees who disagree with these unwritten policies.

No. 2, Credit Policy Group lacks independence. The Credit Policy Group is a team of analysts whose role is to ensure that the methodologies and procedures used in the ratings process are sound and meet minimum credit standards. Unfortunately, the Credit Policy Group at Moody's remains weak and short-staffed. The group's analysts get routinely bullied by business line managers and their decisions are overridden in the name of generating revenue.

Inadequate methodologies. Methodologies produced by Moody's for rating structure finance securities are inadequate and do not realistically reflect the underlying credits. Rating models are put together in a haphazard fashion and not validated if doing so would jeopardize revenues.

Compliance Group lacks independence. The Compliance Group is entrusted with enforcing laws and internal policies. The group is understaffed and has little professional compliance experience. Instead of ensuring that the ratings process is free from conflict, this group sits idly by while these transgressions occur.

In many ways, the incentives for rating agencies have become worse since the credit crisis. There are more rating agencies and they are all chasing significantly fewer transaction dollars. The new controls put in place by regulators are too weak to significantly alter this dynamic.

As an example of how little things have changed, ABS CDOs are being rated once again. These are the same products which are responsible for hundreds of billions of dollars of losses at major financial institutions. They are significant contributors to the problems at CitiBank, Merrill Lynch, and AIG. I firmly believe that ABS CDOs cannot be rated with any certainty and especially not during this volatile period in the capital markets.

The new methodologies used to rate ABS CDOs have not improved their poor credit performance. Many of the recent deals have been downgraded or have had to resort to restructuring to maintain their ratings. This toxic product needs to be consigned to the dustbin of bad ideas, but unfortunately there are no incentives for rating agencies to say no to a product no matter how poorly thought through.

Investors like pension funds, insurance companies, and the Federal Reserve who are required to purchase securities with certain ratings deserve better than this. They need ratings which reflect an analyst's best judgment and not the profit targets of the agency.

However, I believe there is a very simple and straightforward solution for the ills which haunt the ratings industry. It begins with the admission that the function which their agencies perform is quasi-regulatory. Fortunately, a model already exists which combines quasi-regulatory authority with private competition. It is the accounting industry.

While accountants have not been free from scandal, the profession has not suffered the free-falling standards which have befallen the ratings industry. The key limitation has been the existence of a single set of standard methodologies which all accountants need to abide by, for example, GAAP.

While CPAs are free to compete on price and service, they cannot change much the definition of revenue or loss. A single set of standards makes a lot of sense from a market and a regulatory point of view. It is much easier for regulators to learn to pass judgment on a single set of policies, rather than understanding the minutiae in the particulars of multiple approaches. The same benefit applies to investors. A single set of criteria which is debated and promulgated in a public manner will greatly add to the cause of transparencies.

I have witnessed too many instances of rating agencies talking their way out of a poor decision by confusing the listener with esoteric details of their particular methodology.

If I were a doctor, I would diagnose the rating agency patient as very curable. But treatment needs to be urgently applied to avoid further damage. Rating agencies can once again be productive members of the financial community, but they cannot do this by themselves. They need a helping hand to get back on the right track.

Thank you very much.

[The prepared statement of Mr. Kolchinsky follows:]

TESTIMONY of
ERIC KOLCHINSKY

Good morning.

I want to thank Chairman Towns, Ranking Member Issa and all the members of the committee for giving me an opportunity to speak this morning.

My name is Eric Kolchinsky, and during the majority of 2007, I was the Managing Director in charge of the business line which rated sub-prime backed CDOs at Moody's Investors Service. More recently, I was suspended by Moody's as a result of a warning I sent to the compliance group regarding what I believed to be a violation of securities laws within the rating agency.

I am grateful for the opportunity to speak in front of you on the need for rating agency and financial markets reform. Despite the circumstances of my separation, I still believe that Moody's is a good company and the vast majority of analysts there are smart, capable and want to do a good job of analyzing financial products.

Unfortunately, these ingredients are not sufficient to produce quality ratings or to safeguard the financial system. While I do not believe that the rating agencies were the main cause of the credit crisis (there are other parties who were far more responsible), there are still unresolved problems which will lead to continuing poor ratings performance:

1. Conflicts of Interest. The conflicts of interest which ail the ratings industry remain unmanaged. Senior management still favors revenue generation over ratings quality and is willing to dismiss or silence those employees who disagree with these unwritten policies.

2. Credit Policy Group Lacks Independence. The Credit Policy Group is a team of analysts whose role is to ensure that the methodologies and procedures used in the rating process are sound and meet minimum credit standards. Unfortunately, the Credit Policy Group at Moody's remains weak and short staffed. The group's analysts get routinely bullied by business-line managers and their decisions are over-ridden in the name of generating revenue.

3. Inadequate Methodologies. Methodologies produced by Moody's for rating structured finance securities are inadequate and do not realistically reflect the underlying credits. Rating models are put together in a hap-hazard fashion and are not validated if doing so would jeopardize revenues.

4. Compliance Group Lacks Independence. The Compliance Group is entrusted with enforcing laws and internal policies. The group is understaffed and has little professional compliance experience. Instead of ensuring that the ratings process is free from conflict this group sits idly by while these transgressions occur.

In many ways the incentives for rating agencies have become worse since the credit crisis. There are now more rating agencies and they are all chasing significantly fewer transaction dollars. The new controls put in place by regulators are too weak to significantly alter this dynamic.

As an example of how little things have changed, ABS CDOs are being rated once again. These are the same products which are responsible for hundreds of billions of dollars of losses at major financial institutions. They were significant contributors to the problems at Citibank, Merrill Lynch and AIG. While the CDOs held by there institutions had the highest ratings possible, they still ended up being nearly worthless. I firmly believe that ABS CDOs cannot be rated with any certainty and especially not during this volatile period in the capital markets.

The "new" methodologies used to rate ABS CDOs have not improved their poor credit performance – many of the recent deals have been downgraded or have had to resort to restructuring to maintain their ratings. This toxic product needs to be consigned to the dustbin of bad ideas, but unfortunately, there are still no incentives for rating agencies to say "No" to a product no matter how poorly thought through.

Investors, like pension funds, insurance companies and the Federal Reserve, who are required to purchase securities with certain ratings deserve better than this. They need ratings which reflect an analyst's best judgment and not the profit targets of the agency.

However, I believe that there is a very simple and straight forward solution for the ills which haunt the ratings industry. It begins with the admission that the function which the agencies perform is quasi-regulatory. Bank capital requirements and mutual fund holdings are just a few of the areas where regulators rely on ratings. Additionally, there is also a consensus that robust competition is needed in the industry.

Fortunately, a model already exists which combines quasi-regulatory authority with private competition – it is the accounting industry. While accountants have not been free from scandal, the profession has not suffered the free-fall in standards which have befallen the ratings industry. The key limitation has been the existence of a single set of standards or methodologies which all accountants need to abide by (e.g. GAAP). While CPAs are free to compete on price and service, they cannot change much the definition of revenue or loss.

A single set of standards makes a lot of sense from a market and a regulatory point of view. It is much easier for regulators to learn and to pass judgment on a single set of policies, rather than understanding the minutia and the particulars of multiple approaches. The same benefit applies to investors – a single set of criteria which is debated and promulgated in a public manner will greatly add to the cause of transparency. I have witnessed too many instances of rating agencies talking their way out of a poor decision by confusing the listener by with esoteric details of their particular methodology.

I suggest that an independent body set public standards for "regulatory ratings". The agencies would still be free to publish their own ratings, but would have to follow the public standards for any rating used in a regulatory manner. This body, based on FASB, could start with simple things like the definition of the term "AAA". The term is used extensively in regulations and by market participants and yet it has very different, but specific definitions at every rating agency. It makes no sense to use AAA interchangeably if the meanings are completely different. The public body could also determine what kinds of products are "rate-able" and what kind of information is required of issuers for rating purposes.

If I were a doctor, I would diagnose the rating agency patient as very curable. But treatment needs to be urgently applied to avoid further damage. Rating agencies can once again be productive members of the financial community, but they cannot do this by themselves. They need a helping hand to get back on the right track.

Chairman TOWNS. Thank you very much.

Mr. McCleskey.

STATEMENT OF SCOTT MCCLESKEY

Mr. MCCLESKEY. Thank you, Mr. Chairman, Ranking Member Issa, and members of the committee.

My name is Scott McCleskey and I served as senior vice president for compliance at Moody's Investor Service [MIS], from April 2006 to early September 2008. In that capacity, I was the executive formally designated as responsible for the organization's compliance with relevant regulations and internal policies.

I have been asked to discuss my experiences with respect to the independence and authority of the Compliance Department. I will start by saying that in my time at Moody's, I had the privilege to work with a great many professionals of high ability and unquestioned integrity, and that in many cases and in many respects, things worked well. However, my honest assessment is that the compliance function came to lack independence and authority in some important respects.

Before I go into detail, I think it is important to give a caveat that it has been over a year since my departure from Moody's, and until I was contacted by the staff of this committee a few days ago, I had not put a great deal of thought into these past events, so I am at a slight disadvantage with respect to some of the specific dates and details. And for clarity's sake, I would point out that in keeping with the scope of the SEC regulations, my remit did not extend to the accuracy of the rating methodologies themselves.

Until the end of 2007, I reported to an executive vice president who in turn reported to the CEO. This executive vice president had responsibility for three departments: compliance, regulatory affairs, which generally handles relations with regulators and legislators on policy matters, and information technology. During this period, I would characterize the environment as generally supportive of compliance.

In late 2007, my reporting lines were changed. From that point forward, I reported to Michael Kanef who was made responsible for both my department and the Regulatory Affairs Department. Michael reported to the general counsel who reported to the CEO.

So as you can see, an extra layer of management was inserted into my reporting chain, effectively moving the department one level further away from the CEO. Nonetheless, I remained as the formally designated compliance officer in all public SEC filings.

It soon became clear to me that my authority and independence would be greatly diminished. In the interest of time, I will summarize my experience and concerns.

Over the following months, experienced compliance officers on my staff were pushed out over my strenuous objections and structured finance analysts without a single day of compliance experience were foisted upon me. Although I did come to believe that one of the new hires had promise, it does not balance the loss of 35 years of compliance experience from my staff.

The hiring of structured finance analysts also creates a clear conflict of interest issue since, like Michael Kanef, who came from structured finance, they could find themselves passing judgment on their own former practices in deciding whether to discipline friends or former colleagues and potentially their own future managers should they return to their previous business units.

Second, I found myself more and more frequently excluded from decisionmaking meetings concerning potential violations. I will note that this did not occur on each and every occasion, but it did so with increasing frequency and in particularly important matters. This includes an examination conducted by the Securities and Exchange Commission which was handled by our Legal Department and by outside counsel. I was flabbergasted that I, the designated compliance officer, would be excluded from meetings with the SEC during an examination and I was vocal in making this point.

A common answer whenever I would object to these exclusions was that it was necessary in order to preserve attorney-client privilege, although it is my understanding that other non-legal department staff were included in these meetings. This focus on preserving confidentiality, I believe, also led to the sometimes explicit and often implicit directive not to put anything in writing that could be used against Moody's in litigation or regulatory proceedings.

My time at Moody's came to an abrupt end a little over a year ago when I was dismissed without any specific reason, other than senior management no longer has confidence in you. This came as a bolt out of the blue. At no time had Michael or the general counsel given any indication of dissatisfaction with my performance.

Moreover, a few weeks before I was pushed out, I was given responsibility for addressing the issues raised by the SEC following its examination, the one I had been excluded from, following which Michael went on a previously scheduled and I think well-deserved vacation. I hardly think that an organization which takes its regulatory responsibilities seriously would give such a critical project to someone it had lost confidence in. I am left to speculate on the real reason for my departure.

One hour after my departure, it was announced that I would be replaced by an individual from the Structured Finance Department, who had no compliance experience and who, to my recollection, had been responsible previously for rating mortgage-backed securities.

I do understand that he has been replaced now by somebody with compliance background, and if that is the case, I hope that person has the authority that I lacked in the organization.

The matter before you regards how credit rating agencies should be regulated in the future, and I will make two brief observations before closing.

First, my experience leads me to recommend strongly that the regulations be amended to require that the designated compliance officer report directly to the CEO or to the Board of Directors, and that this person not have come from one of the business lines within that organization within the last 3 years. Second, with respect to the notion of removing reference to NRSRO ratings from Federal regulations, I would recommend caution. At present, NRSRO status is the only hook by which regulators in the United States are able to exercise oversight of credit rating agencies. If NRSRO status is made irrelevant, I would urge you to ensure that other measures are taken to continue this important oversight of these important agencies.

Now, Moody's will undoubtedly respond as they habitually do, that I am a disgruntled ex-employee who has an axe to grind. To this, I will simply respond that it has been a year since my departure and I did not actively seek the opportunity to testify today. By putting my head above the parapet again, I am likely burning a lot of bridges with former colleagues whose esteem I value. I am putting my family through stress that could be avoided very easily by simply saying I don't know anything.

Thank you for your time.

Chairman TOWNS. Thank you very much, Mr. McCleskey.

Mr. Cantor.

STATEMENT OF RICHARD CANTOR

Mr. CANTOR. Good morning, Chairman Towns, Congressman Issa and members of the committee. I am Richard Cantor, the chief credit officer for Moody's Investors Service. I welcome the opportunity to contribute Moody's views to this hearing.

I would like to begin with a brief overview of Moody's rating process. At the start of the ratings process, an analyst gathers relevant information from issuers and public sources. He or she then conducts a credit analysis applying Moody's methodologies which are publicly disclosed and freely available on our Web site.

After forming an opinion an analyst brings his or her analysis to a rating committee, which is a critical mechanism in promoting the quality, consistency, and integrity of our ratings process. The committee discusses and then votes on the appropriate rating for the security.

One of the core principles of this process is that different analysts can and will legitimately hold different views on the credit risk, based on the same set of facts. And the committee process is the vehicle for resolving these disagreements.

Once finalized, credit ratings are communicated to the general public free of charge. We monitor these ratings on an ongoing basis and we modify them if our view of the creditworthiness of the issuer or the obligation changes.

The unprecedented credit crisis that began 2 years ago has provided important lessons for Moody's, other credit rating agencies and all market participants. In light of these lessons, Moody's has adopted an array of measures to enhance the quality and transparency of our credit ratings.

These steps include changes in the following five key areas: strengthening the analytical quality of our ratings; enhancing consistency across rating groups; bolstering measures to manage conflicts of interest; improving transparency of ratings and the ratings process; and increasing resources in key areas.

We believe we've made important progress, but more can be done. Indeed, Moody's supports a number of reform proposals currently under discussion that can help restore the credibility of credit rating agencies and return confidence to structured finance markets.

We also believe that other steps could be taken to increase disclosure in structured finance markets. Specifically, we believe that increasing information disclosure by issuers, sponsors, and underwriters of structured finance securities would yield three principal benefits: one, reduce the risk of over-reliance on credit ratings; two, improve the information available about structures and assets; and three, broaden the range of opinions and analysis available to the market.

Finally, let me turn to the allegations raised by Mr. Kolchinsky in a letter sent to this committee. Mr. Kolchinsky has raised a series of evolving claims over the past year. And in July, Moody's retained the outside law firm, Kramer Levin, to conduct an independent investigation of all of these issues. It is important to note that Moody's didn't direct the investigation. Rather, the company gave the independent law firm unfettered access to our personnel and documents. I understand that the outside lawyers have interviewed 22 Moody's employees and the only person who has refused to meet with the investigators is Mr. Kolchinsky.

As the committee is aware, Moody's, in anticipation of today's hearing, also asked the independent law firm to provide the committee staff with a briefing on the preliminary findings of that investigation. These findings have also been shared with our regulator. I understand that the committee has been informed that these preliminary conclusions are consistent with Moody's own internal review. Specifically, Mr. Kolchinsky's claims of misconduct are unsupported. Instead, Mr. Kolchinsky raises issues of longstanding and healthy debate within the company and the credit rating industry. When debates have been resolved contrary to Mr. Kolchinsky's personal views, he has alleged that the process was fraudulent, unreasonable or otherwise improper, when they were not.

All of us at Moody's are committed to meeting the highest standards of integrity, quality and transparency in our rating practices, methodologies and analysis, and we will take all the appropriate steps to uphold these standards.

I am happy to respond to any questions.

[The prepared statement of Mr. Cantor follows:]

Testimony of Richard Cantor
Chief Credit Officer
Moody's Investors Service

before the United States House of Representatives
Committee on Oversight and Government Reform

September 30, 2009

I. INTRODUCTION

Good morning, Chairman Towns, Congressman Issa and Members of the Committee. I am Richard Cantor, the Chief Credit Officer for Moody's Investors Service ("**Moody's**"). I have provided my profile to the Committee under separate cover but as a general background, I hold a Ph.D. in Economics from The Johns Hopkins University and, prior to joining Moody's, held various positions in the research group and was Staff Director at the discount window of the Federal Reserve Bank of New York. I have been in the employ of Moody's for 12 years primarily focusing on credit policy and credit research. On behalf of Moody's, I would like to thank the Committee for inviting us to contribute to the Committee's discussion on the credit rating agency ("**CRA**") industry. Moody's supports examination of our industry with a view to encouraging best practices and the integrity of the products and services our industry uses and provides.

It is widely recognized that the current economic downturn has exposed vulnerabilities in the infrastructure of the financial system. Important lessons for CRAs and other market participants have emerged from the rapid and dramatic changes. In response, we have undertaken a number of initiatives to enhance the quality, independence and transparency of our ratings.[1] These enhancements build on Moody's existing practices and processes through which we continually seek to ensure the integrity and credibility of our ratings. We also have been working to adapt, as needed, our policies, systems and organization to implement rules adopted by the Securities and Exchange Commission ("**SEC**") for nationally recognized statistical rating organizations ("**NRSROs**").

In this submission I will look to provide the Committee with an overview of the rating process at Moody's and how it relates to our current and potential future operating environment. I will address this through a summary of:

1. Moody's rating process including the role of the Credit Policy and Compliance functions;
2. Moody's efforts over the past 24 months to further enhance the quality and transparency of our credit ratings;
3. Moody's view on additional reform recommendations, including the critical need for increased information disclosure in the structured finance markets.

Moody's is committed to maintaining a productive dialogue with this Committee, the entire Congress, the SEC and other regulators and market participants about the necessary steps to restore confidence in our industry and ensure the effective operation of the global credit markets. We are committed to taking whatever steps are necessary to achieve those important goals.

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[1] Please see our updates on *Strengthening Analytical Quality and Transparency* (available through moodys.com), which we began publishing in August 2008 and continue to update. The main elements are summarized in Section III below.

II. MOODY'S CREDIT RATING PROCESS

Moody's operates under an established Code of Professional Conduct (**"Moody's Code"**) modeled closely on the International Organization of Securities Commission's (**"IOSCO"**) Code of Conduct Fundamentals for Credit Rating Agencies. The principles in the Moody's Code which seek to secure the quality, integrity and transparency of the rating process, its independence and the avoidance of conflicts of interest, amongst others, are deeply ingrained in our operational policies and practices.

Within the broad, overarching framework of Moody's Code, Moody's has developed policies, practices and procedures over time to govern the rating process and promote ongoing quality and integrity in that process. Moody's supplements this framework with various control functions, including the Credit Policy Group and the Compliance Group.

A Credit Rating Process

Moody's has a rigorous process for determining its opinion of any security that it rates. This process broadly includes the following components:

- *Gathering Information*: The analyst or analysts assigned to a particular issuer or obligation (**"Assigned Analyst"**) begin the credit analysis by assembling the relevant information. This information comes from various sources, which may include information from the issuer in meetings or through other communications with the Assigned Analyst, as well as from public sources. The information may be supplemented with information generated by Moody's, including macro-economic and sector-specific data.
- *Credit Analysis*: Once information has been gathered, the Assigned Analyst analyzes the issuer or obligation and formulates his or her view for the rating committee to consider. In doing so, the Assigned Analyst will apply relevant Moody's methodologies, which likely will include consideration of both quantitative and qualitative factors. For example, in our Structured Finance Group, quantitative factors may include the degree of credit enhancement provided by the transaction's structure, the historical performance of similar assets created by the originator and macro-economic trends. Qualitative factors could include an assessment of the bankruptcy remoteness of the entity holding the assets, the integrity of the legal structure and management and servicing quality of the parties to the transaction. The Assigned Analyst considers the relevant factors necessary for his/her analysis with a view to presenting an opinion to the rating committee, where members are encouraged to form independent opinions. This rating committee process (discussed in greater detail below) is designed to test the robustness of the opinion reached by the Assigned Analyst in order for the entire rating committee to reach an independent opinion.
- *Utilization of Rating Methodologies*: Moody's rating methodologies address our analytical approach to a particular substantive functional area, industry or sector. For example, a methodology may address a specific approach to analyzing the credit risk of a collateralized debt obligation, while another could describe a general approach to the use of the lognormal method in the analysis of asset-backed securities. Our rating

methodologies as applied to our credit rating analysis are available to the public free of charge on moodys.com. All recently assigned credit ratings include a reference to the principle rating methodology used for the analysis of that credit. The publication of our rating methodologies provides important transparency about our ratings by providing all market participants, and the general public, an explanation of how we rate a given security.

All new methodologies or significant changes to existing methodologies are approved by the Credit Policy Committee. In addition, the Credit Policy Group (which is discussed in more detail below) engages in systematic reviews of the key methodologies used to assign ratings, including validation of the conceptual frameworks and the models used as tools in the rating process. After a new or revised methodology has been developed internally, Moody's may publish it as a Request for Comment to solicit the views of market participants prior to final adoption and implementation. This process enables us to arrive at a more fully informed methodology and also promotes our objective of being transparent in the formulation of our credit ratings. As we continue to refine our methodologies, with all relevant factors taken into account, drafts of new methodologies may circulate internally and will be subject to change until such time as they are finally adopted and published. A new methodology will, therefore, not be applied formally to any rating process until such time as it has been publicly released in final form. However, a rating committee is free to consider the same factors that might be driving a refinement of a methodology prior to that methodology being adopted.

- *The Rating Committee*: Moody's credit rating opinions are determined through rating committees, by a majority vote of the committee's members, and not by an individual analyst. These rating committees are a critical mechanism in promoting the quality, consistency and integrity of our rating process. Once the Assigned Analyst has arrived at a view after applying the relevant rating methodology/ies, he or she presents it to the rating committee. Rating committee composition varies based on the structure and complexity of the security being assigned a rating. Members are also selected based on expertise and are encouraged to express dissenting or controversial views and discuss differences openly. The committee includes the Chair, who acts as the moderator of the committee; the Assigned Analyst, who presents his or her views and the analysis supporting them; and other participants, who may include support analysts, other specialists (such as accounting, legal or risk management specialists) and/or senior-level personnel with analytical responsibilities. Other than analytical staff directly involved in the preparation of the analysis, Moody's does not disclose the names of persons involved in the rating committee. This serves to further protect the independence of our credit opinion from potential undue influence from an issuer or its related persons.

  Once a full discussion has taken place, the members then vote, with the most senior member voting last so as not to influence the votes of the junior members. This voting process is founded upon the core principle that based on a given set of facts, it is entirely legitimate for different analysts to hold different views on the credit risk associated with any issuer or obligation and that ultimately credit ratings are subjective opinions that reflect the majority view of rating committee members.

Once a rating committee has determined what it believes is the appropriate credit ratings to be assigned to an issuer's debt classes, or to debt issued under specific program documents, Moody's will not change these credit ratings unless and until a subsequent rating committee determines otherwise or a rating is withdrawn under Moody's Withdrawal Policy.

- *Dissemination of Credit Rating Announcements*: When a rating committee forms its opinion, we typically contact the issuer or its agent to inform them of the rating. The rating decision is not communicated to any other external party before it is published. Where feasible and appropriate, Moody's may also give the issuer or its agent an opportunity to review a draft of the rating announcement to verify that it does not contain any inaccurate or non-public information. The issuer may agree or disagree with the rating outcome. If the rating opinion relates to an existing published credit rating, we will publish the new opinion in any event unless the issuer or its agent provides us with new credit information that reasonably may change the assumptions underlying our analysis and therefore our conclusion. In such circumstances, a Moody's rating committee would reconvene and consider the new information, determine what it believes is the appropriate rating in light of that information and publish our opinion. Credit ratings are communicated simultaneously to all market participants and to the general public free of charge via credit rating announcements that are published on our website, www.moodys.com, and are distributed to major financial newswires.
- *Ongoing Monitoring of Ratings*: Once a credit rating is published, we monitor the rating on an ongoing basis and will modify it as appropriate to respond to changes in our view of the relative creditworthiness of the issuer or obligation. As part of this monitoring process, analysts may review public information as well as non-public information provided by the issuer or its agent. Analysts also use a range of tools to monitor and track rated issuers and obligations. These include comparisons of Moody's ratings with other measures of credit risk, including measures derived from the market prices of bonds and credit default swaps and accounting ratio-implied ratings based on default prediction. In most of Moody's U.S. Structured Finance groups, monitoring is performed by dedicated surveillance analysts under the leadership and oversight of our Group Managing Director – Structured Finance Global Surveillance Coordinator. In general terms, the surveillance analyst receives and processes data from regular servicer and/or trustee reports. The surveillance analyst then assesses the data and, if necessary (*e.g.*, because the performance data is not in line with expected parameters), conducts a rating analysis. Finally, where necessary, the surveillance analyst (or his or her manager) convenes a rating committee to vote on and authorize the publication of a rating action.

B Moody's Credit Policy Function

Moody's Credit Policy Group leads research on the performance of Moody's credit ratings, reviews and approves methodologies and models, and oversees various internal credit committees that formulate high level rating policies and practices for each of the rating groups. This Group operates independently from the business lines that are principally responsible for rating various classes of issuers and obligations. The independent structure is intended to ensure that decisions taken on methodological or performance related issues are independent of any non-credit business objective.

As Moody's Chief Credit Officer, I oversee the Credit Policy Group - reporting directly to the company's Chief Executive Officer and Chief Operating Officer and reporting quarterly to the Moody's Corporation Board of Directors. There is a Chief Credit Officer for each major rating group, who report to me, as well as a number of regional and group credit officers, who provide additional support and oversight. The Group is divided into two main units:

- *Credit Policy Committee and Credit Committees*. The Credit Policy Committee is made up of credit officers, senior managers of various rating groups, and the head of compliance. It is chaired by me in my capacity as Chief Credit Officer. The Committee is responsible for setting overall standards that govern Moody's rating process. The Committee oversees credit committees specializing in Moody's key business areas – the Fundamental Credit Committee, the Public Sector Credit Committee, and the Structured Finance Credit Committee. Each of these Committees is chaired by the Chief Credit Officer for the relevant rating group.
- *Credit Policy Research*. The Credit Policy Research Group facilitates rating analytics by providing empirical analysis and quantitative tools to Moody's rating personnel and conducts research on defaults, loss-given-default and rating transitions, and develops quantitative tools to support ratings and analysis. The Credit Policy Research Group also publishes studies of Moody's-rated obligations in different rating categories so that the market can understand the historical performance of rating categories. The research is also used to identify methodologies that may need to be reviewed because of evidence that ratings rated according to that methodology either outperform or underperform other ratings in the same category but rated under a different methodology.

The Credit Policy Group takes responsibility for, amongst others:

- *Reviewing Methodologies*. The Chief Credit Officer of each major ratings group (along with the various credit policy committees they chair) is responsible for approving all new methodologies and material changes to existing methodologies. In particular, the Credit Policy function conducts in-depth reviews of rating methodologies, focusing on analytical rigor and key underlying assumptions, the historical performance of the ratings, alternative methodologies (including those of other market participants), and differences between our ratings and market opinion as inferred from credit spreads.
- *Improving Model Verification and Validation*. Moody's is taking significant steps to enhance our model verification and validation processes. Conducted by the Credit Policy Group, the process reviews the key assumptions and overall conceptual framework of our structured finance models, thereby helping to ensure that the results of our models are not only mathematically accurate, but also sufficiently correspond to the real-world scenarios that we are modeling.

- *Instituting Feasibility Reviews for New Products*. Moody's has established a review process that includes one or more senior managers in the Credit Policy Group with appropriate experience to review the feasibility of providing a credit rating for any new type of structure that is materially different from the structures that we have previously rated.

- *Enhancing Analysis Within Rating Groups*. Full-time chief credit officers in the rating groups, as well as industry and regional credit officers, work with the rating groups, each other, credit committees, the Credit Policy Committee and the Chief Credit Officer to ensure that rating methodologies and policies are implemented consistently across the organization. Credit officers also provide an independent check within rating committees and rating groups.

C Moody's Compliance Function

Moody's has established and operates under a strong compliance culture. In particular, we have an independent Office of Ratings Compliance, which is primarily responsible for overseeing adherence to ratings policies and procedures within Moody's. The Chief Regulatory and Compliance Officer for Moody's Corporation has a reporting obligation to the Board of Directors of Moody's Corporation on at least a quarterly basis. Additionally, the Audit Committee of Moody's Corporation's board of directors is responsible for, among other things, assisting the board in fulfilling its oversight responsibilities related to compliance with legal and regulatory requirements. The Office of Ratings Compliance helps underscore the importance of objectivity and independence in the rating process. It does so through:

- understanding and, when necessary, augmenting the existing practices of Moody's ratings groups;
- ensuring that accepted practices are in fact appropriately implemented in the ratings groups; and
- assessing the adherence to accepted practices by the ratings groups.

As recognized in the Securities and Exchange Act,[2] the substance of credit ratings or the procedures and methodologies by which any NRSRO determines credit ratings should be protected from regulatory and/or political interference. This principle extends to protection from interference in the opinion of the rating committee from any internal control function, including a compliance function. The Moody's compliance function will therefore not interfere with the opinions of analysts nor should it be expected to do so but will look to ensure that policies, practices and processes are in place and are being followed by the analytical teams in the rating process.

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[2] See Paragraph (c)(2) of Section 15E of the Securities Exchange Act of 1934.

III. MOODY'S EFFORTS TO FURTHER ADVANCE THE QUALITY AND TRANSPARENCY OF CREDIT RATINGS

The various contributors to the recent market crisis are by now well-chronicled, starting with the performance of U.S. sub-prime home mortgages and then of mortgage-backed and related securities originated primarily in 2006 and early 2007. Moreover, it is now clear that significant, latent vulnerabilities had been developing in the infrastructure of the global financial markets, and that once exposed, these weaknesses could, and would, have severe and reverberating consequences.[3]

Moody's has addressed in previous legislative and regulatory hearings the steps we took prior to and during the financial crisis to watch, warn and react.[4] Like other market participants, however, we did not fully anticipate the magnitude and speed of the deterioration in mortgage quality or the suddenness of the transition to restrictive lending. We were far from alone in that regard, but we believe that we should be the leading edge for predictive opinions about future credit risks, and we have learned important lessons from that experience.

Efforts to Restore Confidence

The past two years have reminded all market participants how rapidly and dramatically markets can change. Throughout this period, Moody's has – in an effort to enhance accountability – reached out to market participants and policymakers globally for feedback regarding the utility of our ratings and ratings system. Based on the feedback we have received and our own deliberations, Moody's has adopted a wide range of measures to enhance the quality, independence and transparency of our credit ratings, including the following:

1) **Strengthening the analytical quality of our ratings:** including creating permanent, internal methodology review and model verification and validation processes; continuing the separation of personnel involved in initial rating assignments and surveillance; reinforcing the independence of the Credit Policy function; implementing methodological modifications; enhancing our existing professional training program; and formalizing model error discovery procedures.

2) **Enhancing consistency across rating groups:** including incorporating common macro-economic scenarios in rating committees; broadening cross-disciplinary rating committee participation; and improving surveillance coordination across rating groups.

3) **Reinforcing measures to avoid conflicts of interest:** including codifying the existing prohibition against analysts providing recommendations or advice on structuring securities; prohibiting fee discussions by ratings managers as well as analysts (who were already subject to such a prohibition); changing rating committee composition to enhance independence and objectivity; conducting

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3 Some of these weaknesses include exceptional leverage and business models that relied on secondary markets for liquidity of complex instruments in periods of stress; the interaction of asset valuation and capital; insufficient risk management practices; interlinked market participants; and limited transparency.

4 For example, see, April 15, 2009 Statement of Raymond W. McDaniel before the United States Securities and Exchange Commission, which is available on www.moodys.com.

"look-back" reviews when analysts leave to join organizations with potential conflicts; revising our Securities Trading Policy; retaining and reviewing complaints about analysts made by third parties; reinforcing independence and objectivity through analyst compensation policies; and adopting a stricter prohibition on Moody's analysts receiving gifts (to supplement our existing Moody's Corporation policy on this matter).

4) **Improving the transparency of ratings and the ratings process:** including enhancing disclosures on incremental changes to methodologies; publishing detailed summaries of our methodologies for rating U.S. RMBS and CDOs; enhancing the review of loan originators in U.S. RMBS transactions and asking issuers for stronger representations and warranties relating to those transactions; providing additional information on structured finance ratings (V Scores, Parameter Sensitivity analysis, loss expectation and cash flow analysis, and key statistics and assumptions); enhancing disclosures regarding attributes and limitations of credit ratings in each rating announcement; pursuing efforts to discourage rating shopping; beginning to publish key statistics and default assumptions for all new structured finance ratings and for surveillance rating actions in major asset classes (including information relating to underlying pool losses); and creating a structured finance "Quick Check" Report which seeks to inform the market of our latest opinions, summaries of rating activities, methodology changes and ratings transition summaries and other key information.

5) **Increasing resources in key areas:** including strengthening the global leadership of the rating surveillance function; increasing the number of rating surveillance analysts; increasing the Credit Policy group's staff; conducting a comprehensive review of our staffing model; and continuing to build out our Compliance function.

While we believe that we have made good progress with respect to augmenting the analytical framework and credibility of our ratings, we are committed to continuing to strive to enhance our policies and procedures even further.

IV. ERIC KOLCHINSKY

Finally, let me briefly turn to the allegations raised by Mr. Kolchinsky. In his August 28 memorandum, Mr. Kolchinsky restated his views that certain rating decisions were improper because Moody's should have applied a new and different methodology to assess certain aspects of certain transactions. In short, Mr. Kolchinsky asserts that because Moody's was developing and planning to implement new methodologies, the continued use of the old methodology was improper.

Mr. Kolchinsky has raised an evolving series of claims of misconduct. As our counsel has informed the Committee, Moody's Compliance Group had reviewed such allegations when they were raised and had determined them to be unsupported. In his most recent memorandum, Mr. Kolchinsky claimed that this determination was evidence that the Compliance Group was not sufficiently independent.

To assure that any concerns regarding the independence of the review of Mr. Kolchinksy's allegations were allayed, on July 29, 2009, Moody's engaged the law firm of Kramer Levin—a firm with no prior relationship with Moody's—to conduct an independent review of all of Mr. Kolchinsky's allegations.

These efforts are being led by a team of prominent and experienced lawyers, including the Co-Chair of the firm's White Collar and SEC Regulatory Practice. Moody's has given this team of independent outside counsel unfettered access to any person or document they wanted to conduct their inquiry. As far as Moody's is aware, the only person to decline to cooperate with the inquiry into Mr. Kolchinsky's claims is Mr. Kolchinsky, notwithstanding the cooperation requirement for all Moody's employees as employees of a regulated entity as expressed in our Code of Conduct. Mr. Kolchinsky was placed on suspended with pay status because he refused to speak with the independent counsel team. It was for this reason only that Mr. Kolchinsky was suspended with pay. Mr. Kolchinsky was not suspended for expressing his concerns.

Independent counsel will report their findings to the Company's most senior management and also to the Company's Board of Directors. Further, Moody's has informed the SEC of Mr. Kolchinsky's claims and independent counsel will report its findings to the SEC, regardless of what they may be. Last week, Moody's offered to have this Committee briefed on the matter and repeats that offer.

V. CONCLUSION

Moody's has always believed that critical examination of the CRA industry and its role in the broader market is a healthy process that can encourage best practices, support the integrity of our products and services, and allow our industry to adapt to thè evolving expectations of market participants. Many necessary actions can and have been taken at both the firm and industry level, and policymakers at the domestic and international levels have proposed a host of constructive reform measures for our industry and credit markets generally. Moody's wholeheartedly supports constructive reform measures and we are firmly committed to meeting the highest standards of integrity in our rating practices, quality in our rating methodologies and analysis, and transparency in our rating actions and rating performance metrics.

I am happy to respond to any questions.

Chairman TOWNS. Thank you very much, Mr. Cantor.

Let me begin by raising questions, and each Member will have 5 minutes to do so.

Mr. Kolchinsky, I have here a memo you wrote to Michael Kanef, the head of compliance at Moody's. In the very first sentence, you said, "Moody's was engaged in illegal conduct."

What kind of illegal activities was Moody's engaged in?

Mr. KOLCHINSKY. Sir, I believe that Moody's violated securities laws by issuing ratings on Nine Grade funding in January. They knew that the ratings were incorrect. They had knowledge of it. And yet they still went forward and issued the rating.

It is not, as Mr. Cantor states, a matter of policy. It is a matter of law, whether you can or not knowing that the ratings are wrong actually opine on a rating, and that is what I believe was the violation of the law.

Chairman TOWNS. Well, did you warn Moody's of the problem?

Mr. KOLCHINSKY. Yes, sir, I did. In the past, Moody's came very close to doing something very similar, and that was September 2007. And at the time, I was able to prevent the occurrence of that from happening. I had warned both the Compliance Group and the Credit Policy Group about these issues, and about precisely this type of an action leading to securities laws violation. And those warnings were ignored.

Chairman TOWNS. Is it true that you also warned Moody's that the ratings procedure used by derivatives groups were inadequate?

Mr. KOLCHINSKY. Yes, sir, I did. I believe specifically this relates to the new methodology for rating ABS CDOs, which was used in the process of rating the deal in question here. I had told Mr. Cantor's group and I had told the Compliance Group that the methodology was not realistic. It had many problems. It was not based on real world scenarios or real world views of how the credit would perform.

Chairman TOWNS. Is it true that you warned Moody's that the ABS CDO methodology used by the Derivatives Group produces misleading ratings that will continue to destabilize the financial markets, as well as cause losses for investors and shareholders?

Mr. KOLCHINSKY. Yes, sir. I did that.

Chairman TOWNS. Mr. Cantor, I understand that Moody's hired an outside counsel, as you indicated, from the law firm of Kramer Levin to investigate Mr. Kolchinsky's allegations. I want your commitment that Moody's will provide to this committee within 1 week copies of all documents that were provided to Kramer Levin regarding their investigation, along with a copy of the preliminary report which they issued just yesterday.

Will you make that commitment right now?

Mr. CANTOR. Mr. Chairman, I will pass along your request to the appropriate people at Moody's and I am confident that they will be able to comply.

Chairman TOWNS. I don't quite understand you. In other words, aren't you appropriate? You are testifying here and you are under oath?

Mr. CANTOR. Yes. I am the chief credit officer. I am responsible for the methodologies that we produce and use in the ratings process. And I will communicate your request to the appropriate people at Moody's and I am confident they will comply.

Chairman TOWNS. Well, who are the appropriate people?

Mr. CANTOR. I would expect the general counsel at Moody's.

Chairman TOWNS. I am sorry?

Mr. CANTOR. The general counsel at Moody's.

Chairman TOWNS. Right. OK. Thank you.

Mr. McCleskey, I have a letter you wrote to the SEC in March 2009. In it, you warned the SEC about Moody's municipal securities ratings. Are these ratings just out of date and inaccurate? Is it true that Moody's did not warn investors these ratings were out of date? Mr. McCleskey.

Mr. MCCLESKEY. Yes, sir. And the intention of that letter was to alert the SEC so they could look into a situation that I was aware of in which there are tens of thousands of municipal securities out there that just due to the sheer number they are not getting the same level of scrutiny, surveillance on the ratings that you would expect from a normal bond or structured instrument.

There were concerns. I had expressed concerns about this because my feeling is that there will be municipal bonds out there that haven't been looked at that may have out of date bond ratings that the public may not be aware that these are out of date.

It is one thing for the bond to be the city of New York or California, where everybody knows the economic state, but these include very small school districts or very small municipalities where it may not be as available to the public.

Now, I am not an economist, but the SEC has economists. And that is the reason why I raised this issue and I urged them to include a review of this in their next routine examination. And I do believe that is important. It has been, as I said, a year since I was at Moody's, maybe things have gotten better. I hope they have. But at the time that I wrote this letter, I felt that it was something that the SEC needed to be aware of.

Chairman TOWNS. Thank you very much. My time has expired.

I yield 5 minutes to the gentleman from California, Congressman Issa.

Mr. ISSA. Thank you, Mr. Chairman.

And I would like to followup on the chairman's statement, Mr. Cantor, a question. To your knowledge since you supplied a great deal of the information that went to the independent investigation, is most of it information which you would consider not to be attorney-client privilege?

Mr. CANTOR. I am not——

Mr. ISSA. In other words, the information you provided was of a statistical and numeric nature. It was emails pertinent to today's discovery. In other words, it was information that should not be withheld based on a claim of attorney-client privilege. Would you agree?

Mr. CANTOR. I have no expertise in this area.

Mr. ISSA. Well, then I will break it down a little bit so the chairman and I are consistent on this part. Was most of this information internal emails and correspondence related to today's hearing that would either affirm or deny Mr. Kolchinsky's claims?

Mr. CANTOR. I am sorry. I am not sure I understand the nature of the question.

Mr. ISSA. It is real simple. Today, you weren't able to answer and you are referring to general counsel. My concern is you go back to general counsel and they claim a broad attorney-client privilege, and then we play that 20 questions game in a subsequent hearing, where I guess we bring your general counsel in.

I want to understand today what it takes to investigate a claim by a whistleblower. We are presuming, but I want an affirmation at least to your knowledge, it doesn't appear to be specific attorneys, you did not turn over, as far as you know, lots of things by your attorneys to this independent group, which we would presume, if they are independent, they are not going to claim attorney-client privilege just because you paid them.

Mr. CANTOR. The firm that conducted the investigation had unfettered access to all of our documentation.

Mr. ISSA. I am only asking if they had independence.

Mr. CANTOR. There was not specific materials that were turned over.

Mr. ISSA. OK. So if I understand correctly today, the chairman and I are going to close the hearing based on the hope that Moody's will turn over what the chairman has asked for, and if they don't, then we have to go back through the process of your claim that they are independent, just as Moody's is independent when they issue credit ratings, and yet you paid them and therefore have an ability to claim attorney-client privilege and may.

Mr. CANTOR. I expect there will be a full compliance with the request.

Mr. ISSA. Good. That is what we expect.

Mr. CANTOR. I am only pointing out that I am not an expert in this area, and you are speaking to someone who——

Mr. ISSA. OK. The chairman and I will be patient on that issue, but I wanted to clarify it because I am deeply concerned that the word "independent" and "outside" generally means they were done for our benefit and the people's benefit, not just for the person paying them, which gets us back to Moody's.

Do you believe that this very narrow, I guess three, now four groups that are allowed to do what you do is reasonable or sustainable? In other words, is there any reason to have an ogopoly or oligopoly, to use a now-Russian word it seems, or could we have dozens of organizations allowed to try to do what you do, and then if you do it better, you would rise. And if you didn't, somebody else who was more accurate would rise.

Is that a better way for this committee to look at the future? Or should we continue with this narrow group that we trust, even though they failed us?

Mr. CANTOR. Moody's favors a vigorous competition in the credit rating industry. There are currently perhaps 100 credit rating agencies around the world. I don't know how many there are in the United States——

Mr. ISSA. Well, let's just say that the big three have 90 percent, and in electronics, the last 10 percent isn't enough for anyone to matter. So if three of you have 90 percent, you have a three-way monopoly.

Mr. CANTOR. Well, there——

Mr. ISSA. Let me followup with another question.

This committee has promoted, I think vigorously, transparent reporting systems. XBRL is one of them. Obviously, well along the way in a nonprofit. Would you believe that this committee should, in fact, make that a public policy so that broadly this information that is not available to the individual consumer or individual investors could become available?

Mr. CANTOR. Moody's strongly supports enhanced disclosures in securities markets, including the type that you have——

Mr. ISSA. OK. For my whistleblowers, and thank you for being here today. I know it is tough and I know there are always the other side whenever someone comes forward. But let me ask you a question. Currently, Congress is considering giving more authority to the SEC to do what they didn't do when you reported to the SEC. Does that seem like it makes sense to you? If they didn't act when you reported, should we rely more heavily on government? Or should we have, as I am suggesting, XBRL and other ways for people to second-guess reporting? Either one of you.

Mr. MCCLESKEY. Sir, if I could go first. I think that transparency is generally a good idea, but I think a distinction needs to be made between transparency and disclosure. In my mind, disclosure is providing information. Transparency is providing it in a meaningful way. I would also draw a distinction in your example with respect to stocks and bonds. I agree with you that many people do not research the stocks and bonds before they buy them. But I would assert that is because they don't wish to.

If you are putting our information about a structured finance product, there may be people who wish to conduct an analysis, but lack the expertise, the models, the methodologies to do so. So I would make that distinction.

Should the SEC have more authority? To my knowledge, they have not done their first routine cyclical examination of the firms yet. I think that the reason for that is, frankly, this is an unregulated industry for the past century. They have needed time to get up to speed. I would frankly have expected something to happen by now, but I think that with respect to the aggressiveness of the SEC with respect to the credit rating agencies, I would suspect that part of that is simply because they are getting staff up to speed. They are hiring staff. I wouldn't write them off just yet.

Chairman TOWNS. The gentleman's time has expired.

Go ahead, Mr. Kolchinsky.

Mr. KOLCHINSKY. I would agree with Mr. McCleskey. I think the SEC has had a difficult role, especially since each agency has its own methodology. I am very familiar with the methodology that I was responsible for. It is very difficult to understand. It has a lot of minutiae, lots of twists and turns.

I think what I propose as a public body along the lines of FASB, where these decisions would be made in a public matter, which would be overseen by the SEC as FASB is, but where these decisions are overseen in a public matter, the types of data that goes out goes out to everybody, and decisions are made publicly with public consent. And I think that would be the best way of opening up this industry to transparency.

Mr. ISSA. Thank you, Mr. Chairman.

Chairman TOWNS. Thank you very much.

I now yield 5 minutes to the gentleman from Pennsylvania, Mr. Kanjorski.

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

Mr. Cantor, in your testimony, you sort of asserted with great pride that the information is made available to the general public free of charge. And there is nothing incorrect about that statement, but do you mean to indicate that nobody pays for this information?

Mr. CANTOR. The information about our rating?

Mr. KANJORSKI. Yes.

Mr. CANTOR. That is correct that the distribution of ratings to investors is free of charge.

Mr. KANJORSKI. Yes, but are you going to tell us who pays for it, or are you going to just indicate that it is free of charge?

Mr. CANTOR. Oh, who pays for the effort that——

Mr. KANJORSKI. You are an eleemosynary corporation, I assume? You don't charge? You do this for free?

Mr. CANTOR. No. We are paid by issuers of securities in the capital markets for the ratings we assign.

Mr. KANJORSKI. Ah, that is surprising.

Now, I am just going to pose a question to you and I hope you can give me a reasonable response. If we went to our colleagues in the House and the Senate and told them that we have discerned a new way to reduce the budget of the United States by significant proportions, and that is we could remove all the expenses for the judiciary branch of government because we have come up with a new formula that all lawyers who represent winning litigants have agreed to pay the judges' salaries.

Would you sort of conclude that is a good, fair, and proper way to carry on the judicial system of the United States?

Mr. CANTOR. I must admit the hypothetical is a little confusing to me, but I imagine you are proposing something that you feel is a very bad idea. I must admit I got a bit lost.

Mr. KANJORSKI. I am proposing what occurs in the rating agencies. You get paid by the issuers, don't you?

Mr. CANTOR. We do.

Mr. KANJORSKI. Well, you didn't want to indicate that. You were bragging about that the public gets it free of charge. That can or cannot be true. If it is an incorrect or prejudicial rating, it is not free of charge. The price we would pay for that was exactly what happened a year ago. The markets would have bad securities. Some people call them toxic securities, and it could in fact cause a crash to occur, which in fact happened.

And I am not saying that we can trace it directly to the rating agency, but that is a possibility. That wouldn't make it free of charge. That would make it extremely expensive.

Do you agree?

Mr. CANTOR. Moody's has been operating under the issuer-pay model that we were just talking about for 40 years. And we have a long track record under this business model that we stand behind and it is the basis of our performing.

Mr. KANJORSKI. One of your colleagues in testifying said they wanted to operate like the accounting businesses, that they don't have any problem. Maybe you are of a short memory. Do you recall Enron?

Mr. KOLCHINSKY. Yes, sir.

Mr. KANJORSKI. What was the problem that we found in Enron?

Mr. KOLCHINSKY. Sir, I believe it was fraud.

Mr. KANJORSKI. No. We found that Enron was being paid exorbitant fees for consulting services and those fees had a tendency to affect their professional opinions as accountants, this exact conflict of interest that exists in this rating agency problem today.

Now, I appreciate if you are whistleblowers that you came through, but I listened to both of your testimony, and I didn't hear anything terribly shocking. If this is the best testimony that we have, I am surprised that Moody's went out and hired the lawyer that they did to attack you.

You haven't given a course of conduct in my opinion of fraud. You haven't given a course of conduct of real gross neglect or negligence. You have said there are some instances like the supervisor was not allowed in the room to meet when the SEC came by. Eh? Maybe good, maybe bad. We should rap their knuckles, but there is nothing criminal about that, or really extreme about that.

And in your instance, what do you find after all these years of issuing these opinions, you said they did things that violated the law. What did they do?

Mr. KOLCHINSKY. Sir, I believe they violated rule 10b(5) of the——

Chairman TOWNS. Speak into the mic.

Mr. KOLCHINSKY. My apologies. I believe they violated rule 10b(5).

Mr. KANJORSKI. And what is rule 10b(5)?

Mr. KOLCHINSKY. The rule 10b(5) is fraud, securities fraud in securities markets.

Mr. KANJORSKI. And how did they do that?

Mr. KOLCHINSKY. Sir, if I might, I can quote from a memo that was produced on behalf of Moody's by another prominent New York law firm, written to the SEC, and they state, "A rating agency would be liable," this is with respect to 10b(5), "if it knowingly published a report that falsely misrepresented its own evaluation of securities." And that is exactly what they did.

Mr. KANJORSKI. And how did they do that?

Mr. KOLCHINSKY. Sir, they knew that the underlying ratings, this was essentially CLO squared. In December, they had just decided to change the methodology on the underlying CLOs. And they knew, in fact, that all those ratings were now wrong. In fact, they ran internal tests that showed that rated securities that were rated below AAA would be moved three to six notches.

That knowledge should have been, must have been incorporated in any new rating. Once that was decided, once the step was taken, it should have been decided, if you are going to base your other ratings on those ratings.

Mr. KANJORSKI. OK. Now, was that directly reported to the appropriate officials at the SEC? Or how was that handled on your part?

Mr. KOLCHINSKY. How was my complaint handled?

Mr. KANJORSKI. What did you do? You found out that they were using false information that they knew was false, so knowingly they did this.

Mr. KOLCHINSKY. Yes, sir. I was not a part of this. I reported it to the Compliance Group as I was supposed to. Once I was——

Mr. KANJORSKI. What do you mean, you were not part of this?

Mr. KOLCHINSKY. I was not in the rating agency.

Mr. KANJORSKI. Well, how did you find this information?

Mr. KOLCHINSKY. From speaking to colleagues and off of——

Mr. KANJORSKI. So this is hearsay?

Mr. KOLCHINSKY. Yes, sir, but it is backed by documented evidence which is available.

Mr. KANJORSKI. Did those colleagues that told you this then report that to appropriate officials, either in the Justice Department or the SEC?

Mr. KOLCHINSKY. I don't know, sir.

Mr. KANJORSKI. Didn't you figure out it may be important to determine that?

Mr. KOLCHINSKY. Sir, I am just a single person. I was trying to do the right thing. As soon as I knew anything, I reported to my Compliance Group. After my suspension, I reported it, tried to report to SEC, and I also spoke to the committee here. But I believe I tried to make sure that these matters were brought up to the attention of the appropriate parties.

Mr. KANJORSKI. If I could just ask one question of all three panelists?

Chairman TOWNS. I ask unanimous consent to give the gentleman another additional minute.

Mr. KANJORSKI. You have heard the example of how rating agencies are paid by the issuer, which poses potentially great conflicts of interest. Do the three of you have opinions whether we should examine this and change this practice? Or do you think it is working perfectly well and has no effect on what the rating agencies are doing in the marketplace?

Mr. KOLCHINSKY. Sir, I think the conflict of interest at the rating agencies is much more pedestrian. It is more a short-term profits versus long-term credit quality. There is nothing special issue pays or investor pays. It is a short-term profit-focused conflict of interest.

In many cases, in my world, in ABS CDOs, one of the reasons you are seeing all the banks like Merrill Lynch, UBS, and Citigroup have problems is because they retained the vast bulk of the debt that they issued, so it was effectively an investor-paid model. They couldn't get outside investors to buy the stuff so they retained the deals on the balance sheet.

So it is very difficult to actually implement a good investor-pay model that would not have the same conflict of interest if the investor has the same incentives as the banker does.

In the case of ABS CDOs, in many cases, the investor and the banker were the same party and they just brought it on the balance sheet because they wanted to show revenue.

So theoretically, I agree with you.

Mr. KANJORSKI. Do I understand your testimony to say it doesn't make a difference who pays? It has no effect on the end result?

Mr. KOLCHINSKY. No, of course it does. Of course it does. My testimony is that in practical terms, it is very difficult to find the ideal investor. Not every investor is a Warren Buffett.

Mr. KANJORSKI. Whoa, whoa, whoa. I didn't ask you the question about whether investors should pay. That is our big problem, who should pay or who can pay, and why we got to this peculiar system that we have. That is what we are examining into.

Mr. KOLCHINSKY. Yes, sir.

Mr. KANJORSKI. I don't want you to conclude we think that is the better system.

I want to ask you, do you see the gross potential conflict of interest when the person issuing the security pays the person who rates that security?

Mr. KOLCHINSKY. Yes, sir.

Mr. KANJORSKI. OK.

Mr. MCCLESKEY. Sir, I think I would agree with Mr. Kolchinsky. I do see the gross conflict. The problem then becomes what do you replace it with? And I don't have an opinion. I am not smart enough to know the answer to that question.

Mr. KANJORSKI. Neither are we. That is why we are working on it.

Mr. MCCLESKEY. If I could, I think I should also respond to your other point about whether it is important that I was or was not in a particular meeting. The compliance officer position is embedded into law with respect to credit rating agencies, as it is in many other sectors of the financial industry, and for good reason. These are the people that are supposed to be independent and supposed to keep their eyes open for any potential violations. If that position is not properly resourced, does not have enough authority, then that puts the firm, that puts the industry at risk.

And so this is not just what you would have in normal office politics. This was something that, in my view, weakened the oversight of the credit rating agencies.

Mr. KANJORSKI. All right.

Mr. Cantor.

Mr. CANTOR. We believe that any rating agency system in which a party that obtains the rating and is interested in the outcome of the ratings process is also paying for the rating. Whether it be an investor-pays model, a government-pays model, or an issue-pay model, it presents a potential conflict of interest which must be carefully managed.

There are a variety of rating agencies using different models today and we carefully manage our potential conflicts of interest to the highest possible standards. We have been engaged in this particular business model for 40 years and produced a strong track record.

We actually have historical experience of operating under an investor-pay model for the previous 60 years, which we can reflect back upon and compare our performance and we have to how we performed under that business model compared to the model we adopted around 1970. And the historical data indicates that our performance has been stronger since that time, both in terms of the way we have been able to rank order the probability of loss across different credits, and in terms of the losses that would have been experienced by investors who bought all the securities that we rated investment-grade in the two different periods.

Chairman TOWNS. The gentleman's time has expired.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Chairman TOWNS. I now yield to the gentleman from North Carolina, Mr. McHenry.

Mr. MCHENRY. Thank you, Mr. Chairman.

Thank you all for testifying today. This is certainly important in light of the financial crisis we have faced over the last year. I am on the Financial Services Committee with my colleague, Mr. Kanjorski. We have gone into the, you know, causes of this crisis and I think there is a wide agreement that the credit rating agencies were complicit in this crisis for a number of reasons, some of which were errors and omissions; others outright fraud by those that are disclosing information to the NRSROs.

So Mr. Kolchinsky, you believe that corruption played a major role in this crisis. Is that true?

Mr. KOLCHINSKY. Sir, I wouldn't call it corruption. I would just say very poor incentives were the major part of——

Mr. MCHENRY. OK. Do you believe that a weak analysis of these new complex financial products was a part of it as well?

Mr. KOLCHINSKY. I think so, as well. More could have been done and should have been done in 20/20 hindsight that could have analyzed these products. The main part of it is a lot of people just should have said no to some of these products. And that is 20/20 hindsight, but I think that is the major part, to have just said, we can't analyze this with any degree of confidence and we should just walk away from it. But that was just not possible.

Mr. MCHENRY. I think there is probably agreement on the panel that reforms need to be instituted. I mean, I think that is fair. Even Mr. Cantor gives a small nod.

But of particular interest to me as a policymaker on the Financial Services Committee is whether or not giving the SEC the authority to outline the minimum information that issuers should provide the NRSROs. Is that a worthy policy that we should put forward, empowering the SEC to specify what information needs to be given to credit rating agencies? Mr. Kolchinsky.

Mr. KOLCHINSKY. Yes, sir. I think it is important for anybody to set, it could be a private-public, self-regulating organization, to set minimum standards that are applicable across the board for data that can be provided. And there should be some government body that passes judgment on that, whether that is sufficient.

Mr. MCHENRY. OK.

Mr. McCleskey.

We will finish with you, Mr. Cantor. I am asking Mr. McCleskey first, then we can finish with you, Mr. Cantor.

Mr. MCCLESKEY. Yes, sir. I would first have to say that this is more within the remit of my colleagues. But I would say this from my own experience with regulations here and in Europe that I am generally in favor of this, but you have to be careful that if you set minimum standards, there is sometimes a tendency that people will only do the minimum.

And I am also familiar enough with the complexity of the market that there will be different types of information that will be appropriate for different types of securities. And as the universe of rated securities expands, that will be difficult.

So there will challenges. But having said that, I am in favor of it.

Mr. MCHENRY. Mr. Cantor.

Mr. CANTOR. I would be opposed of the idea to create minimum standards for disclosure to rating agencies. I think minimum standards for disclosure should be to the general public. I don't think we want to privilege rating agencies with special access to information based on government decisionmaking; that there is a wealth of analysis that is done on fixed-income securities by rating agencies, by investors at large, asset management companies, and in the financial press and by academics, and I think it would be a very bad idea to have specific rules for what should be shared with credit rating agencies.

Mr. MCHENRY. I think what I am saying is, what is the, you know, what is ratable, what information should the issuer provide to rating agencies in order to provide a rate. I think you are answering a different question because——

Mr. CANTOR. Well, I am sorry. Maybe I was just particularly struck by the notion of what should be shared with rating agencies. I do believe there should be minimum standards for information disclosure generally, including to rating agencies, and it should be expanded for structured finance securities from where it is today.

Mr. MCHENRY. OK. It seems like you are answering a different question originally. Yes, I am saying basically what is holding you accountable, what is holding your client accountable to provide accurate, full, and complete disclosure? Because otherwise, then the credit rating agencies are simply incompetent and didn't see a financial crisis coming, if you are saying, you know, you got complete information. Is that fair?

Mr. CANTOR. You are correct. The standards for what is required for an issuer to disclose publicly is very different in structured finance than it is in corporate securities.

Mr. MCHENRY. Obviously.

Mr. CANTOR. And the potential liability of the issuer of such securities for false disclosures is different, and the completeness of those disclosures. The requirements regarding completeness is very different.

Mr. MCHENRY. So then you are in favor of the SEC providing those minimums by which the issuer should provide the NRSROs?

Mr. CANTOR. The NRSROs and the general investing public.

Mr. MCHENRY. Thank you.

Chairman TOWNS. Thank you very much.

I now yield 5 minutes to the gentleman from Ohio, Congressman Kucinich.

Mr. KUCINICH. Thank you, Mr. Chairman. I want to thank you for holding the hearing.

Through the housing crisis and larger financial crisis, the credit rating agencies seemed to have otherwise escaped any real scrutiny. I have been troubled by the increasing popularity of instruments called "re-remics." What this stands for is resecuritization of real estate mortgage investment conduits, and the shorthand is called "re-remics." And it basically amounts to repackaging original investment instruments that no investor will touch into more complex investment vehicles.

Mr. Kolchinsky, are you familiar with these re-remics?

Mr. KOLCHINSKY. Yes, sir, I am.

Mr. KUCINICH. Mr. Cantor.

Mr. CANTOR. Yes.

Mr. KUCINICH. I wrote a letter, Mr. Chairman, to the chairman of the SEC, Mary Schapiro, and I have spoken to her about this issue. And here is what I have learned. The total resecuritization market right now is approximately $664 billion. Of that total, only $60 million is considered registered transactions. That means that the SEC has looked at only $60 million. The vast majority of the transactions are exempt from registration with the SEC.

But, Mr. Chairman, do you know who does look at these resecuritized ties to real estate mortgage investment conduits, the re-remics? Credit rating agencies.

So here we have a group of companies who played a substantial role in bringing our economy to the brink of collapse and we have to ask if they are doing it again. Financial institution takes some toxic assets that no one wants, crams them together into a more complex instrument, and presto, according to rating agencies, you can have an investment-grade product. The practice of securitization gained popularity as a way to provide liquidity to the mortgage market and hedge against risk.

Apparently, the financial services industry has learned nothing from our housing crisis because the rationale behind resecuritization is to provide liquidity to the mortgage market and hedge against risk, and the credit rating agencies, paid by the issuers, are all too happy to oblige.

Now, Mr. Kolchinsky, seeing as that the re-remics are more complex, more opaque than the collateralized debt obligations, the CDOs that came before them, what is to stop these resecuritization of real estate mortgage investment conduits from bringing the entire system to the brink once again? What does the SEC have to do to protect against a new disaster in the securities market? Do you agree?

Mr. KOLCHINSKY. I agree that these re-remics or "repacks" as they are called are potentially dangerous. Some have a purpose. That purpose may be a gaming of capital requirements, accounting requirements or what have you.

Mr. KUCINICH. Gaming?

Mr. KOLCHINSKY. Yes, sir. Recently, I actually saw a repack that was proposed that had absolutely, to my view, no discernible economic value. Substantial costs would be incurred, but to my knowledge there would be no value added. So to me, that is a sign that somebody is playing a game with some regulation somewhere.

Mr. KUCINICH. So you would agree, there is a danger here?

Mr. KOLCHINSKY. Yes, sir. Yes, sir.

Mr. KUCINICH. And then what about the role of credit rating agencies? If someone tries to get assessed what the value of a resecuritized real estate mortgage investment conduit is, they go to a rating agency. Right?

Mr. KOLCHINSKY. That is correct.

Mr. KUCINICH. And is it in the interest of the rating agency to try to find a way to give a rating so that they can get these things out in the market?

Mr. KOLCHINSKY. That is correct.

Mr. KUCINICH. And Mr. Kolchinsky, that is even if you have just a bundle of toxic assets where the value of it might be washed away, essentially.

Mr. KOLCHINSKY. Yes, yes. These can be very problematic. Some re-remics that were done last year went from AAA to C or CA.

Mr. KUCINICH. And Mr. Kolchinsky and Mr. Chairman, in light of that, and we may want to do another hearing on this point, Standard & Poor's has already downgraded these re-remics that they rated less than 5 months ago, due "to the significant deterioration in the performance of the loans backing the underlying certificate."

So the bottom line, Mr. Chairman, these are homes, and these are families, and communities, our constituents. You have to watch these credit ratings agencies. They could be setting us up for the same thing all over again, and I am glad you are holding this hearing, Mr. Chairman. I hope we can get into this deeper.

I yield back.

Chairman TOWNS. Thank you very much. I thank the gentleman from Ohio for his words.

From the State of Missouri, Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. I appreciate the opportunity to discuss this issue today.

Before I get started, I would like to echo the comments and sentiments of the ranking member with regards to the subpoenaed documents, to be able to further investigate and hold accountable those entities that he was discussing a while ago, and I would hope that you would certainly respond to his request.

With regards to the gentlemen before us, as a former bank regulator, I can assure you that when we looked at the investment portfolio of the financial institutions, your ratings are extremely important in our analysis of their financial structure and the liabilities that they have on the books, and assets they have on the books.

And so for us to have this hearing today with regards to the viability of your ratings is extremely disconcerting to me from the standpoint of what has happened and how important they are not only to the banks, but other investment firms and the general public as a whole.

I guess my question to Mr. Kolchinsky is initially, and Mr. McCleskey as well, is why do you believe that this happened? What is the incentive for the ratings agencies to not do their job correctly or to stray from the practice of doing the job they should be doing?

Mr. KOLCHINSKY. Sir, in my view, it is slightly the opposite. There is no incentive for them not to. There is no incentive, and to me, that is the benchmark for the whole industry. There is no incentive to say no to a transaction.

Mr. LEUTKEMEYER. Then why did they do it?

Mr. KOLCHINSKY. For revenue. Rating agencies are large institutions with large fixed costs. And people getting a transaction in the door. It is very difficult to say no to that transaction, especially if that means you can take the revenue. You say no to it, you can take it to another rating agency. There are no 11 rating agencies. You can take it to another one, somebody who will say yes, and that is a problem.

Mr. LEUTKEMEYER. So what you are saying is Congressman Kanjorski's comment to the question of the agency's being paid by the very people who they are rating these securities for is an inherent problem, and that is probably the reason for some of the problems we have here. That is what you are saying?

Mr. KOLCHINSKY. That is right, sir. But the problem is that the person can also select which rating agency they go to.

Mr. LEUTKEMEYER. OK.

Mr. KOLCHINSKY. And they are free to go to one or another until they find one that will help them out. And again, these are——

Mr. LEUTKEMEYER. So there is really, I guess the question, it begs the question, how rampant do you believe the inadequacies are, or their willingness to look the other way, or their willingness to do an inadequate job in lieu of or for further profitable gain is there? I mean, is that the general method of operating, or are there some inherent, or they are normally trying to do a good job, or they just see a big client, we have to skew it so we can make a few bucks here.

Mr. KOLCHINSKY. Sir, I don't believe it is direct. I believe what happens is that you have a client, you have a business, and people talk themselves into being able to think that they can understand a deal, can understand the structure and are comfortable with it.

I do not believe in most cases that any of this is a direct willingness to do something wrong. In most cases, it is getting comfortable with something that may be outside of the envelope and there are usually small little steps all the way down. It is a slippery slope.

Mr. LEUTKEMEYER. OK.

Mr. McCleskey.

Mr. MCCLESKEY. Sir, it would be speculation on my part to guess why organizations are following particular paths, but I will make three points. First, I would just observe that, especially earlier on in my time at Moody's, I will simply say that the senior management of the Structured Finance Group was very proud of the amount of revenues they brought in, quite vocally. And that is all I will say on that matter.

Also, I would say with respect to incentives, organizations don't make decisions. People do. And I think we need to take a look at the incentives that fall on the individuals. And Mr. Cantor will point out, and rightly so, that ratings are arrived at by committees, but committees are led. Committees are made up of individuals. And I think that you would actually have to look not just at, for instance, the compensation practices, but you should also take a look at things like the performance evaluations. What are the criteria on which key people are being evaluated? Yes, sir.

Mr. LEUTKEMEYER. OK.

Very quickly, my time is running out and I have one more quick question for you.

Because it seems to be a prevalent problem with all the rating agencies, is there collusion between the agencies? Have you seen that? Or are you aware of that? Or would you speculate on that?

Mr. McCLESKEY. I am not aware of any, and I would actually say that there were a lot of efforts to make sure that there wasn't even the appearance of collusion.

Mr. LEUTKEMEYER. OK.

Mr. ISSA. Would the gentleman yield?

Mr. LEUTKEMEYER. Yes.

Mr. KOLCHINSKY. I agree with that.

Mr. LEUTKEMEYER. Yes. Thank you.

Thank you, Mr. Chairman.

Mr. ISSA. Yes, the model you have is the same model that basically PriceWaterhouseCoopers, Ernst & Young uses. You pay to get an audit. Why is it yours appears to have failed where audits by comparison, particularly after Sarbanes-Oxley, have been considered to do better?

Mr. KOLCHINSKY. Sir, I believe it is the existence of a minimum standard. The problem is rating agencies today are judges and juries and executioners of their own methodologies. And it is very easy for them to go down a slippery slope and to change methodologies and adjust it in order to get a client.

If you can imagine, for example, if an accountant could go to a potential client and say, you know, your current auditor thinks that this is a loss, but we think it is a gain. According to our methodology, it is a gain. If you hire us, bring us in, pass money, we will do your books and we will make sure that is a gain. You would see standards fall precipitously across the industry.

Accountants can't really do that. And moreover, because there is a minimum standard, if they do deviate from that, it is a clear case of fraud or liability. That is one of the reasons I think you do see some fraud cases, but it is very clear when fraud has occurred, and you can take action in those cases.

Chairman TOWNS. The gentleman's time has expired.

I now yield 5 minutes to the gentleman from Illinois, Mr. Quigley.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Mr. Cantor, you began by talking about some of the improvements you thought your firm had made in the last year. I guess you would specifically talk about changes in methodology, your expertise would be methodology. Can you specify from where we were at a year ago how your firm has changed or methodologies that they no longer use that someone might have questioned at that time?

Mr. CANTOR. Well, I will point out two examples.

Mr. QUIGLEY. I am sorry. Could everybody move their microphone closer because, especially over here, it is just very hard to hear.

Mr. CANTOR. I will point to two examples of changes in methodology that reflect some of the lessons learned from the crisis. One of the big surprises in the crisis was that real estate markets, mortgage credit quality declined extremely rapidly across the entire Nation within a very short period of time, and the ability to refinance a loan, which had been generally widely available, would suddenly disappear in nearly a blink of an eye.

This was a change in the environment for mortgage credit that was beyond the range of our expectations. We consider a lot of scenarios, some of them positive for the outlook for mortgage credit quality; many of them negative. And we have a whole distribution of scenarios that we are contemplating when we evaluate the risk of a mortgage-backed security.

But the particular experience of the last few years was outside that range. We were not alone in being mistaken about this. Most observers of the market, I would say nearly all observers of the market, were completely surprised by what happened.

But having said been so surprised in this particular instance, we recognize now that in all our methodologies, we must allow for a greater possibility that outcomes well beyond our normal range of expectations could be realized in a short period of time. So that is one area of change.

The other area of change would be in our expectations of what issuers of mortgage-backed securities would be providing to us when we rate a mortgage-backed security. While it has been standard always for issuers of mortgage-backed securities or their underwriters to provide representations and warranties that the loans underlying the mortgage-backed security met certain minimum criteria or were described accurately in their offering documents, the ability to enforce those representations and warranties was not as strong as it turned out was needed to make them effective.

We are now requiring much stronger representations and warranties, so if a loan defaults underlying a mortgage-backed security, and it is then discovered that loan was misrepresented in terms of its initial credit characteristics, such as whether income verification had been undertaken by the originator, that loan would have to be bought back by the underwriter and the issuer and investors would not lose any money as a result.

Mr. QUIGLEY. There were new plans. There were new creative ways of pooling mortgages together that were presented to the rating agencies. And it was described as financial alchemy that somehow a bunch of lower-rated mortgages bundled together and then some sort of wand match waved over them and the package as a whole was given a higher rating.

You know, are products like that given much greater scrutiny? Or is that process not allowed at all in your firm?

Mr. CANTOR. Products that have a subprime collateral or low-rated collateral are given greater scrutiny than they had in the past because it has been revealed that the performance of those loans, while we always recognized the performance of those loans were going to be worse than higher quality loans, we hadn't anticipated the suddenness with which we could have a radical change from the historical experience associated with those loans and a simultaneous defaulting across all of them at once.

Mr. QUIGLEY. All right. I am running out of time.

Mr. McCleskey, if there is time, as it relates to municipal bonds. Your concern is primarily the fact that the process isn't reviewed often enough? Or are there processes similar to the ones that have been described last year and the succeeding year, are there still, are there questionable practices as well as to how municipal bonds are reviewed at the same time?

Mr. MCCLESKEY. My concern was with respect to the frequency of the review.

Mr. QUIGLEY. You didn't review and find anything that was similar to the alchemy that has been talked about previously?

Mr. MCCLESKEY. No, sir. The municipal bonds tend to be a bit more straightforward than these complex products.

Mr. QUIGLEY. Very good. Thank you.

Chairman TOWNS. The gentleman's time has expired.

Congressman Chaffetz from Utah.

Mr. CHAFFETZ. Thank you, Mr. Chairman.

And thank you all for being here.

Mr. Chairman, let me just note at the beginning that I too would echo the sentiments of our ranking member and the need to dive deep into the Friends of Angelo and Countrywide program. I would hope and encourage at the very least, Mr. Chairman, is that something that we could potentially vote on in this committee in terms of being with the offer, or go after those subpoenas?

Chairman TOWNS. As indicated early on, the Justice Department, I understand, is seriously looking at it and we do not want to interfere with what the Justice Department is doing. But I understand your concern, and I respect the fact that you——

Mr. CHAFFETZ. Thank you, Mr. Chairman. This committee has done an admirable job in a bipartisan way to dive into issues of great importance. It is just my way of saying, as one Member on the minority side of the aisle here, that this would be important and certainly encourage that.

Let me get right to Mr. Cantor. Over the last 24 months, as you look at this, did Moody's succeed or fail over the last 24 months?

Mr. CANTOR. In the years leading up to the crisis——

Mr. CHAFFETZ. No, I am just looking at the last 2 years here. Do you think you have succeeded or failed?

Mr. CANTOR. Well, the ratings that were put in place in 2006 and 2007 on mortgage-backed securities did not perform as we expected.

Mr. CHAFFETZ. Is that a——

Mr. CANTOR. They performed worse than we expected, much worse.

Mr. CHAFFETZ. You are a rating agency. How would you rate yourself?

Mr. CANTOR. We were deeply disappointed in the performance of those——

Mr. CHAFFETZ. But how would you rate yourself? I mean, what kind of——

Mr. CANTOR. We would not give a high grade to this performance in this sector. We were deeply disappointed.

Mr. CHAFFETZ. You said earlier in your testimony, I was listening here, in response to one of the questions. It was about competition, saying that you would encourage and want competition. What are you suggesting, then, that we do with the nationally recognized statistical rating organization, the kind of oligopoly that you have? Are you suggesting we break that up? Or are you suggesting that we allow more people to compete and more institutions to compete? When you say you are in favor of competition, what does that really mean?

Mr. CANTOR. We welcome additional competition. If the SEC wishes to approve additional NRSROs, we would favor that.

Mr. CHAFFETZ. Do you think you have too much of a grip and a stranglehold on that process, in being able to—and this oligopoly that exists between the different agencies?

Mr. CANTOR. I don't think we have any influence on that process. We don't have any influence on the SEC's process.

Mr. CHAFFETZ. But, I mean, you say on the one hand you want more competition. On the other hand, and you say that you give yourself a, you know, not a very high grade. Is that compatible with the current model that we have with the NRSROs?

Mr. CANTOR. Right. Well, I think we had a lot of company in failing to anticipate the depth of the mortgage crisis. So I expect when investors look at our ratings and think about their utility, they are reflecting on the long historical track record that we have, the performance of our ratings in the corporate sector, in the municipal sector, and other sectors during this crisis. And it is not limited to the performance of mortgage-backed and mortgage-related securities.

Mr. CHAFFETZ. You said that you are increasing the scrutiny that is going on within the marketplace. I think I heard you say that correctly. How many employees do you have now versus, say, 2 or 3 years ago? Do you have more employees or less employees?

Mr. CANTOR. We have a few more employees.

Mr. CHAFFETZ. Like a few more—help me with the numbers here.

Mr. CANTOR. I am really not that familiar with the head count numbers. I know we have had some expansion in our overall staffing during a period in time when the volume of activity has gone significantly down. So during a period of actually reduction in the business, we have actually added employees.

Mr. CHAFFETZ. For the people that you are responsible for, give me a sense of how many people that is. Do you have more?

Mr. CANTOR. In my area, the size of the Credit Policy Group has doubled from roughly 25 to over 50. We are a key part of our initiatives to improve the ratings quality, so it has been a particular focus. And I am regularly asked by my boss, do I have the resources I need, and if I need more, I have been able to get it in all cases.

Mr. CHAFFETZ. Thank you. Let me keep going. My time is so short.

Did you see CNBC's House of Cards?

Mr. CANTOR. No, I did not.

Mr. CHAFFETZ. You have not watched that program?

Mr. CANTOR. I did not.

Mr. CHAFFETZ. I would be interested to hear your reaction if you have seen that.

Let me go specifically to the two gentlemen that are to your right.

Did Moody's retaliate against Mr. Kolchinsky in September 2007 after he raised his concerns that the company implement its planned downgrade policy for the subprime CDOs, the collateralized debt obligations? Did you or did you not retaliate against him?

Mr. CANTOR. [inaudible] me?

Mr. CHAFFETZ. Yes.

Mr. CANTOR. Mr. Kolchinsky's allegations have been investigated and have been found to have no merit.

Mr. CHAFFETZ. So why was he transferred and his salary cut after he raised these concerns?

Mr. CANTOR. I am not familiar with the personnel decisions that were made, and I am certainly not familiar with Mr. Kolchinsky's salary.

Mr. CHAFFETZ. You don't have any first-hand knowledge of why he was transferred?

Mr. CANTOR. I know there was a reduction in staff in his area within Moody's. It was an area that——

Mr. CHAFFETZ. And he just happened to be the guy that——

Mr. CANTOR. This was—he was the manager in charge of rating the mortgage-backed, mortgage-related securities from 2005 to 2007, I believe, and that area was the area of the poorest performance of our ratings, and it was an area that wasn't going to see hardly any activity going forward.

Mr. CHAFFETZ. So is that the extent of your first-hand knowledge? And may I ask you please if there is additional first-hand knowledge that you have as to why he was transferred and why this happened, that you provide it to this committee.

Mr. CANTOR. That is the extent of my knowledge, totally.

Mr. CHAFFETZ. Did Moody's eventually adopt Mr. Kolchinsky's recommended policy after his transfer?

Mr. CANTOR. I know there was a policy recommendation made before, I am not sure when it was. Before or after his transfer, he made one policy recommendation that was communicated I think to Compliance, maybe to others. It was carefully considered and it was adopted, yes.

Mr. CHAFFETZ. So it was.

Mr. CANTOR. Yes.

Mr. CHAFFETZ. So he did give some good advice. Interesting. OK.

Mr. Kolchinsky, did the SEC ever respond to you when you contacted them about our allegations of misconduct at Moody's?

Mr. KOLCHINSKY. They did. They contacted me last week.

Mr. CHAFFETZ. Just last week? So after this hearing was announced, you got contacted.

Mr. KOLCHINSKY. Yes.

Mr. CHAFFETZ. That is amazing. I am just absolutely amazed.

In your opinion, does the SEC's failure to respond to your allegation shed any light on the agency's ability to police the credit rating agencies, as some in the administration has advocated?

One of the concerns, Mr. Chairman, that we have, and now my time is up, is that here we have an agency that is failing to police and dive into instances of alleged abuse, when you have whistleblowers like these gentlemen here who have stepped up and done what is essentially the right thing, and trying to shed light, and yet they only respond the week before this committee actually calls them to testify.

So I know my time is expired, but I thank the chairman.

Chairman TOWNS. Thank you very much. The gentleman's time has expired.

I now call on Mr. Foster of Illinois.

Mr. FOSTER. Thank you, Mr. Chairman, for holding this important hearing.

One of the major problems that we are wrestling with here are the conflicts of interest inherent in the issuer-pays business model for the rating agencies. And I agree with Mr. Kolchinsky that the best analog of this is how we handle conflicts in the oversight of the accounting industry. And I believe that the best model for going forward may be modeled on the Public Company Accounting Oversight Board [PCAOB].

An oversight board like the PCAOB would be constituted largely or dominantly by users of credit ratings and would have teeth. Specifically, it would have the powers to set standards, to mandate disclosures. It could conduct spot checks and investigations. It could impose civil fines. It could ban firms and individuals from the credit rating industry.

I believe that the PCAOB has been necessary and sufficient to restore credibility to the accounting industry in the post-Enron era. And so my question is: What, if any, might be the downside of instituting a similar oversight board for the credit rating industry?

I guess I will start with Mr. Kolchinsky.

Mr. KOLCHINSKY. Sir, the only downside I can see from that would be the argument of homogeneity of the ratings. In practical terms, that is not much of a downside because with ratings shopping and the bankers in charge of selecting which ratings agency to go to, they were effectively, there were very few differences between ratings.

So theoretically, that would be a downside, but in practical purposes, that was already the practice.

Mr. FOSTER. So your reservations are that it might not be a complete solution, but that there would be no——

Mr. KOLCHINSKY. It would not be a complete solution.

Mr. FOSTER. Right.

Mr. KOLCHINSKY. There is no perfect solution to this problem, but I think this is something that allows competition between ratings firms. It allows some minimum standards for the protection of taxpayers and investors. And it allows things to be done in a public transparent matter, instead of being done in backrooms or committee rooms at the rating agencies.

Mr. FOSTER. All right. So in general, you would endorse that way forward?

Mr. KOLCHINSKY. Very strongly. Yes, sir.

Mr. FOSTER. Mr. McCleskey.

Mr. MCCLESKEY. Sir, the model that you describe also sounds analogous to FINRA, which was NASD when I worked there. I worked there for 5 years as an investigator, and I have to say that I am supportive of that model for the reasons that you have already mentioned.

I think that you are able to draw on more experience. You are able to pay people more than on government scale when you have essentially a self-regulatory organization.

Now, I would point out that in essence the SEC backstops FINRA, that there are some shared jurisdiction. And I think that is a good model as well. The SEC also provides oversight of the self-regulatory organizations, and I think that should be a legitimate role of such an organization. So I would agree it is not a complete solution, but I would say that it would be helpful.

What is the downside? I would say, you know, it has to be funded, but you know, some things, you know, my view, having been in this business for quite some time, is sometimes regulation does cost money. It is a cost of doing business.

Mr. FOSTER. Pure industry self-regulation did not stop the Enron scandals and so on. And that would be the advantage of making it somewhat less than pure industry self-regulation.

Mr. Cantor.

Mr. CANTOR. In the list of powers that you would ascribe to this new entity, it seemed to me that most of those powers already reside with the SEC, and I would leave it for others to decide where those, you know, what type of organization is best able to implement those powers. But I would support and continue to support the type of powers that you describe, with the exception of a proposal I thought I heard you say to establish essentially standards for methodologies, which would basically introduce a government agency or a government-type agency into the opinion-setting process and effectively stifle diversity of opinion and would lead to essentially, eventually lead to government-based ratings, not privately determined opinions.

Mr. FOSTER. I understand. That is an issue that I am personally conflicted on. You know, there is the usual debate about discouraging innovation versus setting standards. And I think there is certainly merit that at least part of what gets reported is based on standards that can be compared side by side for all rating agencies.

Anyway, thank you and I yield back.

Chairman TOWNS. Thank you very much.

I now yield 5 minutes to the gentleman from Indiana, Mr. Souder.

Mr. SOUDER. I thank the chairman, and I want to join with the other Republicans. I know you are fair. You try to work these things out, to have a Friends of Angelo hearing. I understand the Justice Department is looking at it. They look at a lot of things that we do, but it appears if we don't do a hearing on that very public subject that we are afraid to touch it because it might have involved Members of Congress. And I would encourage the chairman to continue to look at and I would appreciate if he would do so.

Chairman TOWNS. I appreciate the gentleman's concern.

Mr. SOUDER. I have a couple of general comments I want to make, and then a couple of very direct questions that I fear I am not going to be able to get an answer to.

One is that I don't view this as a failure of capitalism. Part of the problem here is, as Mr. Issa said, is when you have three companies that have 90 percent of the market, how does an oligopoly work versus a true competition? And that is really what we are kind of probing in these hearings, because the function of this committee is to look at the past. We are an oversight committee. Other legislative committees look at the future.

So Mr. Cantor, when you say we have made changes, that isn't really enough right now. We have to dig in and find out what happened to see whether those changes are adequate. We had this discussion with Mark McGwire who didn't want to be here to walk about the past, but we had to understand steroids before we could talk about what we were going to do in the future.

And that the whole fundamental premise of capitalism requires accurate information. We believe capitalism can regulate itself if in fact ratings are accurate, information is there, and can do that. But in the failure to do that, which clearly there were whoppers of errors here, we had five billionaires on the panel here.

When I asked Mr. Paulson, who made the most that year, $3.7 billion, how did you make the money, how did you make that much, because it seemed to me a lot of the evidence of the housing bubble was there, he said, "I bet against all the people who were going the other direction."

That is how they made $1 billion that year because they could figure out that the market was about to collapse, and why couldn't the rating agencies figure that out, which are more for the average person is likely to buy based on the rating agencies. And that suggests that very sophisticated analysts could get different information or had either access to information or understood information differently than the basic bond rating agencies.

Now, Mr. Issa raised another fundamental question, and Mr. Cantor, you gave two things that have been frustrating to this committee. One is we never seem to have the right person there to answer the questions. And the second part is that in the legal question, it was said by Mr. McCleskey, I think, in his testimony, says there may be civil lawsuits here. And part of the problem in getting all the information is that if you have pending lawsuits, just like in the case of Friends of Angelo, the No. 1 thing that people in my District want to know, is if there was corruption or if there was collusion or withholding information, did people go to jail? That is the No. 1 thing. They don't want our committee to trample on that.

But the chairman may have to call some people in to let the American people see that there is a refusal to answer the questions because, in fact, there is an investigation, because my fundamental question is, in Mr. McCleskey's charge, for example, that it was 15 to 20 years that some of these agencies hadn't been reviewed for public securities of cities and towns and so on. Is that true? And have you submitted emails to suggest that you had a debate about that?

Mr. CANTOR. You want to know what are, describe our surveillance practices for U.S., local and regional governments?

Mr. SOUDER. In other words, have you submitted evidence to this committee that suggests that he was factually incorrect?

Mr. CANTOR. I haven't seen the particulars of what Mr. McCleskey has been asserting, so I don't know whether it is correct or not correct.

Mr. SOUDER. Mr. McCleskey, you made the allegation here today in your testimony. Have you ever seen any evidence that suggests you were incorrect in your allegation that they hadn't reviewed these securities in many years?

Mr. MCCLESKEY. No, sir. I think that by the time I left, there were some discussions about how to improve it, but that as I recall there were still a lot of problems out there. And the simple fact of the matter is that you have tens of thousands of these things out there.

In my view, the only way that these can be reviewed at all is through algorithms that will pop up alerts, the same way that we do in a lot of other compliance and regulatory matters.

Mr. SOUDER. Let me ask you a broader question here, because both of you have made allegations. You were whistleblowers. You have a track record of that. The company is responding that you were inaccurate; that for one reason or another your department wasn't performing well. That is why you were terminated. It wasn't anything to do with being whistleblowers.

Well, the only way to check that is because they claim that there was internal debate, and you claim there wasn't internal debate. One of the only ways this committee can verify whether there was an internal debate is to get documents from the company that prove that there was an internal debate. And to my knowledge, we don't have those documents.

And the question is, is the reason we don't have those documents is because this is about a lawsuit that if, in fact, we found that there were no such documents, that the company would be vulnerable to lawsuits because it would show that there wasn't any internal debate.

Do you believe such documents exist anywhere in the system? Or have any knowledge that once it matches up, that they had a debate and your argument was rejected, as opposed to the fact there wasn't a debate, and that is why you were filing your complaints?

Mr. MCCLESKEY. Well, I think, as I said before, the problem is: Was anything documented? So there may be, whether there is a debate or not, the question of whether people could provide you documents may be a different issue, whether documents were actually created.

Mr. SOUDER. Mr. Chairman, this is a very critical point because if they can, because the basic establishment question here is that the whistleblowers' charges were just their opinion, and that in fact there was a robust debate and their opinion was rejected, and they just made a bad decision about what was happening in the market.

Whereas the counter-argument that would say the government does it is basically saying that there was corruption involved. And if there is a civil lawsuit threat here, we may not get those documents. But if there is proof that they actually had an internal debate and they just made a bad decision, that would affect what we would propose legislatively.

I yield back.

Chairman TOWNS. Good point, and that is why we would ask Mr. Cantor to make certain that we get the documents. I mean, I think this is so important. There was a meltdown and we are really trying to get to the bottom of it, and we need your help in the process.

When we look at the fact that Lehman Brothers was rated AAA. AIG was AAA. And then all of a sudden, look what happened? So it is important that, you know, we know. And I am hoping that you will cooperate, you know, or maybe you feel there is no problem.

Do you feel there is a problem?

Mr. CANTOR. Problem with what?

Chairman TOWNS. You don't think there is a meltdown? I mean, you have heard of that, haven't you?

Mr. CANTOR. The financial crisis has been severe.

Chairman TOWNS. Yes. And you don't see that you had a role in it in terms of the rating agencies?

Mr. CANTOR. During the buildup to this financial crisis, there was a whole chain of events and participants in the market of which we were one that made poor decisions and did not perform as expected. I think we were not alone, and I don't think we were the biggest and most important player in this, but we did misjudge the extent of the coming meltdown in mortgage-related securities.

Chairman TOWNS. So that is the reason why we need the documents.

Congresswoman Speier from California.

Ms. SPEIER. Thank you, Mr. Chairman.

Mr. Cantor, I have probably sat in on 200 or 300 hours of hearings in the last year on the financial services industry, and I come to one simple conclusion. The financial service industry has basically created this structure so that heads they win, and tails the American people lose.

And it all comes down to something so very basic. Let's start with Lehman's. You rated them as AAA. $2 billion was lost in Lehman's AAA securities by cities and counties throughout this country, money that they were setting aside because they were about to do constructions on schools and firehouses and the like. And it was just up in air. Poof.

The American people really want to have some level of accountability. And I want to ask you if you took action or Moody's took action against anyone who had rated Lehman's as AAA. Was there any disciplinary action taken against anyone?

Mr. CANTOR. Lehman was rated A and was rated through a rating committee process. There were no actions taken against anyone involved in that process, that everything that was done was according to our codes of conduct, and there was no basis for doing——

Ms. SPEIER. If nothing was done to anyone who rated Lehman's as an A when it was bankrupt, then something is wrong with your methodology.

Now, isn't it true that a couple of years ago your industry, and Moody's was part of it, came to Congress and said, we want to be regulated, but we want you also to pass a law that provides that no private right of action can be brought against us as rating agencies.

Mr. CANTOR. I don't recall any such thing. We currently are subject to securities law, and we are subject and can be sued, and have been sued.

Ms. SPEIER. But no individual private rights of action?

Mr. CANTOR. Again, I am not an expert in legal matters. My understanding is there are private rights of action.

Ms. SPEIER. All right. Let me ask you about this. In Mr. Kolchinsky's internal memo to Moody's executives, he said that the assigned ratings in the Sahara Finance EUR, Limited were clearly wrong. In fact, Mr. Kolchinsky then urged Moody's to stop a related transaction from adding billions of more toxic assets to investment balance sheets.

I guess the first question should be to Mr. Kolchinsky. Did Moody's take any action?

Mr. KOLCHINSKY. Ma'am, I do not believe the second transaction was rated, as far as I know.

Ms. SPEIER. Was not rated?

Mr. KOLCHINSKY. Was not rated. So the second transaction that I warned about——

Ms. SPEIER. And the first was rated, and it was rated at what?

Mr. KOLCHINSKY. I do not recall at this point. It was an investment-grade rating, but I don't recall off the top of my head.

Ms. SPEIER. Mr. Cantor, do you recall?

Mr. CANTOR. I believe this transaction was rated and was rated AA three.

Ms. SPEIER. AA three. And then what happened to this particular transaction?

Mr. CANTOR. It is currently rated AA three.

Ms. SPEIER. It still is rated as——

Mr. CANTOR. Its rating hasn't changed.

Ms. SPEIER. I am sorry?

Mr. CANTOR. Its rating has not changed.

Ms. SPEIER. Its rating has not changed. And the subsequent transaction was not rated. And why was it not rated?

Mr. CANTOR. I am not familiar with the specifics of that, so I can't address it.

Ms. SPEIER. All right. Let me ask you this. One of the big problems that some of us see is that there is a huge conflict of interest, that issuers come to you and ask you to give them consulting services so that when they package their particular issuance, it will be rated highly. So much like the accounting industry where we put firewalls up, many of us suggest that you should have firewalls between your consulting services and your rating services.

It also appears that your compliance staff reports to your general counsel, and the general counsel's responsibility is to prevent liability for Moody's. But the compliance officers are there to make sure that Moody's is complying with all the SEC regulation. So it would suggest that you have on the one hand compliance officers who are supposedly making sure that you are following SEC guidelines, reporting to an individual as general counsel who wants to make sure that you have no liability, so there will be a conflict, just very significant. Has that particular structure——

Mr. CANTOR. I believe on the contrary. The general counsel's role is to avoid liability exposure for the company and there is no better way to avoid liability than to have your employees comply with your regulations and code of conduct.

Ms. SPEIER. Well, Mr. Chairman, my time has expired, but I can't understand how you could take qualified people in your compliance section, dump them, and bring people who don't have any expertise in compliance and place them in that role under the general counsel unless you were really trying to avoid having people who were going to ask questions about how you were doing business.

I yield back.

Chairman TOWNS. Thank you very much.

I now yield to the gentleman from Virginia, Congressman Connolly.

Mr. CONNOLLY. I thank the chairman, and I thank him for this thoughtful hearing.

Well, let me pick up on the last exchange between the gentlelady from California and yourself, Mr. Cantor. You said the best way to avoid liability is to make sure you comply. Is there some reason, our staff were briefed this morning about the Kramer Levin review, which I guess you were referring to when you said that the allegations put forward by Mr. Kolchinsky were investigated and found to be baseless. Although it is my understanding that, a), that review is not complete; and that b), the entirety of this review will be oral. It will not be put in writing. Is there a reason for that?

Mr. CANTOR. We discussed earlier the communications around and documentation around that investigation. I will communicate the wishes of this committee to our legal counsel and I expect they will be able to comply with any request that comes from the committee.

Mr. CONNOLLY. Well, that is really not my question. Is there a reason why, I mean, this strikes me as quite unusual that a review of charges of fraud by your outside counsel would, in fact, not be in writing. And apparently, Kramer Levin indicated it is not going to be put in writing.

Mr. CANTOR. I am not familiar with whether there will be a written report or not.

Mr. CONNOLLY. Are you familiar with the fact that it is or is not the practice of Moody's to give such instructions to outside counsel?

Mr. CANTOR. I am not familiar with the instructions that we have given in these cases. My role as the chief credit officer is to review the methodologies and the quality of the ratings.

Mr. CONNOLLY. Do you remember any outside counsel ever investigating anything at Moody's in the past? Anything strike you in terms of a review and whether it was put in writing or not?

Mr. CANTOR. I have not been part of a process of a previous external review.

Mr. CONNOLLY. Well, all right. Sticking to the same sort of seeming penchant for secrecy, Mr. McCleskey, in your letter to the SEC, you said that John Goggins, the general counsel at Moody's, told employees not to put any compliance or rating problem in emails or any other written form. Why would he give such instructions, do you think?

Mr. MCCLESKEY. Well, sir, the first thing I would say is I didn't have that directly from John Goggins because I had very few conversations with John Goggins at all. Everything came through Michael Kanef. And although Mr. Goggins, the general counsel, was my second-level supervisor, and although he spent considerable time with the other person at my level, in the almost year that I was underneath him, he did not set foot in my office a single time.

Mr. CONNOLLY. Well, irrespective of whether it was Mr. Goggins or not, was it in fact your understanding generally, company-wide, don't put anything in writing?

Mr. MCCLESKEY. That was definitely communicated.

Mr. CONNOLLY. And why do you think that was generally communicated?

Mr. McCLESKEY. Well, my speculation, sir, would be really going back to the point that was raised earlier. You have two different comparatives, if you will, between compliance and legal departments that are concerned about liability. In compliance, you need to document when you see a problem. You need to document what you did about it, because if it is not documented, it didn't happen in the eyes of the regulators.

Mr. CONNOLLY. Yes.

Mr. McCLESKEY. So if we would see something, we would want to document it. From a liability point of view, at least theoretically, you don't want to have documents lying around.

Mr. CONNOLLY. Let me ask you, Mr. McCleskey, at any points did superiors at Moody's tell you not to talk to SEC investigators during the SEC sweep investigation?

Mr. McCLESKEY. Nobody ever directed me not to talk to the SEC.

Mr. CONNOLLY. So we do have secrecy, well, or at least a desire to avoid putting things in writing, whether it be outside reports about fraud allegations or whether it be anything that could be traceable by the SEC, apparently built into the culture. Would that be a fair characterization, in your opinion?

Mr. McCLESKEY. Yes, sir.

Mr. CONNOLLY. Mr. Cantor.

Mr. CANTOR. I am sorry. What was the question? That we have a secrecy culture?

Mr. CONNOLLY. I guess I am asking you to comment as to whether there is this culture of the avoidance of having anything traceable in writing, even to the extent, as I asked you earlier, about an outside counsel report on an allegation of fraud, from Mr. Kolchinsky which, by the way, earlier you assured us was baseless based on a report that is not completed and not in writing, and then you told us, well, I am not familiar with past history or why it might not be in writing. You were confident enough to cite it as exonerating, but not confident to talk about the details of whether it is in writing or not.

Mr. CANTOR. Moody's conducted its own internal review and reached that conclusion. The preliminary findings of the outside law firm confirms those findings.

Mr. CONNOLLY. Was the Moody's internal review in writing? Is that something you can share with the committee?

Mr. CANTOR. I have not reviewed anything. There may be a document. I don't know.

Mr. CONNOLLY. Well, if you haven't reviewed it, sir, how can you speak with such confidence before this committee under oath that internal review can be trusted?

Mr. CANTOR. Because I spoke with our head of compliance and regulatory affairs, and he discussed it with me.

Mr. CONNOLLY. I see.

My time is up, Mr. Chairman.

Ms. NORTON [presiding]. Next, the gentleman from Florida, Mr. Mica.

Mr. MICA. Thank you.

Just a couple of quick questions, I guess to Mr. Kolchinsky. You made a series of allegations about Moody's misconduct. I believe you are the one who made those allegations in a letter to the SEC.

What was the basis of your allegations? I mean, you saw things that were going on and then you thought it was your responsibility to report to SEC what you saw going wrong. So what did you see wrong at what point, and when did you notify the SEC?

Mr. KOLCHINSKY. Sir, my first report was to the Compliance Group about——

Mr. MICA. I am sorry?

Mr. KOLCHINSKY. My first report was to the Compliance Group. I put it into——

Mr. MICA. In writing?

Mr. KOLCHINSKY. In writing. It was a 14-page memorandum.

Mr. MICA. And did they respond to you?

Mr. KOLCHINSKY. As far as I know, they hired Kramer Levin and also suspended me.

Mr. MICA. They what?

Mr. KOLCHINSKY. They suspended me.

Mr. MICA. The company suspended you.

Mr. KOLCHINSKY. Yes, sir.

Mr. MICA. For whistleblowing?

Mr. KOLCHINSKY. That is my belief, yes.

Mr. MICA. OK. But you never got a written response from SEC to this date?

Mr. KOLCHINSKY. Sir, after I was suspended, I reached out to the SEC to make them aware of these violations. I spoke to them last week, and we are planning on meeting so I can discuss further with them.

Mr. MICA. OK. But again, first you found that you thought it was incumbent on you to report what you saw as improper activities. And you talked to Compliance and you also wrote to Compliance both?

Mr. KOLCHINSKY. I wrote to Compliance.

Mr. MICA. I am sorry?

Mr. KOLCHINSKY. I wrote to Compliance.

Mr. MICA. You wrote. OK. And you never had gotten a response?

Mr. KOLCHINSKY. I, as we discussed previous, everything was mostly done by phone call. So I received a phone call.

Mr. MICA. They called you in response to your letter?

Mr. KOLCHINSKY. They called me and they said they are bringing in Kramer Levin and somebody from Kramer Levin will be in contact with me. All communications from them were verbal.

Mr. MICA. So how did Moody's find out about what took place?

Mr. KOLCHINSKY. I handed Michael Kanef the memo that I wrote.

Mr. MICA. OK.

Mr. McCleskey, you also reported wrongdoing. Did you report that to the SEC?

Mr. MCCLESKEY. Sir, I sent a letter after my departure to the SEC. It is probably going too far.

Mr. MICA. I am sorry. For some reason, I couldn't hear you. You sent a letter?

Mr. MCCLESKEY. I am sorry. I sent a letter to the SEC after my departure.

Mr. MICA. After your departure?

Mr. McCLESKEY. Yes, sir. And I don't think I would characterize it as necessarily whistleblowing with respect to wrongdoing. I wanted to flag an issue to them to make sure that they were aware of it when they were preparing to conduct their examinations.

Mr. MICA. Was your departure voluntary?

Mr. McCLESKEY. No, sir.

Mr. MICA. So they terminated you. Did they cite the cause for which you were terminated?

Mr. McCLESKEY. No, sir. All they did was they said that senior management had lost confidence in me.

Mr. MICA. Had you had any contact with SEC or any other individuals in reporting activities before the letter that you sent after you departed and were dismissed?

Mr. McCLESKEY. I did not have any contact with the SEC prior to my departure.

Mr. MICA. Or anyone else who you reported whatever activities you thought should have attention of a regulatory body?

Mr. McCLESKEY. No, sir. I don't think my departure was directly related to any whistleblowing.

Mr. MICA. OK. And did you get a response to your comments that you made for attention to SEC after you were terminated and departed?

Mr. McCLESKEY. They sent me an email confirming receipt and said they were considering what to do about it.

Mr. MICA. OK.

Mr. Cantor, why should the Federal Government continue to grant Moody's and other big credit rating agencies a protected oligopoly by requiring financial institutions to rely only on your ratings?

Mr. CANTOR. Moody's favors the reduction and elimination of the use of ratings in regulation, so we do not favor it.

Mr. MICA. So you feel that others could be involved in the process?

Mr. CANTOR. Yes.

Mr. MICA. Do you think Congress should regulate that process?

Mr. CANTOR. There is currently a draft bill that has been prepared in Congress to remove the use of ratings in many government legislation and regulations.

Mr. MICA. How do you think that should be structured? You don't have to comment on the bill that is before us, but what would be a fair way to have, say, some competitiveness in credit rating, but also keep a high standard of rating?

Mr. CANTOR. Right. Well, I think in addition to reducing the regulatory reliance on ratings, the field of competition in the market could be improved by enhancing the financial disclosures required by issuers of structured finance securities.

At present, given the limited disclosure requirements in that market, only rating agencies that have been asked to rate those securities have the full access to all the information that might be needed to evaluate the risks of those securities. And we recommend that the SEC require more extensive financial disclosure, much as is required of corporations in America when they issue debt into the capital markets.

And that way, multiple rating agencies, not just the ratings agencies asked to rate the debt, and multiple analysts from different types of firms, can do their own analysis and choose to publish that analysis if they wish to monetize their conclusions or just provide for some other reason that information to the broader marketplace.

Ms. NORTON. The gentleman's time has expired.

I will take 5 minutes.

I am curious before I ask a question about the Compliance Group that fascinates me, this internal watchdog. Given the blanket dependence, I would say of the Nation. It is hard to think of an institution, or for that matter, individuals that weren't dependent upon these credit agencies. Given the source of their revenue, has the fall, the collapse of the economy, had an effect on the revenue of Moody's, or for that matter, if you know of any of the other rating agencies?

Mr. Cantor.

Mr. CANTOR. Moody's has had significant decline in revenue over the last 2 years, yes.

Ms. NORTON. Why is that? Is it because people aren't, those who fund them, which of course those whom they regulate, as it were, or who we depend upon them, is it because they go less often to the rating agencies? Why has the revenue fallen?

Mr. CANTOR. We have had fewer requests for ratings.

Ms. NORTON. Sorry?

Mr. CANTOR. We have had fewer requests for ratings.

Ms. NORTON. So people are out there on their own? There is nobody watching. If you can say they were watching, there is nobody watching now. People, does that, any of the three of you think that shows a lack of confidence in the agencies now, that revenue has fallen and folks don't regard a rating as particularly, or at least absolutely indispensable any longer?

Mr. Kolchinsky.

Mr. KOLCHINSKY. I think certainly the confidence in the rating agencies has fallen. The drop in revenue is primarily due to drop in revenue from structured products, and I think——

Ms. NORTON. Due to what? I am sorry.

Mr. KOLCHINSKY. The drop in revenue in structured products. Those are the products, like mortgage-backed securities.

Ms. NORTON. Yes. Fewer of those products, derivatives, etc., to talk about or to grade.

Ms. KOLCHINSKY. Yes, ma'am. And I think a lot of that has to do with the fact that at the time of the boom, one structured product would buy another structured product. So ABS CDO would buy subprime, and SIV would buy a part of the ABS CDO.

When that chain broke, that whole market disappeared. So there weren't a lot of what is called in the industry "real money investors" that were actually buying these products. These were all moved on bank balance sheets or somewhere else into another structured product.

Ms. NORTON. I am fascinated by this internal watchdog. Internal watchdogs normally do not yield a lot of confidence, and one reason it is hard to set one that can yield confidence. We have tried here in this Congress. You know, how do you get enough without too much if you are, in essence, trying to do internal regulation of your own conduct.

Mr. Kolchinsky, you have indicated or cast doubt upon the independence of Moody's' compliance Group.

Mr. KOLCHINSKY. Yes, ma'am.

Ms. NORTON. Why do you believe the Compliance Group is not independent, in whatever the word independent can mean within those internal watchdog circumstances?

Mr. KOLCHINSKY. Ma'am, there are several reasons. First of all, I believe——

Ms. NORTON. Speak a little louder into the microphone.

Mr. KOLCHINSKY. Sorry. I believe there are several reasons for that. I believe, first, a truly independent Compliance Group would report up to the independent members of the Board of Directors. They would not have a reporting line from the general counsel to the CEO on the business generation.

Second of all, I——

Ms. NORTON. So are they reporting in the same way they were reporting?

Mr. KOLCHINSKY. I believe so. They are still reporting through the general counsel up to the CEO. And there is no scrutiny of that from the Board of Directors, or the independent members——

Ms. NORTON. So the same people who were reviewing their work are still reviewing their work, with whatever lessons the collapse may have taught them?

Mr. KOLCHINSKY. Yes.

Ms. NORTON. Do you believe that with the same, is it the same chain of command, essentially?

Mr. KOLCHINSKY. It is the same chain of command as I believe when Scott, Mr. McCleskey, was at the rating agency. Yes.

Ms. NORTON. So no change in the chain. And I understand the conundrum here. How do you change, there are only so many people you can report to. What would be the resistance, since this is a watchdog? Because it doesn't involve matters of ethical matters, matters of the law. You could always ask the general counsel to advise you.

Mr. McCleskey, Mr. Cantor, what would be the resistance to reporting to the Board of Trustees who have a fiduciary obligation and therefore, it seems to me, are the only really appropriate overseers within the organization?

Mr. CANTOR. The individual that is responsible for both compliance and regulatory affairs, so the person in charge of compliance, has an additional duty as well to also liaise with our regulators. That person has met regularly with our Board of Directors, I believe quarterly, and meets with our independent Board of Directors.

Ms. NORTON. My time, too, is limited. I want to know why, as I say, I would expect him to meet. I expect the Board to consult with him. What reason could a rating agency offer for not having the report unfiltered of a violation go first to the Board of Directors? Then they could ask general counsel. They could ask outside counsel. They could ask the government.

Why, in light of what it seems to me was the unkindest cut of all, the cut that came from the agencies on whom everybody depended, why isn't the way to restore confidence at least to place responsibility for notification of violations of ethical standards and the law, first to the Board of Trustees or to the Board, whatever it is called, so that it can decide whom to consult?

What is the resistance and how would anybody justify reporting in the very same way that the chain of command occurred before, and that everyone agrees was an ingredient to the collapse of the economy?

Mr. MCCLESKEY. If I could respond to that question, because I was the person who was involved in this chain of command. The first distinction I would make is that the person who Mr. Cantor described is not the head of Compliance. The head of Compliance, as designated on public filings to the SEC, reports to Mr. Kanef. Mr. Kanef reports to the general counsel.

Now, when I first got to Moody's, we had a different reporting chain and the idea was that once a year I would report to the Board, and in the first year, I did. After the chain of command changed, I did not have access to the board.

Ms. NORTON. Should you have?

Mr. MCCLESKEY. Yes. And to answer your question, what is the motivation for it, I can only speculate, but in my view, having been there and in that situation, it is a matter of controlling risk, that you have somebody there who doesn't come from the litigation background or has this different agenda, the compliance officer. I simply don't believe that it was viewed prudent to have the actual head of Compliance have that kind of access.

Ms. NORTON. Prudent? I am just looking for a reason, you know.

Mr. MCCLESKEY. It is my speculation, but it is speculation based on my experience.

Ms. NORTON. Yes. Finally, if one is looking at how to regulate this matter and one is trying to keep the government from getting into the weeds, would you suggest that a report directly to the Board might be one place to begin?

Mr. MCCLESKEY. I would, yes.

Ms. NORTON. The requirement of a report to the Board might be one place to begin?

Mr. MCCLESKEY. I would.

Ms. NORTON. Yes.

Mr. KOLCHINSKY. Yes, ma'am.

Ms. NORTON. What about you, Mr. Cantor?

Mr. CANTOR. A report from Compliance directly to the Board of Directors would be something we would consider. I don't see a difficulty with it.

Ms. NORTON. So what was good enough before is good enough now. Thank you, Mr. Cantor.

Mr. Lynch of Massachusetts.

Mr. LYNCH. Thank you, Madam Chair.

I want to thank the witnesses for helping us with our work.

It appears that, at least as this reform proposal moves forward, we are still going to have over the counter derivatives traded. These structured products are going to be traded outside of exchanges. And it appears, at least the way this is developing, we are still going to have an issuer-pays model after all this reform is done. So we are still going to have the conflict of interest that we have been dealing with in the past.

It seems to me that if we are not going to eliminate the conflict of interest in the issuer-pays model, then we have to somehow balance that. And at least the only way I can imagine doing that is to introduce some type of liability on the part of rating agencies that stamp AAA on these structured products. Because the vast majority of the market, they don't understand deeply the mechanisms of these structured products, but they do understand AAA. They do. And that is what allowed a lot of these projects to go viral and cause problems in the first place.

It seems to me that there has to be some type of underlying liability for the rating agency if they slap AAA on something that doesn't deserve it. And right now, the way we have this system, it is tantamount to immunity for the rating agencies, even though they recklessly put AAA on a product that turned into junk 30 days later or 60 days later or 90 days later.

Mr. Kolchinsky and Mr. McCleskey and Mr. Cantor, is this a viable option of introducing some liability that might act as a constraint on these rating agencies from giving ratings to these products in return for cash? Because the rating agencies are also going to get extra money, they are going to get a bigger payday for rating these complex structured products, then they do the standard products.

So how would you suggest that we eliminate this conflict of interest and there is liability, one of those options?

Mr. Kolchinsky.

Mr. KOLCHINSKY. Sir, I believe that extra liability should come hand in hand with specific defined standards. And that does two things. On the one hand, it helps investigators and regulators to see when a fraud or misconduct has occurred, because they can compare it to a defined set of standards. Today, most of these standards come from the rating agency itself, so the rating agency becomes the judge, jury and executioner of its own standards.

Second of all, having a defined set of standards would cut down on frivolous lawsuits by an investor, for example, who just made a bad decision. So if you have a set of standards for some minimum sets of things that a rating agency must do, that is a good benchmark to see when liability or fraud has actually occurred or other types of negligence. At the same time, it prevents frivolous lawsuits from investors who just made a bad decision.

Mr. LYNCH. Yes. I do agree that it shouldn't be a hair-trigger test for liability, otherwise you would have everybody who didn't think the instrument performed the way they wanted it to would have a cause of action. We don't want that.

Mr. McCleskey.

Mr. MCCLESKEY. Well, sir, I would be against any kind of blanket immunity of the type that you are describing. I think that, you know, with respect to the first amendment protection for rating agencies, I am not a lawyer, but come on, that is not what the first amendment was for.

Having said that, I would agree that if you are going to introduce more liability, you do need to do it in a measured way with some sort of controls, because we did have difficulties about a decade ago with a lot of frivolous securities lawsuits where, as you say, every time the stock ticked up or down and somebody lost money, off to court we were. So I do see that as a potential danger.

But having said that, I am not a lawyer, but my personal view is that there ought to be some measure of liability.

Mr. LYNCH. Thank you.

Mr. Cantor.

Mr. CANTOR. As we discussed today, Moody's is already subject to liability. We can be sued for fraud and for violation of securities laws. We have a number of lawsuits publicly announced and outstanding. So we already are subject to significant liability.

What I think is most important is that there be accountability, and I think there is a fair measure of accountability, certainly in the private market, in the private use of ratings we are accountable. Our reputation is being constantly reevaluated, and our reputation is being evaluated now.

It has always been the focus of Moody's management and its analysts on producing the highest quality ratings and strengthening our reputation to the maximum degree. And the current and recent experience, if anything, has reinforced that concern and the primacy of that concern in our rating practices.

Mr. LYNCH. Thank you. My time has expired.

Madam Chair, I yield back.

Ms. NORTON. The gentlewoman from Ohio, Ms. Kaptur.

Ms. KAPTUR. Thank you very, very much for appearing this morning.

May I ask each of you gentlemen to state for the record your professional qualifications? In other words, what your background is? Are you attorneys? Are you mathematicians?

We can begin with the first gentleman here.

Mr. KOLCHINSKY. I have an undergraduate degree in aerospace engineering. I have a law degree and a master's of science in statistics. I have worked in structured finance my entire career.

Ms. KAPTUR. Thank you very much.

Mr. CANTOR. I have a Ph.D. in economics. I taught economics for a number of years at universities, and I worked for 10 years in the Federal Reserve system, and have been at Moody's for 12 years.

Ms. KAPTUR. Mr. Cantor, thank you.

And what about Mr. McCleskey?

Mr. MCCLESKEY. I have a master's degree in financial regulation and compliance management. I also have a master's degree in international relations from Cambridge, where my dissertation concerned financial regulation. I have been in the markets in the United States and Europe for approximately 15 years. I participated in the drafting of regulations and I have several published articles and books on the subject.

Ms. KAPTUR. All right. Are any of you gentlemen familiar with the term in the law control fraud?

[Pause.]

Ms. KAPTUR. You are not? Well, if you are not familiar with it, then if you have been a part of it, you wouldn't know it, I guess, if you don't even know the term.

Mr. MCCLESKEY. Can you repeat the term again?

Ms. KAPTUR. Control fraud.

Mr. MCCLESKEY. I am not familiar with it, no.

Ms. KAPTUR. Control fraud is systemic fraud in which many, it goes beyond a single person, but the person participates in a system that is essentially fraudulent, and as a participant in that system causes a great deal of harm and participates in illegal activity.

Let me ask you, as the housing bubble burst and foreclosures increased, mortgage-backed securities issued by mortgage brokers began to crumble, despite the AAA ratings that Moody's and others had placed on these issuances.

As you look back on this, with all of your education and experience, how could you participate in rating particularly the senior tranches that had AAA ratings that collapsed? How is this possible? Would you please explain that? We can start, each one of you.

What happened, Mr. Kolchinsky?

Mr. KOLCHINSKY. I think the main part of the problem were was poor incentives everywhere across the board.

Ms. KAPTUR. Poor incentives?

Mr. KOLCHINSKY. Poor incentives.

Ms. KAPTUR. Define that.

Mr. KOLCHINSKY. You had mortgage brokers who were incentivized to get as many mortgages as possible, without any concern for the credit quality. They would be paid upon closing of the mortgage.

Ms. KAPTUR. Yes, but the rating you gave them, you gave them very favorable ratings, AAA ratings. So the paper was brought to you. I am asking you, though, in terms of how could you have been a participant and your company a participant in a system that collapsed? Don't blame those that brought it to you. Once you got it, what did you do?

Mr. KOLCHINSKY. I think we over-relied on quantitative models.

Ms. KAPTUR. On quantitative models. I wanted to ask you for Moody's, how many people actually worked for Moody's prior to the collapse of the market?

Mr. KOLCHINSKY. I don't have that information off-hand.

Ms. KAPTUR. What would you guess? Anybody?

Mr. KOLCHINSKY. My guess is about 3,000; 3,000 to 4,000.

Mr. CANTOR. Yes, 2,000, maybe in the rating——

Ms. KAPTUR. 2,000, did you say?

Mr. CANTOR. In the rating agency itself, 2,000.

Ms. KAPTUR. Could you speak into the mic?

Mr. CANTOR. 2,000, I believe, maybe more.

Ms. KAPTUR. About 2,000 people. OK. How many of those people, then, would you, of the 2,000, Mr. Kolchinsky, your job was Managing Director. You were the head of it all?

Mr. KOLCHINSKY. No, ma'am. I was one of four managing directors, one of the four managing directors within the CDO group. And we had about 100 people total within that group.

Ms. KAPTUR. About 100 people. Were these the people that were the mathematical brains that ascertained risk?

Mr. KOLCHINSKY. Some were mathematicians. We had a lot of Ph.D.s. We had a lot of lawyers. People came from across the board. But that was part of the group which decided methodologies, built the models, and ran the models.

Ms. KAPTUR. All right. So in other words, the made big mistakes.

Mr. KOLCHINSKY. Yes, ma'am.

Ms. KAPTUR. All right. And so it wasn't just that the mortgage brokers brought this paper to you, but there was a system set up. And explain to me internally, inside your company, what happened in that risk division that was so faulty? What happened and why did it happen?

Mr. KOLCHINSKY. I think the system that existed in place allowed bankers and other participants to game the models that were set up. The models are actually very public, and what participants could do, could look at the models and change——

Ms. KAPTUR. When you say model, are you talking mathematical model?

Mr. KOLCHINSKY. Yes, mathematical models, as put into an actual spread sheet or a piece of software or even a methodology. In my group in the ABS CDO Group and CDOs in general, those models were actually publicly available. Some were free to download from the Web site. But that allowed bankers and other participants to game those models.

Ms. KAPTUR. But who approved those models?

Chairman TOWNS [presiding]. The gentlewoman's time has expired. I ask unanimous consent to give her an additional 1 minute.

Ms. KAPTUR. I thank the gentleman.

Who approved those models? Who invented the models and who approved them?

Mr. KOLCHINSKY. It was different groups and people who were tasked with that. Most of them internally, based on data that was provided to Moody's.

Ms. KAPTUR. Did you approve them?

Mr. KOLCHINSKY. I did not approve any specific one model.

Ms. KAPTUR. Who approved them? Somebody above your pay grade?

Mr. KOLCHINSKY. In some cases it was above my pay rate because I wasn't in the position yet.

Ms. KAPTUR. Can you get me a list of who approved them?

Mr. KOLCHINSKY. Ma'am, I wouldn't know. It was done by the committee, and usually——

Ms. KAPTUR. Which committee?

Mr. KOLCHINSKY. By a committee set up for a particular methodology. So there is a——

Ms. KAPTUR. Under your watch?

Mr. KOLCHINSKY. No, not under, not under my specific——

Ms. KAPTUR. Above you?

Mr. KOLCHINSKY. It would be in some cases above me, some cases below me, but it all, there was no standard process of model review and approval during the credit crisis.

Ms. KAPTUR. Let me just, in closing, Mr. Chairman, I wanted to ask Mr. McCleskey. You were the chief compliance officer?

Mr. MCCLESKEY. Yes, I was.

Ms. KAPTUR. OK. The SEC did an examination of Moody's in what was it, 2006, 2007, something back then?

Mr. MCCLESKEY. I believe 2007.

Ms. KAPTUR. How long did you meet with them as chief compliance officer?

Mr. MCCLESKEY. How long did I meet with them?

Ms. KAPTUR. Yes.

Mr. MCCLESKEY. I did not meet with them.

Ms. KAPTUR. They did not——

Mr. MCCLESKEY. They did not meet with me.

Ms. KAPTUR. You were the chief compliance officer and the SEC did not meet with you?

Mr. MCCLESKEY. That is correct. They met with our Legal Department and outside counsel, and I did object.

Ms. KAPTUR. That is a shocking statement.

Mr. MCCLESKEY. I did object to that.

Ms. KAPTUR. Thank you, Mr. Chairman.

Chairman TOWNS. Thank you very much.

I now yield 5 minutes to the gentleman from Maryland, Mr. Cummings.

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

Mr. Chairman, I wasn't going to ask any questions, but listening to Ms. Kaptur's questions, I was just curious, and could not help what I heard when she was asking about this fraud, and she went on to ask questions concerning why all of this happened. And I think you said something about insufficient incentives. Did somebody say that? Mr. Kolchinsky.

Mr. KOLCHINSKY. Yes, sir, I believe.

Mr. CUMMINGS. And can you help me with that, explain that to me? With all my constituents losing their houses, losing their savings, losing everything they have, we hear about people on Wall Street getting these phenomenal bonuses. And I mean, when I heard those words, I almost fell out of my chair. I was trying to eat my lunch, and I had to come and ask you a question about that. Can you help me with that? Were they making, do we have some making a little bit of money on Wall Street? Is that it?

Mr. KOLCHINSKY. No. Obviously, people on Wall Street——

Mr. CUMMINGS. Make a lot of money.

Mr. KOLCHINSKY. Yes, sir.

Mr. CUMMINGS. While messing over the American people, big time.

Now, tell me, just explain to me because my constituents want to know, when you say a lot of this happened because of insufficient incentives——

Mr. KOLCHINSKY. Poor incentives, yes.

Mr. CUMMINGS. What does that mean?

Mr. KOLCHINSKY. Because for the most part, most people in the securitization chain were not paid based on the long-term performance of the product they originated. So a mortgage broker was paid at the closing of the mortgage, not depending on how the mortgage did. The mortgage originator, like a Countrywide or a New Century, was paid when they sold the mortgages to an aggregator bank, like a Lehman Brothers or a Merrill Lynch. They were paid right there and then, not depending on how the mortgage performed. The bank then structured those mortgages. The bankers were paid on the closing of the deal, not on depending on how the security performed. That security went through an ABS CDO.

Mr. CUMMINGS. So in other words, it was like selling a piece of zero, I started to use another word, and calling it something more valuable than what it is, pass it on like a hot potato. At some point, somebody is going to have to pay, and the American people paid by being thrown out of their houses and losing their savings and what have you. Is that right?

And so, is that right?

Mr. KOLCHINSKY. Yes.

Mr. CUMMINGS. Yes. And then they were also put in a position where, what you are saying is that they were being paid for quantity and not quality. Is that right?

Mr. KOLCHINSKY. That is correct.

Mr. CUMMINGS. And, I mean, if you were, say, Secretary Geithner, what advice would you give to the President of the United States? Because I can tell you there are a lot of people in my District who are mad, and they are wondering whether or not we are doing the things that we need to do to straighten out this mess, but not only to straighten it out, but to make sure it does not happen again.

And I want you to look into, just look straight ahead, there is probably a camera facing you right now, as if you are talking to the President of the United States, and say, Mr. President, this is what I would do; this is how you correct this mess; this is how you make is so that we don't have to go through this again; this is so that Mr. Cummings will not be coming before you telling him about all of the things that his constituents have suffered through, and continue to suffer through, and how they have been robbed of their savings, robbed of their futures, robbed of their houses.

Tell him. Tell the President. He's watching.

Mr. KOLCHINSKY. Well, sir, I would recommend that alignment of incentives across the board would probably be by far the best solution. And that is actually return to the old roots of Wall Street where there used to be a term called "eat what you kill," and that meant somebody only takes home whatever they actually produce, and whatever money that they bring in.

And my recommendation would be that people who work in complex products and structured products retain a vertical slice of whatever they produce. And hopefully that would align their incentives that their eventual pay and whatever they take home is based on whatever they produce.

So the mortgage broker will get paid based on the mortgage. If that mortgage didn't pay on the first payment, then they wouldn't originate. They would know that is a bad investment, and the same down the line. Countrywide, New Century, Lehman, Merrill Lynch and all those bankers, they would not put the taxpayers at risk, because they were putting their own livelihood at risk.

Mr. CUMMINGS. Did you have something, Mr. McCleskey?

Mr. MCCLESKEY. No, sir.

Mr. CUMMINGS. OK.

Thank you very much, Mr. Chairman.

Chairman TOWNS. Thank you. Thank you.

I yield a minute to the gentleman from Indiana.

Mr. SOUDER. Reinforcing the gentlelady from Ohio and the gentleman from Maryland's point, sales people to some degree sell, and yes, it would be nice if they had long term. The check was supposed to be you. You are the rating agency. You knew, obviously, that they had a motive to sell, that there was no back check. The back check is supposed to be the rating agencies. You are supposed to say what they sold wasn't real.

And instead, we had the hedge fund people figuring out and telling us that they figured out it wasn't real. They made money betting against your ratings. And that is what we are trying to figure out how to address here because in the market, yes, some people are sellers. Other people are supposed to long term, but if the rating agencies are cahoots with the sellers, there is no public backstop.

And now everybody is turning to government because the private sector didn't perform the function. And her questioning was along the lines of where were you all. Now, we are going to have some testimony from an attorney, Mr. Abrams, who says that you didn't perform an investigative function. You took basically the word of the management and you basically said a similar thing that they were reporting to you. And the American people think you are an investigative agency. They think you are doing an independent investigation, not just taking a pass-on from the companies.

And so you weren't the check to the sales part. And that is part of our frustration.

I yield back.

Chairman TOWNS. They were saying that if you pay us, then we will rate it. I mean, all you have to do is just pay us. I mean, that is basically what happened here.

So let me thank all of you for your testimony, and say to you, Mr. Cantor, we would appreciate if you would help us get the documents. You know, we would like that very, very much, because, as we look at the overall meltdown, that our interest and concern is to try to make certain that it does not happen again. And in order to do that, you could be very, very helpful in that process. Thank you very, very much for coming.

Thank you, Mr. Kolchinsky.

Thank you, Mr. McCleskey.

Thank you, Mr. Cantor.

Thank you very, very much.

Now, we move to the second panel.

I would like to welcome our second panel. As with the first panel, it is committee policy that all witnesses are sworn in. So if you would please stand and raise your right hands while I administer the oath.

[Witnesses sworn.]

Chairman TOWNS. You may be seated. Let the record reflect that all witnesses answered in the affirmative.

Let me begin by introducing our witnesses.

Senator Alfonse D'Amato served as a New York Senator for 18 years. During his Senate career, Alfonse D'Amato served as the chairman of the Senate Banking Committee and was also a member of the Senate Appropriations Committee and the Senate Finance Committee. Since leaving Congress, Senator D'Amato has founded a public policy firm called Park Strategies.

Good to see you, and I am happy to know there is life after you leave this place.

Mr. Floyd Abrams is a nationally recognized first amendment lawyer. Over his long career, Mr. Abrams has represented a wide variety of clients, including the Brooklyn Museum of Art, the New York Times, Time Magazine, Senator Mitch McConnell, AIG, and most recently, Standard & Poor's. Welcome.

Mr. Eric Baggesen is a senior investment officer of Global Equity for the California Public Employees Retirement System. He is responsible for implementation and management of investment strategy and policy for the pension fund, $132 billion portfolio in publicly traded equity investments worldwide under his current leadership. The Global Equity Unit also oversees CalPERS corporate governance, hedge fund, domestic long and short cash management, and manager development programs, and the ongoing restructuring of the asset class that began last year.

Welcome.

Dr. Lawrence White is a professor of economics and the deputy chair of the Economics Department at New York University, Stern School of Business. Dr. White has also served as a board member for the Federal Home Loan Board and as the director of the Economic Policy Office in the Antitrust Division at the Department of Justice. Before joining the Stern School, Dr. White was a member of the President's Council of Economic Advisers during the Carter administration.

Welcome.

At this time, I ask that each witness deliver their statement within 5 minutes, and of course, you know the procedure. The yellow light comes on, which means you have a minute remaining. And after that, then it becomes the red light, and that means stop. I have been having some problems with the members of the committee recognizing red today because it is such an interesting topic and, of course, they are trying to get to the bottom of it because so many people have been hurt as a result of what has gone on with this meltdown.

So we will start with you, Senator D'Amato. Good to see you.

STATEMENTS OF HON. ALFONSE M. D'AMATO, FORMER CHAIRMAN, SENATE COMMITTEE ON BANKING; FLOYD ABRAMS, PARTNER, CAHILL GORDON & REINDEL, LLP; ERIC BAGGESEN, SENIOR INVESTMENT OFFICER, CALIFORNIA PUBLIC EMPLOYEES RETIREMENT SYSTEM; AND LAWRENCE J. WHITE, PROFESSOR, LEONARD N. STERN SCHOOL OF BUSINESS, NEW YORK UNIVERSITY

STATEMENT OF HON. ALFONSE M. D'AMATO

Mr. D'AMATO. Thank you, Mr. Chairman.

First of all, Mr. Chairman, let me congratulate you for holding this hearing. It is important, because I feel very strongly that the failure of the system, and the credit rating agencies in particular, contributed substantially to the economic chaos that hit this country, small homeowners, business owners, and right across.

Mr. Chairman, credit rating agencies began their lives providing an important and very legitimate investment tool that allowed investors to evaluate securities. Once the system change to one where issuers paid for the agencies to rate their securities, the stage was really set for trouble.

There have been a number of Members today who have raised that issue. And if you want to cut through it all, that is the problem with the system. Issuers are paying the rating agency, and the rating agencies are looking the other way.

Why? You had two young men testify today, and I dare say they lost their jobs and were fired unfairly because they dared to sound an alarm. And the higher-ups didn't like it. And the fellow who testified for Moody's today, that was a debacle. He didn't know anything. He just knew that they try to do good ratings.

You have one person who was the chief compliance officer. They finally adopted things that he had recommended. In the interim, they said, well, you didn't get along and they dumped him out.

By the way, he wasn't the traditional whistleblower. He came in here only after the committee invited him. And I dare say Mr. Kolchinsky, his colleague, somewhat naively thought that if he brought certain matters to the attention of the people that he should have that they would have responded, and they did. They threw him out. And the SEC did not investigate until 1 week ago after you held these hearings. Shame on the SEC. Shame on them. It is like putting a lamb guarding the tiger's den. That is what has been going on. And at long last, they finally came out with a list of recommendations, at long last. I think that this committee and the Financial Services Committee should examine them, because they are meritorious. But one that is most important and should be acted upon, and they have the ability, and Congress has the ability to do so, is the SEC's proposed prohibition against letting a rating agency act as both a rater and a paid adviser for securities issuers. This dual capacity is one that unavoidably creates conflicts of interest. And don't buy this firewall nonsense. It doesn't work. And the American people have a right to be protected.

Mr. Chairman, I have spent some time discussing this matter with the prestigious Financial Economics Roundtable, and they have a number of methodologies that they suggest. I am going to ask that their testimony that we have submitted, that their statement be placed in the record as if read in its entirety.

Chairman TOWNS. Without objection, so ordered.

[The information referred to follows:]

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For Release
December 1, 2008

Statement on
Reforming the Role of the Statistical Ratings Organizations in the Securitization Process

The Financial Economists Roundtable (FER) is a group of senior financial economists, who have made significant contributions to the finance literature and seek to apply their knowledge to current policy debates. The Roundtable focuses on microeconomic issues in investments, corporate finance, and financial institutions and markets, both in the U.S. and internationally. Its major objective is to create a forum for intellectual interaction that promotes in-depth analyses of current policy issues in order to raise the level of public and private policy debate and improve the quality of policy decision.

FER was founded in 1993 and meets annually. Members attending a FER meeting discuss specific policy issues on which statements may be adopted. When a statement is issued, it reflects a consensus among the majority of the attending members and is signed by all members supporting it. The statements are intended to increase the awareness and understanding of public policy makers, the financial economics profession, the communications media, and the general public. FER statements are distributed to relevant policy makers and the media.

The following statement on "Reforming the Role of SROs in the Securitization Process" is the result of a discussion at FER's annual meeting on July 12 - 14, 2008 in Glen Cove, New York. A list of members approving the statement and their current or most recent affiliation is attached.

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December 1, 2008

Statement on

REFORMING THE ROLE OF SROs IN THE SECURITIZATION PROCESS

During the last few decades, securitization has become a primary channel for enlarging financial markets and transferring credit risk from lenders to investors. Outstanding issues of privately securitized assets peaked worldwide at just under $12 trillion in 2008.[1]

When properly structured and monitored, securitization promises numerous benefits. It can generate opportunities for specialization that reduce funding costs, increase the range of financial products available, encourage financial institutions to deploy capital more efficiently, and allow borrowers, lenders, and investors to manage their risks more flexibly. However, transferring risk undermines incentives to perform due diligence at virtually every stage in the securitization process. In the last year, evident shortfalls of care and diligence in the origination, rating, and securitization of mortgages have led to a collapse in the prices of securitizations related to subprime mortgages, alt-A mortgages and other leveraged loans. The suddenness and extent of this price decline has undermined confidence in the reliability and integrity of the ratings process for asset-backed securities, and has reduced prices and credit flows in every market in which investors count on ratings firms to ascertain the quality of debt.

Meeting in Glen Cove, New York in July 2008, the Financial Economists Roundtable (FER) discussed the need to strengthen the securitization process by changing the incentives under which Statistical Ratings Organizations (SROs) operate. SROs (profit-making firms that prefer to call themselves credit rating "agencies") play a central role in testing the quality of the

[1] See Table 1 at the conclusion of this statement.

pool of obligations being securitized and in creating and marketing "tranches" of graded claims to cash flows from the underlying mortgages or other debt. The scope and scale of ongoing ratings downgrades and defaults on securitized debt make it clear that the ways in which credit ratings are used and constructed must be reformed.

The FER sees a strong need for three types of credit-rating reform. First, FER supports strategies designed to improve SRO incentives by increasing the transparency of their modeling practices and holding their managements accountable for negligent ratings errors. Second, the FER challenges the wisdom of incorporating SRO ratings in securities and banking regulations issued by governmental entities. By outsourcing public authority to private firms, this practice intensifies the conflicts of interest that SRO personnel must resolve. Finally, to acknowledge differences in the degree of leverage that is imbedded in different issues of securitized debt, FER recommends that SROs be required to state an express margin for error in their ratings for every tranche of securitized instruments.

Some Historical Perspective

Bond markets functioned internationally for 300 years before the first rating organizations appeared in the United States. An active corporate bond market, largely in debt issued by railroad companies, emerged in the middle of the 19^{th} century in the United States more than half a century before the first SRO opened for business. SROs remained largely US-focused until the 1970s, when global capital markets began to reemerge after fading in the interwar period.

In the pre-SRO era, underwriters performed some certification and monitoring for investors. Thereafter, third-party ratings mitigated asymmetric-information problems between issuers, underwriters, and investors by credibly centralizing efforts to collect and analyze the information needed to estimate, monitor, and update the probability of default of individual bonds.

Ratings data also expanded the range of investors willing to hold corporate bonds to include parties that lacked the resources to undertake a complete and independent credit analysis. SROs originally earned their revenue by selling ratings manuals directly to investors.

Building a reputation for accuracy is critical to the success of any SRO. Ratings firms prospered to the extent that their predictions of the probability of default proved reliable after the fact. Over time, the accumulation of reputational capital by successful SROs made entry difficult for new SROs. The result is that two or three SROs have dominated the market for credit ratings, and did so long before the SEC began to designate particular SROs as **Nationally Recognized Statistical Rating Organizations** (NRSROs) in the 1970s.

In the early 1930s, incentives for SROs to produce reliable information for investors were complicated by introducing ratings into the regulatory process. Regulators of banks, insurance companies and pension funds began to use ratings to limit the riskiness of the assets held by regulated entities. Regulators now set two kinds of rules: rules that restrict the extent to which a firm can hold assets that fall below investment-grade or, as in the case of money market mutual funds, require a higher threshold than investment grade, and rules that link capital requirements to the ratings on individual securities, with lower capital charges for high-rated securities.[2] The existence of such regulatory consequences was bound to intensify pressure on

[2] For example, (Sylla 2002, p. 37) notes that in 1936, the US Comptroller of the Currency issued a regulation prohibiting banks from purchasing investment securities with characteristics that were "distinctly or predominantly speculative," and then added that "the terms employed...may be found in recognized rating manuals, and where there is doubt as to the eligibility of a security for purchase, such eligibility must be supported

SROs to inflate the grades of lower-rated securities, because regulated clients routinely explore and develop ways of reducing their regulatory burdens. Frank Partnoy (1999, p.684)[3] describes client pressure in this way: "[O]nce regulation … incorporates ratings, rating agencies begin to sell not only information but also valuable property rights associated with compliance with the regulation." As ratings became more widely used in trigger clauses in bond contracts, strong ratings conveyed additional benefits to the issuer.

Of course, a concern for protecting their reputations can act as a healthy counterincentive. Studies of ratings accuracy during the 20th century find that SROs have done a reasonably good job of predicting the probability of default of corporate bonds relative to regulatory indicators[4] of default risk and market measures of default risk. Still, grade inflation has occurred. Caouette et al. (2008) observe that though the ratings do represent relative risks (on average) reasonably well, they are less reliable as indicators of absolute credit risks; default probabilities associated with specific rating levels drift over time and therefore need to be frequently updated.[5]

The spread of photocopying technology facilitated unauthorized reproduction of SRO rating manuals, which undermined the traditional user-pays revenue model. SROs responded by

by not less than two ratings manuals." The latter phrasing, referring to recognized raters, was attacked as placing too much authority in the private rating agencies, and on that ground it was deleted from the regulation in 1938, although in a less formal way it remained in effect with regulators. For additional details see Richard Sylla, 2002, "An Historical Primer on the Business of Credit Rating," in *Ratings, Rating Agencies, and the Global Financial System*, edited by Richard M. Levich, Giovanni Majnoni, and Carmen Reinhart, The New York University Salomon Center Series on Financial Markets and Institutions, Kluwer Academic Publishers, pp. 19-40.

[3] Frank Partnoy, 1999, "The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies," *Washington University Law Quarterly, 77, October.*

[4] For example, Hickman (1960) used legal investment lists for savings banks adopted by regulatory authorities in the states of Maine, Massachusetts, and New York as an indicator of regulatory ratings. For additional details see W. Braddock Hickman, 1960, *Statistical Measures of Corporate Bond Financing since 1900*, Princeton: Princeton University Press.

[5] See J. Caouette, E. Altman, P. Narayanan, *Managing Credit Risk*, 2nd edition, John Wiley & Sons, NY, 2008. The expected dollar-denominated default rate on non-investment grade corporate bonds in 1984 was 1.6% per year, but is now 3.9% per year. As late as 2007, Fitch reported that the default rate on structured products through 2006 was similar or lower than that on corporate bonds. Subsequently, results for structured products deteriorated sharply.

shifting to a business plan in which the issuer pays for their services. This plan intensified SRO conflicts of interest with issuers. Issuers and underwriters actively shopped for ratings and were unwilling to pay for ratings they deemed too low.[6] In the case of the newer securitized debt, pressure for favorable ratings has been particularly intense because the large underwriters of structured debt could direct substantial future revenue to a cooperative NRSRO, thus increasing the potential for undue influence. SROs argued that concern for maintaining their reputational capital would nevertheless insulate ratings decisions on securitized debt from undue influence by issuers. This argument became increasingly less persuasive as income from rating structured debt began to increase sharply and account for almost half of the revenues of the three dominant firms.

A further weakness inherent in issuer-pays arrangements is that they undercut SRO incentives to monitor and downgrade securities in the post-issuance market. The re-rating of securities is usually paid for by a maintenance fee that is collected in advance from each issuer. Few issuers are eager to be monitored closely, especially when monitoring is apt to result in downgrades, and so it is not surprising that ratings are seldom downgraded until long after public information has signaled an obvious deterioration in an issuer's probability of default.[7]

Not until 1975 did the SEC confront the problem of how to determine whether a particular SRO could be relied upon to provide ratings of sufficiently high quality that they could be used in the regulatory process. The SEC's solution to this problem was to certify particular SROs as meeting sufficiently high standards to be designated by the SEC as an NRSRO. Other

[6] The June 2008 settlement between the New York Attorney General and the ratings agencies mandated charging separate fees for indicative ratings. While the intent was to reduce shopping for ratings, some FER members raised concerns that it may have the opposite effect by lending tacit official approval to the practice of shopping for ratings.

[7] E. Altman, H Rijken, "How Rating Agencies Achieve Rating Stability," *Journal of Banking & Finance*, 28 (2004), 2629-2714, and E. Altman & H. Rijken, "A Point in Time Perspective on Through the Cycle Ratings," *Financial Analysts Journal*, 62, No. 1, (2006), 54-70.

regulatory agencies, Congress, and many private agreements made use of the SEC's designation of qualified NRSROs. For potential new entrants to the ratings industry, the costs and uncertainty of obtaining NRSRO status imposed an additional, legal barrier on top of their already substantial reputational disadvantage. From 1975 to 2002, although the SEC received numerous applications from entities in the United States and abroad, only one new general-purpose NRSRO was approved.

The NRSRO designation strengthened the market power of the dominant three incumbent firms: Moody's, Fitch, and Standard & Poors. In turn, the oligopolistic position these firms enjoy reduces their incentives to compete in ratings methods and procedures. For example, even though SROs inevitably lack long histories and through-the-cycle data on innovative instruments, they have all been slow to draw on the information generated by derivatives trading (especially in credit default swaps) and from secondary markets for debt and equity, both of which would help them analyze potential defaults in a forward-looking context. Nor have SROs developed procedures for supplying information on correlations that investors need to protect against concentrations in risk exposure that might exist in a portfolio of securities.

Despite the potential benefits of strengthening competitive forces in the SRO industry, the three major NRSROs have been permitted to acquire competitors virtually without challenge.[8] The FER believes that the regulators could enhance competition among SROs by more vigorous application of antitrust policy. Although the SEC recently recognized a handful of additional firms as NRSROs in the last two years in response to pressure from Congress to ease barriers to entry, it will take considerable time for new entrants to wean much market share away from the three dominant firms.

[8] For example, Moody's purchased the market-based credit risk and portfolio management firm, KMV, in 2001 and Duff & Phelps was purchased by Fitch in the early 1990s. Although KMV was not formally an NRSRO, it competed directly with NRSRO firms.

FER's Evaluation of SEC Proposals for Reform

Because some market participants are bound to base investment decisions primarily on credit ratings, efforts to improve ratings quality are important. In June, the SEC proposed several ways to improve the work of SROs and to increase competition in the ratings industry in three ways. The avowed and laudable purpose of these proposals is to foster increased transparency, accountability, and competition in the credit rating industry for the benefit of investors. The precise models used by SROs are proprietary and to encourage an individual SRO to invest in improving its models, the models themselves must remain proprietary. At the same time, to hold SROs accountable for their performance requires that each SRO release enough information on data input into its models to allow outside experts to verify its conclusions or provide alternative results.

The SEC's first proposal seeks to mitigate conflicts of interest, enhance disclosures, and improve internal policies and business practices at SROs. The second proposal would require NRSROs to differentiate the ratings on structured products from those that they issue on traditional bonds and loans, and perhaps to provide a timely and relevant accompanying narrative. The third proposal would nearly eliminate the role of ratings in SEC regulations. FER supports the thrust of each proposal. To explain why, we discuss each in turn.

In the important areas of disclosure and incentive conflicts, the SEC's first proposal would require SROs to:

- Publish all ratings and subsequent re-ratings in ways that facilitate comparisons of SRO performance in a timely manner. Disclosures would include performance statistics for spans of 1, 3, and 10 years within each rating category.[9]
- Disclose all information used to determine ratings for structured products. In addition, this would require each SRO to explain whether and how it might rely on the due diligence of others to verify the character of the assets underlying a structured product and to include sufficient information on the changing value of underlying assets to permit outside analysts (i.e., persons who are not paid by the issuer) to evaluate the riskiness of the structured claims issued against them.
- Explain how frequently credit ratings are reviewed, whether different models are used for ratings surveillance than for setting an initial rating, and whether, when changes are made in an SRO's models and procedures, they are applied retroactively to existing ratings.

The FER is less enthusiastic about the SEC's proposed prohibition against letting an SRO act as both a rater of and a paid advisor for a tranched securitization. Although we appreciate that acting in these dual capacities intensifies SROs' conflicts of interest, we believe that the customary industry practice of presenting alternative structures for an SRO to rate makes it impossible for the courts to distinguish ratings services from advisory services in a definitive way. Moreover, we believe the enhanced disclosures will ease this conflict of interest.

The SEC or Congress might also impose disclosure requirements on issuers. Every US issuer of securitized claims could be required to provide a monthly balance sheet and income statement for each and every securitization structure it creates, even if the securities are to be

[9] Although SROs provide data on default rates for bonds and loans by rating categories, data on structured products have been provided less frequently and ought to be published faster and more extensively in times of market turmoil.

marketed offshore. The revenue-generating pool of underlying assets constitutes the structure's assets and the tranches set by the securitization structure constitute claims against these assets. When underlying assets lose value, whether through rating downgrades or outright defaults, prospective revenues diminish and the values of affected tranches deteriorate. These easy-to-interpret disclosures would make pending deteriorations in cash flows more visible to investors and permit the joint distribution of risk statistics for the various tranches to be studied more effectively.

The SEC's second proposal seeks to differentiate ratings on securitizations in the future from those on ordinary bonds. Because of their imbedded leverage, securitized instruments may have a much deeper downside loss exposure than ordinary bonds. Using the same grading scale for both kinds of instruments reduces the effectiveness of restraints on institutional risk taking built into longstanding regulatory protocols. This renders many inherited regulatory strategies obsolete and was bound to confuse at least some investors. As an estimate, every credit rating carries a calculable margin for error. Introducing a differentiated scale is one way to alert investors that downside margins for error are much larger for securitized claims than for ordinary debt. Because imbedded leverage and downside margins for error grow larger when claims on an underlying asset pool are tranched and retranched, SROs should be required to express ratings on securitized debt in a two-dimensional fashion (i.e., with an accompanying estimate of their particular margin for error). This would be much more useful than merely developing a separate scale for securitized instruments. SROs might either use estimates of potential downside variability to rate claims in an interval framework (e.g., a particular rating might be expressed as lying in the range from A to AAA) or prepare and publish the volatility estimates themselves.

The SEC's third proposal addresses its practice of basing rules and reporting procedures on NRSRO ratings. The concern is that the use of NRSRO ratings in supervision simultaneously outsources some of the regulatory authority's political accountability to profit-making firms and appears to confer an official seal of approval on their methods that might reduce the willingness of other parties to undertake due diligence and invest in securities analysis. The SEC proposes to remove references to NRSRO ratings from virtually all of its rules and protocols.[10]

The FER discussion divided references to NRSRO ratings in SEC regulations into two categories: prescriptive mandates that tell asset managers what they must do and quasi- safe-harbor provisions that provide firms, managers and directors some protection from liability for adverse outcomes.

The FER strongly endorses eliminating from SEC regulations every prescriptive mandate that is or would be based solely on credit ratings set by NRSROs. We believe this will have three advantages. First, the prudence of investment decisions must ultimately be evaluated in a portfolio context and cannot be assured by constraining the credit quality of individual assets an institution holds, regardless of how accurate the SRO ratings might be. Second, depriving SRO ratings of regulatory consequences will remove a major source of pressure for ratings inflation. Third, in the absence of SEC mandates, managers and directors can and will subject the prudence of their decisionmaking to review by a much wider array of outside monitors. In particular, they

[10] An exception is drawn for rules and forms that "relate to non-public reporting or recordkeeping requirements used to evaluate the financial stability of large brokers or dealers or their counterparties and are unlikely to contribute to any undue reliance on NRSRO ratings by market participants." (Quoted from SEC 17 CFR Parts 229, 230, and 240, Release No. 33-8940; 34-458071; File No. S7-18-08, p. 5.) These include rules which impose certain recordkeeping and reporting requirements for holding companies that own broker-dealers and of supervised investment-bank holding companies and reports regarding the risk exposures of large broker-dealers and OTC derivatives dealers.

will expand their use of directors and officers insurance and introduce letters of assurance from well-respected experts. Whether or not these other monitors aspire to attain SRO status, they would supplement, extend, and challenge the assessments of individual securities made by SROs, thereby injecting valuable competition into the market for rating services.

The FER found it harder to assess the net benefits of quasi- safe- harbors (offered mainly to directors and officers of money market mutual funds) based on credit ratings.[11] Some members felt that removal of quasi-safe- harbors would yield benefits from increased managerial diligence and reduced pressures for grade inflation that would more than offset the increased compliance costs and costs of defending nuisance lawsuits. Other members believed that there are efficiencies to be achieved by use of intermediaries specialized in credit review. They argued that the rating requirements for money market mutual funds had worked reasonably well (apart from the current credit crisis) and that increased compliance costs, especially for smaller funds, would swamp any benefits that might emerge from increased managerial effort. Moreover, it was agreed that retaining this role for NRSROs would provide SROs with an incentive to register for NRSRO status and comply with the enhanced disclosure requirements. Even if the SEC should decide to continue to offer quasi- safe- harbors based on credit ratings, requiring a new ratings scale for securitized debt means that the content of such provisions has to be analyzed afresh to acknowledge the implications of the distinctions created. A new scale will similarly force banking agencies and state regulatory bodies to rethink and rephrase all rules and regulations that rely on credit ratings. In view of the importance of regulation-induced innovation in creating financial turmoil, such rethinking is long overdue.

Implications for Other Regulators

[11] This protection is at best a quasi- safe- harbor because rule 2a-7(c) (3) states that the board must take into consideration "factors pertaining to credit quality in addition to any rating." It might better be viewed as indicative guidance.

Although the SEC stressed that it had consulted with the President's Working Group on Financial Markets, the Financial Stability Forum and the Technical Committee of the International Organization of Securities Commissions (IOSCO), the SEC's proposed removal of references to ratings in its regulations diverges sharply from reform strategies currently being implemented by other regulators in the US and abroad. For example, the Treasury's temporary insurance of money market mutual funds relies on compliance with rule 2a-7 that relies on rating as a useful indicative guidance, and the Treasury's recent plan to recapitalize banks will be contingent on ratings to some extent. FER sees the SEC's third proposal as providing a timely challenge to other regulators to reexamine the extent to which they plan to employ SRO ratings in their own regulatory schemes.

Although new rules and enhanced supervision might induce slightly better SRO performance, it is unlikely that increased government oversight of the production of credit ratings can improve SRO performance over time and improve the performance of investment managers as effectively as market forces can. It is particularly important for banking regulators to reconsider their reliance on ratings decisions. By adopting Basel II, they are linking minimum capital requirements for some banks to ratings issued by whatever SROs they recognize in each individual nation. Some banks will be free to use Basel II's Standardized Approach, which the European Union and Japan have already begun to implement and is proposed for implementation in the United States. In this scheme, capital charges are assigned to each bank's assets according to their credit ratings, with unrated assets receiving a 100% risk weight. Since loss reserves are already based on anticipated losses, capital requirements are intended to provide a buffer against unexpected risks. Thus, it is illogical to use credit ratings to establish capital requirements, since they convey no information about the volatility of an asset's return around expected loss experience. In addition, ratings may be useful for establishing loss reserves for particular assets, but they say nothing about how a bank's net worth or its portfolio of assets may vary in value. The amount of capital that must be set aside to achieve a particular target level of safety has to be linked explicitly to measures of the volatility of its earnings, not asset ratings.

Since the subprime crisis has had a world-wide reach, regulatory authorities in other countries are also thinking about how to regulate SROs. Despite the SEC's attempt to coordinate its actions with IOSCO, it is clear that different countries may respond to the crisis in different ways. The use of ratings is hard-wired into many European Union regulations. The EU's internal market commissioner is thinking of introducing some exacting regulatory requirements to make sure ratings are not "tainted" by the conflicts of interest inherent to the ratings business. The European Commission has proposed a registration and oversight regime that would have two features. The first charges the Committee of European Securities Regulators (CESR) with the responsibility for choosing an individual country to register, coordinate and consolidate oversight of individual SROs. The second creates a central supervisor, financed from the EU budget, to license rating organizations. As capital markets become more closely integrated, ratings organizations are bound to find it difficult to operate under different rules in different locations. Also differences in rules would complicate cross-country comparisons of ratings for investors and regulators. If a single supervisory approach is to be adopted, FER strongly supports the SEC's strategy which relies on greater transparency, increased competition and the abandonment of the practice of incorporating NRSRO ratings in regulatory mandates. The FER hopes that other regulators will follow the SEC's lead.

Table 1. Estimated Size of the Global Asset -Backed Securities (ABS) Securitization Market
Classified by Collateral Employed
(in billions of dollars)

Prime Mortgage-Backed Securities	$3,800
Subprime Mortgage-Backed Securities	$780
Commercial Mortgage-Backed Securities	$940
Consumer ABS	$650
High-Grade Corporate Debt	$3,000
High-Yield Corporate Debt	$600
Collateralized Debt Obligations	$400
Collateralized Loan Obligations	$350
Other ABS	$1,100
Total	**$11,920**

Source: Compiled from a variety of sources including Goldman Sachs, JP Morgan Chase & Co, Lehman Brothers, Markit.com, Merrill Lynch and IMF Staff estimates

FINANCIAL ECONOMISTS ROUNDTABLE
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Mr. D'AMATO. Mr. Chairman, let me go on to say that reference was made to the debacle that took place at Enron and that took place in corporate America, and things were done to deal with that. That doesn't mean we have a perfect system today, but you did have an analogy that was striking in terms of conflicts, and it undermines the credibility of organizations that people are dependent upon.

Our accounting industry was subverted for a while when you had accountants, the big three, the big four, who were not only auditing, but being paid as advisers. We stopped that. You can't be an adviser today to a public company and be an auditor. And that is as it should be because inherently there is a conflict to both being an adviser and an auditor.

And Mr. Chairman and members of the committee, that inherent conflict of interest exists today. And all this business about, let me tell you. Every one of the big three rating agencies tell you they want competition. First of all, there is no competition really. They enjoy 90 percent of it. They have the stamp of approval from the SEC. The way to really provide competition and get the most modern methodologies involved today, and there is a way to do that, is to see to it that there is a ban on issuers being paid, or paying rating agencies.

It is rather simplistic, but that is where we should start, and that is the nub of the problem.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Alfonse M. D'Amato follows:]

Testimony of the Honorable Alfonse M. D'Amato before US House Committee on Oversight and Government Reform

Thank you, Mr. Chairman, for giving me the opportunity to testify before your committee today on the topic of credit rating agencies and the role they played in the recent financial crisis. Their failure to adequately protect the interest of the investing public caused homeowners, small businesses, and investors in mortgage backed securities everywhere to suffer.

Credit rating agencies, SRO's, began life providing legitimate investment tools that allowed investors to evaluate securities. Once the system changed to one where issuers pay for agencies to rate their securities, the stage was set for the trouble we have today. Add the fact that a select few ratings agencies had the imprimatur of SEC recognition as *Nationally Recognized Statistical Rating Organizations* (NSRO's) with a near monopoly on their services, and the opportunity for bad results multiplied.

The debacle of the sub-prime mortgage crisis could not have taken place without the total complicity of these credit rating agencies. Until today and this hearing, we have not had a comprehensive investigation relating to how these services- Moody's, Standard & Poor's, Fitch, and others- could have given triple-A rating to securities that clearly deserved junk bond rating.

CNBC aired a magnificent expose titled "House of Cards" in which they documented the shocking abdication of responsibility by the rating agencies. It becomes quite clear after an interview with Anne Rutledge, one of Moody's own securities raters, that rating agencies looked the other way because they were afraid to lose business from Wall Street.

Unless there is some liability attached to their actions, rating agencies will have no real incentive to clean up their act. The testimony the committee is receiving today from another brave former Moody's analyst about the apparently continuing problem of overrating dubious securities and the "moral responsibility" he accepts for this problem underscores the need for action.

Credit rating agencies have such obvious conflicts of interest and were so derelict in their responsibilities to the investing public in the past few years that their opinions should now be heavily discounted. They have lost credibility – for as the very word *credit* itself comes from the Latin *credere* "to trust or believe", their pronouncements simply are no longer believable.

Their failure to detect obvious flaws in the financial products they were evaluating was like *not* crying fire in a burning theater. And given that they were so clearly incentivized to favorably rate their clients' offerings, in effect put the firebug in charge of the fire alarm.

This will not change unless the SEC puts real teeth in its proposed new rating agency rules. Until now the SEC has been too timid and lax in its response. The recent SEC vote to consider amending Commission rules to subject rating agencies to liability when a rating is used in connection with a registered offering is a step in the right direction, but it is one that should have been taken long ago and should not take forever to implement.

The prestigious **Financial Economists Roundtable** has made several suggestions for reform in this area that should be acted upon. I have discussed their recommendations at length with Professor Edward Altman of NYU's Stern School of Business, a distinguished scholar and one of the co-authors of the FER's Statement "Reforming The role of Statistical Ratings Organizations in the Securitization Process". With your permission, I will offer their entire Statement for inclusion in the record. If I might just quote the following recommendations:

"The FER [supports]…. Credit-rating reform. [It] supports strategies designed to improve credit rating agencies' incentives by increasing the transparency of their modeling practices and holding their managements accountable for negligent ratings errors. "

"….FER challenges the wisdom of incorporating SRO ratings in securities and banking regulations issued by governmental entities." (Doing so is like relying on Bernie Madoff's accountant to ascertain if his books were in order.)

"… [it] recommends that SROs be required to state an express margin for error in their ratings for every tranche of securitized instruments."

[Finally], "Every US issuer of securitized claims could be required to provide a monthly balance sheet and income statement for each and every securitization structure it creates."

Along with these reforms I would go one step further and support the SEC's proposed prohibition against letting a rating agency act as both a rater of and a paid advisor for securities issuers, as these dual capacities unavoidably creates conflicts of interest. The analogy I would use here is that of the conflicts that undermined the credibility of accounting firms in the past wherein they both audited and advised certain clients. It is inherently a conflict of interest to be both an advisor and auditor, *and* it is inherently a conflict of interest to be both an advisor and a rater.

The SEC should consider new models for sanctioning credit rating agencies that increases the number of approved raters. It should seek advice from an outside panel of experts to vet and approve new rating agencies that doesn't shut out more thorough approaches to credit rating, *including models that more accurately predict the probability of securities default*. It should devise a way to prevent issuers from buying good ratings by requiring them to pay rating fees into a pool that would then be drawn on independently of the issuers by the SEC to retain rating agencies and give unbiased, un-conflicted opinions.

In conclusion, the stability of our entire financial system rests on credible, objective, conflict-free analysis of securities. If we do not shore up this pillar of US economic security, the economy will continue to suffer from a lack of confidence in both our financial institutions and our government. The time to act is now.

Chairman TOWNS. Thank you very much for your testimony, Senator D'Amato.

Mr. Abrams.

STATEMENT OF FLOYD ABRAMS

Mr. ABRAMS. Good morning. Thank you very much for inviting me, Mr. Chairman and Mr. Ranking Member.

I would like to say, first, it is good to have Senator D'Amato back in town. We all miss him. I come from New York, so I can say that freely.

I am appearing on my own behalf today because I was asked by the committee to come, which is to say I was not designated by my client to come. But I do want you to know that I represent Standard & Poor's and have, and represented them for over 20 years, and I have represented the McGraw-Hill Co., their parent, for over 20 years.

Chairman TOWNS. But I am impressed that you represent the Brooklyn Library.

Mr. ABRAMS. So I am here to talk, at least in the first instance, about the issue of liability and the questions and issues raised in part by the new discussion draft released by Representative Kanjorski, because I thought that I could add something from the fact that I represent Standard & Poor's in now over 30 litigations commenced around the country after and as a result of the economic collapse that has occurred.

Those litigations are of lots of different sorts, under lots of different statutes, Federal, State and common law theories. The proposal before Congress now, at least in the discussion draft, is to amend the 1934 Securities Act, which is a fraud statute. And I come here to urge you to try to see that three principles are adhered to, if you should amendment that act.

The first is that we should adhere to the core principle of the act that currently exists, the 1934 Act, which is liability for knowing or reckless misconduct, as distinct from allegedly negligent misconduct, not what is argued by someone to be unreasonable, but by doing something in bad faith, intentionally, on purpose.

Mr. Kolchinsky, who sat in Senator D'Amato's seat a few minutes ago, had the legal test right when he articulated to you what he thought the test was. If a rating agency or anyone else issues a rating or does something in the securities field where they are saying something they don't believe in, that they either know or think is false, if they do that, they can be held liable. And my view is that you ought to continue to adhere to that standard, whatever else you do.

The second thing I think you should do is to treat every defendant equally. Rating agencies should be singled out so that they wind up in a situation where if a rating agency, an accounting firm, and a securities analyst are in the same case, you have different legal standards apply to the three of them. They should be the same legal standards, whatever they are.

And the third is that whatever you do, you ought to do something which is as pro-competitive as possible. And what I mean by that is that there are proposals now in the discussion draft, for example, which I consider extraordinarily anti-competitive. There is a proposal, for example, which would say in so many words that rating agencies have to share all the information they gather with all the other NRSROs that exist, to investigate everything that comes in from all those other rating agencies, to review them, and to be liable if another rating agency does something which is against the law. This is what the draft statute calls joint liability.

I think that is not a good idea. I don't think it is fair. I don't think it is deserved. I also know it is uninsurable. And I ask, who is going to go into this business? Who are the new NRSROs going to be if you enact legislation of that sort?

So I conclude, then, with the notion that with those principles outstanding, you can change the statute if you think it is necessary to do so. I can assure you on personal knowledge there is lots of litigation against rating agencies in the multi-billions of dollars going on right now.

Thank you.

[The prepared statement of Mr. Abrams follows:]

TESTIMONY OF FLOYD ABRAMS
BEFORE

THE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
UNITED STATES HOUSE OF REPRESENTATIVES

September 24, 2009

Mr. Chairman, Mr. Ranking Member, Members of the Committee, good morning. My name is Floyd Abrams. I am a senior partner in the law firm of Cahill Gordon & Reindel LLP and I appear today, at your invitation, to discuss issues relating to the imposition of liability on credit rating agencies. It is an honor for me to be here.

I appear on my own behalf today and not on behalf of any client. My law firm has served as outside counsel to The McGraw-Hill Companies, Inc. ("McGraw-Hill"), and its subsidiary, Standard & Poor's Ratings Services, LLC ("S&P") on a variety of matters for over 20 years. Lately, I have spent much of my time defending both companies in a wide array of lawsuits in state and federal court, many arising out of S&P's recent credit ratings on certain structured finance securities backed by residential mortgages. There are almost three dozen of these lawsuits currently pending. In these cases, plaintiffs are seeking — literally — tens of billions of dollars in damages.

In my testimony today, I will discuss some of these pending cases, along with recent proposals to amend the pleading standards in new cases brought against S&P and other Nationally Recognized Statistical Rating Organizations ("NRSROs"). I will also address certain protections that apply to S&P and other rating agencies under the First Amendment to the United States Constitution.

Pending Litigation Against NRSROs

S&P is currently facing a number of litigations related to its ratings, including its ratings on certain mortgage-backed securities. These cases have been brought in state and federal courts around the country and have included a wide array of claims based on a wide range of theories. Cases rooted in federal law have been brought under statutes as distinct as the federal securities laws and ERISA. Cases commenced under state or common law seek recovery on grounds ranging from negligent misrepresentation to breach of contract to fraud. And lots of other theories as well. I may disagree with plaintiffs' lawyers on a lot of subjects but no one can deny their creativity in conjuring up theories upon which to base lawsuits.

Although most of these cases are still in their early stages, courts have begun issuing rulings in some of them. In one case in which a judicial opinion was issued three weeks ago, a federal court in the Southern District of New York dismissed most claims by the Abu Dhabi Commercial Bank and another plaintiff but concluded that enough facts had been asserted (although not, of course, proved) to allow a claim for common law fraud against S&P and another NRSRO to go forward.[1] The *Abu Dhabi* suit relates to rating opinions on a structured investment vehicle that held, among other things, residential mortgage-backed securities. When the securities issued by the vehicle defaulted, the plaintiffs sought to recover their claimed losses from rating agencies and others, asserting, among other things, that they would not have purchased the securities – valued in billions of dollars – were it not for the supposedly inflated credit ratings.

The plaintiffs are seeking significant damages in the *Abu Dhabi* case. More immediately, S&P will now have to incur the extensive costs associated with sweeping and burdensome discovery above and beyond the costs it has already incurred in that case in turning over thousands of documents before the court's decision.

1 *Abu Dhabi Commercial Bank* v. *Morgan Stanley & Co*., 2009 WL 2828018 (S.D.N.Y., Sept. 2, 2009).

In another case, also in the Southern District of New York, the court let a federal securities fraud case continue against Moody's under SEC Rule 10b-5. In that case, the court held that the plaintiffs had sufficiently alleged various actionable misstatements. Another NRSRO, Fitch Ratings, has also been sued, along with S&P and Moody's, in a number of actions over its rating opinions, including its ratings on mortgage-backed securities.

Although S&P intends to contest all claims against it vigorously and believes it will ultimately prevail, there can be no doubt that ongoing multi-billion dollar claims certainly reflect the availability of legal redress if it is warranted.

Proposals to Amend The Pleading Standard in Cases Against NRSROs

In the midst of these litigations, Congress is considering various proposals to increase further oversight of NRSROs by the SEC (most of which S&P takes no issue with) as well as at least one legislative proposal that could be read to lower the pleading standard in securities fraud cases against NRSROs and which would make NRSROs uniquely vulnerable to a flood of additional and still more costly litigations.

Before discussing this potential change in the law, I think it is important to address briefly the current state of the law on securities fraud and how it treats NRSROs and other defendants. Under the Private Securities Litigation Reform Act, passed in 1995, a plaintiff seeking to recover against *any* defendant for securities fraud under Rule 10b-5 must allege particular facts providing a strong inference that the defendant acted with "scienter," which is another way of saying that the defendant acted in bad faith. This standard was imposed by Congress in a uniform manner in order to prevent strike suits, in which plaintiffs' lawyers file weak, sometimes frivolous, claims that are designed to extract settlements from defendants that would rather avoid the high cost and inherent risks of large litigations, even if they are entirely without merit. Congressional support for the PSLRA's heightened pleading standard was strong and came from both sides of the aisle.

One proposal currently pending in Congress could undo this standard for claims against NRSROs — and *only* NRSROs. Specifically, this bill, as drafted, could be read to permit securities fraud claims against NRSROs based not on allegations that they acted in bad faith, but instead that they failed to conduct a "reasonable investigation" of a rated security, or failed to obtain "reasonable verification" of the facts underlying their rating. Plaintiffs' lawyers will surely argue that this bill represents a complete departure from the PSLRA, and provides for claims against NRSROs — and again, *only* NRSROs — even where they issued their ratings in complete good faith

Under such a framework, if a plaintiffs' lawyer were to bring a securities fraud suit against three defendants, a securities analyst, an auditor and an NRSRO, the plaintiff would have to allege that the securities analyst and auditor acted in bad faith but, with respect to the NRSRO, would argue that it need to allege only that the NRSRO acted "unreasonably." Different standards would apply in the same case. I respectfully submit that any such change is both unfair and unjustified. There is simply no basis for providing ratings of debt instruments with *less* legal protection than that afforded to recommendations to buy or sell stocks.

Potential Harms Resulting From An Amended Pleading Standard

Any law that subjected NRSROs to the prospect of liability by way of hindsight for opinions issued in good faith would be affirmatively harmful to the markets. In this respect, it is important to focus on what a credit rating really is and what it is not. A rating is not a statement of existing fact. It cannot be since it is an opinion about the future. Nor is it some sort of guarantee of performance. It is, by its nature, a forward-looking opinion that speaks primarily to the *likelihood* that a particular security or obligor will default in the future. Market participants have long understood that some portion of rated debt — even highly rated debt — will ultimately be downgraded and, in some cases, default as issuers encounter financial difficulties, the markets they operate in shrink or economies go into recession. This has been borne out over the years in default and transition studies which show that rated entities across the spectrum, including some AAA-rated securities, have historically defaulted, albeit with increasing frequency at lower rating levels. This is the case even where the NRSRO's work is beyond criticism. That some percentage of defaults occur is not evidence that the initial ratings were "too high," "too low" (we have one case alleging that too) or otherwise "inaccurate."

If S&P could be liable under the securities laws even where it acts in good faith, plaintiffs' lawyers would have an irresistible incentive to file suit against it any time rated securities default, or even when they are simply downgraded. The opportunities for such second-guessing would be legion since at any moment S&P rates trillions of dollars of debt. This dynamic could create the potential for an unprecedented number of suits from an unknown but vast class of potential plaintiffs. Although there would be an opportunity in these cases for S&P to contest clams that it had acted "unreasonably" in investigating and verifying the information used to formulate its ratings, the reality is that the cost of putting up this defense every time disappointed investors bring suit could be prohibitively high, giving rise to the very problem that the PSLRA was intended to address.

The harms I refer to would not just be limited to increased litigation costs. They would extend across the market as a whole. Among other things:

- ***There could be less comprehensive ratings analysis*** — Expanding the potential for litigation against NRSROs would create incentives for NRSROs to narrow the scope of their rating analysis in order, again, to minimize the areas for potential second-guessing by plaintiffs' lawyers. For example, a number of NRSROs consider projections prepared by management when rating corporations, public finance issuers, and others. Performing a "reasonable verification" of such projections would be difficult if not impossible to do, yet the liability risk for failing to do so would be enormous. Faced with this choice, an NRSRO might decide to stop taking such information into account. Ratings would thus become more backward-looking and, as a consequence, less geared towards their primary purpose: an assessment of likely credit quality on a going forward basis.

- ***NRSROs could adopt a homogeneous approach*** — Exposing NRSROs to new expansive liability could well lead to a more homogeneous approach to ratings, resulting in less diversity of opinion and strong disincentives for analytical innovation. Faced with potential liability under the proposed standard, NRSROs across the board would have strong incentives to adopt only those processes that courts deem "reasonable," even if they believe a different approach might be more appropriate analytically.

- ***The market would have access to fewer ratings*** — The proposal could also result in the scaling-back of ratings coverage, with the most profound impact felt by newer and smaller issuers. Faced with a dramatic increase in liability risk, NRSROs would likely rate only those entities and securities that are least likely to default or be downgraded or which have a long history of providing the highest quality data. As a result, issuers which are relatively new to the debt markets may have a difficult time getting rated and, therefore, greater difficulty accessing capital.

- ***NRSROs may avoid downgrades to limit liability*** — Ratings are, as I have said, forward-looking opinions. As such, they sometimes change as the economy does or updated facts about a rated entity or security become available. Some rated securities inevitably default; others are downgraded as new facts surface. If NRSROs could be sued every time an obligor or security is downgraded or defaults, the ratings process itself could be distorted so as to avoid downgrading ratings even if circumstances warrant, thus lowering their potential exposure.

Let me be clear. I am not urging that S&P should receive any special treatment in a securities fraud suit brought under Rule 10b-5. I am simply saying that there is no basis for — and there would be harmful consequences resulting from — any effort to subject NRSROs to a different, more relaxed, pleading standard than the one that applies to all other defendants.

I also want to be clear that S&P has supported efforts by some in Congress and within the SEC seeking greater accountability by NRSROs. S&P has supported proposals to provide the SEC with stronger powers to ensure that NRSROs comply with their policies and procedures designed to promote independence and objectivity. S&P has also supported strengthened oversight of NRSROs by the Commission in the form of increased fines and other sanctions where NRSROs fail to comply with those policies and procedures.

Put simply, increased regulatory oversight of NRSROs would provide a more direct, efficient and fair means of improving NRSROs' accountability as compared to a special pleading standard that is not only unnecessary given the current law, but would also facilitate the filing of new, frivolous lawsuits and would very likely reduce the quality and transparency of credit rating analysis available to the market.

Rating Agencies and the First Amendment

I have also been asked to address certain protections that have been afforded to rating agencies under the First Amendment. In this regard, let me first say that while the First Amendment does protect rating agencies in certain circumstances, it does not provide immunity from all potential claims. Indeed, S&P and its parent company McGraw-Hill have filed many motions seeking the dismissal of the cases filed against them, the vast majority of which do not rely in any respect on the First Amendment.

The First Amendment provides no defense against sufficiently pled allegations that a rating agency intentionally misled or defrauded investors. Thus, the First Amendment would not and does not protect a rating agency in a Rule 10b-5 case — the very type of lawsuit that is addressed by the proposal I have been discussing today. Nor does it protect a rating agency if it issues a rating that does not reflect its actual opinion. In these cases, under the law as it currently stands, rating agencies are subject to the same standard as auditors, equity analysts and other defendants, and have no special defenses available to them. If there is any doubt about that, legislation could make it clearer still.

In certain non-fraud cases, courts have recognized, for a variety of reasons, that credit ratings issued by S&P and other rating agencies are entitled to a level of First Amendment protection. These rulings focus less on the nature of ratings as opinions and more on the need to avoid chilling the speech of those who offer ratings lest they refrain from doing so to avoid the dangers of prolonged and potentially crippling litigation. Indeed, in the recent *Abu Dhabi* discussion that I discussed earlier, the court recognized that it is generally "well-established that under typical circumstances, the First Amendment protects rating agencies, subject to an 'actual malice' exception, from liability arising out of their issuance of ratings and reports[.]'[2] But in that very case, as I stated earlier, the court concluded, based on the plaintiff's allegations, that the First Amendment did not preclude the case from going forward.

As the *Abu Dhabi* case thus illustrates, the First Amendment does not provide immunity in all cases. That includes cases brought today under the very statute, Section 10(b) of the Securities Exchange Act of 1934, that would be affected by the proposed amendment in Congress. It also includes claims that meet the well-established standards for pleading common

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[2] 2009 WL 2828018, at *9.

law fraud. The First Amendment is not and has never served as some sort of absolute shield against all such claims.

Conclusion

I thank you for the opportunity to participate in this hearing, and I would be happy to answer any questions you may have.

Chairman TOWNS. Thank you very, very much for your testimony, Mr. Abrams.

Mr. Baggesen.

STATEMENT OF ERIC BAGGESEN

Mr. BAGGESEN. Yes, good afternoon, Mr. Chairman. Thank you very much for inviting me here, and all the rest of the committee members, for hearing CalPERS' voice and perspective on this issue.

My name is Eric Baggesen. I am the Senior Investment Officer for Global Equity, which also incorporates our corporate governance activities at CalPERS. We see the rating agency issue as one of governance. That is the reason that I am here. This is not simply about fixed income instruments.

CalPERS is the largest State pension fund in the United States. We manage approximately $200 billion currently for 1.6 billion members—excuse me, million members, not billion, not yet. [Laughter.]

We definitely rely on the quality and the integrity of market information, and credit ratings are an important portion of that information set. There is a public interest in ensuring that the information disseminated to investors is reliable, that the providers of the information are free from conflicts, and that there is accountability, transparency and proper oversight of the delivery and the development of that information set.

There are three components of information that we find critical to making investment decisions and positioning our investment portfolio. The first of those is financial information, constituting financial statements. Those financial statements are attested to by auditors.

The next is governance-type information, where companies give us information about the activities of the organization in their prospectuses and the activities they have planned for the organization.

And a third component of information is credit-worthiness.

The first two of these, financial statements and governance information, are held to high standards of accountability and are highly regulated. The third, credit ratings, fall into a never-never land. They are not in the same category of integrity as the first two.

If any of these components of information are weak and unreliable, that weakened the entire financial system. There are a number of entities that have attempted to quantify the impact of credit losses in the recent market dislocations that have happened over the last 2 years, and these figures currently run into the trillions of dollars.

The credit rating agencies certainly had a role in that activity. Part of the market dislocation that we experienced potentially can be laid at the feet of rapidly shifting perspectives as to the credit-worthiness of various entities that existed in the marketplace. When you go from a highly rated entity to an entity that is virtually bankrupt overnight, that creates a huge amount of risk in the system, and that rolled through every aspect of the financial marketplace.

CalPERS uses credit ratings in a number of different ways. The most prevalent area where we have credit ratings are in our policy documents that guide how we structure our investment portfolios. Credit ratings are an integral part of that activity. They reflect the degree of risk-taking and return expectations that we have relative to a number of segments of our investment portfolio.

Another area where these things impact CalPERS is the aspect that credit ratings are embedded in many of the market indices. As we engage in asset allocation activities, we look at market indices to tell us what is the risk and return profile of different investment categories. Credit ratings are an integral part of that, particularly in the fixed-income arena.

In the third area, credit ratings are used to control the risk-taking of outside investment managers, so we will oftentimes specify certain types of securities indicated by credit ratings as being applicable to outside managers.

Certainly, our fixed income portfolios make use of credit ratings, as well as their own research and activities. The credit rating agencies have a position where they have access to sets of information that we do not have in our own research activities at CalPERS.

And to the extent in our global equity portfolio, we have approximately 10,000 different securities contained within that portfolio globally. Many of those issuers are dependent on the attachment of a credit rating to allow them to access the capital markets as they execute their capital-raising activities.

And the very last area that I see us using credit ratings is in the area of performance attribution. It helps us understand and disentangle whether investment managers are making money for CalPERS based on taking credit risk, whether they are taking duration risk, all of the different attributes that can be used in that.

So there are a number of places that these things intersect with CalPERS' activities.

The organization has a number of proposals or concepts that they think will help you as you move forward with attempting to address these issues. We do believe that the compensation model is a problem. We certainly support the SEC's actions. We support a stronger SEC. We think that organization is charged with investor protection. We see no other comparable organization.

The agency should have high level compliance staff. They also need to have accountability and responsibility for the actions and the results that stem from their activities in the marketplace.

And at that, I will stop and invite your questions.

[The prepared statement of Mr. Baggesen follows:]

CalPERS

Testimony of
Eric Baggesen, Senior Investment Officer
California Public Employees' Retirement System
before the
House Committee on Oversight and Government Reform

September 30, 2009

Testimony of Eric Baggesen,
Senior Investment Officer, Global Equities, CalPERS
Before the House Committee on Oversight and Government Reform,
24th September 2009

Introduction

I would like to thank Committee Chairman Towns and Ranking Member Issa for the opportunity to testify before you on a subject of great concern in capital markets reform.

My name is Eric Baggesen, Senior Investment Officer at the California Public Employees' Retirement System, CalPERS. CalPERS is the largest state public pension fund in the United States, responsible for assets of nearly $200 billion, which we invest on behalf of 1.6 million beneficiaries. We rely on the quality and integrity of market information to allocate capital on behalf of our beneficiaries. Credit ratings make a critical contribution to those decisions. We therefore welcome the opportunity to discuss with you:

- CalPERS experience of using credit ratings agencies (CRAs)[1];
- the impact of their failure on investors' portfolios ;
- and our recommendations for reform.

Credit ratings are embedded in financial markets via regulation, license and convention. They cannot be avoided, and in many instances their use is effectively a requirement, not a choice. They are integral to our investment policies, including risk management, oversight of manager performance and to the assessment of the quality of individual securities and products.

[1] The term Credit Ratings Agency (CRA) is used interchangeably with the formal definition Nationally Recognized Statistical Rating Organization (NRSRO).

There is a public interest in ensuring that information disseminated to investors is reliable, that the providers of information are free from conflicts of interest and that there is accountability, transparency and proper oversight from provider to user. This is well understood in other areas of vital importance to the public, such as food and drug safety, but also in the provision of information and opinion by third parties who affect financial decisions. Take the example of financial information. Companies are simply not permitted to raise public funds unless they provide financial statements in line with accounting standards, which are subject to an opinion from auditors who are then liable for that opinion, and are subject to both regulation and oversight by the users (shareowners) who appoint them.

Likewise governance or non financial information provided by companies is subject to standards and regulation via the Securities and Exchange Commission (SEC), to ensure that information in prospectuses, announcements, listing reports and other statements is subject to rigorous legal and regulatory oversight.

By contrast, CRAs' standards of business conduct are opaque, there are no agreed guidelines, and their revenues are based on a fundamental conflict of interest. These organizations have privileged access to issuer information, and operate under license within a narrow oligopoly.

Global markets rely upon the quality and integrity of information. There are three vital elements to that information: financial, non financial and credit. Two of these are subject to high standards of regulation and oversight. One is not. If those three channels of information provide the three legged stool upon which global markets depend, then credit ratings are a source of instability: they are the weak leg on the stool.

2. CalPERS experience of using credit ratings agencies

CalPERS investment staff internally manages $50 billion in fixed income securities in sectors that range from US Government, Corporate, Structured (Mortgages and Asset

Backed Securitizations), and Foreign Sovereign. CalPERS is affected across its portfolio both directly and indirectly by credit ratings.
We make use of credit ratings in establishing our investment policies, which frame our risk appetite against the liabilities we need to meet. We also use credit ratings to specify in contracts with external money managers the investments they are allowed to include in our account. In addition, we use these tools to assess performance against benchmarks, both for our internal and external managers. Credit ratings are also embedded in certain market indices which are structured around particular grades given by the CRAs. Our fixed income portfolio includes a range of rated products, and CalPERS global equity portfolio includes a wide universe of issuers who are dependent upon credit ratings to access the capital markets.

To manage its internal portfolio, CalPERS has staffed its fixed income department with corporate credit and structured securities analysts in order to independently assess the credit quality of issuers and structures. In the Structured markets, CalPERS internal portfolio managers assess key inputs into the ratings of securitizations by performing granular analysis of loan characteristics and stress tests of structures. In addition, our portfolio managers assess securitization market trends including underwriting standards, loan to values, and home price appreciation assumptions.

CalPERS also retains external money managers that have been given delegated responsibility to manage assets. CalPERS incurred losses in some of these portfolios due to the rating agency deficiencies. As a result, CalPERS has initiated litigation against certain credit rating agencies;[2] is bringing more assets in house; and performs detailed credit analyses of managers' holdings.

Issuers can raise and get access to capital more cheaply with a higher rating. CalPERS has been negatively impacted due to mis-rating of risk for issuers and classes of securities. The mid to long term impact of this mis-rating is the misallocation of capital. As we have seen, the CRAs' mis-ratings can have systemic impacts on equity and bond

[2] Please note that this litigation is *sub judice* and therefore not the subject of this testimony.

holders, GDP and employment, when the market realizes the risks are greater than those represented by the rating that was given.

CalPERS itself subscribes directly to the credit opinions of the three leading credit rating agencies, Moodys, S&P and Fitch. CalPERS analysts have access to these opinions as well as the ability to have conversations with the analysts at the firms. CalPERS subscribes to and receives these opinions because the ratings agencies are in the unique position of obtaining non-public information from the issuers and ostensibly have large resources to apply in assessing the credit quality of issuers. Ratings actions can and do cause market prices to move.

3. The impact of credit ratings agency failure on institutional investors.

Quantifying the market impact of credit ratings failure is not a simple task. Estimates vary but the scale is huge. McKinsey calculates that the total credit losses on US originated debt from mid-2007 through to end of 2010 will be in the range of \$2.5 – 3.00 trillion.[3] Goldman Sachs puts the figure for the same at slightly less with \$2 trillion in losses, of which \$1 trillion are carried in the US banking system (50% mortgage losses and 50% other loan losses).[4] The IMF puts worldwide 'toxic loan' and securities losses at just over \$4 trillion by the end of 2010.[5] As one of the largest institutional global investors, CalPERS has suffered from the impact of systemic losses both directly from the credit crisis, and the economic downturn which this accelerated. At its peak, CalPERS portfolio was valued at approximately \$270 billion. This fell dramatically in the wake of the crisis to \$165 billion in early 2009. It has recently recovered about \$35 billion, but the effect of the dislocations in financial markets has been severe.

4. Proposed reforms to Credit Rating Agencies

[3] McKinsey Quarterly, 8th June 2009, 'What's Next for US Banks?'
[4] International Monetary Fund, 21st April 2009, "Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risks."
[5] Tyler Durden 25th January 2009 "Goldman Sachs: Of ~6% Fed Funds Rate and \$9.3 trillion in troubled US assets"

CalPERS considers comprehensive reform of the credit ratings industry to be sorely needed in order to ensure transparency and accountability across the capital markets.

CalPERS Board has formally endorsed the recommendations of the Investor Working Group[6]. We propose the following specific reforms to credit rating agencies:

a. **Congress and the Administration should consider ways to encourage alternatives to the predominant issuer-pays business model.**
There is a fundamental conflict of interest when the issuer pays the fees of the CRA. There should be a change in the business model. For example, the fees earned by the CRAs should vest over a period of time equal to the average duration of the bonds rated. Fees should vest based on the performance of the original ratings and changes to those ratings over time relative to the credit performance of those bonds.

In addition CalPERS staff consider that users of credit ratings should have oversight over the hiring, remuneration and firing of the agencies which provide these services. We consider this should be explored, via an existing governance forum, such as the issuer's Annual General Meeting, where users could exercise a proxy vote on the appointment and fees paid to CRAs, or alternatively via a new mechanism that would need to be established across the industry.

b. **Congress and the Administration should bolster the SEC's position as a strong, independent overseer of CRAs.**
The SEC's authority to regulate rating agency practices, disclosures and conflicts of interest should be expanded and strengthened. The SEC should also be empowered to co-ordinate the reduction of reliance on ratings. CalPERS staff supports the announcements by the SEC last week to remove CRAs from various rules. This is a welcome start to the process of removing the requirement for use.

[6] Co-Chaired by William Donaldon and Arthur Levitt, 15th July 2009, sponsored by the Council of Institutional Investors and the CFA Institute Center for Financial Market Integrity. Note Joe Dear is co-chair of the CII.

We also recommend that the SEC establish a CRA User Advisory Board of investors, which can provide feedback on methodologies, admission requirements and regulatory proposals.

c. **CRAs should be required to manage and disclose conflicts of interest.**
Complete, prominent and consistent disclosure of conflicts is also needed.
As an immediate step, CRAs, should be required to create an executive-level compliance officer position.

d. **CRAs should be held to a higher standard of accountability.**
CRAs should bear responsibility for mis-representing credit-worthiness of issuances. Congress should eliminate the effective exemption from liability provided to credit rating agencies under Section 11 of the Securities Act of 1933 for ratings paid for by the issuer or the offering participants. CalPERS staff also recommend that CRAs should be required to abide by Regulation FD, and not retain their privileged position of exclusion which has exacerbated investors' reliance upon their information.

e. **Credit rating agencies should not rate products for which they lack sufficient information and expertise to assess.**
Credit rating agencies should only rate instruments for which they have adequate information and skill. They should be held legally responsible if they overstep their abilities. They should not be permitted to rate any product where they cannot disclose the specifics of the underlying assets. Credit ratings agencies should be restricted from taking the metrics and methodology for one class of investment to rate another class without compelling evidence of comparability.

In addition, CalPERS staff consider that there should be a requirement for full disclosure of the methodology employed by CRAs, including data, models and assumptions used to develop the ratings on a security, along with comment on all risks identified in the process of making a decision to rate or not to rate a security or product.

CalPERS staff recommend that transparency requirements should include a "ratings scorecard" to assess the practices, accuracy and effectiveness of the rating process via historical rating outcomes. This would be the first step towards developing industry standards which can be regulated and made subject to codes of professional ethics.

Thank you for this opportunity to share our views on this vitally important element of financial market regulatory reform. I look forward to answering your questions.

Chairman TOWNS. Thank you very much for your testimony.
Professor White.

STATEMENT OF LAWRENCE J. WHITE

Mr. WHITE. Chairman Towns, Ranking Member Issa, and members of the committee, my name is Lawrence J. White. I am a professor of economics at the NYU Stern School of Business, and a member of the Financial Markets Working Group at the Mercatus Center at George Mason University.

During 1986 to 1989, I served as a board member on the Federal Home Loan Bank Board. I represent solely myself at this hearing. Thank you for the opportunity to testify today on this important topic.

The three large U.S.-based credit rating agencies, Moody's, Standard & Poor's, and Fitch, and their excessively optimistic ratings of subprime residential mortgage-backed securities in the middle years of this decade played a central role in the financial debacle of the past 2 years.

Given this context and history, it is understandable that there would be strong political sentiment as expressed in the recent proposals by the Obama administration, as well as other proposed legislation, and recent rulemaking by the SEC for more extensive regulation of the credit ratings agencies in hope of forestalling future such debacles.

The advocates of such regulation want figuratively to grab the rating agencies by the lapels, to shake them, and shout: Do a better job. This urge for greater regulation is understandable and well intentioned, but it is misguided and potentially quite harmful. The heightened regulation of the rating agencies is likely to discourage entry, rigidify a specified set of structures and procedures, and discourage innovation in new ways of gathering and assessing information, new technologies, new methodologies, new models, including new business models, and may well not achieve the goal of inducing better ratings from the agencies.

Ironically, it will also likely create a protective barrier around the incumbent rating agencies and is thus likely to make them even more central to and important for the bond markets.

There is a better route. That route starts with the recognition that the centrality of the three major rating agencies for the bond information process has been mandated by more than 70 years of prudential financial regulation of banks and other financial institutions.

In essence, regulatory reliance on ratings, for example, the prohibition on banks being able to hold speculative bonds as determined by the rating agencies ratings, has imbued these third party judgments about the credit-worthiness of bonds with the force of law. This problem was compounded when the SEC created the category of nationally recognized statistical rating organizations, NRSROs, in 1975 and subsequently became a barrier to entry into the rating business. As of year end 2000, there were only three NRSROs: Moody's, Standard & Poor's, and Fitch.

It should therefore come as no surprise that when this literal handful of rating firms stumbled badly in their excessively optimistic ratings of the subprime RMBS, the consequences were quite serious. This recognition of the longstanding role of financial regulation enforcing the centrality of major rating agencies then leads to an alternative prescription: eliminate regulatory reliance on ratings; eliminate it; eliminate the ratings force of law and bring market forces to bear.

Since the bond markets are primarily institutional markets, and not the retail security markets where retail customers are likely to need more help, market forces can be expected to work. And the detailed regulation that has been proposed would be unnecessary. Indeed, if regulatory reliance on ratings were eliminated, the entire NRSRO structure could be dismantled and the NRSRO category could be eliminated. This could well make the incumbent rating agencies less important for the future.

The regulatory requirements that prudentially regulated financial institutions must maintain safe bond portfolios should remain in force. But the burden should be placed directly on the regulated institutions to demonstrate and justify to their regulators that their bond portfolios are safe and appropriate, either by doing the research themselves or by relying on third party advisers.

Since financial institutions could then call upon a wider array of sources of advice on the safety of their bond portfolios, the bond information market would be opened to innovation and entry in ways that have not been possible since the 1930's.

Thank you again for the opportunity to testify today. I would be happy to answer questions from the committee.

[The prepared statement of Mr. White follows:]

TESTIMONY

Lawrence J. White
Professor of Economics, Stern School of Business
New York University

Before the
Committee on Oversight and Government Reform
United States House of Representatives
Hearing on
"Credit Rating Agencies and the Next Financial Crisis"
September 24, 2009

Chairman Towns, Ranking Member Issa, and members of the Committee: My name is Lawrence J. White. I am a Professor of Economics at the NYU Stern School of Business and a Member of the Financial Markets Working Group at the Mercatus Center at George Mason University. During 1986-1989 I served as a Board Member on the Federal Home Loan Bank Board. I represent solely myself at this hearing.

Thank you for the opportunity to testify today on this important topic. I have appended to this statement for the Committee a longer Statement that I delivered at the Securities and Exchange Commission's (SEC) "Roundtable" on the credit rating agencies on April 15, 2009, which I would like to have incorporated for the record into the statement that I am presenting today.

The three large U.S.-based credit rating agencies -- Moody's, Standard & Poor's, and Fitch -- and their excessively optimistic ratings of subprime residential mortgage-backed securities (RMBS) in the middle years of this decade played a central role in the financial debacle of the past two years. Given this context and history, it is understandable that there would be strong political sentiment -- as expressed in the recent proposals by the Obama Administration, as well as other proposed legislation, as well as recent rulemaking by the SEC -- for more extensive regulation of the credit rating agencies in hopes of forestalling future such debacles. The advocates of such regulation want (figuratively) to grab the rating agencies by the lapels, shake them, and shout "Do a better job!"

This urge for greater regulation is understandable and well intentioned -- but it is misguided and potentially quite harmful. The heightened regulation of the rating agencies is likely to discourage entry, rigidify a specified set of structures and procedures, and discourage innovation in new ways of gathering and assessing information, new technologies, new methodologies, and new models (including new business models) -- and may well not achieve the goal of inducing better ratings from the agencies. Ironically, it will also likely create a protective barrier around the incumbent credit rating agencies and is thus likely to make them even more central to and important for the bond markets.

There is a better route. That route starts with the recognition that the centrality of the three major rating agencies for the bond information process has been mandated by more than 70 years of prudential financial regulation of banks and other financial institutions. In essence, regulatory reliance on ratings -- for example, the prohibition on banks' holding "speculative" bonds, as determined by the rating agencies' ratings – has imbued these third-party judgments about the creditworthiness of bonds *with the force of law!* This problem was compounded when the SEC created the category of "nationally recognized statistical rating organization" (NRSRO) in 1975 and subsequently became a barrier to entry into the rating business. As of year-end 2000 there were only three NRSROs: Moody's, Standard & Poor's, and Fitch.[1]

It should therefore come as no surprise that when this (literal) handful of rating firms stumbled badly in their excessively optimistic ratings of the subprime RMBS, the consequences were quite serious.

This recognition of the longstanding role of financial regulation in forcing the centrality of the major rating agencies then leads to an alternative prescription: *Eliminate regulatory reliance on ratings -- eliminate the ratings' force of law -- and bring market forces to bear.* Since the bond markets are primarily institutional markets (and not a retail securities market, where retail customers

[1] Because of subsequent prodding by the Congress, and then the specific barrier-reduction provisions of the Credit Rating Agency Reform Act of 2006, there are now ten NRSROs.

are likely to need more help), market forces can be expected to work -- and the detailed regulation that has been proposed would be unnecessary. Indeed, if regulatory reliance on ratings were eliminated, the entire NRSRO superstructure could be dismantled, and the NRSRO category could be eliminated. This could well make the incumbent rating agencies *less important* for the future.

The regulatory requirements that prudentially regulated financial institutions must maintain safe bond portfolios should remain in force. But the burden should be placed directly on the regulated institutions to demonstrate and justify to their regulators that their bond portfolios are safe and appropriate -- either by doing the research themselves, or by relying on third-party advisors. Since financial institutions could then call upon a wider array of sources of advice on the safety of their bond portfolios, the bond information market would be opened to innovation and entry in ways that have not been possible since the 1930s.

My appended April 15 Statement for the SEC provides greater elaboration on many of these points. Since that Statement preceded the Obama Administration's specific proposals for further regulation of the credit rating agencies, I will expand here on the drawbacks of those proposals.

The proposals -- as found initially in the Administration's Financial Regulatory Reform: A New Foundation (p. 46) that was released in mid June, and then in the specific legislative proposals that were released on July 21 -- are devoted primarily to efforts to increase the transparency of ratings and to address issues of conflicts of interest. The latter arise largely from the major rating agencies' business model of relying on payments from the bond issuers in return for rating their bonds.[2] These proposals expand and elaborate on a set of regulations that the SEC has recently implemented.

Again, the underlying urge to "do something" in the wake of the mistakes of the major credit rating agencies during the middle years of this decade is understandable. Further, the "issuer pays"

[2] It is worth noting that three smaller U.S.-based NRSRO rating agencies have "investor pays" business models and that the "investor pays" model was the original model for John Moody and for the industry more generally, until the major rating agencies switched to the "issuer pays" model in the early 1970s.

business model of those rating agencies presents an obvious set of potential conflict-of-interest problems that appear to be crying out for correction.[3]

Nevertheless, the dangers of the proposals are substantial. They ask the SEC to delve ever deeper into the processes and procedures and methodologies of credit ratings -- of providing judgments about the creditworthiness of bonds and bond issuers. In so doing, the proposals (if enacted) are likely to rigidify the industry along the lines of whatever specific implementing regulations that the SEC devises, as well as raising the costs of being a credit rating agency. In so doing, the proposals will discourage entry and innovation in new ways of gathering and assessing information, in new methodologies, in new technologies, and in new models -- including new business models.

There is one especially worrisome provision in the specific legislation that was proposed in July (and that was absent in the earlier June proposals) that is guaranteed to discourage entry: the requirement that all credit rating agencies should register as NRSROs with the SEC. This requirement would seem to encompass the independent consultant who offers bond investment recommendations to clients (such as hedge funds or bond mutual funds), as well as any financial services company that employs fixed income analysts whose recommendations become part of the services that the company offers to clients.

This provision, if enacted, will surely discourage entry into the broader bond information business, as well as encouraging the exit of existing providers of information. Ironically, it will likely become a new protective barrier around the incumbent credit rating agencies -- when, again ironically, the Credit Rating Agency Reform Act of 2006 was intended to tear down the earlier barrier to entry that the SEC had erected when it created the NRSRO category in 1975. This can't be a good way of encouraging new and better information for the bond market.

[3] It is important to remember, however, that the major credit rating agencies switched to the "issuer pays" model in the early 1970s, and that the serious problems only arose three decades later. Apparently, the agencies' concerns for their long-run reputations and the transparency and multiplicity of issuers prior to the current decade all served to keep the potential conflict-of-interest problems in check during those three intervening decades.

Further, it is far from clear that the proposals will actually achieve their goal of improving ratings. One common complaint against the large agencies is that they are slow to adjust their ratings in response to new information.[4] But this appears to be a business culture phenomenon for the agencies (which was present, as well, in the pre-1970s era when the rating agencies had an "investor pays" business model). As for the kind of over-optimism about the RMBS in this decade that subsequently created such serious problems, the rating agencies were far from alone in "drinking the Kool-Aid" that housing prices could only increase and that even subprime mortgages consequently would not have problems. It is far from clear that the proposed regulations would have curbed such herd behavior. Also, the incumbent rating agencies are quite aware of the damage to their reputations that have occurred and have announced measures -- including increased transparency and enhanced efforts to address potential conflicts -- to repair that damage.

The Obama Administration's proposals do -- briefly -- entertain the possibility of reducing regulatory reliance on ratings. But this seems to be largely lip service, embodied in promises that the Administration will examine the possibilities. The only specific provision on this point in the proposed legislation is a requirement for the U.S. Government Accountability Office (GAO) to undertake a study and deliver a report. Also, the reference in the proposals is to "reduction" rather than to elimination; and there seems to be no recognition that even a reduction of regulatory reliance on ratings would represent a movement in the opposite direction from increasing the regulation of the credit rating agencies.

In sum, the proposals of the Obama Administration with respect to the reform of the credit rating agencies are deeply flawed and wrongheaded.

In addition, most recently, the SEC (on September 17) adopted some final rules and proposed additional rules with respect to the credit rating agencies. The adopted and proposed rules

[4] This complaint has been present for decades. It surfaced strongly in the wake of the Enron bankruptcy in November 2001, with the revelation that the major rating agencies had maintained "investment grade" ratings on Enron's debt until five days before that company's bankruptcy filing. More recently, the major agencies had "investment grade" ratings on Lehman Brothers' debt on the morning that it filed for bankruptcy.

primarily address transparency and conflict-of-interest issues (as did the rules that the SEC adopted in December 2008), and they also began the process of reducing the SEC's reliance on ratings.

There is one gaping hole in the SEC's actions, however: Absent from the SEC's announcement (and actions) was any mention of eliminating the SEC's reliance on ratings for its regulation of the safety of money market mutual funds (MMMFs) – a major facet of the SEC's reliance on ratings. This absence was not accidental: The SEC on June 30 proposed stiffer safety regulation of MMMFs, which entailed the continued reliance on NRSRO ratings as indicators of the safety of the assets that MMMFs are permitted to hold. The SEC thus appears to be ambivalent, at best, about its efforts to reduce its reliance on ratings.

There is a better overall route: Eliminate all regulatory reliance on ratings, by the SEC and by all other financial regulatory agencies -- eliminate the force of law that has been accorded to these third-party judgments. The institutional participants in the bond markets could then more readily (with appropriate oversight by financial regulators) make use of a wider set of providers of information, and the bond information market would be opened to new ideas and new entry in a way that has not been possible for over 70 years.

Thank you again for the opportunity to appear before this Committee; I would be happy to respond to your questions.

Statement by
Lawrence J. White*
for the
"Roundtable to Examine Oversight of Credit Rating Agencies"
U.S. Securities and Exchange Commission
Washington, DC
April 15, 2009

Summary

The three major credit rating agencies -- Moody's, Standard & Poor's, and Fitch -- played a central role in the subprime mortgage debacle of 2007-2008. That centrality was not accidental. Seven decades of financial regulation propelled these rating agencies into the center of the bond information market, by elevating their judgments about the creditworthiness of bonds so that those judgments attained the force of law. The Securities and Exchange Commission exacerbated this problem by erecting a barrier to entry into the credit rating business in 1975. Understanding this history is crucial for any reasoned debate about the future course of public policy with respect to the rating agencies.

The Securities and Exchange Commission has recently (in December 2008) taken modest steps to expand its regulation of the industry. Further regulatory efforts by the SEC and/or the Congress would not be surprising.

There is, however, another direction in which public policy could proceed: Financial regulators could withdraw their delegation of safety judgments to the credit rating agencies. The goal of safe bond portfolios for regulated financial institutions would remain. But the financial institutions would bear the burden of justifying the safety of their bond portfolios to their regulators. The bond information market would be opened to new ideas about rating methodologies, technologies, and business models and to new entry in ways that have not been possible since the 1930s.

* Lawrence J. White is professor of economics at the NYU Stern School of Business. During 1986-1989 he was a board member on the Federal Home Loan Bank Board. This statement draws heavily on a forthcoming article, "The Credit

"...an insured state savings association...may not acquire or retain any corporate debt securities not of investment grade." 12 Code of Federal Regulations § 362.11

" ...any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision." The usual disclaimer that is printed at the bottom of Standard & Poor's credit ratings

Introduction

The U.S. subprime residential mortgage debacle of 2007-2008, and the world financial crisis that has followed, will surely be seen as a defining event for the U.S. economy -- and for much of the world economy as well -- for many decades in the future. Among the central players in that debacle were the three large U.S.-based credit rating agencies: Moody's, Standard & Poor's (S&P), and Fitch.

These three agencies' initially favorable ratings were crucial for the successful sale of the bonds that were securitized from subprime residential mortgages and other debt obligations. The sale of these bonds, in turn, were an important underpinning for the U.S. housing boom of 1998-2006 -- with a self-reinforcing price-rise bubble. When house prices ceased rising in mid 2006 and then began to decline, the default rates on the mortgages underlying these bonds rose sharply, and those initial ratings proved to be excessively optimistic -- especially for the bonds that were based on mortgages that were originated in 2005 and 2006. The mortgage bonds collapsed, bringing down the U.S. financial system and many other countries' financial systems as well.

The role of the major rating agencies has received a considerable amount of attention in Congressional hearings and in the media. Less attention has been paid to the specifics of the regulatory structure that propelled these companies to the center of the U.S. bond markets. But an understanding of that structure is essential for any reasoned debate about the future course of public policy with respect to the rating agencies.[1]

Background

A central concern of any lender -- including investors in bonds -- is whether a potential or actual borrower is likely to repay the loan. Lenders therefore usually spend considerable amounts of time and effort in gathering information about the creditworthiness of prospective borrowers and also in gathering information about the actions of borrowers after loans have been made.

The credit rating agencies offer judgments -- they prefer the word "opinions"[2] -- about the credit quality of bonds that are issued by corporations, governments (including U.S. state and local governments, as well as "sovereign" issuers abroad), and (most recently) mortgage securitizers. These judgments come in the form of ratings, which are usually a letter grade. The best known scale is that used by S&P and some other rating agencies: AAA, AA, A, BBB, BB, etc., with pluses and minuses as well.[3] Credit rating agencies are thus one potential source of such information for bond investors; *but*

Rating Agencies and the Subprime Debacle," in the journal Critical Review.

[1] Overviews of the credit rating industry can be found in, e.g., Cantor and Packer (1995), Partnoy (1999, 2002), Richardson and White (2009), Sylla (2002), and White (2002, 2002-2003, 2006, 2007).

[2] The rating agencies favor that term because it allows them to claim that they are "publishers" and thus enjoy the protections of the First Amendment of the U.S. Constitution (e.g., when the agencies are sued by investors and issuers who claim that they have been injured by the actions of the agencies).

[3] For short-term obligations, such as commercial paper, a separate set of ratings is used.

they are far from the only potential source.

The history of the credit rating agencies and their interactions with financial regulators is crucial for an understanding of how the agencies attained their current central position in the market for bond information.

Some History

John Moody published the first publicly available bond ratings (mostly concerning railroad bonds) in 1909. Moody's firm[4] was followed by Poor's Publishing Company in 1916, the Standard Statistics Company in 1922,[5] and the Fitch Publishing Company in 1924.[6] These firms' bond ratings were sold to bond investors, in thick rating manuals. In the language of modern corporate strategy, their "business model" was one of "investor pays." In an era before the Securities and Exchange Commission (SEC) was created (in 1934) and began requiring corporations to issue standardized financial statements, Moody and the firms that subsequently entered were clearly meeting a market demand for their information services.

A major change in the relationship between the credit rating agencies and the U.S. bond markets occurred in the 1930s. Eager to encourage banks to invest only in safe bonds, bank regulators issued a set of regulations that culminated in a 1936 decree that prohibited banks from investing in "speculative investment securities" as determined by "recognized rating manuals". "Speculative" securities were bonds that were below "investment grade." Thus, banks were restricted to holding only bonds that were "investment grade" (e.g., bonds that were rated BBB or better on the S&P scale).[7]

This regulatory action importantly changed the dynamic of the bond information market. Banks were no longer free to act on information about bonds from any source that they deemed reliable (albeit within constraints imposed by oversight by bank regulators). They were instead forced to use the judgments of the publishers of the "recognized rating manuals" (i.e., Moody's, Poor's, Standard, and Fitch). Further, since banks were important participants in the bond markets, perforce other participants would want to pay attention to the bond raters' pronouncements as well.

On the regulatory side of this process, rather than the bank regulators' using their own internal resources to form judgments about the safety of the bonds held by banks (which the bank regulators continued to do with respect to the other kinds of loans made by banks), the regulators had effectively delegated -- "outsourced" (again using the language of modern corporate strategy) -- to the rating agencies their safety judgments about bonds that were suitable for banks' portfolios. Equivalently, *the creditworthiness judgments of these third-party raters had attained the force of law.*

In the following decades, the insurance regulators of the 48 (and eventually 50) states followed a similar path: The state regulators wanted their regulated insurance companies to have adequate capital (in essence, net worth) that was commensurate with the riskiness of the companies' investments. To achieve this goal, the regulators established minimum capital requirements that were *geared to the*

[4] Dun & Bradstreet bought Moody's firm in 1962; subsequently, in 2000, Dun & Bradstreet spun off Moody's as a free-standing corporation.

[5] Poor's and Standard merged in 1941, to form S&P; S&P was absorbed by McGraw-Hill in 1966.

[6] Fitch merged with IBCA (a British firm) in 1997, and the combined firm was subsequently bought by FIMILAC, a French business services conglomerate.

[7] This rule still applies to banks today. This rule did not apply to savings institutions until 1989. Its application to savings institutions in 1989 forced them to sell substantial holdings of "junk bonds" (i.e., below investment grade) at the time, causing a major slump in the junk bond market.

ratings on the bonds in which the insurance companies invested -- the ratings, of course, coming from that same small group of rating agencies. Once again, an important set of regulators had delegated their safety decisions to the credit rating agencies. And in the 1970s, federal pension regulators pursued a similar strategy.

These additional delegations of safety judgments to the rating agencies meant that the latter's centrality for bond market information was further strengthened.

The SEC crystallized the rating agencies' centrality in 1975. In that year the SEC decided to set minimum capital requirements for broker-dealers (i.e., securities firms). Following the pattern of the other financial regulators, it wanted those capital requirements to be sensitive to the riskiness of the broker-dealers' asset portfolios and hence wanted to use bond ratings as the indicators of risk. But it worried that references to "recognized rating manuals" were too vague and that a "bogus" rating firm might arise that would promise "AAA" ratings to those companies that would suitably reward it and "DDD" ratings to those that would not; and if a broker-dealer chose to claim that those ratings were "recognized", the SEC might have difficulties challenging this assertion.

To deal with this problem, the SEC created a wholly new category -- "nationally recognized statistical rating organization" (NRSRO) -- and immediately "grandfathered" Moody's, S&P, and Fitch into the category. The SEC declared that only the ratings of NRSROs were valid for the determination of the broker-dealers' capital requirements. The other financial regulators soon adopted the SEC's NRSRO category and the rating agencies within it as the relevant sources of the ratings that were required for evaluations of the bond portfolios of their regulated financial institutions.[8]

Over the next 25 years the SEC designated only four additional firms as NRSROs;[9] but mergers among the entrants and with Fitch caused the number of NRSROs to return to the original three by year-end 2000. In essence, the SEC had become a significant barrier to entry into the bond rating business, because the NRSRO designation was important for any potential entrant. Without the NRSRO designation, any would-be bond rater would likely be ignored by most financial institutions; and, since the financial institutions would ignore the would-be bond rater, so would bond issuers.[10]

In addition, the SEC was remarkably opaque in its designation process. It never established criteria for a firm to be designated as a NRSRO, never established a formal application and review process, and never provided any justification or explanation for why it "anointed" some firms with the designation and refused to do so for others.

One other piece of history is important: In the early 1970s the basic business model of the large rating agencies changed. In place of the "investor pays" model that had been established by John Moody in 1909, the agencies converted to an "issuer pays" model, whereby the entity that is issuing the bonds also pays the rating firm to rate the bonds.

The reasons for this change of business model have not been established definitively. Among the candidates are:

-- a) The rating firms feared that their sales of rating manuals would suffer from the consequences of the high-speed photocopy machine (which was just entering widespread use), which

[8] Also, in the early 1990s, the SEC again made use of the NRSROs' ratings when it established safety requirements for the short-term bonds (e.g., commercial paper) that are held by money market mutual funds.

[9] The SEC bestowed the NRSRO designation on Duff & Phelps in 1982, on McCarthy, Crisanti & Maffei in 1983, on IBCA in 1991, and on Thomson BankWatch in 1992.

[10] The SEC's barriers were not absolute. A few smaller rating firms -- notably KMV, Egan-Jones, and Lace Financial -- were able to survive, despite the absence of NRSRO designations. KMV was absorbed by Moody's in 2000.

would allow too many investors to free-ride by obtaining photocopies from their friends;

-- b) The bankruptcy of the Penn-Central Railroad in 1970 shocked the bond markets and made issuers more conscious of the need to assure bond investors that they (the issuers) really were low risk, and they were willing to pay the credit rating firms for the opportunity to have the latter vouch for them (but that same shock should have also made investors more willing to pay to find out which bonds were really safer, and which were not);

-- c) The bond rating firms may have belatedly realized that the financial regulations described above meant that bond issuers needed the "blessing" of one or more NRSROs in order to get their bonds into the portfolios of financial institutions, and the issuers should be willing to pay for the privilege; and

-- d) The bond rating business, like many information industries, involves a "two-sided market", where payments can come from one or both sides of the market; in such markets, which side actually pays can be quite idiosyncratic.[11]

Regardless of the reason, the change to the "issuer pays" business model opened the door to potential conflicts of interest: A rating agency might shade its rating upward so as to keep the issuer happy and forestall the issuer's taking its rating business to a different rating agency.[12]

Recent Events of the Current Decade

The NRSRO system was one of the less-well-known features of federal financial regulation, and it might have remained in that semi-secretive state had the Enron bankruptcy of November 2001 not occurred. In the wake of the Enron bankruptcy, however, the media and then Congressional staffers noticed that the three major rating agencies had maintained "investment grade" ratings on Enron's bonds until five days before that company declared bankruptcy. This notoriety led to the Congress's "discovery" of the NRSRO system and to Congressional hearings in which the SEC and the rating agencies were repeatedly asked how the latter could have been so slow to recognize Enron's weakened financial condition.[13]

The Sarbanes-Oxley Act of 2002 included a provision that required the SEC to send a report to Congress on the credit rating industry and the NRSRO system. The SEC duly did so; but the report simply raised a series of questions rather than directly addressing the issues of the SEC as a barrier to entry and the enhanced role of the three incumbent credit rating agencies, which (as explained above) was due to the financial regulators' delegations of safety judgments (and which the SEC's NRSRO framework had strengthened).

In early 2003 the SEC designated a fourth NRSRO (Dominion Bond Rating Services, a

[11] Other examples of "two-sided" information markets include newspapers and magazines, where business models range from "subscription revenues only" (e.g., Consumer Reports) to "a mix of subscription revenues plus advertising revenues" (most newspapers and magazines) to "advertising revenues only" (e.g., The Village Voice, some metropolitan "giveaway" daily newspapers, and some suburban weekly "shoppers").

[12] Skreta and Veldkamp (2008) develop a model in which the ability of issuers to choose among potential raters leads to overly optimistic ratings, even if the raters are all trying honestly to estimate the creditworthiness of the issuers. In their model, the raters can only make *estimates* of the creditworthiness of the issuers, which means that their estimates will have errors. If the estimates are (on average) correct and the errors are distributed symmetrically (i.e., the raters are honest but less than perfect), but the issuers can choose which rating to purchase, the issuers will systematically choose the most optimistic. In an important sense, it is the issuers' ability to select the rater that creates the conflict of interest.

[13] The rating agencies were similarly slow to recognize the weakened financial condition of WorldCom, and were subsequently grilled about that as well.

Canadian credit rating firm), and in early 2005 the SEC designated a fifth NRSRO (A.M. Best, an insurance company rating specialist). The SEC's procedures remained opaque, however, and there were still no announced criteria for the designation of a NRSRO.

Tiring of the SEC's persistence as a barrier to entry (and also the SEC's opaqueness in procedure), the Congress passed the Credit Rating Agency Reform Act (CRARA), which was signed into law in September 2006. The Act specifically instructed the SEC to cease being a barrier to entry, specified the criteria that the SEC should use in designating new NRSROs, insisted on transparency and due process in the SEC's decisions with respect to NRSRO designations, and provided the SEC with limited powers to oversee the incumbent NRSROs -- but specifically forbade the SEC from influencing the ratings or the business models of the NRSROs.

In response to the legislation, the SEC designated three new NRSROs in 2007 (Japan Credit Rating Agency; Rating and Information, Inc. [of Japan]; and Egan-Jones) and another two NRSROs in 2008 (Lace Financial, and Realpoint). The total number of NRSROs is currently ten.

Finally, in response to the growing criticism (in the media and in Congressional hearings) of the three large bond raters' errors in their initial, excessively optimistic ratings of the complex mortgage-related securities (especially for the securities that were issued and rated in 2005 and 2006) and their subsequent tardiness in downgrading those securities, the SEC in December 2008 promulgated regulations that placed mild restrictions on the conflicts of interest that can arise under the rating agencies' "issuer pays" business model and that required greater transparency in the construction of ratings.[14] Political pressures to do more -- possibly even to ban legislatively the "issuer pays" model -- remain strong.

<u>An Assessment</u>

It is clear that the three dominant credit rating firms have received a considerable boost from financial regulators. Starting in the 1930s, financial regulators insisted that the credit rating firms be the central source of information about the creditworthiness of bonds in U.S. financial markets. Reinforcing this centrality was the SEC's creation of the NRSRO category in 1975 and the SEC's subsequent protective barrier around the incumbent NRSROs, which effectively ensured the dominance of Moody's, S&P, and Fitch. Further, the industry's change to the "issuer pays" business model in the early 1970s meant that potential problems of conflict of interest were likely to arise, sooner or later. Finally, the major agencies' tardiness in changing their ratings -- best exemplified by the Enron incident mentioned above[15] -- has been an additional source of periodic concern.[16]

[14] See <u>Federal Register</u>, 74 (February 9, 2009), pp. 6456-6484.

[15] Most recently, the major rating agencies still had "investment grade" ratings on Lehman Brothers' commercial paper on the day that Lehman declared bankruptcy in September 2008.

[16] This delay in changing ratings has been a deliberate strategy by the major rating agencies. They profess to try to provide a long-term perspective -- to "rate through the cycle" -- rather than providing an up-to-the-minute assessment. But this means that these rating agencies will always be slow to identify a secular trend in a bond's creditworthiness, since there will always be a delay in perceiving that any particular movement isn't just the initial part of a reversible cycle but instead is the beginning of a sustained decline or improvement. It may be that this sluggishness is a response to the desires of their investor clients to avoid frequent (and costly) adjustments in their portfolios; see, e.g., Altman and Rijken (2004, 2006); those adjustments, however, might well be mandated by the regulatory requirements discussed above. It may also be the case that the agencies' ratings changes are sluggish (especially downward) so as not to anger issuers (which is another aspect of the potential conflict-of-interest problem). And the absence of frequent changes also allows the agencies to maintain smaller staffs. Except for the regulatory mandates, however, the agencies' sluggishness would be inconsequential, since the

The regulatory boosts that the major rating agencies received, starting in the 1930s, were certainly not the only reason for the persistent fewness in the credit rating industry. The market for bond information is one where economies of scale, the advantages of experience, and brand name reputation are important features. The credit rating industry was never going to be a commodity business of thousands (or even just hundreds) of small-scale producers, akin to wheat farming or textiles. Nevertheless, the regulatory history recounted above surely contributed heavily to the dominance of the three major rating agencies. The SEC's belated efforts to allow wider entry during the current decade were too little and too late. The advantages of the "big three's" incumbency could not quickly be overcome by the entrants (three of which were headquartered outside the U.S., one of which was a U.S. insurance company specialist, and three of which were small U.S. firms).

It is not surprising that a tight, protected oligopoly might become lazy and complacent. The "issuer pays" model opened the door to potential abuses. Though this potential problem had been present in the industry since the early 1970s, the relative transparency of the corporations and governments whose debt was being rated apparently kept the problem in check. Also, there were thousands of corporate and government bond issuers, so the threat of any single issuer (if it was displeased by an agency's rating) to take its business to a different rating agency was not potent.

The complexity and opaqueness of the mortgage-related securities that required ratings in the current decade, however, created new opportunities and apparently irresistible temptations.[17] Further, the rating agencies were much more involved in the creation of these mortgage-related securities: The agencies' decisions as to what kinds of mortgages (and other kinds of debt) would earn what levels of ratings for what sizes of "tranches" (or slices) of these securities were crucial for determining the levels of profitability of these securitizations for their issuers. Finally, unlike the market for rating corporate and government debt, the market for rating mortgage-related securities involved only a handful of investment banks as securitizers with high volumes. An investment bank that was displeased with an agency's rating on any specific security had a more powerful threat -- to move all of its securitization business to a different rating agency -- than would any individual corporate or government issuer.

Fueling the Subprime Debacle

The U.S. housing boom that began in the late 1990s and ran through mid 2006 was fueled, to a substantial extent, by subprime mortgage lending.[18] In turn, the securitization of the subprime mortgage loans, in collateralized debt obligations (CDOs) and other mortgage-related securities, importantly encouraged the subprime lending.[19] And crucial for the securitization were the favorable ratings that were bestowed on these mortgage-related securities.

Favorable ratings were important for at least two reasons: First, as has been discussed above, ratings had the force of law with respect to regulated financial institutions' abilities and incentives (via

credit default swap (CDS) market provides real-time market-based judgments about the credit quality of bonds.

[17] The Skreta and Veldkamp (2008) model predicts that greater complexity of rated bonds leads to a greater range of errors among (even honest) raters and thus to the ability of the issuers to select raters that are even more optimistic.

[18] The debacle is discussed extensively in Gorton (2008), Acharya and Richardson (2009), Coval et al. (2009), and Mayer et al. (2009).

[19] This importance extended to the development of other financing structures, such as "structured investment vehicles" (SIVs), whereby a financial institution might sponsor the creation of an entity that bought tranches of the CDOs and financed their purchase through the issuance of short-term "asset–backed" commercial paper (ABCP). If the CDO tranches in a SIV were highly rated, then the ABCP could also be highly rated. (Interest rate risk and liquidity risk were apparently ignored in the ratings.)

capital requirements) to invest in bonds.[20] More favorable ratings on larger fractions of the tranches that flowed from any given package of mortgage securities thus meant that these larger fractions could more readily be bought by regulated financial institutions Second, the generally favorable reputations that the credit rating agencies had established in their corporate and government bond ratings meant that many bond purchasers – regulated and non-regulated – were inclined to trust the agencies' ratings on the mortgage-related, even (or, perhaps, especially) if the market yields on the mortgage-related securities were higher than on comparably rated corporate bonds.

Driving all of this, of course, was the profit model of the securitizers (packagers) of the mortgages: For any given package of underlying mortgages (with their contractually specified yields) to be securitized, the securitizers made higher profits if they attained higher ratings on a larger percentage of the tranches of securities that were issued against those mortgages. This was so because the higher rated tranches would carry lower interest rates that needed to be paid to the purchasers of/investors in those tranches, leaving a greater spread for the securitizers. It is not surprising, then, that the securitizers would be prepared to pressure the rating agencies, including threats to choose a different agency, to deliver those favorable ratings.

A Counter-Factual Musing

It is worth "musing" about how the bond information industry's structure would look today if financial regulators hadn't succumbed (starting in the 1930s) to the temptation to outsource their safety decisions and thus allowing the credit rating agencies' judgments to attain the force of law. Suppose, instead, that regulators had persisted in their goals of having safe bonds in the portfolios of their regulated institutions (or that, as in the case of insurance companies and broker-dealers, an institution's capital requirement would be geared to the riskiness of the bonds that it held) but that those safety judgments remained the responsibility of the regulated institution, with oversight by regulators.[21]

In this counter-factual world, banks (and insurance companies, etc.) would have a far wider choice as to where and from whom they could seek advice as to the safety of bonds that they might hold in their portfolios. Some institutions might choose to do the necessary research on bonds themselves, or rely primarily on the information yielded by the credit default swap market. Or they might turn to outside advisors that they considered to be reliable -- based on the track record of the advisor, the business model of the advisor (including the possibilities of conflicts of interest), the other activities of the advisor (which might pose potential conflicts), and anything else that the institution considered relevant. Such advisors might include the credit rating agencies. But the category of advisors might also expand to include investment banks (if they could erect credible "Chinese walls") or industry analysts or upstart advisory firms that are currently unknown.

The end-result -- the safety of the institution's bond portfolio -- would continue to be subject to review by the institution's regulator.[22] That review might also include a review of the institution's

[20] For banks and savings institutions, in addition to the absolute prohibition on holding bonds that were below investment grade, there was a further important impact of ratings: Mortgage-backed securities (MBS) – including CDOs -- that were issued by non-governmental entities and rated AA or better qualified for the same reduced capital requirements (1.6% of asset value) as applied to the MBS issued by Fannie Mae and Freddie Mac the instead of the higher (4%) capital requirements that applied to mortgages and lower rated mortgage securities.

[21] This oversight would be an appropriate aspect of the safety-and-soundness regulation of such institutions. For a justification of safety-and-soundness regulation for these kinds of institutions, see White (1991).

[22] Again, this is necessary because the regulator has the goal that the regulated institution should maintain a safe bond

choice of bond-information advisor (or the choice to do the research in-house) -- although that choice is (at best) a secondary matter, since the safety of the bond portfolio itself (regardless of where the information comes from) is the primary goal of the regulator. Nevertheless, it seems highly likely that the bond information market would be opened to new ideas -- about ratings business models, methodologies, and technologies -- and to new entry in ways that have not actually been possible since the 1930s.

It is also worth asking whether, in this counter-factual world, the "issuer pays" business model could survive. The answer rests on whether bond buyers are able to ascertain which advisors do provide reliable advice (as does any model short of relying on government regulation to ensure accurate ratings). If the bond buyers can so ascertain,[23] then they would be willing to pay higher prices (and thus accept lower interest yields) on the bonds of any given underlying quality that are "rated" by these reliable advisors. In turn, issuers -- even in an "issuer pays" framework -- would seek to hire these recognized-to-be-reliable advisers, since the issuers would thereby be able to pay lower interest rates on the bonds that they issue.

That the "issuer pays" business model could survive in this counter-factual world is no guarantee that it would survive. That outcome would be determined by the competitive process.

Conclusion

Whither the credit rating industry and its regulation? The central role -- forced by seven decades of financial regulation -- that the three major credit rating agencies played in the subprime debacle has brought extensive public attention to the industry and its practices. The Securities and Exchange Commission has recently (in December 2008) taken modest steps to expand its regulation of the industry. Further regulatory efforts by the SEC and/or the Congress would not be surprising.

There is, however, another direction in which public policy could proceed. That direction is suggested by the "counter-factual musing" of the previous section: Financial regulators could withdraw their delegation of safety judgments to the credit rating agencies.[24] The policy goal of safe bond portfolios for regulated financial institutions would remain. But the financial institutions would bear the burden of justifying the safety of their bond portfolios to their regulators. *The bond information market would be opened to new ideas about rating methodologies, technologies, and business models and to new entry in ways that have not been possible since the 1930s.*

Participants in this public policy debate should ask themselves the following questions: Is a regulatory system that delegates important safety judgments about bonds to third parties in the best interests of the regulated institutions and of the bond markets more generally? Will more extensive SEC regulation of the rating agencies actually succeed in forcing the rating agencies to make better judgments in the future? Would such regulation have consequences for flexibility, innovation, and entry in the bond information market? Or instead, could the financial institutions be trusted to seek their own sources of information about the creditworthiness of bonds, so long as financial regulators oversee the safety of those bond portfolios?

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portfolio (or have appropriate capital for the risks).

[23] This seems a reasonable assumption, since the bond market is, for the most part, one where financial institutions are the major buying and selling entities. It is not a market where "widows and orphans" are likely to be major participants.

[24] The SEC proposed regulations along these lines in July 2008; see Federal Register, 73 (July 11, 2008), pp. 40088-40106, 40106-40124, and 40124-40142. No final action has been taken on these proposals.

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Chairman TOWNS. Thank you very much.

Let me thank all of you for your testimony. You know, we talked earlier with Mr. Cantor. He didn't feel that they have played a role in this meltdown, but I want you to know that our role here today is to try to find ways and methods to fix what is going on.

I want to start with you, Senator D'Amato, and of course, Mr. Baggesen, and probably all of you, as to what can we do to prevent credit rating agencies from contributing to the next financial collapse. What can we do?

Mr. D'AMATO. Mr. Chairman, Professor White did touch on a number of things, and they can get a little bit esoteric. But the fact is that once we stamped NRSRO on those three agencies, and I think there is one other now, Moody's, Fitch, Standard & Poor's and one other. We gave them a headlock. We kept out competition, innovation that the market forces are very capable of providing.

So I think there is a lot to what we can do. And I will come back, to beat the dead horse, how do you keep honest people honest? You have the fence or the wall or the prohibition. You do it one way or the other. I think the fence and the wall are half-hearted attempts, and you are always going to find, I mean, here you saw this fellow McCleskey, who was in charge of compliance, and they moved him right out. You know, you are still going to have those kinds of things.

If you want to keep honest people honest, an issuer should not be paying or, put it the other way around, the rating agencies should not be paid by an issuer for a particular issue. The two are incompatible. You saw that situation in the accounting problems. It is the same here.

And I think that is one of the important elements, and I think the SEC finally has it right in their proposed recommendation. That should be adopted, and we should open the system up to competition. Professor White touched on some methodologies that can and should be employed.

Chairman TOWNS. Right. You know, I get your point because even in research with doctors and with the patients, they finally had to come up with patients that were involved in the research to have their own doctors, because the person that was involved in research, the only thing he was doing or she was doing was looking at their research, and not at the patient, how the patient was doing. So I get your point very well there, Senator.

Any other comments here?

Mr Abrams, yes?

Mr. ABRAMS. My reaction is two-fold. First, one of the problems here is that there has been too much reliance on rating agencies, as if they were the only source of information, which they have never been, as if that was the place to go. CalPERS, by way of example, is suing my client, so I am very interested in CalPERS and I am glad to sit next to the gentleman here who I may depose someday.

Chairman TOWNS. Well, we arranged this. [Laughter.]

Mr. ABRAMS. And for over $1 billion, by the way. And let me read you one line from CalPERS complaint in that case. It says: "Other than the rating agencies' evaluation and subsequent credit rating of an SIV, a special investment vehicle, an investor had no access to any information on which to base a judgment of an SIV's credit-worthiness." My reaction is that if that is the case, and I don't want to argue our case, if that were the case, they shouldn't be investing in the sort of entities where they know nothing other than its rating. And I think in general there has been an over-reliance on ratings only.

One of the things I know that my client has been trying to do since the bad events of the last few years is to try to get out the story a little bit better about what ratings are and what they are not; that they are essentially an assessment of credit-worthiness in the future, the likelihood of repayment down the road, not of market value, not of volatility, not of liquidity, not of a lot of things which will ultimately and even short term affect pricing.

But it is not easy to get that story out, and I think one of the things that has to be done is for a much better public understanding of just what ratings are and what they are not.

Chairman TOWNS. So are you saying that the SEC should play a greater role in this process? I mean, I am not sure I understand.

Mr. ABRAMS. I think there are things the SEC can do. Indeed, I think the SEC can play a role in helping to restore credibility, if you will, of this whole process, particularly if we are moving in the direction of more competition. We have 10 NRSROs now. As Senator D'Amato said, not so long ago we had three, four, give. Now we have 10 since and because of the act passed by Congress in 1966, the Credit Rating Reform Act, which took effect in 2000, rather, 2006 which took effect in 2007.

If we are going to open this up and have more and more and more NRSROs or perhaps, as Professor White says, not have NRSROs anymore, we will still need a significant level of oversight by the SEC, and some of their proposals in that respect are in the direction, I think, of helping the industry to be better viewed because, again with all these entities in now and more and more to come, you are taking entities which may not always be of the highest level in terms of experience and making them NRSROs.

The SEC used to say, you can't be an NRSRO because you haven't had experience. And the argument against that was, how can we get experience? And we need the designation, etc.

All right, we went in the direction, then, of saying we will give the stamp, so to speak, of NRSRO to, I don't want to say almost any, but any financially secure entity, even if they don't have a lot of past experience. There is a societal risk in that. I think it was a good decision, but there is a risk-reward in it. And one of the consequences of doing that is that I think you need a higher level of SEC involvement so long, at least, as you have the NRSRO designation in the first place.

Chairman TOWNS. I yield to the gentleman from California. My time is expired.

Mr. ISSA. Thank you, Mr. Chairman.

Mr. Abrams, under Sarbanes-Oxley, we looked at the auditing world and the big 10, 9, 8, 7, 6, 5, 4 accounting firms. And we found that in fact they were playing two sides of the game. They were doing the annual audited financial, and then they were selling a bunch of products. And the two basically could not have firewalls. They simply couldn't get past the fact that partners all benefited effectively from that. And if there wasn't money in one side, and there was money in the other side, the partners wanted to share, or they didn't want to be on the other side. So Congress made a decision that we could no longer have that.

In the case of rating agencies, do you believe that we should consider narrowing what 1 or 3, 5, 10, whatever amount of rating agencies can do, versus other services so as to make it as close to the equivalent of your annual audit, rather than a more broad set of opinions and products being sold? Do you think that would help?

Mr. ABRAMS. Two thoughts. One is I think the notion of saying that rating agencies shouldn't do consulting, say———

Mr. ISSA. That is exactly what I am saying.

Mr. ABRAMS. I understand—it is an appropriate one. My understanding is my client doesn't do consulting. But without, you know, getting into definitional issues, the notion of separating consulting as such from ratings I think is a wise one.

But that said, I think you really do have to take care about how far you go in terms of limiting———

Mr. ISSA. Let's take it for a moment in the direction that Professor White would take it. If I look at stocks, rather than bonds or other debt instruments, if I look at stocks, if Goldman Sachs wants to take me public, they take me public and everybody understands that they are making a market. They are making a lot of money. They have a lot of fees. They are making their portfolio for me look as good as possible. Basically, they are finding ways in a legal way to kite the stock's value to the highest possible level for the public offering, and then they set it at a little less than that so it pops on day one. We all understand that.

However, if five other institutions begin tracking my stock, they are tracking it much more independently, and that is the difference between who takes me public and who, in fact, is giving their clients' advice.

Is that model, and I will go to Professor White I think, part of where the direction we need to go? We need to recognize that those who look at the papers and present an opinion are very different than those who provide an opinion on an ongoing basis for the value of something.

And I would like to go to Professor White, perhaps, to see when you look at the obsolescence of the existing model, should we end it in favor of something with more transparency and a number of rating organizations for the protection of CalPERS and others? Or should we try to mend the existing system?

Mr. WHITE. Congressman, the existing model that I would abandon is the regulatory reliance on ratings. That is the crucial thing. That is where everything else follows. Once we get rid of that, and you know, the SEC has taken some initial steps. We need bank regulators to do the same, pensions fund regulators, insurance regulators. The Congress can legislate in this direction.

Once that is done, remember this is an institutional market and bond managers at pension funds, at banks, at insurance companies, at money market mutual funds should be and can be expected to exercise judgment about who is a trusted source of information, look at the business model of an adviser and say, you know, I am not so good with that.

Mr. ISSA. I have one person with $200 billion at stake here. Mr. Baggesen, in your case, if we moved to a model where obviously somebody is going to put the wrapper together initially, but instead of relying either on that rating organization or, Lord help us, on AIG to wrap it in the AAA rating, which often was the problem, wouldn't you be better served if, in fact, that model were in place, because you are a sophisticated buyer, but you don't have enough to do a full analysis, perhaps, in the old model without relying too heavily on the rating agency?

Mr. BAGGESEN. Yes. There are a number of areas where the current model breaks down. These things have been addressed, for example, in the auditing profession. You are well aware of that. That is one possible alternative, is to move down that kind of a structure.

Certainly, another structure is to remove the regulatory reliance. That is another alternative. There is no, in the equity world that I am most familiar with, there is no requirement, for example, that I look at Goldman Sachs stock rating before I purchase a security. That is, you know, or to put it into a particular type of a portfolio. That does not exist in the equity world in that area.

Mr. ISSA. And you invest in the equity world on an informed basis?

Mr. BAGGESEN. Absolutely, absolutely. The credit rating agencies, currently we are almost required, again by my naive judgment, in respect to Mr. Abrams wanting to oppose me potentially later.

Mr. ISSA. We will try it later, not here.

Mr. BAGGESEN. We are almost required to look a those ratings simply because the credit rating agencies are allowed access to inside information that we do not have access to. So if we did not consider that information, we would certainly potentially be ignoring another pool of information, and that in itself could cause problems.

So there are a number of different structures to this. If you take away the accessibility of inside information to credit rating agencies and make them the equivalent of any other security analyst or whatever you care to out there, that certainly changes the degree of reliance that we would be able to place or would be willing to place on that pool of activity. That is definitely a way to mitigate against the power and the leverage that these organizations have.

Mr. ISSA. My time is expired. I just want to sort of bring to a focus your statement.

So if you had all the same information that the credit agencies had as a sophisticated investor, a large sophisticated investor, you wouldn't even be having this potential day in court if you had all the same information. At the heart of it, you had to rely on something you didn't know that he did know.

Mr. BAGGESEN. Conceptually, sir, but recognize there are hundreds of thousands of credit instruments out there. So the scale of this industry makes it almost impossible for any enterprise, even one the size of CalPERS, to go in and dissect every possible issue, issuer and so on and so forth. So there are some resource limitations to that even in the presence of place like CalPERS.

Mr. ISSA. Sure. We understand that, you know, we rely on Google when we put in a word, and we don't necessarily get it all. But in this case, you believe you were denied access to the same information and therefore you relied on it, both regulatory-wise and because they were given information you were not.

Mr. BAGGESEN. Yes, sir.

Mr. ISSA. Thank you.

Chairman TOWNS. Right. Thank you very much. The gentleman's time is expired.

I now call on the gentleman from Maryland, Mr. Elijah Cummings.

Mr. CUMMINGS. Thank you very much.

I want to put all this into some kind of context, Mr. Baggesen. I think the point for all of us to remember is that CalPERS and other public pension systems is that they manage the retirement security for a lot of our constituents. I mean, you are from California, I assume, but for teachers, bus drivers, policemen, other public servants, and those pensions are funded with public tax dollars and losses, however they may occur, cost taxpayers money. Is that right?

Mr. BAGGESEN. Yes. That would ultimately be correct, sir, but recognize that our pension beneficiaries, we do not see as being in any risk in this issue. But certainly, if we lose money or make less in return on our portfolios, the contribution rates that roll back to taxpayers could have to increase, certainly.

Mr. CUMMINGS. Yes, that is the point I was trying to make.

And I know for a fact, having been a former, in the red book and a bond counsel before I came to Congress, that I remember when I first started doing bond work and they talked about Moody's and Fitch, and what they said, you know, the rating of a bond agency you can rely on because it is like God talking. That is exactly what they told me. And now I realize that, you know, maybe they were over-rating the bond agencies.

And that brings me to the point of, you know, you didn't have much of a choice as to whether or not to use the credit rating agencies. Is that right, Mr. Baggesen? What else were you going to do?

Mr. BAGGESEN. Well, that is exactly right. Their activities are enshrined in market practice and regulation throughout the marketplace. Throughout the marketplace, sir, their activities are rife throughout it.

Mr. CUMMINGS. Right.

Mr. BAGGESEN. Whether it is regulatory requirement, historic practice, whatever you care to———

Mr. CUMMINGS. And so your own investment policies determine the portfolio's risk and the bond ratings. Is that correct?

Mr. BAGGESEN. Yes, sir. Enshrined again in our policies, there are references to the amount of risk that we are willing to take within certain segments of our investment portfolio. That risk is often expressed in the terms of a rating. Those ratings have been held out historically as the yardstick by which to judge credit-worthiness.

Mr. CUMMINGS. And you didn't say this, but the fact is that in talking to a member of my staff who used to be involved in looking at how Baltimore invests its pension money, he told me that they would often look at CalPERS to see what kind of things that you all were doing.

I know you didn't say this, but because you all were seen to be so good at it, and of course you are dealing with, what did you say, 200 million people? And they figured that if you all were doing something, they might want to at least take a look at it, because you all, whether you admit it or not, became sort of a gold standard. And your gold standard, I guess, was based largely on information that you were getting from these rating agencies. Is that a fair statement?

Mr. BAGGESEN. The information from the rating agencies is absolutely incorporated in everything CalPERS does. The degree of reliance is something, I guess, that we will explore probably in a courtroom.

Mr. CUMMINGS. Had you decided at some point that you could no longer trust the bond ratings being issued? What were your options, if any?

Mr. BAGGESEN. The option is to try to do the research yourself, and that becomes extremely, obviously, labor-intensive, resource-intensive and very expensive.

Mr. CUMMINGS. And almost impossible, is that right?

Mr. BAGGESEN. Well, the scale of the marketplace is so large that we certainly don't have a staff. We have 40 people in our fixed income area.

Mr. CUMMINGS. Now, could you have disregarded those ratings without risking suits for breach of fiduciary duties? In other words, you are looking at a rating and you don't rely on it. I mean, what happens then?

Mr. BAGGESEN. Well, for example, I will go back to the example of the benchmarks that we use in order to execute our asset allocation work to determine where we deploy capital in the portfolio. Credit ratings are enshrined in a portion of that benchmark exercise. The fixed income indices all are rated by are these investment-grade debts, are these junk bonds, all different kinds of implied ratings attached to that.

Those benchmarks have an effect on how you deploy your capital as you match your capital deployment to the liability stream that we are trying to meet the needs of with the pension fund. So certainly the activity in the presence of those ratings and their use in the marketplace have impacts on how we allocate capital. That is inescapable.

Mr. CUMMINGS. If I might just ask one quick followup, and that is that as a result of all of this, all of this information, how has that affected, if at all, your business? I mean, from what you have learned about what the rating agencies may have failed to do?

Mr. BAGGESEN. Well, again, from the perspective of what I do on behalf of CalPERS, this looks like a very familiar governance problem. This is the same problem that was dealt with back in the days of Sarbanes-Oxley with auditors and all the rest of that. I mean, so this is a very similar governance issue, and it is providing, obviously, a huge array of work for us in trying to figure out how to accommodate and how to compensate for that.

So even now, our fixed income portfolios, for example, if we are not able to farm capital out to external managers where those external managers are being controlled by being constrained to investing in certain rated securities or certain tiers of securities, if we cannot rely on those managers to be able to really understand the risks attached to those securities, that causes us to have to bring capital back internally to manage, which we may or may not have the resources to do.

So there is a whole raft of effects on our business model that are stemming from this activity.

Mr. CUMMINGS. Thank you, Mr. Chairman.

Chairman TOWNS. Thank you very much.

You know, we promised to have the Senator out by 1:30, so Senator, we recognize———

Mr. D'AMATO. Mr. Chairman, the clock is ticking and I have a plane to catch.

Chairman TOWNS. Yes.

Mr. D'AMATO. I commend you again for the hearing.

Chairman TOWNS. Thank you, thank you very, very much.

Mr. D'AMATO. Thank you, Mr. Chairman.

Chairman TOWNS. Pleasure. All right.

We now yield 5 minutes to the gentlewoman from Ohio.

Oh, I am sorry. I didn't realize you were here.

The gentleman from Indiana. They change up on me here. Mr. Souder? I am sorry.

Mr. SOUDER. No. I understood. I switched seats.

There is a big temptation to go off on a higher level challenge about how bubbles work, because in fact, like we talked about Enron, the dot.com bubble, back to tulips in Holland, like mark to market. You know, you go too much and then you contract too much, and it is the challenge of how to keep an even flow.

But one of the fundamental questions that comes every time we go through one of these in world history is: Who is actually doing the investigating?

And one of the bankers from my area who is on the Federal Reserve sat down with me early on as we were going through TARP and TALF and so on, and said one of the challenges here was that basically the housing market went up by 400 percent. The growth was going up 25 percent. So how did people miss the bubble? And that one of the challenges any of you—in other words, how did Moody's, how did the investment firms, how did the banks? Because once you sit back and go, well, there is going to be a housing bubble whenever you have, just like in the dot.coms or a run-up in energy, historical, looking back on it, you can see it, but sometimes you want to say on this one, it was pretty evident.

Now, I want to probe a little bit with Mr. Abrams' testimony, because we had lots of good testimony here. But most people thought that bond ratings were investigating, but the implications of your talking about what is a reasonable verification, reasonable investigation in your written testimony, and what in fact bond entities, the rating agencies do, that underneath this, if you are mandated, if the firms are, and I realize you are not officially representing them today, but these firms are to look at the underlying capital. In other words, does this firm have enough capital?

Wouldn't that require investigation into whether some basic assumptions like did the housing market grow 400 percent, where the economy was only going 25 percent; in securitization, that the different tranches, the more far out you went in the tranches, the more risk you were taking. And doesn't that require investigation to do a capital requirement?

Mr. ABRAMS. Well, my understanding is this, that Standard & Poor's, at least, has conducted a loan-by-loan investigation through its computerized analytic efforts, which I don't begin to understand personally, but it is loan by loan. But it does presuppose that when they receive information from the entities that supply it to them, the information itself is accurate. Then they deal with the information.

Mr. SOUDER. May I interrupt for a second?

Mr. ABRAMS. Yes, please.

Mr. SOUDER. In your written testimony, you said that, for example, if required assuming in forecasting, because Standard & Poor's isn't a forecasting organization, that the management forecasts were reasonable. But isn't that assuming that the entity that you are about to rate is, in fact, giving you a forecast that is accurate, rather than going and looking back at the housing market to determine whether the forecast was accurate, because otherwise, the capital assumption is wrong?

Mr. ABRAMS. Now look, Standard & Poor's has economists. Their job is to do the best job they can in forecasting internally in a way that helps them how the housing market and other markets are going to do. They gather information, lots and lots of information, which bears on it. They come to assumptions based on history which goes back to the Great Depression. And they did that, and they did it with respect to the housing market, and the presupposed that the housing market was going to go down. I mean, it isn't so, that they thought that it was going to keep going up. They thought it would go down, and they worked with models based on historic experience to try to tell them how much it could rationally, predictably be said to go down, and that wasn't enough. It went down much more and much more quickly.

I am sorry.

Mr. SOUDER. AIG, I mean, it was a house of cards that it appears that nobody really investigated.

And if I could go to Mr Baggesen for a second. When you say that you can't afford enough investigators, I mean, I think your investors assume you are doing it. What you are really saying is that it would cost you more money and reduce the return to your investors if you hired a bunch more investigators. Isn't that correct? If you hired 80 investigators, it would lower your rate of return.

And part of the problem here is everybody wants a high rate of return, so everybody starts chasing, hoping that they can get this high rate of return. Nobody really wants to check because if you only offer 4 percent and somebody else is offering 12 percent, then your holders will complain. And that is how it spread to the whole economy because everybody started going into speculative stocks because if you didn't buy housing tranches and securitization, if you didn't buy pharmaceuticals and you didn't buy energy, you couldn't get higher than a 4-percent to 6 percent because 4 percent to 6 percent was what the economy was growing.

So anything you were getting up here was pretty speculative, yet nobody really wanted to dig in, and everybody goes, well, we didn't do the kind of core investigation. We were just relying on the statistics. And based on past models, we thought it might go down a little, but not this much. Yes, but nobody got in and looked at the core. And that is what is hard to understand. The consumer didn't, the agencies that were placing the consumers' dollars, the different companies. Insurance companies started speculating more than they would have in order to be able to compete to get money into insurance policies.

And it is like somewhere in here, we have to have somebody looking at the core, not just circulating information, or we will repeat it.

Chairman TOWNS. The gentleman's time has expired.

I now yield 5 minutes for the gentlewoman from Ohio, Ms. Kaptur.

Ms. KAPTUR. I thank the chairman for the time and inviting this excellent group of panelists this morning, and this afternoon. [Laughter.]

Mr. Abrams, I wanted to ask for the record, in what community is your law firm located?

Mr. ABRAM. I am sorry. In what?

Ms. KAPTUR. In what community is your law firm?

Mr. ABRAM. Oh, I am sorry. New York City.

Ms. KAPTUR. You are in New York City.

Mr. ABRAM. Yes.

Ms. KAPTUR. I noticed as a Midwesterner the coastal nature of most of our witnesses. And therefore, from the heartland, I have to send this message. The first is that going back to the 1980's, the abuse that occurred in the savings and loan system was followed by an even greater set of abuses we are experiencing today, because what Congress did back then, and I served back then, sent the wrong message. It sent the message that if you abuse the financial system, the taxpayers would bail you out, and it has been done again to a much greater degree.

If I look at the current situation today and how it affects my region, just so the folks from the coast know this, Ohio has now lost an additional money center bank. PNC, whose Vice President, Mr. Demchak, invented the derivative when he worked for J.P. Morgan up there in New York moves to Pittsburgh. And one of the results of this debacle has been we have made the big banks bigger and places like Ohio, now, we only have three money center banks left. National City was bought by PNC.

We look at which banks are failing, 126 of them, I guess, have been resolved at this point at the FDIC. And we see the big banks getting bigger. I think three rating services isn't enough. That is an oligopoly, the way I look at it. All right? Out from the heartland. Maybe folks from the coasts look at it a different way.

I am just putting this on the record. The result of this system of housing rescue has been that now the Federal Government is the dump basket for all the mistakes of the private sector. The large banks have essentially taken profits and socialized losses. Just look at FHA. If we look at our Federal mortgage instrumentalities, we used to hold one of 50 mortgages. Guess what? We now hold one of four, because all the toxic assets have been dumped on the public.

And what worries me most is that what is going to happen again, because of the power of these institutions, is that we are going to open the floodgates more. I don't know how much more damage they can do than they have done already.

But here is what I want, and this is going to be my question to you, as you see the financial reform proceeding, whatever that reform is over in some of these committees, here is what I want. Tell me how close we are going to get from what you have seen is occurring over in the Financial Services Committee to it?

I want a safe and sound banking system again. I want more than financial services. I want a banking system again. I want a healthy housing market. I want the re-empowerment of communities capital accumulation versus the movement of that capital to just a few money center institutions.

How close am I going to get to the re-empowerment of community capital accumulation? And how close am I going to come to the restoration of prudent lending and responsible savings, based on what you have heard is occurring here, you heard the President's speech, you talk to your colleagues up there in New York?

I asked Mr. Bernanke, and I will end with this statement: "Mr Bernanke, you know, we are under the Cleveland Fed, and the Cleveland Fed sort of has something to say about what the New York Fed does, but not really. Would you be for the democratization of the Fed, where every single region has an equal vote?"

You know what his answer was? Absolutely not.

So my question to you is, based on what you have heard, how close are we coming under these reform proposals to a safe and sound banking system, a healthier housing market, the empowerment of community capital accumulation versus money center bank capital accumulation, and prudent lending and savings in this country again? Who is brave enough to take that on?

Mr. ABRAMS. I will go first because I can be very brief on this because it is so far from my area of expertise. But speaking for myself, I think a number of the proposals will move us significantly in the direction that you want, including a number that the President has proposed. But to get where you want to wind up is going to take a lot of doing.

Ms. KAPTUR. Yes, it is.

Mr. BAGGESEN. That is a very difficult question. From the capital market perspective, we think that many of the reforms that have been proposed are certainly encouraging, things like proxy access. There is a whole raft of governance things that have been proposed under the, I would say, the new SEC, which seems to be reinvigorated at its job as a protector of investor interests.

So we are very encouraged by those actions. It has yet to translate into real differences in the behavior of the marketplace. You have laid out a number of attributes here that it is not clear to me how much of this can be commanded by a regulatory system. In many cases, what you are asking for———

Ms. KAPTUR. Excuse me. May I just interject there, it isn't just the regulatory system which is the track we are on. It is the architecture of the entire system.

Mr. BAGGESEN. Excellent point. But you cannot, I don't think that you can turn the clock back. For example, if capital formation and people are moving, for example, from Ohio to California, you are not going to turn back the influence that migrates, let's say, to California, in other words, from Ohio. So that, you know, people in the dynamics of how they live and where they choose to live and what they choose to do are going to have a large impact on the relative influence of the different regions of the United States.

Ms. KAPTUR. I hear what you are saying, but, I mean, we want to have strong community lending. We want rigor and prudent lending to be possible again, and it won't be unless everyone has a piece of the action. And you just can't sell risk up the chain that then ends up being dumped on the Federal Government.

And my concern is we are going to be off into consumer agencies, a little tinkering here with regulatory, and we are missing the big picture. I can remember the day, and my time has expired, and Professor, I would love for you to answer my questions to the record, by the way, when they came down to the Banking Committee and they took the name off the door. It used to be Banking, Housing and Urban Affairs. That is when we had a real, that is what was left of a real banking system, what was left of a sound housing market, and what was left of a real commitment to our urban areas across this country.

What we have ended up with is financial services. The name says it all. We have to go back on top. We are down here in the middle. We have to go back to the architecture. And my greatest fear is we are not going to get there and we will end up with even bigger crisis because the architecture will be wrong, and just dealing with regulation won't be enough.

Thank you very much, Mr. Chairman.

Chairman TOWNS. Right. Thank you very much.

In closing, you know, I am still having problems with this conflict of interest. A few rating agencies are paid to help structure securities. They then get paid to rate the same securities. I am telling you, that to me sounds like a conflict of interest. So I am still having that problem.

You know, Winston Churchill—did the ranking member have anything else that he would like to add?

Mr. ISSA. Mr. Chairman, I just want to thank you for this hearing. I think, in closing, it certainly has shed light on the fact that we are not going to mend this system without significant change. And I commend you for doing comprehensive and I hope more comprehensive review of all the causes of the financial meltdown.

I yield back.

Chairman TOWNS. Right. Thank you very much.

And let me close by saying Winston Churchill once described Soviet Russia as a riddle wrapped in a mystery inside an enigma. After listening to today's testimony, I think he could just as easily have said that about the way credit rating agencies operate.

Today, we had testimony from two former senior employees at Moody's who described a culture of secrecy, a place where putting things in writing was frowned upon. Can you imagine working at a place where the very act of writing a memo or sending an email is suspect?

This culture of secrecy extended to companies outside Moody's as well. Moody's tells us they retained an outside law firm, Kramer Levin, to investigate Mr. Kolchinsky's allegations of illegal conduct at Moody's. But this morning, we learned that this outside firm was given oral instructions, only oral instructions.

Moody's says there is no written statement or work and no contract specifying the work to be done. In addition, this outside firm is not expected to produce any written report of its findings and has no schedule of completion.

On top of that, Kramer Levin says this is their normal behavior. They never produce written reports. Instead, they give their clients oral briefings. In other words, the Moody's business model could be summed up as: leave no fingerprints; don't ask, don't tell.

This might be all right if the credit rating agencies hadn't played a starring role in the collapse of the financial system. For that reason, this cannot continue. It is very clear to me at this point that effective legislation is needed, along with effective oversight, to bring about the confidence that is needed to be able to turn things around.

The testimony we have heard today is just the opening chapter of what promises to be a sordid story. We intend to pursue this further.

Finally, I want to thank all of our witnesses, and I want to thank the two witnesses, Mr. Kolchinsky and Mr. McCleskey, who had the courage to come forward to testify about what they saw at Moody's.

I am aware that testifying before Congress is never, never easy, and we want you to know that we appreciate their participation and also we appreciate the participation of all the witnesses.

On that note, without anything further to do, the committee stands adjourned.

[Whereupon, at 1:43 p.m. the committee was adjourned.]

[Additional information submitted for the hearing record follows:]

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December 2, 2009

<u>VIA HAND DELIVERY</u>

The Honorable Edolphus Towns, Chairman
Committee on Oversight and Government Reform
U.S. House of Representatives
2157 Rayburn House Office Building
Washington, D.C. 20515

Re: Production of Documents on Behalf of Moody's & Kramer Levin Briefing

Dear Chairman Towns:

On behalf of our client, Moody's, I write in response to your letter to Raymond McDaniel dated October 29, 2009, as well as in furtherance to the subsequent communications I have had with Committee staff. As I have discussed with Committee staff, Kramer Levin Naftalis & Frankel LLP ("Kramer Levin") has now concluded its independent investigation of Mr. Kolchinsky's claims and can provide the briefing to Committee staff to supplement the initial briefing provided by Kramer Levin on September 30, 2009. As I have indicated, Kramer Levin would be prepared to do a single briefing for both the Republican and Democratic staffs, or if it is preferential to the Committee, two separate briefings – but, we would request that in this case, both briefings be scheduled for the same day.

Staff had requested that in advance of this briefing Moody's provide a copy of the documents contained in Mr. Kolchinsky's Human Resources file, as well as a copy of the engagement letter from Kramer Levin to Moody's. As requested, copies of these documents, as well as two letters sent by Human Resources to Mr. Kolchinsky in September, 2009, are being provided today. It is important to note that the contemplated Kramer Levin briefing will be critical in providing the necessary context and background related to these documents. For purposes of identification and references, these documents have been consecutively numbered from MOODY'S-COGR09-00082 – MOODY'S-COGR09 – 00137. As discussed with Committee staff, transmittal information generated in connection with the collection of such

AKIN GUMP
STRAUSS HAUER & FELD LLP
Attorneys at Law

The Honorable Edolphus Towns
December 2, 2009
Page 2

documents has been redacted. Production of these documents is not intended to be a waiver of the attorney-client, attorney work product, or any other applicable privilege.

The documents we are producing today are confidential and proprietary in nature, and have been marked accordingly. We ask that these documents be kept confidential by the Committee and its staff. Moreover, these documents may contain material non-public information concerning Moody's that should be kept confidential. We therefore ask that the Committee staff provide us with notice and an opportunity to be heard before the Committee, notwithstanding our request that these documents be kept confidential, discloses any non-public information from these documents to third parties.

In addition, the documents being produced today contain certain confidential, personal information (including, among other information, social security numbers, home phone numbers, personal e-mail addresses, home addresses, birth dates, passport numbers, and compensation information), and, as discussed with Committee staff, such information has been redacted. Finally, as also discussed with Committee staff, to the extent that any other individual employees are referenced in any of the documents also referencing Mr. Kolchinsky, the names of such employees have been redacted if such references are unrelated to Mr. Kolchinsky and/or his claims. Please note that pages containing redactions have been marked accordingly.

Please let us know if you have any questions.

Sincerely,

Steven R. Ross
Counsel for Moody's

Enclosures

cc: The Honorable Darrell Issa (w/ Encl.)
cc: Ron Stroman, Esq. (w/ Encl.)
cc: John Arlington, Esq. (w/ Encl.)
cc: Jennifer Safavian, Esq. (w/ Encl.)

Moody's Investors Service

7 World Trade Center at 250 Greenwich Street
New York, NY 10007

November 6, 2007

Eric Kolchinsky
[redacted]

Dear Eric:

We are pleased to confirm your new position as Team Managing Director in the Research and Analytics Group of Moody's Investors Service, reporting to Gus Harris, effective as of November 16, 2007. This letter sets forth certain terms of your new position. Except as amended by this letter, the terms of your offer letter with Moody's, dated April 29, 2005, will continue to govern your employment.

1. Compensation

You will receive a base salary of [redacted] per year, payable according to Moody's customary payroll practices. For calendar year 2007, you will be eligible for a discretionary bonus under Moody's Executive Performance Incentive Compensation ("EPIC") Plan, and your target bonus will be [redacted] Your actual bonus payout will be payable during the first quarter of 2008. Funding for EPIC will be based on Moody's Corporation financial performance against target for 2007. Under the EPIC Plan, your actual bonus payout will be based on a combination of your performance and Moody's performance relative to its financial targets for the year. The payment of all bonuses will be subject to satisfactory performance and conduct on your part, as well as your remaining employed by Moody's, through the date on which the payment is made.

2. Benefits

As of the date of your transfer, you will accrue vacation days pro rata based on 4 weeks of vacation for each calendar year, in accordance with Moody's customary vacation policy.

Eric, we wish you continued success and hope that you will find your new position rewarding.

Sincerely,

ARosenfeld

Adrienne Rosenfeld
Recruiting Director

cc: G. Harris

CONFIDENTIAL & PROPRIETARY
REDACTED

MOODY'S-COGR09-00082

Moody's Investors Service

Internal Job Opportunity Application

Name: Ilya Kokhlinsky Position Applying for: TMD

Current Title: TMD Date of Current Assignment: NOV 16-07

Current Department: Derivatives Current Manager: Yuri Yoshizawa

[redacted]

Reason for applying for this position (use additional sheet if necessary):

New Opportunity

Please include any other information that might favorably affect consideration of your application (e.g., special qualifications, interests, ambitions, professional licenses):

Employee's Signature

11/15/07
Date

Note: If employee is offered the position, the transfer date should be no later than four weeks after acceptance of the job offer.

Current Manager's Signature

11/15/07
Date

[redacted]

Notes:

Human Resources Representative

11/15/07
Date

ERIC KOLCHINSKY

[redacted]

EXPERIENCE

Moody's Investors Service — New York, NY
Managing Director, *Derivatives Group* — 5/05 to present

- Head of ABS CDOs. Responsible for all U.S. cash, hybrid and synthetic ABS CDO business. Also responsible for Municipal CDOs.

Senior Vice President

- Team Leader for ABS CDOs. Duties include chairing credit committees and developing new rating methodologies. Lead the ABS CDO manager outreach efforts.
- Manage the Moody's CDO analytics technology platform. Responsible for the development of the CDOEdge software package and supervise a team of 6 junior analysts. Participated in the acquisition of Wall Street Analycis.

Lehman Brothers — New York, NY
Vice President, *CDO Origination* — 5/04 to 5/05

- Execute ABS CDO transactions. Direct the transaction process from client solicitation to closing. Manage the client, counsel, guarantor and rating agency relationships.
- Advised client in structuring and closing a complex, private market-value transaction which required the development of new rating approaches and methodologies.

Moody's Investors Service — New York, NY
Vice President, *Derivatives Group* — 5/00 to 5/04

- Rated numerous CDO transactions. The rating process involves modeling indenture requirements, analyzing collateral and negotiating with underwriters. Assessed transaction documents to insure compliance with rating agency requirements.
- Conducted collateral manager operations reviews.
- Developed new and reviewed existing rating methodologies.

MBIA Insurance Corporation — New York, NY
Assistant Vice President, *Alternative Structured Finance / CBO Group* — 1/99 to 5/00

- Developed criteria and parameters for purchasing equity pieces of and insuring CDO transactions. Created models to implement selection criteria.

Merrill Lynch — New York, NY
Assistant Vice President, *Global Credit Derivatives* — 4/98 to 10/98

- Modeled, structured and executed CDO transactions.
- Assisted in the solicitation of new business and the marketing of CDO equity.

Goldman Sachs — New York, NY
Associate, *Investment Banking Division* — 1/97 to 4/98

- Executed structured transactions backed by real estate assets, including public CMBS offerings.

EDUCATION

New York University Stern School of Business — New York, NY
Master of Science (Statistics), January 1997

New York University School of Law — New York, NY
Juris Doctor, May 1996

University of Southern California — Los Angeles, CA
Bachelor of Science in Aerospace Engineering, May 1993

PERSONAL

Qualifications: New York State Bar
Languages: Native fluency in Russian

Moody's Analytics

Performance Review

91001416

[redacted]

Name: Eric Kolchinsky
Department: MEI

Date:
Location: New York

I. Key Objectives / Areas of Responsibility Review 2008

- List your key objectives / areas of responsibility for this review period in the boxes provided in column A.
- Evaluate your performance, accomplishments and contributions underneath each one.
- Give specific examples to support your comments.

Columns B and C will be completed by your manager.

(A) Employee Self Assessment	(B) Manager's Assessment *Include summary of colleague reviews*	(C) Manager Rating
1. "Smooth integration of Mergent into MEI" – performed exceedingly well. Mergent pricing was a difficult company to integrate – critical systems had to be rebuilt from scratch. The task was made more difficult by the lack of funding and resources at the MCO level. For example, replicating the FTP functionality was made very difficult by the contemporaneous transition to Perot systems. Considering the scale of the task at hand, I performed exceedingly well.	Eric did a very good job in ensuring a smooth transition of the former Mergent team into MEI (and into MA). From ensuring office space layout to technology needs to HR integration, Eric appropriately managed this facet of the integration.	4
2. "Meet revenue targets – $1.25mm": did not meet. Revenue goal was not possible without substantial investment in the business. However, this resulted in substantial cost savings versus budget	While funding to Eric's team fell short of the budgeted amount, the team was well staffed to sign some new contracts. The MEI team signed just one (1) contract in all of 2008 – far short of expectations – resulting in our revenue numbers falling short of budgeted amounts. Eric could have instilled a greater sense of urgency in the team to sign up new clients and he could have been more proactive in ensuring that we were appropriately focused on prospective clients. At times our turnaround to prospects was not as timely as we would have desired.	2
3. "Work towards replacing Fintech" – work not funded	Eric helped spec out our needs to create a replacement to Fintech. Eric demonstrated an understanding of our development needs, but the work was ultimately not funded.	NA
4. Strong relationships with large clients – developed working relationships with Reuters and Telekurs. Attended several conferences, including NYSSCPA Banking conference along with IDC, KMV Practioner's conference. Interviewed for Bond Buyers article on muni pricing.	While Eric established working relationships with some of our clients, he could have done more in building stronger relationships with clients and prospects. We could also have been more visible in on the conference circuit.	3
5. "Help build abscdo dcv service" – work not funded / M3 not available for substantial period of time		NA
6. Build SF evals service – work not funded		NA
7. Build surveillance tool for rating agency – have provided pricing information for several groups including research, Munis, and funds. Developing a pricing tool for MFRA.	Eric assisted several groups within MIS with pricing information.	3
8. Building Alliances [EK add] – in lieu of getting funding – entered into alliance with Andrew Kalotay Assc. and eMBS. Difficult, multi-party negotiation.	Eric did a great job in closing the MBS deal with Kalotay and eMBS. There were several difficult personalities involved in the negotiations, but Eric stayed focused on closing the deal. He also ensured that we effectively integrated the MBS data into our end of day data files.	4

If needed, add row(s) by pressing tab in row above.

II. Key Competencies Review 2008

How you work towards achieving your objectives is also important. There are key competencies, or behaviors, that lead to success in your job. Refer to the "Competencies Key" at end of form. Select your key job competencies (at least 5) and provide specific examples. Evaluate how your performance this year reflected these key competencies.

- List the appropriate competencies in the box provided in column A.
- Evaluate how your performance reflected these key competencies.
- Give specific examples to support your comments.

Column B will be completed by your manager. Your manager may address additional competencies.

(A) Employee Self Assessment	(B) Manager's Assessment *Include summary of colleague reviews*
1. Problem Solving/Judgment Skills. Running MEI has required me to solve a number of critical problems as a result of the challenging business environment and lack of funding. These problems covered data and software vendor issues (Mergent T&C, Tenfore), software development (powerbuilder application) and client delivery requirements.	On several occasions Eric demonstrated strong creative problem solving skills. For example, he worked with several vendors to create economical arrangements. He was also able to leverage other groups within Moody's to maximize the value of these arrangements. Eric was also very helpful in trying to value TRUPs instruments and is often a source for other groups within MA looking for a better understanding of structured finance instruments. Eric could have demonstrated better judgment in the area of his focus on sales. He should have directed more energy in this area.
2. Human Relations Skills. One of the challenges with running MEI has been integrating the legacy personnel into the Moody's culture. My direct reports have a great deal of practical experience, but have not recently worked in a large corporate setting. While everyone has adjusted to the new environment, some took longer and more work than others.	Eric has done a good job in assimilating the MEI team into Moody's. I expected more from Eric, however, in motivating the team to work harder at times and produce more results. Eric could have expected more from the team and held them more accountable for any shortfalls in their performance. For example, we continue to have an outdated white paper. I also think that Eric could have established a stronger relationship with the sales force.
3. Job Knowledge and Technical Skills. While I did not begin the year with an in-depth knowledge of the business of pricing, I have learned a great deal. Additionally, I brought to the group an unsurpassed knowledge of the structured markets and valuations. I have personally performed several valuations for the Financial Institutions Group. One such valuation for the Insurance group involved the valuations of Super Senior ABS CDOs.	Eric has come a long way towards learning the evaluations business though more remains to be learned.
4. Initiative/Results Orientation	While Eric was proactive in and focused on several important aspects of his job -- eg, resolving HR issues, correcting data issues, technology integration, etc... -- he was not as proactive in focusing on some of the important business aspects of his role. For example, Eric's involvement with the sales efforts had waned over the year. He could have been more active in ensuring that the sales force kept him fully informed of developments and he could have been more proactive in pushing the sales force and his team and in reaching out to sales prospects.
5. Teamwork/Commitment to Moody's. I have demonstrated deep commitment to Moody's. MEI has provided pricing to various other groups at Moody's (e.g public finance, managed funds). I have personally devoted a great deal of time in an attempt to improve the accuracy of Moody's ratings.	Eric willingly assists other groups within MCO. For example, he has helped the Banking Group in better understanding structured finance by providing evaluations estimates and a training program. The team was very complementary of Eric's work.
6. Adaptability. I have shown a great deal of adaptability in managing MEI without the promised funding. Instead of internal growth, we are progressing on building and alliances to provide pricing in various assets classes.	Eric is very adaptable, even in helping with projects outside his MEI role. For example, he has helped test some of the MCQ data, review the MWSA tools and provided insight to several structured finance evaluations

Dealing with a transitioning IT infrastructure also required an enormous amount of adaptability and resourcefulness. Our business required MEI to duplicate mission critical delivery functions, with sparse dedicated resources, while dealing with MIT transition to an outsourcing.	projects. He always accepts these diverse roles in a positive manner.

If needed, add row(s) by pressing tab in row above.

Your manager will complete the rest of the form with you.

Overall 2008 Performance Rating Refer to "Performance Evaluation Ratings" document	**3**

This section you will finalize with your manager.

III. 2009 and Beyond Career Planning

List your business objectives, in order of importance, over the next year. Objectives should be specific and measurable. Include how results will be measured and the target dates for completion.

Objectives	Measures	Target Date
1. Help the MACs team achieve sales targets for DCV services – ensure high level of quality of the MACs evaluations services. Help team develop sound practical solutions. Actively participate in committee process and monitoring our work.	Quality tested by reference to committee guidelines.	Ongoing
2. Work well with diverse participants in the structured finance evaluation services – MEDC, MWSA, MACS, MKMV. Take leadership role where necessary and help ensure smooth working relationships. Support client and prospect communications about our service.	Feedback from others on the team	Ongoing
3. Support the SAV team in other projects, including quality testing.	TBD - as requested	TBD
4. Assist MEI, MWSA and MCQ in their businesses	TBD – as requested	TBD

What specific skills do you need to complete your key job objectives? Identify programs or projects to build those skills.

Development Goals	Actions	Target Date

EMPLOYEE Signature:	Name: Eric Kolchinsky Date: 2/23/09
MANAGER Signature:	Name: Date: 2/23/09
NEXT LEVEL MANAGER if applicable Signature:	Name: Date:

For HR Use ONLY

Preliminary HR Review Signature:	Name: Date:
Final HR Review Signature:	Name: Date:
PeopleSoft Input Signature:	Name: Date:

Moody's Analytics

Competencies Key

1	**Job Knowledge and Technical Skills** Understands and applies knowledge and skills required for the job. Maintains current knowledge of industry/area of expertise.
2	**Planning & Organizing** Completes work tasks efficiently and effectively. Prioritizes time and multiple tasks appropriately. Processes requests quickly and accurately. Develops systems/processes for managing work effectively. Structures and staffs department appropriately. Manages effective execution of work.
3	**Adaptability** Adjusts quickly to multiple demands, shifting priorities, ambiguity and rapid change. Demonstrates resilience in the face of adversity and frustrations.
4	**Dependability** Accomplishes assigned tasks completely. Meets deadlines. Follows through on commitments. Adheres to standards for attendance & punctuality.
5	**Human Relations Skills** Interacts with others in an open, positive, and professional manner. Resolves issues collaboratively. Values differences in others.
6	**Communication Skills** Speaks and writes clearly, persuasively. Tailors message to audience. Listens effectively to hear and value different perspectives and viewpoints.
7	**Productivity** Produces an appropriate quantity and quality of work for the position and individual level of experience. Takes responsibility for actions/results.
8	**Initiative/Results Orientation** Sets high standards for performance. Focuses on results with a sense of urgency. Overcomes obstacles. Brings issues to closure.
9	**Problem Solving/Judgment Skills** Thinks critically and exercises sound judgment. Identifies problems and/or opportunities proactively and provides solutions.
10	**Thinking Strategically** Analyzes opportunities from broad perspective. Anticipates, plans for reactions of others. Identifies critical, high payoff strategies impacting results.
11	**Leadership** Provides clear direction/priorities. Mobilizes and motivates others to take action. Gains support and commitment for change. Creates a positive environment.
12	**Coaching** Accurately assesses employee performance. Gives timely, specific feedback. Provides challenging developmental opportunities.
13	**Teamwork/Commitment to Moody's** Supports other team members. Willing to compromise. Places organizational priorities above personal goals. Fosters collaboration, commitment to common goals. Applies and adheres to Moody's policies (Business Conduct, Harassment, etc.). Interacts positively.

Gus

I am protesting the "2" rating I received on my PE with respect to my budget numbers as well as the "3" overall rating.

While the stated goal "Meet revenue targets – $1.25mm" was not met, this was not due to my performance and I should not be penalized. Specifically, the following external factors played critical roles in the group's inability to raise revenue:

- Declining economic conditions. Moving from one pricing service to another causes a drain on a client's resources – personnel and financial. At a time of great dislocation among the financial community, few clients had the desire or mandate to undergo the stressful process.
- Lack of Investment by Moody's. The business that was purchased from Mergent (for a nominal sum) was understood not to be able to operate without significant investment. Specifically, there were three areas which required immediate attention: 1) technology support, as this portion did not transfer; 2) additional evaluators to help with areas of weakness (eg converts) and 3) client support. None of these areas were funded properly. The technology effort also suffered (along with the rest of Moody's) from the transition to Perot Systems. Had these areas had been funded properly we would have certainly improved the initial customer experience and increased sales.
- Lack of focus from Sales. Increasing the revenues is the direct responsibility of the sales group, but their efforts were not focused. While the sales staff assigned to pricing are capable personnel, their mandate was to sell two different products. One, the ratings feed for which Moody's is the only source was a "sure thing", the other, pricing, was ultra competitive. They had no incentive to expend extra sales efforts on pricing.

Additionally, I do not understand why revenue is performance factor for me. Take, for example, Derivatives – our former group. According to our full year earnings release, the US revenues in structured finance dropped 57%. According to Morgan Stanley, CDO issuance dropped in US dropped over 80%! And yet, despite the lack of work and new issuance, the group saw a rash of managerial promotions. I would like to understand how promotions are possible in a group where the new issue work load is declining, while I am penalized for managing a business that is finished relatively flat and required a great deal of integration work. As you know, the comparison is made more relevant by the fact that the management of the derivatives group retaliated against me in the Fall of 2007 for preventing their illegal activity.

In conclusion, I believe that the two grades above should be raised to "3" and "4" respectively. Alternatively, I would like to understand the performance evaluation discrepancy between derivatives and pricing described above.

Sincerely
Eric

January 29, 2009

Moody's Corporation

7 World Trade Center at 250 Greenwich Street
New York, New York 10007

Ilya (Eric) Kolchinsky
[redacted]

Dear Eric:

We are pleased to confirm your new position as Managing Director - Quality Assurance (Structured Finance) in Moody's Analytics, reporting to Gus Harris, effective as of January 29, 2009. This letter sets forth certain terms of your new position. Except as amended by this letter, the terms of your offer letter with Moody's, dated April 29, 2005, will continue to govern your employment, in full force and effect.

1. **Compensation**

You will receive a base salary of $[redacted] per year, payable according to Moody's customary payroll practices. For calendar year 2009, you will be eligible for a discretionary bonus under Moody's Executive Performance Incentive Compensation ("EPIC") Plan, and your target bonus will be [redacted]. Your actual bonus payout will be payable during the first quarter of 2010. Funding for EPIC will be based on operating income growth relative to budget for each operating company for 2009. Under the EPIC Plan, your actual bonus payout will be based on a combination of your performance and Moody's Analytics performance relative to its financial targets for the year. The payment of all bonuses will be subject to satisfactory performance and conduct on your part, as well as your remaining employed by Moody's, through the date on which the payment is made.

2. **Benefits**

As of January 29, 2009 your benefits and vacation allotment will remain unchanged and you will continue to accrue vacation days pro rata for each calendar year, in accordance with Moody's Investors Service vacation policy.

Eric, we wish you continued success and hope that you will find your new position rewarding.

Sincerely,

Marianne Fabozzi

Marianne Fabozzi
VP –HR Generalist

cc: G. Harris
L. Agostini

CONFIDENTIAL & PROPRIETARY
REDACTED

MOODY'S-COGR09-00092

21100146

U.S. Department of Justice
Immigration and Naturalization Service

OMB No. 1115-0136

Employment Eligibility Verification

Please read instructions carefully before completing this form. The instructions must be available during completion of this form. ANTI-DISCRIMINATION NOTICE: It is illegal to discriminate against work eligible individuals. Employers CANNOT specify which document(s) they will accept from an employee. The refusal to hire an individual because of a future expiration date may also constitute illegal discrimination.

Section 1. Employee Information and Verification. To be completed and signed by employee at the time employment begins.

Print Name: Last Kolchinsky First Ilya Middle Initial Maiden Name

Address (Street Name and Number) [redacted] Apt. # Date of Birth (month/day/year) [redacted]

City [redacted] State [redacted] Zip Code [redacted] Social Security # [redacted]

I am aware that federal law provides for imprisonment and/or fines for false statements or use of false documents in connection with the completion of this form.

I attest, under penalty of perjury, that I am (check one of the following):
- [X] A citizen or national of the United States
- [ ] A Lawful Permanent Resident (Alien # A____________
- [ ] An alien authorized to work until ___/___/___ (Alien # or Admission #) ____________

Employee's Signature [signature] Date (month/day/year) 5/31/05

Preparer and/or Translator Certification. *(To be completed and signed if Section 1 is prepared by a person other than the employee.) I attest, under penalty of perjury, that I have assisted in the completion of this form and that to the best of my knowledge the information is true and correct.*

Preparer's/Translator's Signature Print Name

Address (Street Name and Number, City, State, Zip Code) Date (month/day/year)

Section 2. Employer Review and Verification. To be completed and signed by employer. Examine one document from List A OR examine one document from List B and one from List C, as listed on the reverse of this form, and record the title, number and expiration date, if any, of the document(s)

	List A	OR	List B	AND	List C
Document title:	US PASSPORT		____________		____________
Issuing authority:	N TNL		____________		____________
Document #:	[redacted]		____________		____________
Expiration Date (if any):	[redacted]		___/___/___		___/___/___
Document #:	____________				
Expiration Date (if any):	___/___/___				

CERTIFICATION - I attest, under penalty of perjury, that I have examined the document(s) presented by the above-named employee, that the above-listed document(s) appear to be genuine and to relate to the employee named, that the employee began employment on (month/day/year) ___/___/___ and that to the best of my knowledge the employee is eligible to work in the United States. (State employment agencies may omit the date the employee began employment.)

Signature of Employer or Authorized Representative [signature] Print Name VICTORIA TRETYAKOV Title HR ADMIN

Business or Organization Name Address (Street Name and Number, City, State, Zip Code) Date (month/day/year)

Moody's Investors Service 99 Church Street, New York, NY 10007 5-31-05

Section 3. Updating and Reverification. To be completed and signed by employer.

A. New Name (if applicable) B. Date of rehire (month/day/year) (if applicable)

C. If employee's previous grant of work authorization has expired, provide the information below for the document that establishes current employment eligibility.

Document Title:__________ Document #:__________ Expiration Date (if any): ___/___/___

I attest, under penalty of perjury, that to the best of my knowledge, this employee is eligible to work in the United States, and if the employee presented document(s), the document(s) I have examined appear to be genuine and to relate to the individual.

Signature of Employer or Authorized Representative Date (month/day/year)

Form I-9 (Rev. 11-21-91)N Page 2

U.S. Department of Justice
Immigration and Naturalization Service

OMB No. 1115-0136
Employment Eligibility Verification

Please read instructions carefully before completing this form. The instructions must be available during completion of this form. ANTI-DISCRIMINATION NOTICE. It is illegal to discriminate against work eligible individuals. Employers CANNOT specify which document(s) they will accept from an employee. The refusal to hire an individual because of a future expiration date may also constitute illegal discrimination.

Section 1. Employee Information and Verification. To be completed and signed by employee at the time employment begins

Print Name: Last: Kolchinsky First: Ilya Middle Initial: E Maiden Name:

Address (Street Name and Number): [redacted] Apt. #: Date of Birth (month/day/year): [redacted]

City: [redacted] State: [redacted] Zip Code: [redacted] Social Security #: [redacted]

I am aware that federal law provides for imprisonment and/or fines for false statements or use of false documents in connection with the completion of this form.

I attest, under penalty of perjury, that I am (check one of the following):
- [x] A citizen or national of the United States
- [ ] A Lawful Permanent Resident (Alien # A ____)
- [ ] An alien authorized to work until __/__/__ (Alien # or Admission # ____)

Employee's Signature: Ilya E [signature] Date (month/day/year): 5/26/00

Preparer and/or Translator Certification. *(To be completed and signed if Section 1 is prepared by a person other than the employee.) I attest, under penalty of perjury, that I have assisted in the completion of this form and that to the best of my knowledge the information is true and correct.*

Preparer's/Translator's Signature: Print Name:

Address (Street Name and Number, City, State, Zip Code): Date (month/day/year):

Section 2. Employer Review and Verification. To be completed and signed by employer. Examine one document from List A OR examine one document from List B and one from List C as listed on the reverse of this form and record the title, number and expiration date, if any, of the document(s)

List A	OR	List B	AND	List C
Document title: passport				
Issuing authority: US				
Document #: [redacted]				
Expiration Date (if any): [redacted]		__/__/__		__/__/__
Document #:				
Expiration Date (if any): __/__/__				

CERTIFICATION - I attest, under penalty of perjury, that I have examined the document(s) presented by the above-named employee, that the above-listed document(s) appear to be genuine and to relate to the employee named, that the employee began employment on *(month/day/year)* __/__/__ **and that to the best of my knowledge the employee is eligible to work in the United States. (State employment agencies may omit the date the employee began employment).**

Signature of Employer or Authorized Representative: [signature] Print Name: [illegible] Title: HR Adm

Business or Organization Name: MOODY'S INVESTORS SERVICE Address (Street Name and Number, City, State, Zip Code): 99 CHURCH ST, NY, NY 10007 Date (month/day/year): 5/30/00

Section 3. Updating and Reverification. To be completed and signed by employer

A. New Name *(if applicable)* B. Date of rehire *(month/day/year) (if applicable)*

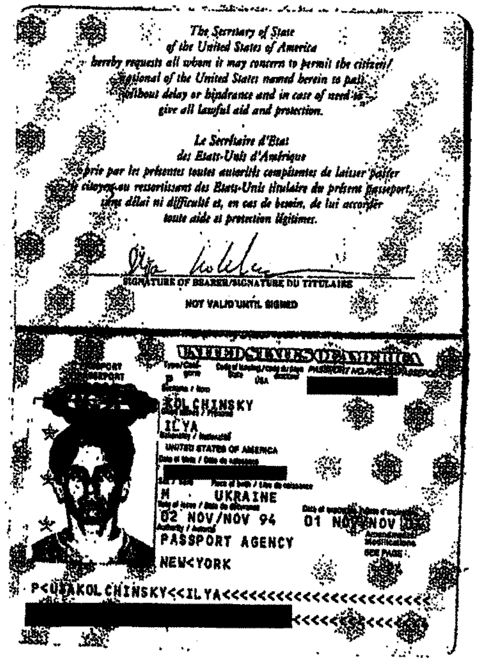
C. If employee's previous grant of work authorization has expired, provide the information below for the document that establishes current employment eligibility.

Document Title: ____ Document #: ____ Expiration Date (if any): __/__/__

I attest, under penalty of perjury, that to the best of my knowledge, this employee is eligible to work in the United States, and if the employee presented document(s), the document(s) I have examined appear to be genuine and to relate to the individual.

Signature of Employer or Authorized Representative Date (month/day/year)

Form I-9 (Rev. 11-21-91) N



The Secretary of State
of the United States of America
hereby requests all whom it may concern to permit the citizen/
national of the United States named herein to pass
without delay or hindrance and in case of need to
give all lawful aid and protection.

Le Secrétaire d'Etat
des Etats-Unis d'Amérique
prie par les présentes toutes autorités compétentes de laisser passer
le citoyen ou ressortissant des Etats-Unis titulaire du présent passeport,
sans délai ni difficulté et, en cas de besoin, de lui accorder
toute aide et protection légitimes.

SIGNATURE OF BEARER/SIGNATURE DU TITULAIRE

NOT VALID UNTIL SIGNED

UNITED STATES OF AMERICA

PASSPORT / PASSEPORT

P USA [redacted]

KOLCHINSKY

ILYA

UNITED STATES OF AMERICA

[redacted]

M UKRAINE

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PASSPORT AGENCY

NEW<YORK

P<USAKOLCHINSKY<<ILYA<<<<<<<<<<<<<<<<<<<<<<<<

[redacted]<<<<<<<<<<<<

[redacted] URCES DATA SHEET

Human Resources Data Sheets should be completed by associates prior to or on their first day of employment

Name: Kolchinsky Ilya Eric
Last First Middle Initial (Maiden Name)

Address: [redacted]
City State Zip Code

Preferred first name Eric Male [X] Female [ ] Birth Date [redacted]

Social Security # [redacted]

Home Phone # [redacted] Home Fax # ( )

Bus. Fax # ( ) Beeper/Pager # ( )

Cellular Phone # ( ) E-Mail Address

Race
White [X] Hispanic [ ] American Indian [ ]
Black [ ] Asian/Pacific Islander [ ] Other [ ]

Nationality: US

Marital Status: Married [ ] Single [ ]

If Married: Spouse first name: Amy Spouse last name: Arginteanu

Optional: Divorced [ ] Separated [ ] Widowed [ ]

U.S. Citizen? Yes [X] No [ ] If not, what country are you a citizen of?

Visa Status Expiration Date

Fluent Languages Russian Proficient Languages

Conversational Languages

U.S. Armed Forces Reserve Category:

\# of Drills Annually Annual # of Weeks of Active Duty

Are you a veteran of the "Vietnam era"? Yes [ ] No [X] or a "special disabled" veteran? Yes [ ] No [X]

A "Vietnam era" veteran is one who served 180 days active duty between August 5, 1964 and May 7, 1975, and received an honorable, general or other discharge but not a dishonorable one, or one who served 180 days between the above dates and was released due to a service-connected disability.

A "special disabled" veteran is one entitled to compensate for a disability rated at 30 percent or more, or rated 10 or 20 percent but has a "serious employment handicap", or one discharged or released from active duty because of a service-connected disability.

I certify that the information herein is correct.

Ilya E [signature] 5/26/00
Signature Date

THIS IS NOT USED FOR SCREENING JOB APPLICANTS
AN EQUAL OPPORTUNITY EMPLOYER
M/F/D/V

DATA_SOC
APRIL 1998NC

Moody's Investors Service

99 Church Street
New York, New York 10007

Adrienne Rosenfeld
VP/Human Resources
Tel: 212.553.1496

May 2nd 2000

Eric Kolchinsky
[redacted]

Dear Eric:

We are pleased to offer you the position of VP/Sr. Analyst with Moody's Investors Service at a starting salary of [redacted] per annum with a bonus target of [redacted] Your actual bonus payout for 2000 will be affected by your performance as an analyst and Moody's performance relative to its financial targets for the year. The 2000 bonus will be paid in the first quarter of 2001. Your bonus payout for 2000 will be calculated as if you had been employed as of January 1, 2000 and will not be pro-rated based upon your date of hire.

Beginning in 2001, you will accrue 4 weeks vacation, for the remainder of this year, your vacation days will be pro-rated based upon your start date.

In addition to the salary offered, you will be eligible to participate in the Dun & Bradstreet benefits program. Please call Fidelity Investments, our benefits administrator at 1-877-DNB-8953 to request benefits enrollment material. Once you receive the benefits information, you must call Fidelity Investments to enroll in the benefits plan. If you do not call within 31 days of employment, you will not have benefit coverage. You can enroll by speaking with a service representative from 8:00 a.m. to 8:30 p.m., Monday through Friday, or through the Voice Response System virtually 24 hours a day.

You will also be required to bring with you on your date of hire appropriate documentation providing proof of United States citizenship or authorization to work in the United States.

The offer as stated is contingent upon the satisfactory check of your references as well as the satisfactory results of a drug test to be taken prior to your starting with us.

In closing, we hope that you will find this opportunity with Moody's rewarding. If you have any questions, please call me.

Sincerely,

ARosenfeld

Adrienne Rosenfeld

Cc: Jerry Gluck
Rosanna Thacke

A company of The Dun & Bradstreet Corporation

[redacted]

ANNEX A

ACKNOWLEDGEMENT AND AGREEMENT
BY
ASSOCIATE

I HEREBY ACKNOWLEDGE AND AGREE that:

1. I have carefully read the Code of Ethics ("*Code*") and the Standards of Professional Conduct ("*Standards*") of MOODY'S INVESTORS SERVICE, including its subsidiaries and controlled affiliates ("*MOODY'S*"), and have been given sufficient time and access to discuss the content thereof with appropriate management. On the basis of the foregoing, I understand and agree to abide by the terms of the Code and the Standards.

2. As an Associate (as defined in the Code), I may in the course or by virtue of my employment receive, acquire, learn, develop, create or otherwise gain access to trade secrets and other confidential information ("*Confidential Information*") that are proprietary to MOODY'S or its Business Contacts (as defined in the Standards). Because it is a registered investment adviser under the *Investment Advisers Act of 1940*, MOODY'S and its Associates are subject to the provisions of such Act and the *Insider Trading and Securities Fraud Enforcement Act of 1988*, including the provisions thereof concerning the protection of Confidential Information from unauthorized disclosure or diversion to any unauthorized use or purpose.

3. At all times during the course and after termination of my employment at MOODY'S, I will treat all Confidential Information as the property of MOODY'S or its Business Contacts, as the case may be, and will not, unless expressly authorized in writing by an executive officer of MOODY'S, divulge any Confidential Information to any person who is not an Associate or divert any Confidential Information to any use or purpose (including without limitation any personal gain or benefit of any kind) other than that for which such Information was acquired or developed by, or entrusted to, MOODY'S.

4. Any violation by me of the Code or the Standards will subject me to immediate disciplinary action by MOODY'S, including without limitation termination of employment, and may, in addition, subject me to civil and/or criminal liability and penalties under applicable state and federal law.

5. Nothing in this Acknowledgement and Agreement shall, nor shall it for any purpose be deemed to, (a) constitute any agreement, express or implied, establishing the duration of my employment by MOODY'S or (b) limit or restrict in any manner the right of MOODY'S or me to terminate such employment at any time or for any reason.

SIGNATURE: Ilya E. Kolchinsky

NAME: Ilya Eric Kolchinsky

DATE: 5/26/00 TITLE: VP/ Senior Analyst

DEPARTMENT: ~~Derivatives~~ CRA

COST CENTER NO: .... GROUP: Derivatives

(MAR-93)
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CONFIDENTIAL & PROPRIETARY
REDACTED

MOODY'S-COGR09-00098

ANNEX A

MOODY'S INVESTORS SERVICE
SECURITIES TRADING POLICY

QUARTERLY COMPLIANCE CERTIFICATE

I HEREBY CERTIFY that:

1. I have read and understand the *Securities Trading Policy* of MOODY'S.

2. I agree that, at all times while employed by MOODY'S and for a period of three (3) months following termination of such employment, I will faithfully comply with the *Policy*.

3. I understand and agree that failure to comply with the *Policy* will subject me to immediate disciplinary action, which may include termination of my employment, by MOODY'S and may, in addition, subject me to civil and/or criminal penalties under state and federal law.

4. During the course of the three (3) months immediately preceding the date of this Certificate:

4.1. (*check one*)

X 4.1.1. I have not engaged in any transaction in Securities (as defined) required by the *Policy* to be disclosed in a Securities Transaction Report.

or

___ 4.1.2. I have engaged in one or more transactions in Securities required by the *Policy* to be disclosed in Securities Transaction Reports and have either submitted all such Reports as and when required or, if not, submit them with this Certificate.

4.2. I have neither purchased nor sold any Security in violation of the *Policy*, nor communicated any information in connection with, or with a view toward causing or inducing, the purchase or sale of any Security in violation of the *Policy*.

		SIGNATURE:	
REPORT FOR: QUARTER:	2	NAME:	Ilya Eric Kolchinsky
YEAR:	~~199~~ 2000	TITLE:	VP / Senior Analyst
DATE:	7/19/00	DEPARTMENT:	SFG
COST CENTER NO:	8266	GROUP:	Derivatives

PLEASE SUBMIT THE COMPLETED FORM TO:
HUMAN RESOURCES DEPARTMENT
ATTENTION: DIRECTOR

This Certificate must be submitted not later than ten (10) days after the end of each calendar quarter.

(JAN-96)

[redacted]

Moody's Investors Service

DATE: 6/14/02

Health & Fitness Center
Tel: (212) 553-4180/Fax:(212) 553-4199

MEMBERSHIP CANCELLATION

NAME: Ilya Eric Kolchinsky

SOCIAL SECURITY # [redacted]

DEPARTMENT: SFG Derivatives

REASON FOR CANCELLATION

I haven't gone in months.

SIGNATURE: Ilya E Kolchinsky

NAME (PLEASE PRINT): Ilya E Kolchinsky

EXTENSION: 7928

FITNESS MANAGER SIGNATURE:

MOODY'S-COGR09-00100

[redacted]

Matthews, Levi

From: Maughn, Paul
Sent: Monday, March 10, 2003 5:56 PM
To: Matthews, Levi
Subject: FW: Employee Location Code Change

-----Original Message-----
From: Kozlowski, Matthew
Sent: Monday, March 10, 2003 5:55 PM
To: Maughn, Paul; Curulli, Matthew
Cc: Solomon, Michael
Subject: Employee Location Code Change

Paul,

Please change the location (Operating Unit) in ADP to 26400 for these two associates (for the March 15 payroll if possible):

Ilya Kolchinsky
[redacted]

Matt - Please make sure these are up to date in ETS as well.

Let me know if you have questions.

Thanks,

Matt

[redacted]

Moody's Name/Address Change Form

By completing this form you are authorizing Moody's to change your name and or address in our Human Resources and Payroll systems. Moody's will communicate your changes to all Medical and Benefit vendors.

Social Security Number:	[redacted]
Effective Date:	07/19/02
Current Name:	Ilya Eric Kolchinsky
New Name:	
Marital Status:	
Spouse's Name:	
Address:	[redacted]
Apartment Number:	[redacted]
City:	[redacted]
State:	[redacted]
Zip Code:	[redacted]
Primary Phone Number:	[redacted]
Mobile Phone Number:	

Changing your address may impact your State and/or Local withholding. To change your withholding, please complete the appropriate withholding certificate and forward to the Payroll department (New York Office, 2nd floor). You may access withholding forms by using the link below:
http://moodysnet/moodysnet/forms.nsf

Should you wish to update your emergency contact information, please go to the on-line HR Self-Service Center and follow the instructions. You may access the site by using the link below:
http://moodysnet/hr/hrkiosk.nsf

Please return this form to Human Resources (New York Office, 2nd Floor).

Associate's Signature:	

CONFIDENTIAL & PROPRIETARY
REDACTED

MOODY'S-COGR09-00102

Moody's Corporation
99 Church Street
New York, New York 10007
John Rutherfurd, Jr.
President & Chief Executive Officer

Tel: 212.553.4014
Fax: 212.406.1696
E-mail: john.rutherfurd@moodys.com

Kolchinsky, Ilya
BC/NK/New York

March 3, 2003

Dear Ilya:

I am pleased to advise you that your 2002 Performance Incentive Plan (PIP) bonus payment is [redacted] and will be made by direct deposit to your account in an amount less appropriate withholdings and deductions.

I want to thank you for your hard work and dedication during the past year. Your efforts contributed to overall growth for Moody's Corporation (including MKMV) of 28.4% in revenue and 35% in operating income and strong cash flow as compared with 2001. Overall, Moody's employees delivered outstanding financial performance in 2002. Attached is a summary of how the PIP bonus payout was determined.

Working together, I have every confidence that we will be successful in creating additional value for our shareholders in 2003.

Sincerely,

PIP_Reg

Moody's Corporation

99 Church Street
New York, New York 10007

John Rutherfurd, Jr.
President & Chief Executive Officer
Tel: 212.553.4014
Fax: 212.406.1696
E-mail: john.rutherfurd@moodys.com

BC/NK

Ilya Kolchinsky
New York

February 11, 2002

Dear Ilya:

Congratulations! I am pleased to inform you that the Board of Directors of Moody's Corporation recently awarded you a stock option grant. This letter outlines the key terms and conditions of that stock option grant. After reading this letter, please sign a copy and return it to*Grace Genna/Human Resources in New York.*

Your stock option grant is governed by the terms and conditions of the 1998 Moody's Corporation Key Employees' Stock Incentive Plan (the "Plan"). A copy of the Plan, as well as the original prospectus and prospectus supplement relating to the offering of shares of Moody's Corporation stock pursuant to the Plan, are enclosed with this letter. You should read each of those documents in their entirety for a better understanding of your grant.

In addition, enclosed is a brochure with general information about your option grant, as well as information about establishing an on-line brokerage account with Charles Schwab & Company, Moody's stock option plan administrator.

Your Stock Option Grant

Your stock option grant provides you with an equity stake in Moody's and an opportunity for long-term capital appreciation. It provides a direct link between an associate's compensation opportunity and increases in stockholder value.

Your grant gives you the right to buy Moody's Corporation stock at a fixed price in the future. This is called the exercise price. The value of your options is tied directly to the stock market price of Moody's stock during the life span of the options. The higher the stock price rises in the future, the more valuable your options become.

Each Moody's associate who receives an option grant will be provided with a Charles Schwab on-line brokerage account, at no cost to the associate, through which Moody's stock options may be

[redacted]

exercised. Since you may only exercise your options by means of your Charles Schwab brokerage account, you are encouraged to promptly complete the enclosed application form from Charles Schwab Employee Stock Plan Services, if you have not already done so. Once you exercise your options and purchase shares, you may transfer your shares to another brokerage account or leave them in your Schwab account.

Details of Your Stock Option Grant

Number of Shares of Moody's Stock Subject to Your Option: [redacted]
Exercise Price: **$39.975**
Date of Grant: **February 7, 2002**

Expiration Date and Vesting Schedule

Your stock option grant is a grant of non-qualified stock options, which expires 10 years after the date of grant ***(February 7, 2012)***, or upon your termination of employment, if earlier. You should review the enclosed copy of the Plan and informational brochure for details about the effect of a termination of employment on your options.

Subject to your continued employment, your options will vest and become exercisable with respect to 25% of the shares on each of the first, second, third and fourth anniversaries of the date of grant, so that your options will be 100% vested and exercisable after the fourth anniversary of the date of grant, as set forth in the following schedule:

Timeframe from Date of Grant	Vesting	Cumulative Vesting
February 7, 2003 (1 year)	25%	25%
February 7, 2004 (2 years)	25%	50%
February 7, 2005 (3 years)	25%	75%
February 7, 2006 (4 years)	25%	100%

Exercise

You may exercise all or a portion of your options to purchase shares, to the extent vested, at the fixed exercise price at any time after vesting commences and on or before the option expiration date. You may exercise the vested portion of your options by contacting Charles Schwab either on-line or by using the toll-free number, depending on your means of exercise. Further information on how to exercise your options and pay the exercise price is set forth in the enclosed informational brochure.

Transferability

Your options may not be assigned, alienated, pledged, attached, sold or otherwise transferred or encumbered by you otherwise than by will or by the laws of descent and distribution, and any such purported assignment, alienation, pledge, attachment, sale, transfer or encumbrance will be void and unenforceable against Moody's. During your lifetime, your options are exercisable only by you.

[redacted]

No Right to Employment

Your option grant will not constitute or be evidence of any agreement or understanding, expressed or implied, on the part of Moody's or any of its subsidiaries to continue your employment for any specific period or in any particular capacity and will not prevent Moody's or any of its subsidiaries from terminating your employment at any time.

Responsibility for Taxes

Regardless of any action Moody's or your employer takes with respect to any or all income tax, social insurance, payroll tax or other tax-related withholding ("Tax-Related Items"), you acknowledge that the ultimate liability for all Tax-Related Items is and remains your responsibility and that Moody's and/or your employer (1) make no representations or undertakings regarding the treatment of any Tax-Related Items in connection with any aspect of the option grant, including the grant, vesting or exercise of the option, the subsequent sale of shares acquired pursuant to such exercise and the receipt of any dividends, and (2) do not commit to structure the terms of the grant or any aspect of the option to reduce or eliminate your liability for Tax-Related Items.

Prior to exercise of the option, you agree to pay or make adequate arrangements satisfactory to Moody's and/or your employer to satisfy all withholding obligations of Moody's and/or your employer. In this regard, you authorize Moody's and/or your employer to withhold all applicable Tax-Related Items legally payable by you from your wages or other cash compensation paid to you by Moody's and/or your employer or from proceeds of the sale of the shares. Alternatively, or in addition, if permissible under local law, Moody's may (1) sell or arrange for the sale of shares that you acquire to meet the withholding obligation for Tax-Related Items, and/or (2) withhold in shares, provided that Moody's only withholds the amount of shares necessary to satisfy the minimum withholding amount. Finally, you shall pay to Moody's or your employer any amount of Tax-Related Items that Moody's or your employer may be required to withhold as a result of your participation in the Plan or your purchase of shares that cannot be satisfied by the means previously described. Moody's may refuse to honor the exercise and refuse to deliver the shares if you fail to comply with your obligations in connection with the Tax-Related Items as described in this section.

Federal Income Tax Consequences

A summary of the United States federal income tax consequences with respect to the Plan and your options are set forth in the enclosed prospectus. However, you should consult your own tax advisor concerning the federal, state, local or other tax implications of the Plan and your options.

If you have any questions regarding this grant, please contact your Human Resources representative.

Sincerely,

[redacted]

I hereby accept and agree
to the foregoing terms of
this option grant.

Signature

Ilya Kolchinsky

Name

Feb 21, 2002

Date

[redacted]

Moody's Corporation
99 Church Street
New York, New York 10007

John Rutherford, Jr.
President & Chief Executive Officer
Tel: 212.553.4014
Fax: 212.406.1696
E-mail: john.rutherford@moodys.com

Eric Kolchinsky

BC/NK/USA/NY

February 13, 2003

Dear Eric:

Congratulations! I am pleased to inform you that the Board of Directors of Moody's Corporation recently awarded you a stock option grant. This letter outlines the key terms and conditions of that stock option grant. After reading this letter, please sign a copy and return it to *Grace Genna/Human Resources Department, 99 Church Street, 2nd Floor, New York, NY 1007.*

Your stock option grant is governed by the terms and conditions of the 1998 Moody's Corporation Key Employees' Stock Incentive Plan (the "Plan"). A copy of the Plan, as well as the original prospectus and prospectus supplement relating to the offering of shares of Moody's Corporation stock pursuant to the Plan, are enclosed with this letter. You should read each of those documents in their entirety for a better understanding of your grant.

In addition, enclosed is a brochure with general information about your option grant, as well as information about establishing an on-line brokerage account with Charles Schwab & Company, Moody's stock option plan administrator.

Your Stock Option Grant

Your stock option grant provides you with an equity stake in Moody's and an opportunity for long-term capital appreciation. It provides a direct link between an associate's compensation opportunity and increases in stockholder value.

Your grant gives you the right to buy Moody's Corporation stock at a fixed price in the future. This is called the exercise price. The value of your options is tied directly to the stock market price of Moody's stock during the life span of the options. The higher the stock price rises in the future, the more valuable your options become.

Each Moody's associate who receives an option grant will be provided with a Charles Schwab on-line brokerage account, at no cost to the associate, through which Moody's stock options may be exercised. Since you may only exercise your options by means of your Charles Schwab brokerage account, you are encouraged to promptly complete the enclosed application form from Charles Schwab Employee Stock Plan Services, if you have not already done so. Once you exercise your options and purchase shares, you may transfer your shares to another brokerage account or leave them in your Schwab account.

[redacted]

Details of Your Stock Option Grant

Number of Shares of Moody's Stock Subject to Your Option [redacted]
Exercise Price: **$42.535**
Date of Grant: **February 7, 2003**

Expiration Date and Vesting Schedule

Your stock option grant is a grant of non-qualified stock options, which expires 10 years after the date of grant ***(February 7, 2013)***, or upon your termination of employment, if earlier. You should review the enclosed copy of the Plan and informational brochure for details about the effect of a termination of employment on your options.

Subject to your continued employment, your options will vest and become exercisable with respect to 25% of the shares on each of the first, second, third and fourth anniversaries of the date of grant, so that your options will be 100% vested and exercisable after the fourth anniversary of the date of grant, as set forth in the following schedule:

Timeframe from Date of Grant	Vesting	Cumulative Vesting
February 7, 2004 (1 year)	**25%**	**25%**
February 7, 2005 (2 years)	**25%**	**50%**
February 7, 2006 (3 years)	**25%**	**75%**
February 7, 2007 (4 years)	**25%**	**100%**

Exercise

You may exercise all or a portion of your options to purchase shares, to the extent vested, at the fixed exercise price at any time after vesting commences and on or before the option expiration date. You may exercise the vested portion of your options by contacting Charles Schwab either online or by using the toll-free number, depending on your means of exercise. Further information on how to exercise your options and pay the exercise price is set forth in the enclosed informational brochure.

Transferability

Your options may not be assigned, alienated, pledged, attached, sold or otherwise transferred or encumbered by you otherwise than by will or by the laws of descent and distribution, and any such purported assignment, alienation, pledge, attachment, sale, transfer or encumbrance will be void and unenforceable against Moody's. During your lifetime, your options are exercisable only by you.

No Right to Employment

Your option grant will not constitute or be evidence of any agreement or understanding, expressed or implied, on the part of Moody's or any of its subsidiaries to continue your employment for any specific period or in any particular capacityand will not prevent Moody's or any of its subsidiaries from terminating your employment at any time.

[redacted]

Responsibility for Taxes

Regardless of any action Moody's or your employer takes with respect to any or all income tax, social insurance, payroll tax or other tax-related withholding ("Tax-Related Items"), you acknowledge that the ultimate liability for all Tax-Related Items is and remains your responsibility and that Moody's and/or your employer (1) make no representations or undertakings regarding the treatment of any Tax-Related Items in connection with any aspect of the option grant, including the grant, vesting or exercise of the option, the subsequent sale of shares acquired pursuant to such exercise and the receipt of any dividends, and (2) do not commit to structure the terms of the grant or any aspect of the option to reduce or eliminate your liability for Tax-Related Items.

Prior to exercise of the option, you agree to pay or make adequate arrangements satisfactory to Moody's and/or your employer to satisfy all withholding obligations of Moody's and/or your employer. In this regard, you authorize Moody's and/or your employer to withhold all applicable Tax-Related Items legally payable by you from your wages or other cash compensation paid to you by Moody's and/or your employer or from proceeds of the sale of the shares. Alternatively, or in addition, if permissible under local law, Moody's may (1) sell or arrange for the sale of shares that you acquire to meet the withholding obligation for Tax-Related Items, and/or (2) withhold in shares, provided that Moody's only withholds the amount of shares necessary to satisfy the minimum withholding amount. Finally, you shall pay to Moody's or your employer any amount of Tax-Related Items that Moody's or your employer may be required to withhold as a result of your participation in the Plan or your purchase of shares that cannot be satisfied by the means previously described. Moody's may refuse to honor the exercise and refuse to deliver the shares if you fail to comply with your obligations in connection with the Tax-Related Items as described in this section.

Federal Income Tax Consequences

A summary of the United States federal income tax consequences with respect to the Plan and your options are set forth in the enclosed prospectus. However, you should consult your own tax advisor concerning the federal, state, local or other tax implications of the Plan and your options.

If you have any questions regarding this grant, please contact your Human Resources representative.

Sincerely,

I hereby accept and agree
to the foregoing terms of
this option grant.

Signature

Kolchinsky, Eric
Name: (Kolchinsky, Eric)

4/29/03
Date

Performance Evaluation Form – Rating Analyst

[illegible]		
Associate Name: Eric Kolchinsky	Title: VP, Snr Analyst	Department/Location: Derivatives/8266
Employment Date: May 2000	Review Period/From: 6/01 To: 5/02	Date of Last Salary Action: May 2001
Review Written by: Gus Harris	Reviewer's Title: Managing Director	Date Prepared: 6/17/02

[illegible]					
1. Assign accurate ratings on a timely basis	☐	☐	☐	X	☐
2. Monitor existing ratings	☐	☐	X	☐	☐
3. Contribute to our CDO Navigator efforts. Provide guidance to team preparing CDO reports.	☐	☐	☐	☐	X
4. Contribute to group-wide issues. Assist others as need arises.	☐	☐	☐	X	☐
5. Write research, contribute to outreach efforts and speak at conferences	☐	☐	☐	X	☐
	☐	☐	☐	☐	☐

Overall Business Results Rating 1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐

III. Competencies for Rating Analysts – *Evaluate the associate's performance on each of the following competencies. Higher ratings indicate better performance (use definitions of Performance Levels on page 4). Evaluation should be based on demonstrated competencies, not potential or unrealized abilities.*

[illegible]	[illegible]
Rating 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 X ☐ NA	Rating 1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐ ☐ NA
[illegible]	[illegible]
Rating 1 ☐ 2 ☐ 3 X 4 ☐ 5 ☐ ☐ NA	Rating 1 ☐ 2 ☐ 3 X 4 ☐ 5 ☐ ☐ NA
[illegible]	[illegible]
Rating 1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐ ☐ NA	Rating 1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐ ☐ NA

4

Rating	Rating
1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 X ☐ NA	1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐ ☐ NA

IV. Overall Performance Evaluation/Summary Comments – *Use the Definitions of Performance Levels on page 4 to determine the associate's Overall Performance Rating. Generally, the Overall Performance Rating should vary only +/- one rating level from the Overall Business Results Rating. Please explain any larger variance.*

1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐

Describe the rationale for the associate's Overall Performance Evaluation level. In addition, documentation is required for those areas in which the associate's performance is outstanding or requires improvement. Link areas identified for improvement to Individual Development Plan on page 3.

In two short years, Eric has become one of the most valuable quant analysts in our Group. He has exhibited the ability to master fairly complex quantitative issues while concurrently dealing effectively with difficult issuers. Eric has also developed a strong understanding of the qualitative aspects of CDOs. Eric has worked on a wide array of deals, including plain vanilla CDOs and resecuritizations. In the area of resecuritizations, he has also assisted in resolving some sticky issues such as excess Caa haircuts.

Eric's attitude is also exemplary. He is respected and well-liked by his peers and has earned the confidence of his MDs, peers and the issuers. Eric is always willing to go above and beyond expectations. For example, with the launch of our CDO Navigator product suite, Eric has taken a leadership role in managing the data quality efforts and reviewing the reports prior to publication. He has helped us develop smart data checks and he has also written the commentary in the most recent monthly publication. The team working on this demanding project respects Eric and appreciates the direction and guidance he offers.

Another sign of Eric's commitment to our team - In the wake of the 9/11 disaster, Eric arranged to drive to Florida for a CDO conference in order to satisfy our obligation to a conference organizer. Not once did Eric mention the inconvenience of this arrangement.

Written and Conducted by:

Name/Title: Gus Harris — Signature/Date: Gus Harris / 6/21/02

Reviewed by Next Level Manager:

Name/Title: NOEL KIRNON / GMD — Signature/Date: Noel Kirnon 6/25/02

[illegible] 6/21/02

Note: Signature by associate does not signify approval or agreement to the evaluation. It indicates only that the associate has seen the evaluation.

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REDACTED

MOODY'S-COGR09-00112

V. Business Objectives Worksheet - *List the business objectives, in order of importance, for the individual during the next review cycle. Include how you will measure results and target dates for completion.*

Goals/Results/Projects	Measures	Target Date
1. Monitor existing deals		Ongoing
2. Continue to manage the data quality functions for CDO Navigator reports. Continue to develop "smart" data checks, and help train other analysts. Eventually rotate off this role.		12/02
3. Write NIRs for every deal, write at least one Special Report and speak in at least one conference panel in the upcoming year.		12 months
4.		
5.		
6.		

Individual Development Plan - *Identify areas for individual development from Part II & III. List suggested approaches (developmental assignments, participation on special projects, etc.)*

Key Areas	Suggested Actions	Target Date
1.		
2.		
3.		

Associates' Signature ____ **Date** 6/21/02 **Manager's Signature** ____ **Date** 6/21/02

[redacted]

DEFINITIONS OF PERFORMANCE LEVELS

5	*Individual performance was outstanding throughout the review cycle. Business results were achieved at levels exceeding significantly specified targets or expectations. Individual also demonstrated consistently the competencies that made him/her a role model for other associates. Individual took initiative and sought additional responsibilities and tasks resulting in important contributions to the department. Required little or no supervision/ coaching and frequently took on the coaching of others.*
4	*Individual performance often exceeded expectations during the review cycle. Business results were achieved at levels that were regularly above specified targets or expectations. Individual also demonstrated the competencies necessary for performance at levels that exceed expectations for the position. Initiative was frequently demonstrated to improve performance. Required minimal supervision.*
3	*Individual performance consistently met expectations throughout the review cycle. Business results were achieved at levels that met specified targets or expectations. Individual demonstrated competency in the technical requirements of the position and the behaviors necessary for fully satisfactory performance. Extra tasks were performed as required. Required some supervision.*
2	*Individual performance does not fully meet expectations for the position. Although performance may meet expectations in some areas, improvement is necessary in others to completely meet expectations. This improvement may be required to fully achieve expected business results, or to demonstrate acceptable technical or behavioral competence. Individual requires a higher than usual amount of direct supervision.*
1	*Performance consistently falls short of performance expectations. Improvement is required in both technical and behavioral competence to meet performance expectations. Direct supervision is regularly required.*

Moody's Corporation

99 Church Street
New York, New York 10007
John Rutherfurd, Jr.
President & Chief Executive Officer

Tel: 212.553.4014
Fax: 212.406.1696
E-mail: john.rutherfurd@moodys.com

BC/NK

Ilya Kolchinsky
New York

March 1, 2002

Dear Ilya:

I am pleased to advise you that your Performance Incentive Plan (PIP) bonus award for 2001 has been approved at the level shown below. In addition, management's proposal to supplement the formula bonus payments to reward exceptional sectors and individual performance has been approved. In recognition of your outstanding contribution to Moody's in 2001, you have been chosen to receive a supplemental bonus.

Your 2001 regular bonus payment is [redacted] and your 2001 supplemental bonus payment is [redacted]. A payment for [redacted] will be made by direct deposit to your account in an amount less appropriate withholdings and deductions. Attached is a summary of how the PIP bonus payout was determined.

I want to thank you for your hard work and dedication during the past year. Your efforts contributed to overall growth for Moody's Corporation of 32% in revenue and 38% in operating income and strong cash flow as compared with 2000. Overall, Moody's employees delivered outstanding financial performance in 2001.

Working together, I have every confidence that we will be successful in creating additional value for our shareholders in 2002.

Sincerely,

John Rutherfurd, Jr.

[redacted]

PAYMENT PLAN

PLEASE TYPE OR PRINT ALL ENTRIES

Kolchinsky Ilya Eric

Last name **First name** **Middle initial** **SS#**

7928

Department **Telephone Extension**

PAYROLL DEDUCTION

I hereby authorize the SEMI-MONTHLY payroll deduction $13.00 (current fee) for membership in Moody's Fitness Center. I understand my initial membership commitment is for six months unless I relocate at the Company's request, terminate my employment or become continuously disabled for more than one month. If I elect to terminate my membership after six months (or under one of the foregoing conditions). I will notify Moody's Human Resources Department in writing by the first of the month in which I wish my membership to be discontinued.

6/4/01

Date **Signature**

LUMP SUM PAYMENT.

My check or money order, made payable to Moody's Investors Service in the amount of $__________, is attached to pay my membership in Moody's Fitness Center for the period beginning on the following date:______________ and ending:_____________. Refunds will be made only under the conditions stated above. The payment includes a minimum of the first 6 months (currently $156.00)

Date **Signature**

Recommendation for Compensation Adjustment
US Payroll

Associate Name:	Kolchinsky, Ilya E	**Performance Evaluation:**
Employee ID Num:	21001416	
		PE Date:
Social Security Num:	[redacted]	
Payroll Location:	United States(45)	
Cost Center:	266 - Derivatives	
Hire Date:	05/30/2000	
Last Perf Appraisal:	05/30/2000	

Compensation History
Recommendation/Change

Recommended By:	Gus Harris on 04/24/2001		
Reason for Change:	Merit	**Effective Date:**	05/30/2001
Performance Rating:	Exceeds Expectations (3)	**Since Last Change:**	9 months, 1 day
Local Currency:	USD		

Other Comp: I **Bonus Type:** Target

[redacted]	Current	New	Amt Change	% Change
Base Salary:	[redacted]	[redacted]	[redacted]	[redacted]
Target Bonus:				
Compensation:				
Semi-monthly:				

Position Change/Transfer...

	Current Position Information	New Position Information
ID Num:	P21001668	P21001668
Long Title:	Vice President/Senior Analyst	Vice President/Senior Analyst
Grade:		
Cost Center:	266 - Derivatives	266 - Derivatives
SBU:	CRA	CRA
Group:	Structured Finance Group	Structured Finance Group

5/31

Comments...

Approvals
Initial Approval...
Executive Approval...
Finance Approval...

CONFIDENTIAL & PROPRIETARY
REDACTED

MOODY'S-COGR09-00117

[redacted]

Lennon, Danna

From: Kolchinsky, Eric
Sent: Friday, October 13, 2000 2:08 PM
To: Lennon, Danna
Subject: New Address

Dana,

My new address is:

[redacted]

My emergency contact is the same at the new number.

Thank you very much,

Eric

10/23

[redacted]

COMPANY--> 00500 EMPLOYEE NUMBER--> [redacted]

EMPLOYEE NAME-----> ILYA E KOLCHINSKY
PO BOX/APT/SUITE--> [redacted]
STREET ADDRESS---->
CITY-------------->
STATE------------->
ZIP CODE---------->
HOME PHONE-------->

RECORD 1 OF 1

10/23/00 12:49:21 1 M39L MFHR ____

Recommendation for Compensation Adjustment
US Payroll

Associate Name:	Kolchinsky, Ilya E	**Performance Evaluation:**
Employee ID Num:	21001416	
		PE Date:
Social Security Num:	[redacted]	
Payroll Location:	United States(45)	
Cost Center:	266 - Derivatives	
Hire Date:	05/30/2000	
Last Perf Appraisal:	05/30/2000	

Compensation History
Recommendation/Change

Recommended By:	Gus Harris on 08/22/2000		
Reason for Change:	Merit, Compression	**Effective Date:**	09/01/2000
Performance Rating:	Exceeds Expectations (3)	**Since Last Change:**	3 months, 4 days
Local Currency:	USD		

Other Comp: ○ None ● Bonus Eligible ○ Commission **Bonus Type:** Target

[redacted]	Current	New	Amt Change	% Change
Base Salary:	[redacted]	[redacted]	[redacted]	[redacted]
Target Bonus:				
Compensation:				
Semi-monthly:				

Position Change/Transfer...

	Current Position Information	New Position Information
ID Num:	P21001668	P21001668
Long Title:	Vice President/Senior Analyst	Vice President/Senior Analyst
Grade:		
Cost Center:	266 - Derivatives	266 - Derivatives
SBU:	CRA	CRA
Group:	Derivatives & Funds	Derivatives & Funds

Comments...

Approvals
Initial Approval... Gu Harris
Executive Approval... Noel Kirnon

RC 9/7

9/15

0 0

CONFIDENTIAL & PROPRIETARY
REDACTED

MOODY'S-COGR09-00120

[redacted]

```
GUH   500,>[redacted]                                                  ON HOBID

                 ------BASIC EMPLOYEE IDENTIFICATION------

COMPANY--> 00500 EMPLOYEE NUMBER-->[redacted]
EMPLOYEE NAME-----> ILYA         E KOLCHINSKY
PO BOX/APT/SUITE--> [redacted]
STREET ADDRESS----> [redacted]
CITY STATE ZIP----> [redacted]     10022
HOME PHONE--------> [redacted]     BUSINESS PHONE----> (000)000-0000
PAY TYPE----------> SALARY         SALARY OR RATE----> [redacted]
STANDARD HOURS----> 75.75          STANDARD HOURS 2--> 999.99
TIME CARD STATUS--> AUTOMATIC      SOCIAL SECURITY---> [redacted]
BIRTH DATE--------> [redacted]     PAY FREQUENCY-----> 71
EMPLOYMENT DATE---> 05/30/2000     SEX---------------> MALE
ANNUAL SALARY-----> [redacted]     AMT LAST PAY CHG--> [redacted]
ORGANIZATION------> 8266           DATE LAST PAY CHG-> 09/01/2000
SALARY GRADE------> 17             SALARY STEP-------> A
MARITAL STATUS----> 2              ADJUSTED EMP DATE-> 05/30/2000
START PAY DATE----> 00/00/0000     START DAY OF WEEK-> 2
WORK DAYS/WEEK----> 5              STD HOURS/DAY-----> 7.0

                        09/07/00  15:24:14 1 M39L MFHR ____
```

[redacted]

Performance Evaluation Form – Rating Analyst

I. Associate Information		
Associate Name: Eric Kolchinsky	**Title:** VP – Snr Credit Officer	**Department/Location:** Derivatives / 143000
Employment Date: May 2000	**Review Period/From:** 6/02 **To:** 5/03	**Date of Last Salary Action:** 5/02
Review Written by: Gus Harris	**Reviewer's Title:** Managing Director	**Date Prepared:** May 15, 2003

II. [illegible]	1	2	3	4	5
1. Assign timely and accurate ratings to assigned primary deals. Monitor existing deals	☐	☐	☐	X	☐
2. Continue to manage the data quality functions for CDO Navigator reports. Continue to develop "smart" data checks, and help train other analysts. Eventually rotate off this role.	☐	☐	☐	☐	X
3. Write NIRs for every deal; write at least one Special Report (monthly market recap – part of CDO service).	☐	☐	☐	X	X
4. Speak in at least one conference panel in the upcoming year. Demonstrate CDO service to potential subscribers.	☐	☐	☐	X	☐
5.	☐	☐	☐	☐	☐
6.	☐	☐	☐	☐	☐
Overall Business Results Rating	1 ☐	2 ☐	3 ☐	4 X	5 ☐

III. Competencies for Rating Analysts – *Evaluate the associate's performance on each of the following competencies. Higher ratings indicate better performance (use definitions of Performance Levels on page 4). Evaluation should be based on demonstrated competencies, not potential or unrealized abilities.*

[illegible]	[illegible]
Rating 1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐ ☐ NA	**Rating** 1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐ ☐ NA
[illegible]	[illegible]
Rating 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 X ☐ NA **Eric has made several proposals to enhance our CDO service. He has also currently identified potential opportunities in the area of stock risk rankings.**	**Rating** 1 ☐ 2 ☐ 3 X 4 ☐ 5 ☐ ☐ NA
[illegible]	[illegible]

4

CONFIDENTIAL & PROPRIETARY
REDACTED

MOODY'S-COGR09-00122

Rating 1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐ ☐ NA	Rating 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 X ☐ NA Eric has proactively designed "smart checks" for our CDO service. He has led our efforts to identify interest-only securities and revolving facilities in our service. He has taken the initiative to help others on the team better understand deals structures and interpretation of deal reports.
7. [illegible]	[illegible]
Rating 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 X ☐ NA Eric is extremely hard-working, often working well into the evening during the week in each month that we publish our CDO reports. At the same time, he has rated a relatively large number of deals (6), some of which are fairly complicated (synthetic CDO of CDOs). He has also written NIRs for all his deals and has published monthly commentary on the CDO market for our CDO Service. In every instance, Eric has assumed these often-demanding responsibilities with a positive "can-do" attitude. Eric has consistently shown that he is willing to make a sacrifice for our Group.	Rating 1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐ ☐ NA

IV. Overall Performance Evaluation/Summary Comments – *Use the Definitions of Performance Levels on page 4 to determine the associate's Overall Performance Rating. Generally, the Overall Performance Rating should vary only +/- one rating level from the Overall Business Results Rating. Please explain any larger variance.*

1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐

Describe the rationale for the associate's Overall Performance Evaluation level. In addition, documentation is required for those areas in which the associate's performance is outstanding or requires improvement. Link areas identified for improvement to Individual Development Plan on page 3.

Eric's performance this past year, his third with the Moody's Derivatives Group, clearly exceeded expectations. Over the past year, Eric's workload was extensive. He accomplished his constantly-demanding assignments effectively.

Eric possesses very strong quantitative skills (Eric has an advanced statistics degree). Eric worked on several challenging deals – including a synthetic CDO of CDOs Eric rated six deals this past year (plus three secondary market ratings) – among the most prolific analyst in our Group. He has also helped back-up some of our newe analysts. His work is analytically comprehensive and he consistently met issuer deadlines.

Eric has been assigned to some difficult banker relationships. He has worked very hard to earn the respect of all issuers and has done an excellent job further improving our issuer relationships. Issuers consistently comment on Eric's pleasant temperament, timely responses and excellent service. Eric has done a great job enhancing issuer relations without compromising our ratings integrity. Likewise, Eric has earned the respect of his peers at Moody's.

Eric has done much in the way of representing our Group. He has spoken at several external conferences (IMN in NY and Bahamas) and also presented at our SFG internal offsite. Eric has also assisted our Marketing Group by joining them on several calls. As part of this effort, Eric has demonstrated the CDO Service (which he has been a very important contributor) to many potential subscribers. In all his appearances, Eric displays a high level of understanding of the CDO product. Nonetheless, I do believe that Eric could be more effective by showing more enthusiasm during his presentations.

Eric's strong performance this past year doesn't end with the quantity and quality of his deal analysis, strong issuer relations or public representation of our Group. Perhaps the most demanding aspect of Eric's job (and one that few other analysts volunteered to do) has been his commitment to supporting our CDO Service –

anticipated to generate well over $2mln revenue during 2003 (generated $1.5mln during 2002). On a monthly basis, Eric leads a team of about seven in generating reliable comprehensive reports that are posted onto moodys.com. The process of releasing these reports (about 1000 pages of data each month) is extremely grueling. Eric has taken the lead to construct various "smart checks," Excel macros that are constantly being refined, aimed at identifying potential errors. He is the "go to" member of the team when structural and data integrity issues are raised. Over the course of 3-4 days each month, Eric is almost consistently inundated with questions and problems related to this product. The end result has been impressive. Our CDO service is widely considered to be the best among the various agencies. With a subscriber list approaching 200 and close to 10,000 hits (on moodys.com) in some months, the service has been an unequivocal success. Eric deserves a lot of credit for his unending dedication and extremely hard work in cementing the success of this product.

In the area of research, Eric has written roughly a dozen monthly market commentaries which are included in our monthly CDO Indices (our revised schedule will require quarterly summaries by Eric). Eric has also written NIRs for all deals that he rated over the past year (a few are currently in Production). A more timely publication of his NIRs would have warranted a "5" in the area of research under the Business Objectives section of this evaluation.

Eric has recently taken the initiative to propose a quantitative stock ranking system that our Group could introduce to the market. His proposal is based on Moody's credit ratings of issuers and reverses the MKMV approach (which uses stock market prices as the key input driver). Eric's proposal has been presented to senior management and he has been asked to further expand the details of his proposal.

Written and Conducted by:

Name/Title:	Gus Harris / 5-15-03	[illegible]	[illegible] / 5/30/03

Reviewed by Next Level Manager:

Name/Title:	NOEL KARNON / GMD	[illegible]	[illegible] 6/4/03

Associate's Comments:

Associate's Signature:	[illegible]	Date:	5/30/03

Note: Signature by associate does not signify approval or agreement to the evaluation. It indicates only that the associate has seen the evaluation.

3

[redacted]

V. Business Objectives Worksheet - *List the business objectives, in order of importance, for the individual during the next review cycle. Include how you will measure results and target dates for completion.*

Goals/Results/Projects	Measures	Target Date
1. Monitor and rate deals assigned to you.		Ongoing
2. Continue to support CDO Service by leading team during monthly postings and further enhancing smart checks.		Ongoing
3. Consider developing models that scour our database to identify CDO notes that may require rating action.		1/31/04
4. Continue to develop your stock ranking system. Follow up wit h management as you complete future phases.		Still in preliminary phase
5. Speak at conferences and investor/issuer meetings. Focus on improving delivery of message.		Ongoing
6.		
7.		

Individual Development Plan - *Identify areas for individual development from Part II & III. List suggested approaches (developmental assignments, participation on special projects, etc.)*

Key Areas	Suggested Actions	Target Date
1. Consider taking a public speaking course.	Monitor progress in response to current PE feedback. Consider course if progress is slow.	12/03
2.		

[redacted]

[redacted]

3.		

Associates' Signature ____ Date 5/30/03 Manager's Signature ____ Date 5/30/03

DEFINITIONS OF PERFORMANCE LEVELS

In evaluating associate performance use the following guidelines	
5	Individual performance was outstanding throughout the review cycle. Business results were achieved at levels exceeding significantly specified targets or expectations. Individual also demonstrated consistently the competencies that made him/her a role model for other associates. Individual took initiative and sought additional responsibilities and tasks resulting in important contributions to the department. Required little or no supervision/ coaching and frequently took on the coaching of others.
4	Individual performance often exceeded expectations during the review cycle. Business results were achieved at levels that were regularly above specified targets or expectations. Individual also demonstrated the competencies necessary for performance at levels that exceed expectations for the position. Initiative was frequently demonstrated to improve performance. Required minimal supervision.
3	Individual performance consistently met expectations throughout the review cycle. Business results were achieved at levels that met specified targets or expectations. Individual demonstrated competency in the technical requirements of the position and the behaviors necessary for fully satisfactory performance. Extra tasks were performed as required. Required some supervision.
2	Individual performance does not fully meet expectations for the position. Although performance may meet expectations in some areas, improvement is necessary in others to completely meet expectations. This improvement may be required to fully achieve expected business results, or to demonstrate acceptable technical or behavioral competence. Individual requires a higher than usual amount of direct supervision.
1	Performance consistently falls short of performance expectations. Improvement is required in both technical and behavioral competence to meet performance expectations. Direct supervision is regularly required.

[redacted]

Performance Evaluation Form – Rating Analyst

[redacted]

Associate Name: Eric Kolchinsky	**Title:** VP, Snr Analyst	**Department/Location:** Derivatives/8266
Employment Date: May 2000	**Review Period/From:** 6/01 **To:** 5/02	**Date of Last Salary Action:** May 2001
Review Written by: Gus Harris	**Reviewer's Title:** Managing Director	**Date Prepared:** 6/17/02

[redacted]

1. Assign accurate ratings on a timely basis	☐	☐	☐	X	☐
2. Monitor existing ratings	☐	☐	X	☐	☐
3. Contribute to our CDO Navigator efforts. Provide guidance to team preparing CDO reports.	☐	☐	☐	☐	X
4. Contribute to group-wide issues. Assist others as need arises.	☐	☐	☐	X	☐
5. Write research, contribute to outreach efforts and speak at conferences	☐	☐	☐	X	☐
	☐	☐	☐	☐	☐

Overall Business Results Rating 1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐

III. Competencies for Rating Analysts – *Evaluate the associate's performance on each of the following competencies. Higher ratings indicate better performance (use definitions of Performance Levels on page 4). Evaluation should be based on demonstrated competencies, not potential or unrealized abilities.*

[redacted]

Rating 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 X ☐ NA	**Rating** 1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐ ☐ NA

[redacted]

Rating 1 ☐ 2 ☐ 3 X 4 ☐ 5 ☐ ☐ NA	**Rating** 1 ☐ 2 ☐ 3 X 4 ☐ 5 ☐ ☐ NA

[redacted]

Rating 1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐ ☐ NA	**Rating** 1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐ ☐ NA

Rating	Rating
1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 X ☐ NA	1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐ ☐ NA

IV. Overall Performance Evaluation/Summary Comments – *Use the Definitions of Performance Levels on page 4 to determine the associate's Overall Performance Rating. Generally, the Overall Performance Rating should vary only +/- one rating level from the Overall Business Results Rating. Please explain any larger variance.*

1 ☐ 2 ☐ 3 ☐ 4 X 5 ☐

Describe the rationale for the associate's Overall Performance Evaluation level. In addition, documentation is required for those areas in which the associate's performance is outstanding or requires improvement. Link areas identified for improvement to Individual Development Plan on page 3.

In two short years, Eric has become one of the most valuable quant analysts in our Group. He has exhibited the ability to master fairly complex quantitative issues while concurrently dealing effectively with difficult issuers. Eric has also developed a strong understanding of the qualitative aspects of CDOs. Eric has worked on a wide array of deals, including plain vanilla CDOs and resecuritizations. In the area of resecuritizations, he has also assisted in resolving some sticky issues such as excess Caa haircuts.

Eric's attitude is also exemplary. He is respected and well-liked by his peers and has earned the confidence of his MDs, peers and the issuers. Eric is always willing to go above and beyond expectations. For example, with the launch of our CDO Navigator product suite, Eric has taken a leadership role in managing the data quality efforts and reviewing the reports prior to publication. He has helped us develop smart data checks and he has also written the commentary in the most recent monthly publication. The team working on this demanding project respects Eric and appreciates the direction and guidance he offers.

Another sign of Eric's commitment to our team - In the wake of the 9/11 disaster, Eric arranged to drive to Florida for a CDO conference in order to satisfy our obligation to a conference organizer. Not once did Eric mention the inconvenience of this arrangement.

Written and Conducted by:

Gus Harris — Gus Harris / 6/21/02

Reviewed by Next Level Manager:

NOEL KIRNON / GMD — Noel Kirnon 6/25/02

Eric [signature] — 6/21/02

Note: Signature by associate does not signify approval or agreement to the evaluation. It indicates only that the associate has seen the evaluation.

V. Business Objectives Worksheet - *List the business objectives, in order of importance, for the individual during the next review cycle. Include how you will measure results and target dates for completion*

Goals/Results/Projects	Measures	Target Date
1. Monitor existing deals		Ongoing
2. Continue to manage the data quality functions for CDO Navigator reports. Continue to develop "smart" data checks, and help train other analysts. Eventually rotate off this role.		12/02
3. Write NIRs for every deal, write at least one Special Report and speak in at least one conference panel in the upcoming year.		12 months
4.		
5.		
6.		

Individual Development Plan - *Identify areas for individual development from Part II & III. List suggested approaches (developmental assignments, participation on special projects, etc.)*

Key Areas	Suggested Actions	Target Date
1.		
2.		
3.		

Associates' Signature Vl Ll Le **Date** 6/21/02 **Manager's Signature** [signature] **Date** 6/21/02

[redacted]

Moody's Investors Service

7 World Trade Center at 250 Greenwich Street
New York, NY 10007

Marianne Fabozzi
Vice President
Human Resources
Tel: 212.553.0457
Fax: 212.298.7478
Email: marianne.fabozzi@moodys.com

September 10, 2009

Mr. Eric Kolchinsky
[redacted]

Dear Eric:

Per your request, this is to confirm that on Thursday, September 3, 2009, you were asked to meet with Barry Berke of Kramer, Levin who is investigating the issues that you raised in your July 29, 2009 and August 21, 2009 letters. When asked to attend this meeting, you told Marianne Fabozzi and Amy Winkelman that you intended to give notice, i.e. that you intended to resign from Moody's, and that you would not cooperate with the investigation. You were told that as a current employee of Moody's you were expected to cooperate with compliance investigations and if you did not you would be suspended with pay. You again refused to cooperate. We are hopeful you will reconsider your decision and will agree to meet with Mr. Berke as soon as possible. You may contact him directly at 212-715-7560.

In the meantime, as you are not to be performing any work for or on behalf of Moody's, please contact me at 212-553-0457 immediately to arrange for the return of any company property still in your possession. Our records indicate that three computers – two desktop and one laptop – were issued to you. We only found one desktop computer in your office. Please let us know of the whereabouts of the other computers immediately.

Thank you,

Marianne Fabozzi

Cc: A. Winkelman

Moody's Investors Service

7 World Trade Center at 250 Greenwich Street
New York, NY 10007

Marianne Fabozzi
Vice President
Human Resources
Tel: 212.553.0457
Fax: 212.298.7478
Email: marianne.fabozzi@moodys.com

September 22, 2009

Ilya E. Kolchinsky
[redacted]

Dear Eric,

I am responding to your email of September 16 to Gus Harris to correct some of the many misstatements in your email and to address your employment decision.

First and foremost, Moody's did not terminate your employment. Rather, you were suspended - with pay - for refusing to cooperate in an investigation of allegations you raised. Specifically, you were suspended for refusing to meet with the law firm Kramer Levin, which, as you know, was retained by Moody's to investigate your compliance concerns. You were given several opportunities to meet with Kramer Levin but you consistently refused to do so.

Contrary to the statements in your letter, my understanding of your phone conversations with Kramer Levin is that they were limited in nature and focused primarily on scheduling and on providing you, at your request, with an agenda for your scheduled interview. This limited engagement did not satisfy your cooperation obligations to Moody's. Moreover, at no time did you advise Moody's that your refusal to meet with Kramer Levin was because you wanted your lawyer present. Moody's has never objected to your lawyer attending any requested interview; nor, to our knowledge, would this have posed an issue for Kramer Levin had you simply raised this request at the outset.

Second, we strongly disagree with your characterization of our September 3, 2009 meeting. Amy Winkelman and I called you to a meeting that day to discuss your stated refusal to meet with Kramer Levin after you had requested that an independent investigation be conducted and after you had agreed to cooperate in that investigation but then changed course. At the meeting you reiterated your refusal to cooperate. I reminded you that you have an obligation as an employee of Moody's to cooperate fully. You maintained that you would not meet with Kramer Levin and stated that you would be resigning from Moody's shortly. I inquired whether you were providing me (your HR representative) with notice of your resignation and you stated that you were not because you still had an assignment to complete. After that exchange, Ms. Winkelman and I requested again that you sit for an interview with Kramer Levin and explained that the consequences of non-compliance would be suspension with pay. In response, you stood up and brought an end to the meeting. I gathered the Company property in your possession and escorted you to your office where you gathered your belongings, then waited while you spoke with Gus Harris, and finally escorted you to the exit of the building.

At no point did Ms. Winkelman or I treat you in a "humiliating manner" or attempt to "intimidate you into dropping your case." Indeed, we have no knowledge that you have initiated or filed any case against Moody's. Nor have Moody's actions since the September 3rd meeting been in any way inconsistent with your suspension. Because you were suspended from active duty pending your decision to cooperate in an ongoing investigation, your electronic access was terminated and your blackberry and computers were secured.

Third, I understand that several people have spoken with you previously about your disappointment with your group being reorganized and the Company's decision to transfer you to Gus Harris's group in late 2007 rather than include you in a layoff. Your contention that this was a retaliatory move or a demotion is inaccurate. Indeed you voluntarily accepted a transfer to Moody's Analytics and did not raise any concern about your transfer until nearly one year after the transfer.

We accept your resignation effective September 16, 2009. We will, of course, reimburse you for appropriate business expenses incurred prior to your resignation. We will also provide you with a final pay check and any unused, accrued vacation time, and send you relevant conversion of benefits information under separate cover.

Finally, the Kramer Levin investigation is ongoing and Kramer Levin would still like to speak with you. Therefore, please contact Barry Berke to arrange a time you and your counsel can meet with them.

Sincerely,

Marianne Fabozzi

Marianne Fabozzi
Vice President HR Generalist

cc: A. Winkelman

KRAMER LEVIN NAFTALIS & FRANKEL LLP

BARRY H. BERKE
PARTNER
PHONE 212-715-7560
FAX 212-715-7660
BBERKE@KRAMERLEVIN.COM

July 30, 2009

BY EMAIL
PRIVILEGED AND CONFIDENTIAL

Amy S. Winkelman
Associate General Counsel
Moody's Corporation
250 Greenwich Street
New York, NY 10007

Dear Amy:

We are pleased that you have asked Kramer Levin Naftalis & Frankel LLP ("Kramer Levin" or the "firm") to represent Moody's Corporation ("Moody's" or "the company") in connection with an internal inquiry and related matters. As is our practice, we are writing to set forth our understanding of the terms of our engagement.

1. Fees. We charge fees based on the actual time spent by attorneys and other members of staff who perform services on Moody's matters. Our hourly rates for attorneys and other members of staff are based on years of experience, specialization in training and practice, and level of professional attainment. My billing rate presently is $780. Other attorneys who may work on this matter will be billed at their customary rates.

2. Disbursements and Other Charges. In performing services for you, we may incur expenses for items such as travel, lodging, meals, long distance or conference telephone calls, search and other fees, and courier services. In addition, matters may require ancillary services such as photocopying, word processing, document preparation, secretarial, proofreading, messenger, and computerized legal research. These disbursements and other charges represent out-of-pocket expenses, and, in some cases, the firm's approximate cost and/or comparable market pricing. If specifically requested by the company, we will furnish detailed billing information regarding such disbursements and other charges. Third-party charges (*e.g.*, filing fees, consultants, expert witnesses, transcripts) incurred on the company's behalf are payable directly by the company to the third party. If direct billing is not practical, such third-party charges will be passed through at our cost.

3. Billings. Fees and disbursements will generally be billed monthly and are payable upon presentation. We reserve the right to postpone or defer providing additional services or to discontinue our representation if billed amounts are not paid when due. We also reserve the right to charge interest at the legal rate from time to time for balances that remain outstanding for more than 30 days.

4. Conflict of Interest Waiver. Kramer Levin has many national and international clients, covering a wide range of industries and businesses. Conflicts of interest might arise that could deprive existing or prospective clients of the right to use this firm as its counsel. As part of this agreement, the company agrees that we may represent current or future clients, whether with respect to counseling, transactional matters, litigation, adversarial proceedings, or other matters, so long as those matters are not substantially related to the firm's work for the company.

5. The Firm's Privilege Concerning Ethics Consultations. In the course of representing the company, we may from time to time consult with the firm's General Counsel or with lawyers or others within or outside the firm regarding issues of professional responsibility and professional ethics that arise in connection with the firm's representation of it. We believe that the ability to undertake such consultations with the expectation of confidentiality benefits our clients by fostering the firm's ability to frankly and candidly discuss concerns which implicate the company's interests. The company acknowledges and agrees that these conversations shall be confidential communications between the firm and its internal and external advisors as to which the firm shall be entitled to an attorney-client privilege, notwithstanding the potential for a conflict between the interests of the firm and the company's interests as a client of the firm.

6. Use of Information Obtained in Other Representations. As you know, the firm represents many clients in many diverse matters, and it is possible that, in connection with its representation of other clients, the firm may have obtained or may obtain in the future information with respect to the company or other matters which the firm may be prohibited from disclosing to it or using in connection with our representation of it because of obligations to such client or otherwise. The company acknowledges and agrees that the firm is not under an obligation to disclose such information to the company or to use such information in connection with our representation of the company. The company further agrees that it will not assert that the firm has an actual or potential conflict or has breached any duty or obligation to the company by virtue of the firm's possession of such information, our not revealing such information to the company, and/or our not using such information in connection with our representation of the company.

7. Disclosure of Federal Tax Advice. The company may disclose to any person, without limitation, advice or materials we provide to it relating to the United States federal income tax treatment or structure of any transaction (referred to as "Federal Tax Advice"). No such Federal Tax Advice is proprietary or exclusive to the firm. No entity other than the

company is entitled to rely on the Federal Tax Advice, unless expressly authorized by the firm in writing. The company hereby agrees to inform any other party to whom it discloses Federal Tax Advice that such party may not rely on the Federal Tax Advice. This paragraph is intended to avoid the application of a possible reporting requirement to the IRS under Treasury Regulation § 1.6011-4(b)(3); it is not intended to affect the privileged nature of communications between the company and the firm which might be waived by disclosures to third parties.

8. Compliance with Audit Requests, Subpoenas, Legal Process and Other Requests or Demands for Information. From time to time we may be required to respond to requests for information, documents or testimony about the company or our work for it. Such requests may come from the company or its auditors. They may also come from third parties through a subpoena or other legal process to which we are required to respond. We will bill the company for any time spent or costs incurred responding to such requests or demands in connection with any matters we handle for it. In the event the firm considers it necessary to engage counsel in connection with any such third party inquiries, those expenses will be reimbursable costs under this engagement. The firm will consult with the company before engaging counsel.

9. Termination. The company has the right to terminate our representation at any time upon written notice to the firm. We have the same right on written notice to the company, subject to applicable provisions of the New York Rules of Professional Conduct. One of the circumstances in which the firm will terminate the representation is the company's failure to timely pay bills rendered by the firm. If our representation of the company is terminated, it agrees to take all steps necessary to free us of any obligation to perform further services, including the prompt execution of any documents necessary to withdraw from the representation. We will be entitled to be paid for our services rendered and disbursements paid or incurred on the company's behalf to the date of termination, and, thereafter, to the extent required to permit the smooth transition of the company's matter(s) and files.

Unless previously terminated, the firm's representation will terminate upon the sending of a final statement for services rendered in this matter.

10. Arbitration. Under certain circumstances, the company may have a right to arbitrate fee disputes under Part 137 of the Rules of the Chief Administrator of the New York Courts. Such a right does not exist in many circumstances, including when the amount in dispute involves a sum of less than $1,000 or more than $50,000. The firm does not consent to arbitration of fee disputes with respect to any situation that is not subject to Part 137. We will be happy to provide a copy of those rules on request.

11. Records Relating to the Representation. At the conclusion of any specific matter we are handling for the company, we will return its papers to it upon request and receipt of payment for outstanding fees and disbursements. Files that are retained by the firm will be

retained in accordance with our records retention policy, usually for a maximum period of ten years. The firm reserves the right to destroy or otherwise dispose of records that the company has not timely requested, in order to minimize unnecessary storage expenses.

12. Survival of Agreements. The provisions of this letter will continue in effect, even after the termination of our relationship. In addition, the provisions of this letter will apply to future engagements of our firm by the company unless we mutually agree otherwise.

13. Applicable Law. This agreement shall be governed by and interpreted in accordance with the laws of the State of New York without regard to its conflicts of laws principles.

Please call me at (212) 715-7560 if you have any questions. We look forward to working with you.

Sincerely,

KRAMER LEVIN NAFTALIS & FRANKEL LLP

By:
Barry H. Berke