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CREDIT RATING AGENCIES AND THE FINANCIAL CRISIS

Wednesday, October 22, 2008

House of Representatives,

Committee on Oversight and

Government Reform,

Washington, D.C.

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Committee Hearings

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The committee met, pursuant to call, at 10:00 a.m., in Room 2154, Rayburn House Office Building, Hon. Henry A. Waxman [chairman of the committee] presiding.

Present: Representatives Waxman, Maloney, Cummings, Kucinich, Tierney, Watson, Lynch, Yarmuth, Norton, McCollum, Sarbanes, Speier, Davis of Virginia, Shays, Souder, Issa and Bilbray.

Staff Present: Kristin Amerling, Chief Counsel; Russell Anello, Counsel; Caren Auchman, Communications Associate; Phil Barnett, Staff Director; Jennifer Berenholz, Assistant Clerk; Brian Cohen, Senior Investigator and Policy Advisor; Christopher Davis, Professional Staff Member; Zhongrui "JR"

Deng, Chief Information Officer; Miriam Edelman, Special Assistant; Alexandra Golden, Investigator; Michael Gordon, Senior Investigative Counsel; Earley Green, Chief Clerk; Karen Lightfoot, Communications Director and Senior Policy Advisor; Karen Lightfoot, Communications Director and Senior Policy Advisor; Jennifer Owens, Special Assistant; David Rapallo, Chief Investigative Counsel; Suzanne Renaud, Counsel; Leneal Scott, Information Officer; Mitch Smiley, Staff Assistant; Matt Weiner, Staff Assistant; John Williams, Deputy Chief Investigative Counsel; Lawrence Halloran, Minority Staff Director; Jennifer Safavian; Minority Chief Counsel for Oversight and Investigations; Brien Beattie, Minority Professional Staff Member; Molly Boyl, Minority Professional Staff Member; Larry Brady, Minority Senior Investigator and Policy Advisor; Christopher Bright, Minority Senior Professional Staff Member; Alex Cooper, Minority Professional Staff Member; John Cuaderes, Minority Senior Professional Staff Member; Adam Fromm, Minority Professional Staff Member; Todd Greenwood, Minority Professional Staff Member; Patrick Lyden, Minority Parliamentarian and Member Services Coordinator; Brian McNicoll, Minority Communications Director; and Nick Palarino, Minority Senior Investigator and Policy Advisor.

Chairman WAXMAN. Today the committee is holding its third hearing on the financial crisis on Wall Street. Our subject today is the role of the credit rating agencies.

The leading credit rating agencies, Standard & Poor's, Moody's and Fitch, are essential financial gatekeepers. They rate debt obligations based on the ability of the issuers to make timely payments. A triple-A rating has been regarded as the gold standard for safety and security of these investments for nearly a century.

As our financial markets have grown more complex, the role of the credit rating agencies has grown in importance. Between 2002 and 2007, Wall Street issued a flood of securities and collateralized debt obligations called CDOs backed by risky subprime loans.

These new financial inventions were so complex that virtually very few people really understood them. For investors, a triple-A rating became the stamp of approval that this investment is safe. And for Wall Street's investment banks, a triple-A rating became the independent validation that turned a pool of risky home loans into a financial gold mine. The leading credit rating agencies grew rich rating mortgage-backed securities and CDOs. And we have a chart. I hope we can display it. That chart will show the total revenues for the three firms, double from $3 billion in 2002 to over $6 billion in 2007.

At Moody's, profits quadrupled between 2000 and 2007. In fact, Moody's had the highest profit margin of any company in the S&P 500 for 5 years in a row. Unfortunately for investors, the triple-A ratings that proved so lucrative for the rating agencies soon evaporated. S&P has downgraded more than two-thirds of its investment-grade ratings. Moody's had to downgrade over 5,000 mortgage-backed securities.

In their testimony today the CEOs of Standard & Poor's, Moody's and Fitch will tell us that, quote, virtually no one anticipated what is occurring, end quote. But the documents that the committee obtained tell a different story.

Raymond McDaniel, the CEO of Moody's, will testify today that, quote, we have witnessed events that many, including myself, would have thought unimaginable just 2 months ago, end quote. But that is not what he said in a confidential presentation he made to the board of directors in October 2007.

The title of the presentation is "Credit Policy Issues at Moody's Suggested by the Subprime Liquidity Crisis." In this presentation, Mr. McDaniel describes what he calls a dilemma and a very tough problem facing Moody's.

According to Mr. McDaniel, and I'm quoting, the real problem is not that the market underrates rating quality but rather that in some sectors it actually penalizes quality. It turns out that ratings quality has surprisingly few friends: Issuers want high ratings; investors don't want ratings downgrades; short-sighted bankers labor short-sightedly to gain the rating agencies, end quote.

Mr. McDaniel then tells his board, and I want to quote, unchecked competition on this basis can place the entire financial system at risk, end quote. Mr. McDaniel describes to his board how Moody's has, quote, erected safeguards to keep teams from too easily solving the market share problem by lowering standards, end quote.

But then he says, quote, this does not solve the problem, end quote. In his presentation, the "not" is written in all capitals.

He then turns to a topic that he calls, "Rating Erosion by Persuasion." According to Mr. McDaniel, quote, analysts and MDs, managing directors, are continually pitched by bankers, issuers, investors and sometimes we drink the Kool-Aid, end quote.

A month earlier in September 2007, Mr. McDaniel participated in a managing director's town hall, and we obtained a copy of the transcript of the proceeding.

And let me read to you what Mr. McDaniel said: The purpose of this town hall is so that we can speak as candidly as possible about what is going on in the subprime market. What happened was it was a slippery slope. What happened in 2004 and 2005 with respect to subordinated tranches is that our competition, Fitch and S&P, went nuts. Everything was investment grade. It didn't really matter. We tried to alert the market. We said we're not rating it. This stuff isn't investment grade. No one cared, because the machine just kept going.

The following day, a member of the Moody's management team commented, quote, we heard two answers yesterday. One, people lied; and two, there was an unprecedented sequence of events in the mortgage markets. As for one, it seems to me that we had blinders on and never questioned the information we were given. As for two, it's our job to think of the worst-case scenarios and model them. Combined, these two errors make us look either incompetent at credit analysis or like we sold our soul to the devil for revenue.

The documents from Standard & Poor's paints a similar picture. In one document, an S&P employee in the structured finance division writes, quote, it could be structured by cows, and we would rate it, end quote.

In another, an employee asserts, quote, rating agencies continue to create an ever bigger monster, the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters, end quote.

There are voices in the credit rating agencies that called for a change, and we are going to hear from two of them on our first panel: Frank Raiter from Standard & Poor's and Jerome Fons from Moody's. In 2001, Mr. Raiter was asked to rate an early collateralized debt obligation called Pinstripe. He asked for the collateral tapes so that he could assess the creditworthiness of the home loans backing the CDO.

This is the response he got from Richard Gugliada, the managing director: Any requests for loan level tapes is totally unreasonable. Most investors don't have it and can't provide it. Nevertheless we must produce a credit estimate. It's your responsibility to provide those credit estimates and your responsibility to devise some method for doing so.

Mr. Raiter was stunned. He was being directed to rate Pinstripe without access to essential credit data. He e-mailed back, quote, this is the most amazing memo I have ever received in my business career, end quote.

Last November, Christopher Mahoney, Moody's vice chairman, wrote Mr. McDaniel, the CEO, that Moody's has made mistakes and urged that a manager in charge of the securitization area should be held to account. Mr. Mahoney's employment was terminated by the end of the year.

Investors, too, were stunned by the lax practices of the credit rating agencies. The documents we reviewed showed that a portfolio manager with Vanguard, the large mutual fund company, told Moody's over a year ago that the rating agencies, quote, allow issuers to get away with murder, end quote.

A senior official at Fortis Investments was equally blunt saying, quote, if you can't figure out the loss ahead of the fact, what is the use of your ratings? If the ratings are BS, the only use in ratings is comparing BS to more BS, end quote.

Some large investors like PIMCO tried to warn Moody's about the mistakes it was making. But according to the documents, they eventually gave up because they, quote, found the Moody's analysts to be arrogant and gave the indication we're smarter than you, end quote.

Six years ago, Congress pressed the SEC to assert more control over the credit rating agencies. In 2002, the Senate Governmental Affairs Committee investigated the rating agencies and found serious problems. The committee concluded that meaningful SEC oversight was urgently needed. The next year, the SEC published its own report, which also found serious problems with credit rating agencies.

Initially, it looked like the SEC might take action. In June 2003, the SEC issued a concept release seeking comments on possible new regulations. Two years later, in April 2005, SEC issued a proposed rule.

Yet despite the Senate recommendation and SEC's own study, the SEC failed to issue any final rule to oversee credit rating agencies. The SEC failed to act and left the credit rating agencies completely unregulated until Congress finally passed a law in 2006.

At tomorrow's hearing with Federal regulators, members will have a chance to ask the SEC chairman, Christopher Cox, about his agency's record. Today, our focus is on the credit rating agencies themselves, and members can question the CEOs of Standard & Poor's, Moody's and Fitch about their performance. Running the credit rating agencies has been a lucrative occupation. Collectively, the three CEOs have made over $80 million dollars. We appreciate that they have cooperated with the committee and look forward to their testimony.

The story of the credit rating agencies is a story of a colossal failure. The credit rating agencies occupy a special place in our financial markets. Millions of investors rely on them for independent objective assessments. The rating agencies broke this bond of trust, and Federal regulators ignored the warning signs and did nothing to protect the public.

The result is that our entire financial system is now at risk, just as the CEO of Moody's predicted a year ago. And now I want to recognize the Republican side for their opening statements.

[Prepared statement of Chairman Waxman follows:]

******** INSERT 1-1 ********

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Chairman.

I'm going to have Mr. Shays give it.

Let me just make two comments. Number one, I associate myself with your remarks today. And secondly, we have a letter signed by all of our members on our side invoking our right to a day of testimony by witnesses selected by the minority on matters we think should be included. And we look forward to working with you.

Chairman WAXMAN. The letter will be part of the record.

[The information follows:]

******** COMMITTEE INSERT ********

Mr. SHAYS. Mr. Chairman, when the referee is being paid by the players, no one should be surprised when the game spins out of control. That is what happened on Wall Street when credit rating agencies followed the delirious mob making millions on mortgage-backed securities and sold their independence to the highest bidder.

As a result, investments once thought safe are being downgraded, some to no more than junk status. Trillions of dollars could vanish as asset redemptions calls for additional collateral, payments on derivative contracts, and outright defaults unwind, sending unpredictable after-shocks into an already traumatized economy.

It has been known for years that that quantitative analysis armed with cutting-edge software, realtime data and ultra sophisticated algorithms were operating light years beyond regulators and credit evaluators using static econometric models. Esoteric investment products were structured to garner a triple-A grade by slicing and dicing risks into bits too small to register. Investors did not have enough information about the real value of the underlying assets or about how credit analysts reached their conclusions on the safety of their products being sold.

Despite significant warning signs of a system under strain dating back to the failure of the large hedge fund, Long Term Capital Management, in the late 1990s, Congress and the Securities Exchange Commission, SEC, were slow to recognize the peril posed by insensitive or financially compromised creditworthiness rating systems.

Proposals to deconflict the interests of rating companies and their pay masters and to exact greater transparency and autonomy from the rating process came too little, too late. So the con game continued: A scheme to engender and sustain a false sense of confidence in the improbable proposition that housing prices would never fall. Like the Titanic, the Good Ship Subprime was universally hailed as unsinkable. Succumbing to and profiting from the mass hysteria, rating agencies stopped looking for the icebergs always waiting in the world's financial sea lanes.

Subjective judgments, perceptions of risk and opinions on value, obviously, can't be regulated. But the rigor and consistency of the methodologies used and the validity of the data inputs relied upon can and should be far more transparent to investors and the SEC. Only that will rebuild genuine confidence in credit rating.

Finally, Mr. Chairman, I'm glad you agree to hold a hearing on the role of Fannie Mae and Freddie Mac. While I understand your reluctance to probe politically volatile topics for both parties before the election, the planned November 20th hearing date should give the committee time to request documents and shine some much needed sunlight on to the failed operations of the toxic twins of mortgage finance. The document requests have to include all records of lobbying contracts, lobbying expenditures, political action committee strategy and contributions to various organizations, particularly those favored by Members of Congress. It is past time for Fannie and Freddie to come clean about their reform avoidance activities and just as overdue that Congress confront its own role in coddling the arrogant authors of the housing finance crisis.

Chairman WAXMAN. Thank you very much, Mr. Shays. I look forward to working with you on that issue.

Before we recognize panel one, I have a unanimous consent. Without objection, questioning for panel one will proceed as follows: The majority and minority will each begin with a 10-minute block of time with the chairman and ranking member, each having the right to reserve time from this block for later use.

And without objection, that will be the order.

STATEMENTS OF JEROME S. FONS, FORMER EXECUTIVE, MOODY'S CORPORATION; FRANK L. RAITER, FORMER EXECUTIVE, STANDARD & POOR'S; AND SEAN J. EGAN, MANAGING DIRECTOR, EGAN-JONES RATINGS.

Chairman WAXMAN. On panel one, we have Jerome Fons, who is an economist who worked at Moody's Investor Service as a managing director until 2007. Frank Raiter worked as a managing director for residential mortgage-backed securities at Standard & Poor's until 2005, and Sean Egan is the managing director of Egan-Jones Ratings in Haverford, Pennsylvania.

We're pleased to welcome you to our committee. We appreciate your being here. It's the practice of this committee that all witnesses that testify before us do so under oath, so I would like to ask you if would please stand and raise your right hands.

[Witnesses sworn.]

The record will show that each of the witnesses answered in the affirmative.

Your prepared statements will be in the record in its entirety. We would like to ask you to try to limit your oral presentations to around 5 minutes. We will have a clock that will have green for 4 minutes, orange for 1 minute, and then after 5 minutes, it will turn red. When you see that it's red, we would like that to be a reminder that we would like you to sum up the oral presentation to us.

There is a button on the base of each mike, so be sure it's pressed in and close enough to you so that we can hear everything that you have to say.

Mr. Fons, why don't we start with you.

STATEMENT OF JEROME S. FONS

Mr. FONS. Thank you, Mr. Chairman.

Chairman Waxman and Ranking Member Davis and members of the committee, good morning.

I am pleased to be invited to offer testimony on the state of the credit rating industry. Until August of 2007, I worked at Moody's Investors Service where I had exposure to nearly every aspect of the ratings business. My last position at Moody's was managing director, credit policy. I was a member of Moody's Credit Policy Committee, and I chaired the firm's Fundamental Credit Committee. Prior to my 17 years at Moody's, I was an economist with the U.S. Federal Reserve and with Chemical Bank New York. Since leaving Moody's, I have been an independent consultant advising firms on rating agency issues.

As this committee has heard before, the major rating agencies badly missed the impact of falling house prices and declining underwriting standards on subprime mortgages. Subprime residential mortgage-backed securities with initially high ratings found their way into nearly every corner of the financial system. Although evidence of falling home values began to emerge in late 2006, ratings did not reflect this development for some time. The first downgrades of subprime-linked securities occurred in June 2007. In short order, faith in credit ratings diminished to the point where financial institutions were unwilling to lend to one another. And so we had and are still having a credit crisis.

Why did it take so long for the rating agencies to recognize the problem? Why were standards so low in the first place? And what should be done to see that this does not happen again?

My view is that a large part of the blame can be placed on the inherent conflicts of interest found in the issuer-pays business model and on rating shopping by issuers of structured securities. A drive to maintain or expand market share made the rating agencies willing participants in this shopping spree.

Let me speak from my experience at Moody's. Moody's reputation for independent and accurate ratings sprang from a hard-headed culture of putting investors' interests first.

Up until the late 1960s, the firm often refused to meet with rated companies. Even through the mid-1990s, long after the firm and its competitors began to charge issuers for ratings, Moody's was considered the most difficult firm on Wall Street to deal with.

A 1994 article in Treasury & Risk Management Magazine pointed to surveys that highlighted issuers' frustrations with Moody's. This had a profound impact on the firm's thinking. It raised questions about who our clients were and how best to deal with them. Management undertook a concerted effort to make the firm more issuer-friendly.

In my view, the focus of Moody's shifted from protecting investors to marketing ratings. The company began to emphasize customer service and commissioned detailed surveys of client attitudes. I believe the first evidence of this shift manifested itself in flawed ratings on large telecom firms during that industry's crisis in 2001.

Following Moody's 2000 spin from Dunn & Bradstreet, management's focus increasingly turned to maximizing revenues. Stock options and other incentives raised the possibility of large payoffs. Managers who were considered good businessmen and women, not necessarily the best analysts, rose through the ranks. Ultimately, this focus on the bottom line contributed to an atmosphere in which the aforementioned ratings shopping could take hold.

The so-called reforms announced to date are inadequate. While there are no easy fixes to the problems facing the rating industry, I will offer some suggestions. First, we need to see wholesale change at the governance and senior management levels of the large rating agencies. Managers associated with faulty structured finance ratings must also depart. New leadership must acknowledge the mistakes of the past and end the defensive posture of denial brought on by litigation fears.

Second, bond ratings must serve the potential buyer of the bond and no one else; that is, ratings must be correct today in the sense that--that a rating must be correct today in the sense that it fully reflects the views of the analyst or rating committee with no attempts to stabilize ratings. A byproduct of this behavior will be that rating changes eventually lose their influence. Such a situation might arise sooner if regulators and legislators cease reliance on ratings. Elimination of the SEC's NRSRO designation will be a step in this direction. Also, regulators must drop restrictions on unsolicited ratings. This would help to minimize rating shopping and allow competition to yield positive benefits, such as lower costs and higher quality ratings.

Going forward, structured finance rating practices must emphasize transparency and simplicity. Statistical backward-looking rating methods need to be augmented with a strong dose of common sense. All rated structured transactions should be fully registered and subject to minimum disclosure requirements.

The rating agencies need to implement concrete measures for taming the conflicts posed by the issuer-pays business model. I do not believe that investor-pays model is the correct answer. There is a free rider problem with subscriber-funded ratings, and most would agree that ratings should be freely available particularly if they are referenced in regulations.

It is not my intention to indict everyone working in the rating industry. Indeed, the analysts that I interacted with took their responsibility seriously and demonstrated high moral character. I was proud to be associated with Moody's, a feeling shared by many others at the firm. And I fervently believe that substantive reforms can restore the integrity and stature of the bond rating industry.

Thank you.

[Prepared statement of Mr. Fons follows:]

******** INSERT 1-2 ********

Chairman WAXMAN. Thank you very much, Mr. Fons.

Mr. Raiter.

STATEMENT OF FRANK L. RAITER

Mr. RAITER. Chairman Waxman and Ranking Member Davis, I would like to thank you for inviting me to this hearing today.

My name is Frank Raiter, and from March 1995 to April 2005, I was the managing director and head of the Residential mortgage-backed securities Ratings Group at Standard & Poor's. I was responsible for directing ratings criteria development, ratings production, marketing and business development for single-family mortgage and home equity loan bond ratings and related products. My tenure at S&P coincided with the rapid growth in mortgage securitization and development of new mortgage products, including subprime and expanded Alt-A products. During this period, total residential mortgage production in the United States grew from $639 billion in 1995 to $3.3 trillion in 2005. Subprime production grew from $35 billion to $807 billion over the same period.

By regulation, institutional investment policy and tradition, the sale of associated mortgage-backed securities generally required ratings from two of the nationally recognized statistical rating organizations, or NRSROs. While a necessary player in the exploding market, the rating agencies were not the drivers of the train. The engine was powered by the low interest rates that prevailed after the turn of the century. The conductors were the lenders and the investment bankers who made the loans and packaged them into securities, and the rating agencies were the oilers who kept the wheels greased. And I might add, the passengers on the train were the investors, and it was standing room only. There is a lot of blame to go around.

To appreciate the unique role that the rating agencies performed in the residential mortgage market, it is necessary to understand the ratings process. The mortgage-backed security consists of a pool of individual mortgage loans, and depending on the type of mortgage product, whether it's prime, subprime, Alt-A, whatever, an underlying given security could have as many as 1,000 to 25,000 loans in it. The ratings process consisted of two distinct operations, the credit analysis of the individual mortgages and a review of the documents governing the servicing of the loans and the payments to investors in the securities.

The credit analysis is focused on determining the expected default probabilities on each loan and the loss that would occur in the event of default. And these in turn established the expected loss that support triple-A bonds. In short, what the ratings process attempts to do is to find out what that equity piece is that needs to support the triple-A bonds so that investor won't take any losses. It's very similar to the home equity you have in a home loan. That equity is intended to protect the lender from taking a loss in the event of a change in circumstance.

In 1995, S&P used a rules-based model for determining the loss expected on a given bond. Late that year, it was determined and decided to move to a statistical-based approach, and we began gathering data to come out with a first model that was based on approximately 500,000 loans with performance data going back 5 years.

That version of the LEVELs model was implemented in 1996 and made available for purchase by originators, investment bankers, investors and mortgage insurance companies. By making the model commercially available, S&P was committed to maintain parity between the model that they ran and the answers that they were giving to the investors and the issuers that purchased the model.

In other words, S&P promised model clients that they would always get the same answers from the LEVELs model that the rating agency got. Implicit in this promise was S&P's commitment to keep the model current. In fact, the original contract with the model consultant called for annual updates to the model based on a growing database. An update was accomplished in late 1998, 1999, and that model was ultimately released.

The version was built on 900,000 loans. And I'm going to speed this up a little bit. We developed two more iterations of the model, one with 2.5 million loans and one with 10 million loans. In a nutshell, those versions of the model were never released. While we had enjoyed substantial management support up to this time, by 2001, the stress for profits and the desire to keep expenses low prevented us from in fact developing and implementing the appropriate methodology to keep track of the new products.

As a result, we didn't have the data going forward in 2004 and 2005 to really track what was happening with the subprime products and some of the new alternative-payment type products. And we did not, therefore, have the ability to forecast when they started to go awry. As a result, we did not, by that time, have the support of management in order to implement the analytics that, in my opinion, might have forestalled some of the problems that we're experiencing today.

And with that, I will end my remarks and be happy to answer any questions you might have.

[Prepared statement of Mr. Raiter follows:]

******** INSERT 1-3 ********

Chairman WAXMAN. Thank you very much, Mr. Raiter.

We will have questions after Mr. Egan for the three of you.

Mr. Egan.

STATEMENT OF SEAN J. EGAN

Mr. EGAN. Thank you.

The current credit rating system is designed for failure, and that is exactly what we are experiencing.

AIG, Fannie Mae, Freddie Mac, Bear Stearns, Lehman Brothers, Countrywide, IndyMac, MBIA, Ambac, the other model lines, Merrill Lynch, WaMu, Wachovia, and a string of structured finance securities all have failed or nearly failed to a great extent because of inaccurate, unsound ratings.

The ratings of the three companies appearing before this committee today, Moody's, S&P and Fitch, were a major factor in the most extensive and possibly expensive financial calamity in recent American history. The IMF has estimated financial loss from the current credit crisis at $1 trillion, but other estimates from knowledgeable sources have pegged it at twice that amount. Of course, there have been other contributing parties to this debacle, including some of the mortgage brokers, depository institutions, and investment banks, but there should be no doubt that none of this would have been possible were it not for the grossly inflated, unsound and possibly fraudulent ratings provided to both the asset-backed securities directly issued as well as companies which dealt in these securities, whether it be originating, aggregating, financing, securitizing, insuring, credit enhancing or ultimately purchasing them.

Issuers paid huge amounts to these rating companies for not just significant rating fees but, in many cases, very significant consulting fees for advising the issuers on how to structure the bonds to achieve maximum triple-A ratings. This egregious conflict of interest may be the single greatest cause of the present global economic crisis. This is an important point which is often overlooked in the effort to delimit the scope of the across-the-board failures of the major credit rating firms. This is not just a securitization problem.

The credit rating industry is a $5 to $6 billion market with these three companies, S&P, Moody's and Fitch, controlling more than 90 percent of the market. With enormous fees at stake, it is not hard to see how these companies may have been induced, at the very least, to gloss over the possibilities of default or, at the worst, knowingly provide inflated ratings.

Again, the problems were not just in structured finance but also the unsecured bonds and other plain vanilla debt offerings of many of the corporate entities participating in the mortgage market.

These shortcomings moreover are nothing new. We have been here before, specifically in 2002, after Enron failed, despite the fact that the major rating agencies had its debt at investment grade up through and including just before the company filed for bankruptcy protection. At Egan-Jones, we downgraded Enron months before our competitors. In the case of WorldCom, it was about 9 months before our competitors.

In testimony at the time, it was before the Congress we pointed out the inherent conflict of interest in the business model of the credit rating agencies, which purport to issue ratings for the benefit of investors but in fact are paid by the issuers of those securities. At a Congressional hearing in 2003, I stated that Fannie Mae and Freddie Mac did not merit a triple-A rating which Moody's, S&P, and Fitch accorded to them. At about that time, we issued a rating call to the same effect with respect to MBIA which our competitors rated triple-A until just a few months ago.

Currently, we rate MBIA and Ambac significantly in the spec grade category; I think we are at about single-B or below.

How is it that the major rating agencies, which have approximately 400 employees for every analyst at Egan-Jones have been consistently wrong over such an extended period of time? I would like to say that we have more sophisticated computer models or that our people are just plain better at what they do. I hope that some of that is true, but the real answer is that Egan-Jones is in the business of issuing timely, accurate credit ratings; whereas Moody's, S&P, and Fitch have gravitated to the much more lucrative business of expediting the issuance of securities.

Investors want credible ratings. Issuers on the other hand want the highest rating possible, since that reduces funding costs. Under the issuer-pay business model, a rating agency which does not come in with a highest rating will before long be an unemployed rating firm. It's that simple. And all the explanations and excuses cannot refute this elementary truth.

Let's go back to the Enron example. At the time, the major rating agencies rationalized this on the basis that there was fraud involved. We've heard that same thing to reflect the mortgage assets underlying the current crisis. Guess what? There may always be an element of fraud involved in the financial markets, and contrary to what you may hear from the other rating agencies, it is expressly the job of the rating agency to ferret out that fraud before providing an imprimatur upon which thousands of institutional investors and tens of thousands of individual investors have every reasonable expectation to rely on.

It was not always this way. When John Moody founded the company which still bears his name almost 100 years later, many of his colleagues on Wall Street urged him to keep the information to himself. He declined to do so and instead opted for public dissemination used by and paid for by investors. The same history was true for S&P and Fitch until all three companies reversed their business model in the late 1970s and sought compensation from the issuers of the securities. The fact that this shift occurred contemporaneously with the rise of asset-backed financing is by no means a coincidence. Profits soared at these companies, but quality and independence moved increasingly inversely. And advocating the principle of returning the ratings industry to its roots, we've been told by the public policy makers that they in the Congress or the administrative agencies should not be expected to choose among competing business models. We are at a loss to comprehend this hands-off approach.

If the business model currently utilized by Egan-Jones and previously used with great success by our competitors demonstrates a track record of serial failures with at least $1 trillion of adverse financial consequences, why is it not sufficient cause for the government to intervene? When the

Congress was confronted with the safety record of the Corvair versus, for example, a Subaru or Volvo, the response was not laissez-faire. The Congress and the regulators, indeed even the auto industry itself, responded with corrective actions. For the rating industry the only real reform is to realign the incentives and get the industry back in the business of representing those who invest in securities, not those who issue them.

Our written testimony includes a number of recommendations that would restore checks and balances to the rating system. But my main purpose in being here today is to highlight the nature of the problem and the need to address the root cause not merely symptoms. Thank you for having me at this hearing and inviting Egan-Jones to present testimony. I would be pleased to address any questions.

[Prepared statement of Mr. Egan follows:]

******** INSERT 1-4 ********

Chairman WAXMAN. Thank you very much, Mr. Egan.

Now, pursuant to the unanimous consent agreement, we will start the questioning 10 minutes on each side, and the Chair yields 5 of his minutes, of his time, to Mr. Yarmuth.

Mr. YARMUTH. Thank you, Mr. Chairman.

I want to thank the witnesses for their testimony.

Mr. Raiter, you explained that mortgage-backed securities are very complicated. We're all beginning to find that out, that each one could contain literally thousands of mortgages and the way you explained in your testimony you need a very sophisticated statistical modeling system to analyze all these mortgages to see how likely it is that each one or any one might default, and things get even more complicated when we start talking about collateralized debt obligations, the securities that are constructed out of numerous asset-backed securities, is that right?

Mr. RAITER. The premise, as I understand it, and I was not in the CDO group, but the premise in the CDO arena was, by bundling a pool of bonds that had already been rated, that what you were looking at predominately was the diversity index between the performance of bonds in the residential market in the pool with bonds from the corporate market.

Mr. YARMUTH. These are obviously very sophisticated models that are needed to analyze.

Mr. RAITER. They are supposed to be.

Mr. YARMUTH. So I want to show you a document that the committee obtained from S&P and get your reaction to it. This is not an e-mail. This is an instant message or series of instant messages between two S&P officials who were chatting back and forth over the computer. It took place on the afternoon of April 5, 2007, and based on the document, we can identify the two employees as officials who work in a Structured Finance Division of S&P in New York City. So a Structured Finance Division would be the one that analyzes these types, these complicated securities?

Mr. RAITER. That is correct.

Mr. YARMUTH. As I show you these, you will see that what they're talking about. They're talking about whether they should rate a certain deal. Here is what they said.

Official number one: By the way, that deal is ridiculous.

Official number two: I know, right, model definitely does not capture half the risk.

Official number one: We should not be rating it.

Official number two: We rate every deal. It could be structured by cows, and we would rate it.

Official number one: But there is a lot of risk associated with it. I personally don't feel comfy signing off as a committee member.

This document is not testimony. And it hasn't been prepared by an attorney and vetted by the company. It's just two S&P officials sending messages to each other, but what they say is extremely disturbing. Their attitude seems to be casual acceptance that they rate deals that they should not be rating, deals that are too risky, and they rate deals no matter how they're structured.

So I want to ask you, what does the official mean when she says, quote, the model definitely des not capture half the risk? What is she referring to there?

Mr. RAITER. Well, again, I'm not an expert on the CDO model or the methods that they used. But what I have read about is it's tremendously driven by this diversity index that is supposed to tell you whether the bonds that are put in one of those transactions are correlated, so if one sector of the market starts to go down, whether that might have an impact on the performance of other bonds. As they started, in my opinion, putting more residential mortgage and consumer bonds in these transactions, they were highly correlated in our intuition. We weren't working on it, but it was highly correlated. It really amazed us that they could put so many mortgages in the pool and still believe that it had diversification risk.

But we were not part and parcel to those conversations. The only thing that I really got involved in was when I was requested to put these ratings on transactions we hadn't seen and to basically guess as to what a rating might be.

Mr. YARMUTH. I guess maybe to be, put it more simply for lay people like us is, if somebody says that they're not assessing half the risk, would that mean that somebody who was relying on the ratings to make an investment in those securities would not be getting an accurate picture of the risk that was involved?

Mr. RAITER. I would presume that is an interpretation.

Mr. YARMUTH. Which is the purpose of the ratings, correct?

Mr. RAITER. The purpose of the rating is to clearly and on a timely basis reflect what that risk is according to the experts at the rating agencies, and that rating apparently did not.

Mr. YARMUTH. Now the committee went back to investigate whether S&P had in fact rated this particular deal, the one the instant message discusses, and yesterday the SEC informed the committee that, the committee staff, that it indeed had rated it.

So I'm going to ask, Mr. Egan, what do you think the official means when she says it could be structured by cows and we would rate it?

Mr. EGAN. Well, perhaps that cow is particularly talented. What it means is that it's ridiculous; that, as the--we have the approach, again we stepped into the shoes of the investor, that if you don't understand it, if it's unsound, don't put your rating on it. There is no law that says that you have to rate everything. In fact, you view the rating agencies as being similar to the meat inspectors. If the meat is unsound, that it's tainted, the inspector has the obligation to stop the line and get rid of it or it threatens the whole system, because what happens on the other end of the line that is with investors is they can't tell the difference between good meat and tainted meat. The investors don't have access to all the information. They don't have the expertise. They're relying on, hopefully, an independent agent--and that is the crux of the problem, the independence--to stop things from coming down the line.

In fact, I would argue that the Fed's and Treasury's actions are going to have less and less impact because it's not solving the underlying problem. The underlying problem is that ratings link up providers of capital and users of capital. And if that linkage is broken, which is what has happened right now, you're not going to have people coming into the market. They don't trust it. They won't eat the meat if it is tainted, and we have a breakdown in the system, despite probably about $3 trillion worth of support for the financial system.

Mr. YARMUTH. Thank you for using the beef metaphor for the cow question.

Chairman WAXMAN. Thank you, Mr. Yarmuth.

The Chair reserves the balance of his time, and now turns to Mr. Davis for 10 minutes.

Mr. DAVIS OF VIRGINIA. I think you milked that one.

I have a couple of questions. First of all, thank you very much for your testimony. I think it has been very helpful to both sides.

On the next panel, we're going to hear from senior executives that acknowledge that the assumptions that S&P used to estimate the risk of subprime mortgage default in order to produce ratings of mortgage-backed securities between 2005 and 2007 were wrong. Is it simply, my question is to each of you, is it simply the case that they got the assumptions wrong, or do you think there is more to the story that maybe they aren't willing to share with us? So I throw out a couple. Their clients, when you say, who are their clients, it really wasn't the general public, was it? It was the securities they were rating, and it was their shareholders. And they were real happy with these, isn't that the underlying problem?

I will start you with, Mr. Egan.

Mr. EGAN. Absolutely. If you're a manager of a public company, your job is to enhance value of that company as much as possible. And the providers of 95 percent, between 90 and 95 percent of the revenues of S&P and Moody's and Fitch happen to be the issuers. And the other oddity, and we look at industries all the time you never find an industry like the credit rating industry. The Justice Department used the term "partner monopoly," and that is a fair term. The problem is that there is no downside for being wrong. In our case, we're paid solely by the institutional investor. If we're wrong, we lose clients. So our job is to get to the truth quickly. We're sort of like a bank. In the old business model, if you went to a bank, let's say 15 years ago, you wanted a mortgage, you go to a bank, the bank would assess, the banking officer along with the credit officer would assess your ability to repay the loan. And then it would go to the head of the credit committee, and then it would go to the State or Federal bank examiner. So you had three checks. The goal is to make sure that the credit was assessed properly. You don't want to be too tight or you won't do any business, and you don't want to be so loose so you have garbage in the portfolio.

That system has been thrown out the door to one whereby everybody involved in the process has an incentive for letting things go by basically, from the mortgage broker, the mortgage banker, the investment bank, the issuer-paid rating firm; they all get paid if a deal happens, and they don't get paid if a deal doesn't happen. In the case of the rating firms, if S&P decides or Moody's decides to tighten up their standards, S&P and Moody's will take the transaction. And so it's very easy to just go along with the flow because the downside is very limited. You can't be sued, effectively.

Mr. DAVIS OF VIRGINIA. It's a great point. The real question is, I understand where the incentives are. What is your ethical obligation? Is it to your clients and your shareholders that are putting you, up or is it to the public?

Mr. EGAN. They serve two masters. And the most important master is the one who pays the freight which happens to be the issuers. In our case, it's the institutional investors. Our business has grown over the past year because we have warned people about the disasters coming down the pike. We got a lot of grief for it because people thought we were wrong. But we were worried about the bond alliance and the broker dealers and a series of others. So our interests are aligned with the ultimate holders of these securities.

Mr. DAVIS OF VIRGINIA. Mr. Raiter, Mr. Fons, do you want to make any comment? You sat there trying to make the right decisions. You didn't have the pressures that they felt above to make profits and to--

Mr. RAITER. I believe that Standard & Poor's at this time, there was a raging debate between the business managers and the analysts. The analysts were in the trenches. We saw the transactions coming in. We could see the shifts that were taking place in the collateral. And we were asking for more staff and more investment in being able to build the databases and the models that would allow us to track what was going on. The corporation, on the other hand, was interested in trying to maximize the money that was being sent up to McGraw-Hill, and the requests were routinely denied. So, by 2005, when I retired, we did have two very excellent models that were developed but not implemented. And it's my opinion that had we built the databases and been allowed to run those models and continually populated that base and do the analysis on a monthly quarterly basis, we would have identified the problems as they occurred.

Another big area that Mr. Egan has discussed is there are two sides to the rating. You have an initial rating when the bonds are sold, and then you have the surveillance. And at some point in the mid-1990s, the management in Standard & Poor's decided to make surveillance a profit center instead of an adjunct critical key part of keeping investors informed as to how their investments were performing after they bought the bonds. And as a result, they didn't have the staff or the information. They didn't even run the ratings model in the surveillance area which would have allowed them to have basically re-rated every deal S&P had rated to that time and see exactly what was going on and whether the support was there for those triple-A bonds.

The reason they gave for not doing it was because they were concerned that the ratings would get volatile and people would start to feel like all triple-As aren't the same. And it was a much more pragmatic business decision than really focusing on how to protect the franchise and the reputation by doing the right thing for the investors. Mr. Jones and Mr. Egan pointed out, we weren't paid by the investors, but we certainly, at the ratings level, pitched them because we would say in our presentations, if S&P isn't on a transaction, you ought to ask, why? And we would do the same thing in presentations that we shared jointly with Moody's analysts. We would always tell the investors, you guys are driving this big market, and you're not doing your homework. You're buying everything that is coming out the chute, and you need to spend a little more time on your own analysis and review.

Mr. DAVIS OF VIRGINIA. Nobody looked under the hood.

Mr. FONS. The large ratings agencies do take some fees from investors. They have so-called investor clients. They market their services in terms of their research service and other things, so there is some focus there. But as I said in my testimony, as Mr. Raiter just mentioned, the franchise derives from the reputation that the firms have. And that comes from serving the ultimate clients, and that is the investor, particularly an investor who hasn't bought a bond yet who is considering a purchase of a security.

Mr. DAVIS OF VIRGINIA. And that was really what was betrayed here, isn't it?

Mr. FONS. That focus led to the rise in the reputation that helped build the franchise that they eventually saw as a cash cow, and they wanted to milk and start serving many masters. As you said, you can't do that.

Mr. DAVIS OF VIRGINIA. I will reserve the balance of my time.

Chairman WAXMAN. The gentleman reserves the balance of his time.

Mrs. Maloney.

Mrs. MALONEY. Thank you Mr. Chairman.

And I thank the panelists today.

Mr. Egan, in your testimony, you basically said that these credit rating agencies were the gatekeepers. They rated these very complex products, the derivatives, the mortgage-backed securities on which investors and, I would say, the entire economy relied. I have got to say that it is important to note that the President's working group has said that the credit rating agencies contributed substantially to the present financial crisis by their failure to warn investors of the recent wave of credit defaults and institutional failures.

I would like to begin with you, Mr. Fons, and look at how aware these credit rating agencies were of the risk that was out there. And I want to ask you about a presentation prepared by Moody's CEO Raymond McDaniel. This presentation was prepared for a meeting of Moody's board of directors on October 25, 2007, when the company was coming to grips with its role in the subprime debacle. The document, in my opinion, is an exceptionally candid internal assessment of what went wrong at Moody's. Its title is, "Credit Policy Issues at Moody's Suggested by the Subprime Liquidity Crisis," and it is marked "confidential and proprietary."

RPTS STRICKLAND

DCMN MAGMER

[11:05 a.m.]

Mrs. MALONEY. Under the heading, "Conflicts of Interest: Market Share," the documents says, and I quote, the real problem is not that the market underrates ratings quality but rather that in some sectors it actually penalizes quality. It turns out that ratings quality has surprisingly few friends. Issuers want high ratings. Investors don't want ratings downgrade. Shortsighted bankers labor shortsightedly to game the ratings agencies.

And, Mr. Fons--and that's the end of the quote.

Mr. Fons, you used to work at Moody's. This document appears to contradict years of public statements by Mr. McDaniel and other Moody's officials that they are not pressured by the issuers. And I'd like to ask you, Mr. Fons, are you surprised by this kind of assessment that Mr. McDaniel would be making to his board of directors?

Mr. FONS. No, I'm not surprised at all. I mean, this totally reflected my views and the views of many others at the firm. Many, of course, didn't want to hear this.

One problem with this whole statement is that the emphasis is on rating quality, and in my view that is something that has never really been clearly articulated by the agencies or by the regulators or by anybody else. We talk about ratings quality, but there is no clear definition of what that means, and without a firm target there, we don't have much to go on.

But clearly what he is referring to is accurate ratings here. And we definitely knew that the investors were conflicted in what they wanted in terms of having stable ratings on bonds once they held them, that issuers are conflicted and they wanted high ratings on their securities, whether or not they deserved them, and that bankers were taking advantage of the competition in the industry to game the system.

Mrs. MALONEY. Let me read another quote from this document. Mr. McDaniel further writes, and I quote: Unchecked competition on this basis can place the entire financial system at risk. End quote.

It appears he was correct, knowing back in 2007 their failure to act put our entire financial system at risk. And are you surprised by this statement? What is your comment on this statement?

Mr. FONS. Well, at that point it was too late to do anything. It was clear the ratings were wrong. It was clear at that point that the securities that had faulty ratings had already permeated the entire financial system. And many of these other institutions were unwitting victims, including the monoline insurers, including the banks and insurance companies and others. And so I think this is not surprising, and I believe it was prescient.

Mrs. MALONEY. In this statement, Mr. McDaniel described how Moody's has addressed the tension between satisfying the investment banks and providing honest ratings; and I quote:

Moody's for years has struggled with this dilemma. On the one hand, we need to win the business and maintain market share or we cease to be relevant. On the other hand, our reputation depends on maintaining ratings quality.

He describes some of the steps that Moody's has taken to, and I quote, square the circle, end quote. But he then says, and I quote, this does not solve the problem.

I would like permission, sir, to put this in the record.

Chairman WAXMAN. Without objection.

[The information follows:]

******** COMMITTEE INSERT ********

Mrs. MALONEY. And what is your view on this statement, Mr. Fons? And I welcome Mr. Egan and Mr. Raiter to make comments likewise.

Chairman WAXMAN. The gentlewoman's time has expired, but we will allow you the time to answer.

Mr. FONS. I believe you hit the nail on the head. It is a difficult problem, and we don't see an easy answer.

Mr. EGAN. In our view, it is not a difficult problem. In fact, it is very simple. This is a--go back to a model that has worked, actually, from biblical times. And that is you want an alignment between the ultimate holder of these assets and whoever is assessing them. If you have that, a lot of problems will fall away. You won't have people, you know, taking out mortgages that they had little chance of paying back.

But you want to focus on the right thing. Some people say it is a subprime crisis or Alt-A or whatever. No, our view is is that it is really an industry problem. It is a regulatory problem. We use the analogy of a 90-year-old man that had a triple bypass operation. There is no reason that that person shouldn't be allowed to get insurance. Just like subprime mortgages have a legitimate purpose, Alt-A mortgages have a legitimate purpose. But back to the 90-year-old man who wants to get insurance, just make sure that the risk is properly assessed. Okay? That he is charged appropriately for that.

Chairman WAXMAN. Thank you, Mr. Egan. Thank you, Mrs. Maloney.

Mr. Issa.

Mr. ISSA. Thank you, Mr. Chairman.

I would hope we are not talking about dental insurance here for that 90-year-old gentleman. But I understand the risk assessment.

Let's go through a couple of things. I think up here on the dais we realize that there has been an aircraft crash. And, you know, there is probably a pilot that didn't do the right thing, a mechanic that didn't do the right thing, maybe Boeing didn't do the right thing; and you go back and you say the plane fell out of the sky because everyone messed up.

What we're trying to did here and what we're hoping you will help us with is assess how to keep Congress from doing the two things we do so well, which is nothing at all and overreact. And it is the latter that I am concerned about.

Mr. Egan, I want to follow up on something that is the premise of your testimony, I believe; and that is that "whose bread I eat, whose praise I sing," period. And that is what I think I heard. That inherently you give an honest answer to your client, but you are also skewed that way. That the rating agencies taking money from the people selling the instruments was a conflict. Is that roughly, loose-sense correct?

Mr. EGAN. It is a conflict, yes. An unmanageable conflict, too.

Mr. ISSA. Okay, let's go through a couple of things. I want to judge how much of a conflict. PricewaterhouseCoopers rates a public company in their audit; right?

Mr. EGAN. Yes.

Mr. ISSA. They are paid by the company that they are auditing to give an honest and independent audit.

Mr. EGAN. Right.

Mr. ISSA. There is an assumption that they do. If they don't, the entire audit system falls apart.

A CEO of a public company under Sarbanes-Oxley signs saying I'm telling the truth about the condition of my company on that report that is prepared by the public accounting firm but has his signature. Generally truthful; right?

Mr. EGAN. Right.

Mr. ISSA. Held to be truthful. We rely on it.

If you are an ISO 9001 manufacturer, you pay people to say whether your quality manufacturing system is in fact credible; and they rate you for whether you meet that; right?

Mr. EGAN. Yes.

Mr. ISSA. Okay. Goldman Sachs takes a company public, takes their stock and sells it. Ultimately, Goldman Sachs makes a fortune on it. But isn't there an essential belief that they are bringing it to market--they are making a lot of money, but they are bringing it to market at a relatively par level; and, historically, isn't that relatively true?

Mr. EGAN. Yes.

Mr. ISSA. My premise to you is, since we rely on all of these in the system and all of these are paid for by the person who in a sense gets rated, might I not ask the question this way? The subprime loans were essentially the equivalent of taking the Dow Jones industrial average, having no equity in it, and then having no margin call, but saying it is triple-A rated. If I put a package together of the S&P 500 today and I took one of each of those stocks and put it in there and I sold it as a package and Moody's underwrote it as triple-A but it had no equity in it and it had no statement of my income and it had no recourse, wouldn't in a sense that be closer to what these packages were? Where you had a liar's loan, no down payment, and the only way that the loans are going to be paid back was, A, they had to stay the same or go up; and in some cases if they didn't go up the people couldn't have made the payments anyway and yet they got a high rating.

Isn't it the fundamental, actual underpinning of these documents that should never have gotten a triple-A rating separate from the question of conflict?

Mr. EGAN. No. Let me explain.

Mr. ISSA. Okay. Let's go through that. Now I have very limited time. So I want you to answer, but I want to pose it in a way that you can answer it I think consistent. And I think Mr. Fons also wants to.

Were there subprime loans in which the substantial portion of the package had little or no down payment?

Mr. EGAN. Yes.

Mr. ISSA. Okay. Were these in most cases people who in retrospect were unlikely to be able to make those payments with their current income if it stayed the same?

Mr. EGAN. Yes.

Mr. ISSA. And, by definition, the economy has rises and falls and real estate goes both directions up or down; isn't that true?

Mr. EGAN. Sure, yes.

Mr. ISSA. So how do you put a triple-A rating, knowing that if that happens these cannot in fact be repaid in full or even close to it?

Mr. EGAN. The core problem in the case of the mortgage-backed securities was that the assumption was that housing prices would increase. In fact, they embedded an acronym--what is it--the House appreciation rate, which is somewhat ironic because it doesn't account for the fact that sometimes houses deflate, decline.

You brought up a lot of very good examples, but there is a distinction between the examples you gave and the rating industry. In the case of PriceWaterhouse, okay, accounting firms are sued--and successfully sued--if they're substantially wrong. In the case of the rating industry, what the current practice is is that ratings are opinions. And we agree with that. Because, ultimately, we are not guaranteeing all the securities. There is too much out there. The industry would go away. It is a force that--if you did away with the freedom of speech defense.

In the case of the accounting industry, Arthur Andersen said we would never allow this nonsense to happen because our reputation is too important. Well, guess what? On an individual basis, they obviously did bend their standards with Enron, WorldCom and the others.

You mentioned Goldman Sachs and others. Sometimes they have liability. In fact, in the case of WorldCom, they were the underwriters for I think it was about $11 billion worth of debt that WorldCom issued about 10 months before bankruptcy. They had to pay $12 billion. So there are checks and balances. It is rare that the rating firms have to pay anything for their inaccuracies.

Mr. ISSA. Thank you. And thank you, Mr. Chairman. I think the word "recourse" has come out of this discussion. Thank you.

Chairman WAXMAN. Thank you, Mr. Issa.

Mr. Cummings.

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

Mr. Raiter, Deven Sharma, the President of Standard & Poors, is probably going to sit in the seat you are sitting in in a few minutes. And one of the things that he is going to say to us is that they received inaccurate information and therefore had no duty to look at individual mortgages. And one of the things I think that concerns the American people is how it seems that everybody is passing the buck, passing the blame, and nobody seems to want to take responsibility for this phenomenal fiasco.

So I want to ask you--you and other panel members--about a particularly complex type of financial product, a CDO squared. A CDO squared is created when CDOs are constructed from pools of securities issued by other CDOs. They are also sometimes called synthetic CDOs because they can be backed by no actual mortgages. The complexity of these instruments can be simply staggering.

Let me show you an e-mail exchange between three analysts at S&P that took place on December 13th, 2006. They are trying to figure out if the rating they are giving a CDO squared is justified.

In this first e-mail, an analyst named Chris Myers says he is worried about the CDO problems; and this is what he writes:

Doesn't it make sense that a triple-B synthetic would likely have a zero recovery in a triple-A scenario? If we ran the recovery model with the triple-A recoveries, it stands to reason that the tranche would fail, since there would be lower recoveries and presumably a higher degree of defaults.

Now Mr. Myers then writes: Rating agencies continue to create an even bigger monster, the CDO market. Let's hope--and this is--this is striking--let's hope we are all wealthy and retired by the time this house of cards falters.

Mr. Raiter, I know you usually rated mortgage-backed securities and not CDOs, but this is a striking statement for an S&P analyst to make. What do you think Mr. Myers meant when he called the CDO market a house of cards? And this would seem to almost go directly against what Mr. Sharma has written in his written testimony that there were certain--that they had come to a point where they didn't have information and therefore they had no obligation and therefore let the buck pass to somebody else.

Do you have a response?

Mr. RAITER. Well, my short response is Mr. Sharma wasn't there at the time, so somebody else wrote his--

Mr. CUMMINGS. What he has done is he has talked about what has happened over that time.

Mr. RAITER. I don't believe they didn't have the information. I believe it was available on both the residential side and on the CDO side. I believe there was a breakdown in the analytics that they relied on. And that the house of cards, intuitively, to a lot of us analysts that were outside the CDO area but were looking at it through the glass, intuitively, it didn't make a whole lot of sense.

And as Mr. Egan has suggested, we are all relatively well educated and intelligent people; and if you couldn't explain it to us, we were real curious how this product was enjoying such a tremendous success. And, unfortunately, anecdotally, we were told that it was enjoying a lot of success because they were selling these bonds in Europe and Asia and not in the United States, particularly the lower-rated pieces.

Mr. CUMMINGS. It sounds like Mr. Egan and you and perhaps Mr. Fons believe, as Nobel Prize winner, Mr. Krugman, believes, is that there may have been some fraud here.

Mr. RAITER. Well, I wouldn't use fraud, sir. I would suggest that there became a tremendous disconnect between the business managers at our firm that were trying to maximize McGraw Hill's share price--

Mr. CUMMINGS. Clearly, would you agree there was greed?

Mr. EGAN. I think that there was. Look at the definition of fraud. When you have--when you hurt somebody and you do it willfully, then it is fraud.

And in the case--I am relying on the information provided by the Financial Times, Moody's knew there was problems with the model and withheld that information because they didn't want to move off of the triple-A. They hurt investors in the process. They knew they were hurting investors if the information in the Financial Times report was accurate. So, yes.

Another comment on fraud.

Mr. CUMMINGS. Yes, what?

Mr. EGAN. It meets the normal definition of fraud, exactly. You have to do some additional investigation, but if the Financial Times is right, yes, there is fraud.

Also, in terms of fraud in the underlying securities, I stated in connection with the Enron and WorldCom hearing that there's always fraud connected with financial matters where people--where firms are failing. It is normal. Okay? It is normal for the WorldCom executives to say everything is fine, don't worry about it. But yet it is the job of the credit rating firm to assess that and to get to the truth.

And that's where the alignment of interests is absolutely critical. If you don't have that, you have a breakdown in the system; and that is exactly what we have right now.

Mr. CUMMINGS. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Cummings.

Before I recognize the next questioner, I want to ask unanimous consent to allow all documents referred to in statements and questions throughout this hearing to be part of the record.

Without objection, that will be the order.

Mr. Bilbray.

Mr. BILBRAY. Thank you, Mr. Chairman; and I want to thank all the panel for being here.

And I really want to say, Mr. Egan, thank you for saying bluntly what a lot of people have been thinking, wanting to have open--and saying, look, this thing has reached the point to where there is no reasonable way to say that it has not crossed fraud. Now how much over? We could say who would have thought that real estate would ever go down in this illusionary time. That is the difference between the expert and the general public, supposedly.

Do you think the rate shopping played a major role in this crisis?

Mr. EGAN. Absolutely.

Mr. BILBRAY. And that--would you say that that rate shopping and the way it was done would be defined to reasonable people as fraud instead of just a normal business cycle?

Mr. EGAN. Well, it is incremental. So it is harder to throw it in--in my opinion, it is harder to throw it into the category. To ultimately reach that level where you are hurting the public, you knew were hurting the public and yet as a firm, a publicly held rating firm, you are pressured into it.

But I think there is a deeper problem, and the deeper problem is addressing the question why is there ratings shopping? Why can issuers go from one firm to the other firm to the other firm and get the highest rating and there is relatively little downside for the rating firm because they have the freedom of speech defense?

I think you have to step back and say, how do we fix this? And I think you fix it from the institutional investor standpoint, which will trickle down to the individual. The institutional investor should know darned well that these ratings are paid for by the issuers--99.5 percent. Why in the world do they have all their investment guidelines geared to conflicted ratings? They should make the adjustment, because it is a fool's error to try and rein in the activities of S&P and Moody's. It won't happen over the long term, because there is a natural tendency to serve their master's, the issuers.

Mr. BILBRAY. Following your analogy to the meat inspector, the fact that if the meat inspector gets paid per side of beef that is approved, there is an inherent conflict with him finding the tainted meat and throwing it off the line because they get paid less.

Mr. EGAN. Absolutely. Yes, sir.

Mr. BILBRAY. That is the analogy that you worked on.

The other analogy that you used--Saint Augustine teaches us that when we want to find fault then we should start looking at what we're not doing properly.

Mr. EGAN. Sure.

Mr. BILBRAY. The analogy that you used of the elderly man getting a triple bypass needs to be required to pay more because there is more risk there.

Mr. EGAN. Yes.

Mr. BILBRAY. And that that more is not punitive. It is just common sense--I mean, it is not punitive, but it is prudent.

Mr. EGAN. It is sustainable. You could set up a firm just to insure those people.

Mr. BILBRAY. And you realize in this town, in Congress, they would call you mean spirited and that that attitude picks on those who can least afford to pay on that. And I'll give you an example. We have the same thing here. We were talking about, I have to assume, that the degree of subprime loan, the general population that received those subprime loans tended to be in the lower socioeconomic rating, wouldn't you say?

Mr. EGAN. Yes.

Mr. BILBRAY. Okay. Now in this town you start requiring those people to carry more of the burden of ensuring their loan, there are a lot of people here that would be the first ones to attack you for doing that because you are targeting those who could pay the least.

Mr. EGAN. There is a place for public policy interests, and there is a place for good business decisions. We are in the--our job is to protect investors, and everything is geared towards that.

Mr. BILBRAY. And I understand that. And I will just tell you something. There are a lot of people in this town on our side of the dais who would love to turn every program into a welfare program--be it loans, be it the tax system or everything else. And then when the system starts crumbling because it cannot maintain itself, it is the little guy that gets hurt the worst in these crises. And I wish we would remember that when we mean to help the little guy we actually can do damage.

Mr. EGAN. Absolutely. One case in point is the commercial paper crisis. It might be that GE is helped out because it is a large, important issuer. But what about the secondary and tertiary issuers of commercial paper?

That is why we encourage a return to a sustainable system. The government can't--the Fed and the Treasury can't issue a new program every week and hope to save the market. What is needed is a return to the policies that have worked over time. And that is basically checks and balances, two forms of ID. Make sure that the credit quality is properly assessed so that the money will flow in. So that the French treasurer who is burned because he invested in triple-A of Rhinebridge and Automo was rated triple-A and was slammed down to D in a period of 2 days will come back into the market after there are some checks and balances reinstalled.

Mr. BILBRAY. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Bilbray.

Mr. Kucinich.

Mr. KUCINICH. Thank you, Mr. Chairman.

Mr. Fons, did you write a white paper on rating competition and structured finance?

Mr. FONS. I did.

Mr. KUCINICH. And in that paper did you say that recent rating mistakes, while undoubtedly harming reputations, have not materially hurt the rating agencies? On the contrary, rating mistakes have in many cases been accompanied by the increase in the demand for rating services. Did you say that?

Mr. FONS. Yes.

Mr. KUCINICH. And so we have a situation where the rating services are actually profiting even though their ratings may not in fact have been created; is that correct?

Mr. FONS. [Nonverbal response.]

Mr. KUCINICH. Thank you, sir.

Mr. Chairman, members of the committee, look at this system. Investment banks need high ratings. Moody's, Standard & Poors need lucrative fees from the investment banks. Investment banks get the ratings, Moody's gets the fees, we know what the investors get, and we know what the taxpayers get.

Now, Mr. Fons, we have a document here called Ratings Erosion by Persuasion, 2007, October. It is a confidential presentation that was prepared for the company's board of directors at Moody's. I want to read you one part of the section that says: Analysts and managing directors are continually pitched by bankers, issuers, investors, all with reasonable arguments whose use can color credit judgment, sometimes improving it, other times degrading it. We drink the Kool-Aid.

What does that mean?

Mr. FONS. I think it's human nature to be swayed to some extent by the people you interact with. And they are being pressured--they are being pitched because their ratings are important, their ratings carry weight in the market. At least they had at that time. And they had a lot of incentives to listen to these people.

Mr. KUCINICH. Thank you.

I would like to submit for the record from the Oxford dictionary of American Political Slang: To drink the Kool-Aid: To commit to or agree with a person, a course of action, et cetera.

Mr. Fons, did Moody's offer a German insurance corporation, Hannover, to rate its credits? Do you have any knowledge of that?

Mr. FONS. I'm not sure. No. I don't know exactly what happened there.

Mr. KUCINICH. Could you provide to this committee the answer to this question: Whether or not Moody's offered to rate Hannover's credit and when Hannover refused, whether it gave it an adverse rating?

And I'm raising this question, Mr. Chairman and members of the committee, for this reason. On January 10th, the same day that you wrote your article, according to Alex Coburn in Counterpunch, he said that Moody's gave the U.S. Government a triple-A credit rating. But while it was giving the U.S. Government a triple-A credit rating, it said, according to this report, that in the very long term, the rating could come under pressure if reform of Medicare and Social Security is not carried out, as these two programs are the largest threat to the financial health of the United States and to the government's triple-A rating.

Are you familiar with that report.

Mr. FONS. I didn't read that. No.

Mr. KUCINICH. I am going to submit this for the record, Mr. Chairman.

[The information follows:]

******** COMMITTEE INSERT ********

Mr. KUCINICH. Because we know that Wall Street has been trying to grab Social Security forever. Imagine, Mr. Chairman, if we had gone along with these privatization schemes and all the people on pensions in the United States lost their Social Security benefits because the market crashes.

Here we have Moody's--according to this article, Moody's is involved in promoting not only privatization of Social Security but privatization of Medicare. If we privatize Medicare, the insurance companies Moody's rates can make more money. You privatize Social Security, Wall Street investors make a windfall.

Now this racket known as ratings has not just a whiff of fraud, as pointed out by Mr. Cummings in a conversation with Mr. Tierney, but if the investment banks are paying to get a form of a high rating, that is kind of extortion. If they pay to make sure--can they also pay to make sure their competitors get low ratings? Which would be a type of bribery.

If Moody's could essentially offer credit to rate someone and then if they don't accept the rating, give them an adverse rating, that is a form of a racket. And if they could go to the U.S. Government and tell the U.S. Government either you go along with privatization of Social Security and Medicare or we are going to downgrade your rating. I mean, this is criminal.

Mr. Egan, would you like to comment on that?

Mr. EGAN. You have a current example of that process whereby reportedly S&P and Moody's went to the monoline insurance companies, the MBACs and the MBIAs, and said--they were at that time involved only in municipal finance--and said that if you don't get involved in structured finance we're going to have to take a negative action on you because your funding sources aren't sufficiently diversified. A core aspect is do they really believe it or were they pressuring them to bolster the structured finance market? Don't know. But your point is well taken that they can abuse the power that they have.

And, by the way, the best source of information on Hannover reinsurance is an article by Al Klein in the Washington Post. It is probably about 2-1/2 years ago. And there is a subtlety. Because this came up when I testified in front of the Senate Banking Committee. The subtlety was that Moody's was providing a rating for Hannover Re but is looking for additional compensation on another form of rating. I think--what was it--their insurance side. But they wanted to be rated, I believe--they wanted to be paid for the rating on the debt side.

So Moody's answer was we are already being paid, but the response was a little bit more nuanced than that. They wanted to be paid on the more lucrative part, the one where they had the more extensive relationship; and, according to Al Klein's story, they took negative action while S&P and I think it was A.M. Best did not.

Basically, the opportunity, the means for mischief is there. And that is why we press that there at least be one rating that has the interest of the investors at heart. Because you can check these things. You say, hey, wait a second. This is a real credit rating and forget about this nonsense that is going on.

Chairman WAXMAN. Thank you, Mr. Kucinich. The time has expired.

Mr. Souder.

Mr. SOUDER. All of us are really crashing and learning as much as we can about the finances. And every time I think I can get into a couple of questions that I want to, but some of the answers just appall me. It is clear that greed led to not only "see no evil, hear no evil" but "report no evil". It is clear that there was fraud here. But there is also to me incredible gross incompetence.

It is an embarrassment to the business profession to have businesspeople stand up here, and even some of you who have been warning, to make some of the statements you have made in front of these hearings.

For example, Mr. Raiter, you said we didn't have the ability to forecast when these were going awry. You also said there was a breakdown on fundamental analysis.

My background by training is business management. I spent two years in a case program where you basically analyze what is the core source problem? What is the secondary problem? What is tertiary? How do you do this? And you wake up at night and, basically, everything for the rest of your life you are tearing it apart in that system.

This just screams out in 60 minutes of analyzing what happened certain base management things that were not done. That if you have basic mortgages, you come out and start to try to separate these into no-risk mortgages. Then you come down to a six-pack of derivatives with some toxic things inside that. Then you do another derivative package off of that, and then you do another derivative off of that.

Number one management theory is, if you are building a house like this, every level you go you should be drilling down where the foundation is and know every variation of that foundation because you built an entire system of ratings on a foundation that requires increasing scrutiny. Not we don't quite know this. I wonder how we're going to do this. And so on. Basic core management.

If you say you are a business exec, you would be crawling all over the specifics of that. Then, guess what? Because these new vehicles came that were supposedly, quote, risk free, now out three and four levels, some without even a mortgage behind it, demand came. It was no secret that whether it was political driving on Fannie Mae, whatever, part of this was demand for everybody who wanted higher returns to go get these packages. So we have an artificial doubling of the housing market without anybody asking where are these coming from? Where did all of these new people come to get these new homes? Who was building this foundation?

Yes, some of it is a conflict of interest. It is clear that when the temptation was there the conflict of interest came in. But the core problem is we have this in multiple categories in the financial, and not all of them had conflicts of interest. We have a conflict of interest here, but we also have a core problem founded in what were the bond rating managers doing? You could tell from the change in the market. You could tell why are some of these yielding so much? Guess what? They are yielding more because they are getting charged more points. They are having to pay higher interest rates. Any manager--any manager looking at that should have said these are higher risk. What are we getting here?

How can you say that this wasn't predictable? Are you--the things were all there.

Mr. EGAN. In our opinion, it is not, by the way, incompetence. If you look at the job of a manager of a public company, it is to increase the revenues, increase the profitability. You probably could come to the conclusion that they did everything possible to do that.

Mr. SOUDER. I understand your point. You are making an ethical argument. I would argue that that presumes that they actually knew the danger, rather than they were just trying to--I believe there is possible legal culpability.

Because, in fact, another thing that was stated here, in the multiples of memos, but in the--I think Mr. Raiter said the question was, did we want to come up with two categories of triple-A bonds? Because some of these were more risky. Yes, that is an ethical obligation. It's probably a legal obligation. If there were inside triple-A bonds some things that didn't really have the criteria that is the public definition of a triple-A bond, there should have been another category. Because that suggests that management actually knew.

Now, I understand your point. Their goal is to maximize revenue, if you take that model. But, by the way, in agriculture, agriculture does fund some of the inspectors. But the reason they don't have a conflict of interest is they know if there is tainted meat or tainted chicken their entire category goes under. Nobody will buy their meat as in mad cows. And there can be a conflict of interest and still, in fact, maintain inspectors.

The problem is if they're incompetent and greedy and corrupt and behaving illegal, then the conflict of interest pushes them over the top and it destroys their industry, which is what happened here. It has not happened in agriculture. The examples that were being used in agriculture are wrong.

Mr. EGAN. Can I address that, since it is my example? I think in economics--this is from going back 20 years--it is what is called the tragedy of the commons. And that is that, given a town in the 1700s, you let people put the cow on the commons to graze. The problem comes in when everybody puts their cow. Then the commons deteriorates, and it doesn't support any of the cows. And so there is a delay in the reaction.

Did the investment banks--did they want to see--did the industry want to see three of the five investment banks disappear? No. But the decision isn't being made on that level. It is being made on the individual level, just like the cow example. We want to get this deal through. We want to get the lowest possible issuance cost. Let's do what we can to do it.

I think this breakdown surprised a lot of people in the industry, in the finance sector. But here we are, and we have to step back and say what is the underlying cause and how can we address it.

Chairman WAXMAN. The gentleman's time has expired.

In this example, it is the aggregate of the excrement on the commons with all the cows that becomes the problem.

Mr. Tierney.

Mr. TIERNEY. Thank you, Mr. Chairman.

Mr. Raiter, I'm not sure that we need any more examples of things gone awry. I think we want to find out how far up the chain this goes.

But I do want to ask you about one remarkable incident during the time you were at S&P. Around 2001, my understanding is that you were asked to do work on rating a collateralized debt operation call Pinstripe. Do you recall that?

Mr. RAITER. Yes, sir.

Mr. TIERNEY. Now a collateral debt obligation is essentially a collection of the different mortgage-backed securities; and I think you were asked to look at one segment of those mortgage-backed securities; is that accurate?

Mr. RAITER. I was asked to put a rating on a bond that has been rated by Fitch. It was being included in the CDO.

Mr. TIERNEY. Now the foundation for the ratings analysis is usually the value of the underlying mortgages?

Mr. RAITER. Yes.

Mr. TIERNEY. And I suppose the information like the credit worthiness of the borrower, the borrower's credit score, things of that nature would be important to you.

Mr. RAITER. That was the tape that we asked for.

Mr. TIERNEY. Okay. Well, that is exactly what I want to get into. You sent an e-mail; and in the e-mail on March 19th, 2001, you asked for collateral tapes. What was on the collateral tapes that you sought?

Mr. RAITER. That would have been the information on every loan that was in the pool. It would have had the FICO score. It would have had the loan-to-value information, the kind of note that was written, whether it was fixed or floating. A variety of information about the house's price, where it was located. The tape had about at that time 85 or 90 data points for every loan on the tape.

Mr. TIERNEY. To most of us sitting here, that seems like a reasonable request. It seems exactly what we would expect somebody to do in underwriting, whether or not they were going to make that rating.

But the S&P executive in change of those ratings, Mr. Richard Gugliada, I want to show you an e-mail he sent back to you when you made that request.

He answered back: Any request for loan level tapes is totally unreasonable. And he made the words "totally unreasonable" in bold. Most investors don't have it and can't provide it. Nevertheless, we must--again in bold--produce a credit estimate. It is your responsibility to provide those credit estimates and your responsibility to devise some method for doing so.

Now that's a little hard for us to understand, given what we just discussed and the need for those documents. So you were assessed to assign a credit risk for the mortgage-backed securities that backed a CDO; and now you were being ordered, apparently, to give the rating without having the backup information that you need.

You forwarded that e-mail on to a number of other officials at S&P, and here is what you wrote, and I quote: This is the most amazing memo I have ever received in my business career.

Why did you write that and what did you intend to imply by that?

RPTS STRICKLAND

DCMN ROSEN

Mr. RAITER. Well, it was copied to the chief of credit quality in the structured finance group, and earlier in the memo, I had also said I want some guidance from Mr. Gillis to tell me what we are supposed to, otherwise I have no intention of providing guess ratings for anybody. And there were no responses to the memo, so we just let it die. We never gave them a rating.

Mr. TIERNEY. Never gave them a rating?

Mr. RAITER. No.

Mr. TIERNEY. Good for you. Mr. Egan what is your reaction to that scenario, that someone would send an e-mail to Mr. Raider demanding that he give a rating without the back up materials?

Mr. EGAN. I think it is reasonable if you are being paid by issuers and unreasonable if you have the investor's interests at heart.

Mr. TIERNEY. Why wouldn't the government just get out of the business of certifying agencies like yours? Why wouldn't we just say that this is too fraught with errors and problems and risks. We are going to get out of the business of certifying agencies and we will establish our own standards. Then you can do what you want to do. We can't put you out of business. It would be an overstep to do that. But there is no reason we should certify you as a government. You give your ratings and let the market decide whether or not you are worthy of them and sort out of conflicts issue, but we're not going to do it anymore. We're going to step in and be the regulators instead of contracting it out to you. Why wouldn't we do that?

Mr. RAITER. If I could just--there is no reason why under the certain circumstance that you don't take those steps. There is a big difference in this market between the rating at issue and the surveillance. A breakdown occurred both in the proper sizing of the rating at issue. But surveillance has been atrocious. And the NRSRO designation that has been provided to the three majors, and A.M. Best and maybe others, it doesn't distinguish across what kind of ratings you can give. If you get rid of that designation, you can keep the investment policy guidelines that say if you are the investment manager, you have to get two ratings. But let the responsibility fall on the investor to find the best rating, and then to find the best surveillance that would keep them informed on a timely basis as to how that rating is performing.

Mr. TIERNEY. Wouldn't that be the better course? Mr. Fons, would you agree?

Mr. FONS. Yes, I advocated that that in my oral testimony that the NRSRO designation should be abolished.

Mr. TIERNEY. Mr. Egan, do you agree as well?

Mr. EGAN. The government has been part of the problem in this industry. It took us 12 years to obtain the NRSRO--

Mr. TIERNEY. Excuse me, but when you say the government is part of the problem, are you referring to the SEC?

Mr. EGAN. The SEC, exactly. It took us 12 years to obtain an NRSRO, and yet there is proof from the studies of Federal Reserve Board of Kansas City and from Stanford and Michigan that pointed out that we had much better ratings than S&P and Moody's but yet there is still no response.

In that time period, what has happened is that because the government only recognized those few rating firms and continued this unsound business model, permitted it, it enabled the issuer-compensated rating firms to grow much faster, much further, and have a more consolidated industry than it would be otherwise. Think the equity research industry. There are a lot of equity research shops out there. In the case of the rating industry, as Jim Graham said, it is a 2-1/2 firm industry. That was before we got the NRSRO. Now he puts us in the category.

But I think that what has to happen at this point--clearly there is a breakdown--what has to happen is something that gives confidence for the investors that are not in the market and they happen to be in many cases non-U.S. investors. The Asian and European investors, to get back in the market. Because they can't do the work themselves. They have to be able to rely on a credible agent to be able to properly assess credit quality. You are not going to change significantly S&P and Moody's and Fitch's way of doing business. You can't do it. These are rating opinions; they will remain rating opinions. What is needed is an alternative business model to be more or less on the same plane so that people have some confidence and get back into the market and get credit flowing again.

Mr. TIERNEY. I think you can change the nature of that model because we can set standards at the Securities and Exchange Commission saying that we don't accept it when the issuer makes the payments as opposed to the investors.

Mr. EGAN. We've argued for that--

Mr. TIERNEY. Rather than having the government stepping in and protecting that conflict and then leaving it there. But other than, I think the idea is right. Mr. Raiter is right. Set the standards and leave your standards out there, but don't start picking winners and losers.

Chairman WAXMAN. Thank you, Mr. Tierney. Ms. Watson.

Ms. WATSON. Thank you, Mr. Chairman. On July 10th, 2007, Moody's downgraded over 450 mortgage-backed securities. It placed another 239 on review for possible downgrade.

Although many of these bonds were not rated highly to begin with, Moody's had awarded them of them as its highest rating of triple-A.

So the committee has obtained an internal Moody's e-mail written the next day, July 11th, 2007. I think it is going to be up on the screens in a moment. And this e-mail was written by Moody's vice president, who took multiple calls from investors who were irate about these downgrades. And I would like to get your reaction to these comments.

First the e-mail describes a call with an investor from the company PIMCO and the vice president writes: PIMCO and others have previously been very vocal about their disagreements over Moody's ratings and their methodology. He cited several meetings they have had questioning Moody's rating methodologies and assumptions. And he feels that Moody's has a powerful control over Wall Street, but is frustrated that Moody's doesn't stand up to Wall Street. They are disappointed that this is the case Moody's has toed the line. Someone up there just wasn't on top of it, he said. And mistakes were so obvious.

So this goes to Mr. Fons. PIMCO is a very highly regarded investor management. It's run by Bill Gross, who is widely regarded as one of the Nation's most experienced fixed-income investors. Does it surprise you, Mr. Fons, that PIMCO would be so critical of Moody's?

Mr. FONS. No, it doesn't surprise me. I personally met with folks at PIMCO and they are eager to express their opinions about how they think the ratings should be run and how we should be doing our business. So this doesn't surprise me at all.

Ms. WATSON. This e-mail described a similar call from an investor from Vanguard, which is one of the Nation's leading mutual fund companies. According to the e-mail, Vanguard expressed frustration with the rating agency's willingness to allow issuers to get away with murder.

And so again, Mr. Fons, why would Vanguard say credit rating agency allow people to get away with murder?

Mr. FONS. They are addressing the rating shopping issue, the erosion in standards that were obviously clear to them and clear to many others in the market. And the delay by the rating agencies to adjust their methodologies and ratings accordingly.

Ms. WATSON. I want to read three more lines and they are up on the screen. Vanguard reports it feels like there is a big party out there. The agencies are giving issuers every benefit of the doubt. Vanguard said that portfolio managers at Vanguard began to see problems in the work of the rating agencies beginning about 18 months ago. At first, we thought that these problems were isolated events. Then they became isolated trends. Now they are normal trends. And these trends are getting worse and not getting better.

So Mr. Egan, down at the end, what do you make of this e-mail and do you agree that these isolated events turned into worsening trends?

Mr. EGAN. It is not at all surprising. In fact, we argued that the current ratings system is designed for failure and that's exactly what we have.

Ms. WATSON. You know, I want to thank you particularly, Mr. Egan, because you have been one of the clearest speaking people that we have had up here since we have been looking at the collapse of the market. What we need is plain English to try to unscramble these eggs that we find ourselves in and they are rotten eggs at this time. And so I appreciate all the panel being here and I appreciate clear responses that the public out there can understand. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Ms. Watson. Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman. And I also want to thank the witnesses.

I also have the dubious honor of serving on the Financial Services Committee and in our hearing yesterday, I began my remarks by saying I wasn't interested in assigning blame or responsibility. And that I was more interested in hearing about how we might go forward and build a regulatory framework that would actually be reliable and would secure the markets. That was the Financial Services Committee.

This is the Oversight Committee which actually, in my opinion, does have a responsibility to identify those who are responsible and to hope in a way to hold those people accountable. It is a fact that Moody's and Standard & Poor's especially as rating agencies held a position of trust in relation to investors and market participants and over time over the past 75 years or so investors and market participants were induced to rely on the ratings that were produced by those agencies.

It is also a fact that while there were other bad actors in this crisis, none of the others held a special responsibility as being a gatekeeper or to serve as a firewall in the event that this toxicity arrived in order to prevent it from, first of all, being systemic, and in this case, actually going global. But the rating agencies facilitated that by putting triple-A stamps on this, they induced people to rely. They were facilitators of allowing this whole problem to go systemwise and then go global.

And as a result, I have a lot of families in my district and across America who had their live savings wiped out and had their pensions cut in half. Their investments have disappeared. Some have been thrown out of their houses. I have retirees coming out of retirement asking me to find them a job in this economy. There is a human side to this that I think that some of our ratings agencies and financial services do not recognize.

My constituents were not in the position to understand what a binomial expansion was or did not have the ability to scrutinize the different tranches of securities. They just did not have that ability And they were not sophisticated like this. But they know what triple-A meant. They knew what triple-A meant--and what it has meant for the past 75 to 100 years--and they relied on that. And they were induced to rely on that. These securities are so complex. People in America and across the globe knew what triple-A meant because Moody's and Standard & Poor's as agencies were trusted. They were trusted to be accurate and honest. And that was then.

I have a lot of people in my district who feel that they have been defrauded. And they are mad as hell. And they think that in light of what has happened to them, that somebody ought to go to jail. Someone ought to go to jail. And the more I hear in these hearings, the more I read, I am inclined to agree with them. I am inclined to agree.

I just, you know, Mr. Egan, you have been very helpful and I just want to touch on one of the things that is at the root of this and that is this forum shopping or ratings shopping. I want to ask you about the problem of ratings shopping when the investment banks go around and take their mortgage backed securities to various credit agencies to see which one will give them the highest rating. And under the current system, a rating agency gets paid by the issuer as we have talked about here.

Let me show you an example. We have an e-mail that was sent on May 25, 2004, from one of the managing directors at Standard & Poor's to two of the company's top executives. The subject line of this e-mail is "competition with Moody's." It says: We just lost a huge Mazullo RMBS, which is a residential mortgage-backed security deal, to Moody's due to a huge difference in the required credit support level. That is the amount of other mortgages supporting the upper tranche.

Later on, the S&P official explains how Moody's was able to steal away the deal by using a more lenient methodology to evaluate the risk. He says this: "They ignored commingling risk and for the interest rate risk they took a stance that if the interest rate rises they will just downgrade the deal."

Mr. Raiter, you used to work at Standard & Poor's. And were officials at the company concerned about losing rating deals to your competitors?

Mr. RAITER. Well, I believe that might have been a deal that was rated in Tokyo. And in the United States we had, as I believe my statement explains, we had delivered our models out to the street. So there was no real rating shopping in our market share, because they could basically run the pool of mortgages through the model on their own desk and get exactly the same answer that we got.

Mr. LYNCH. Are you saying there is a difference between what you did in the Asian market versus what you did here?

Mr. RAITER. Yes, there was a difference in every market. The U.S. market had its criteria, the Japan had a separate set of criteria, the Spain, England, based on the nature and structure of the market and the securities.

Mr. LYNCH. But this is Moody's stealing accounts from S&P and vice versa. This is competition between the two firms we are talking about here.

Mr. RAITER. Predominantly, yes between the two firms.

Mr. LYNCH. Whether you are stealing work that was in Asia or the United States, it is the competition between the firms. Let me ask Mr. Fons, you were a senior official at Moody's--

Chairman WAXMAN. The gentleman's time has expired. You want to conclude with one last question?

Mr. LYNCH. Sure this will be it. Let me read the rest of the e-mail. After describing the loss to Moody's and the S&P officials say this. This is so significant that it could have been--it could have an impact on future deals. There is no way we can get back this one, but we need to address this now in preparation for future deals. I had a discussion with the team leaders and we think the only way to compete is to have a paradigm shift in thinking, especially with interest rate risk.

It just in my last question would be, Mr. Raiter, what is your views about these e-mails? It seems to say--indicate that credit rating agencies are engaged in a race to the bottom in terms of credit ratings quality. And I'd like to hear your comments on it. And I thank you for your forbearance, Mr. Chairman.

Mr. EGAN. I think we have had ample evidence that ratings shopping is alive and well. And when you couple that with the fact that ratings have been viewed as opinions and therefore there is relatively little downside to inaccurate opinions, you have a condition that has led to the collapse that we are experiencing.

Mr. LYNCH. Thank you, I yield back.

Chairman WAXMAN. Thank you, Mr. Lynch.

Ms. McCollum.

Ms. MCCOLLUM. Thank you, Mr. Chair. Credit rating agencies are viewed as source of information for independent analysis. Investors--and that includes the families in my district who purchase these products--they look for the credit rating agency to speak to the financial conditions, the creditworthiness, so that they can assess their risk or lack of risk.

I want to cite an April 26th, New York Times piece that was called Triple Failure. And I quote from it: Moody's used statistical models to assess CDOs. It relied on historical patterns of default. It assumed the past would remain relevant in an era in which the mortgage industry was metamorphing into a wildly speculative business. In fact, the chief executive of JPMorgan and Chase said, and I quote, "There was a large failure of common sense by the rating agencies."

Mr. Fons, from your testimony, I quote from it, "The focus of Moody's shifted from protecting the investors to being a market driven organization."

So my question for you gentlemen. I want to ask about July 10th, 2007, when Moody's downgraded over 450 mortgage-backed securities and threatened to downgrade over 200 others. The investors were irate because Moody's had previously rated some of these bonds as triple-A, equivalent to Treasury.

So one of the documents that the committee has obtained in Moody's internal e-mail from July 12, 2007, only 2 days after these downgrades, shows how these complaints continued and they rose all the way up to the CEO level.

RPTS HUGILL

DCMN MAYER

Ms. MCCOLLUM. [Continuing.] In this e-mail Moody's officials described a tough phone call with the chief investment officer at Fortis Investments. The Moody official wrote that the Fortis investor requested to speak to someone very senior very quickly. She said she was extremely frustrated and had a few choice words, and here's what she told the Moody official: "If you can't figure out the loss ahead of the fact, what's the use of your ratings? You had legitimized these things," referring to subprime and ABs, that's asset-backed CDO assets," as leading people into dangerous risk.

Quote again, "If the ratings are BS, the only use in ratings is to compare BS relatively to BS.

Mr. Fons, you used to work at Moody's, so my question for you is going to be that's a pretty damning indictment of the entire system, to use the phrase, and I quote her again, to use only ratings "compared BS relatively to BS."

So my question to you, does Fortis have a point?

Mr. FONS. Absolutely. The deterioration in standards was probable. As I said, evidence first arose at least in 2006 that things were slipping, and the analysts or the managers for whatever reason turned a blind eye to this, did not update their models or their thinking and allowed this to go on. And what these investors are most upset about clearly, is the fact that a triple-A was downgraded.

Triple-As had historically been very stable ratings through time. And so there was an implicit compact, if you will, that the triple-A was to be something that was to last at least for several years without losing that rating. And when you see something go from triple-A to a low reading in such a short period of time, clearly that's evidence of a massive mistake somewhere.

So she's venting her frustration.

Ms. MCCOLLUM. So the triple-A is like the gold standard?

Mr. FONS. It is, yeah. It's the brand. That's what Moody's is selling.

Ms. MCCOLLUM. According to the e-mail, a Fortis Investments manager had come to Moody's the year before to discuss their concerns about the company's methodologies. So she's been concerned before. In fact, she told Moody's, quote, that she and "other investors had formed a steering group to try to get the rating agency to listen to the need of the investors."

So, Mr. Egan or Mr. Raiter, what does it say about a system when the investors that--the people these ratings are supposed to be serving, their customers--their customer has to form a steering group just so the credit agencies won't ignore them?

What does that say about the credit agencies?

Mr. RAITER. Well, I just think it's a further indictment that there was a big breakdown between the people that were trying to maximize profits and the people that were trying to maximize the credit ratings methodology and activities, and that the people with the profit motive won.

Ms. MCCOLLUM. Mr. Egan?

Mr. EGAN. I think it is similar to a Yiddish saying, which is that we have to get smart quickly, okay, that we're stupid right now. This system is stupid; we need to make some adjustments. It's not fair and it's not going to be a good use of your time and energy and effort to try to curb the behavior of S&P and Moody's and Fitch.

Why? Because that's the way they're set up. Ratings are opinion; and you're stuck. Accept them for what they are and go around and get another check and balance in this system.

Yes, the investors are upset, but you need to provide a pathway for some other independent voices. We're out there. There are other firms that are out there that are similar to us, but we have a small voice compared to S&P and Moody's. And so we, yeah, we can continue on the current path, have more failures.

The U.S. slips in importance. The financial services industry is one of the most important industries, and we see it fall apart. We can continue along the path or we can take some tangible actions to correct the problems. And I think that would be much more fruitful than beating up on S&P and Moody's for doing what they have an incentive to do, basically, which is to issue the ratings that will satisfy the people who pay 90 percent of their bills, that is, the issuers.

Ms. MCCOLLUM. Thank you, Mr. Chair.

Chairman WAXMAN. Thank you, Ms. McCollum.

We are checking out that Yiddish quote to see if it's accurate.

Mr. Sarbanes.

Mr. SARBANES. Thank you, Mr. Chairman.

It seems like the rating agencies were ignoring risks in two directions. We have talked a lot about one direction in which is they were ignoring the risk inherent, it seems, in these subprime, mortgage-backed securities by not doing the level of due diligence that they should have done; or once they had done it, sort of ignoring the analysis that they performed.

But in the other direction, I gather they were also--they were also enhancing the status of these risky securities based on the fact that the investment banks were going out and purchasing this, quote, "insurance" in the form of the credit default swaps, which were themselves very risky instruments. You had this kind of perverse situation where because the CDS was there, that kind of insurance product, they would take something that was already risky and suggest that somehow the risks have been reduced because you had gone and gotten this insurance product, this CDS product, which we know from our AIG hearings was inherently risky itself.

And I just ask a couple of you to speak very briefly to that side of the equation, as well, in terms of them ignoring this credit.

Mr. FONS. I would like to comment.

First of all, the insurance that the rating agencies looked to, it was typically from a monoline insurer to back the mortgage-backed securities. The credit default swap activity you mentioned was typically used by financial institutions to hedge their exposures to these things. And so it would have been on the financial institutions' ratings side where they would be depending on that; or the institutions were at least, you know, asserting that this protected them to a certain extent.

Mr. SARBANES. But the rating agencies were giving them some credit for that, were they not?

Mr. FONS. Yes. I think they counted that as hedging to a certain extent.

Mr. EGAN. In fact, I'm glad you brought out the monolines. We were on the record probably about 18 months ago, in fact, even earlier than that, in 2003, I think I was quoted in Fortune in saying that MBIA is not a triple-A rated credit.

Triple-A is a special standard. Basically it means that an obligor can pay its obligations come hell or high water. No matter what, they can pay the obligations. And there are relatively few issuers that rise to that high level.

In our opinion, the monolines didn't fit that. Basically we looked at their liabilities and found that they had--was that exposure to--I think it was about $30 billion in collateralized debt obligations. We took a 30 percent haircut on it as $10 billion, and we said, those are just the pipeline losses; and to cover it, to come up to the triple-A, they'd have to raise that to about three times that. So that would have been $30 billion just for one issuer.

We multiply that, too, by seven issuers, and we got to 210, but we backed it down to $200 billion. We issued that statement publicly, I think it was probably about 9 months ago. And a lot of people said we were ridiculous.

But that is the crux, that these are not triple-As, and a lot of people have been making investment decisions and have not taken markdowns, assuming they were true triple-As, but yet we're talking about bailing out these supposedly triple-A-rated firms.

It makes no sense. The sooner we get back to reality, the better off we'll be.

Mr. SARBANES. Thank you.

Let me ask you, Mr. Fons, because this sort of follows up on Mr. Tierney's questions earlier about kind of--what do we do next. In your testimony you talked about wholesale change, right? That's the term you used. And you talk about change in the government in senior management levels. And you don't really buy the notion that the reforms that have been announced so far meet that standard.

I was reading ahead a little bit the testimony of Mr. Sharma, who is coming next, where he talks about 27 new initiatives and other things that have been undertaken to address the breakdown that you've all alluded to: new governance procedures and controls, analytical changes focusing on substantive analysis, changes to information used in the analysis, new ways to communicate.

You basically list out everything, which is what the ranking agencies should have been doing in the first place. I mean, it's not like saying, we've got to come along and change a couple of things. If you read the list, it's basically saying, everything we were supposed to do we weren't doing, and now we are going to start doing it.

Which gets to the question of, you can change procedures, you can change controls, you can change protocols, et cetera, but why should we trust the same people who ignored these warnings to fix the problem in a way that means it's not going to happen going forward?

So I think that's what you're getting at. If you could just speak to that a little more specifically, I'd appreciate it.

Mr. FONS. I think that's exactly what I meant, that you still have the same overall incentives in place, you still have the same structures; and as you said, they should have been doing those things in the first place. These are not reforms; these are just doing business properly and doing them better.

So at the governance level you need the board of directors who are actually acting in shareholders' interest and that interest is preserving the franchise and preserving the reputation of the firm. And I didn't see that happening. They weren't interested in hiring good businessmen and seeing a business run; and as I said, that's why I have advocated wholesale change at those levels.

Mr. SARBANES. Mr. Chairman, my time is up. I would just point out there is going to be huge resistance to that notion because the same people that were part of this are going to want to say, we screwed up, things broke down, but we know how to fix it and everything will be fine going forward.

And we're going to have to look past that.

Chairman WAXMAN. Members of the Sarbanes family have heard that story before. Thank you, Mr. Sarbanes.

Ms. Speier.

Ms. SPEIER. Thank you, Mr. Chairman.

Gentlemen, thank you for your testimony. You have provided us with a definition of corruption that I think is bone chilling. I can't begin to tell you how dismayed I am by what you have told us today.

Mr. Egan, let me start with you. You said that in 2003 you alerted Congress to what was coming down. It sounds like Congress didn't listen to you. You don't have to respond to that, but I want to ask you a question today. What's the next shoe that's going to fall? And maybe we can listen to you this time.

Mr. EGAN. People pay us a lot of money to get that answer. Basically, there's a series. You have a breakdown in all the--you have investment banks that are way undercapitalized right now, investment now--commercial banks that are way undercapitalized. You have the commercial banks that are undercapitalized. You have the money market funds that are in fear of breaking the buck.

So basically anything that isn't propped up by the Fed or the Treasury is going to drop, unfortunately; and what is needed--and it should drop, actually. It should drop until it reaches a point where it's sustainable.

So there's a variety--we tell our clients that there are certain--that the ecosystem, if you will, in funding has broken down, okay? Everybody connected with the mortgage market, you've seen them fall; the mortgage brokers, the mortgage bankers, the investment banks, the commercial banks, they're all in terrible shape.

So if you want to protect your investments, there are certain industries that you want to look at that aren't dependent on that ecosystem and aren't dependent on the consumers that will do all right. So it's basically--and this came up in an interview I had yesterday on Bloomberg Television. It's basically those firms that are either propped up by the Federal Government--and that propping will remain, won't expire after 2009, which is the case of Fannie and Freddie--but are propped up by the Federal Government or are not dependent on the ecosystem or anything directly or indirectly connected to that ecosystem.

Ms. SPEIER. All right. Thank you.

I would like to move to the motivation for much of what you've told us today, which appears to be money. I want to show you how the revenues for these rating--residential mortgage-backed securities and CDOs became a significant part of these rating agencies' bottom line. Let's start with S&P.

As you can see from this chart, S&P increased its share of revenue for rating mortgage-backed securities from 24 percent of U.S. rating revenue in 2002 to as much as 37 percent in 2006.

Let's now show you Fitch. As you can see from this chart, Fitch's revenues for rating these bonds increased steadily, accounting for 35 percent of its U.S. rating revenue in 2004 and 2005 before dropping slightly in 2006.

Now, we have a slightly different chart with Moody's, but it shows the same trend. By 2006, Moody's structural finance position, which rates mortgage-backed securities and CDOs, accounted for more than half of the company's total rating revenue.

So profits have played a huge role in the rating of these exotic instruments; is that not the case? And if you could just each indicate that.

Mr. RAITER. Well, profits were what drove it starting in about 2001 at Standard & Poor's. It was the growth in the market and the growth--profits were running the show. In a nutshell, that was the simple answer. And the business managers that were in charge just wanted to get as much of the renew as they saw like this, growing out in the street, into their coffers.

And the breakdown, in my opinion, was that while we can talk about or you all can consider different ways of fixing the rating agencies' current situation, by and large, the analysts, as we have seen in the e-mails, they were honest, hardworking people. And they were sending messages to the business managers through the MDs, et cetera, and they weren't getting any response.

So there was a big breakdown, and that reputation that was lost shouldn't be totally blamed on the analysts because most of them were trying to do the right thing, but the money became so great that the management lost focus.

In residential mortgages alone, just that piece of the business, from 1995 when I joined the firm to 2005, grew from $16 million a year for S&P to $150-plus million, a tenfold increase. And the market was just being driven--it was being driven by low interest rates, by these new products that were coming out so fast and furious that it took a lot of money to track them and analyze them, and the money wasn't available. So our analysts spent their time just trying to get the ratings out the door and to alert management what was going on, and none of that money was plowed back and reinvested.

And I firmly believe that had we continued to track at the loan level those new products, we would have seen things in 2004-2005 that would have forewarned us.

And when you talk about the way these deals work, you can't lose the fact that triple-A bond has support; just like you should have equity in your house, the support underneath that was established by the rating. With more information about those new products, that support requirement could have gone up significantly and made some of those products uneconomic to originate. But because they weren't tracking the data, they weren't allowing the analysts to collect it and analyze it continuously, those alerts waited until 2007 when everything collapsed.

There were good people in those firms at Moody's and S&P and Fitch that saw what was coming, and they tried to make management aware of it. And money was the overriding concern at the top of the firm.

And the point Mr. Sarbanes made is right on the money. Some of these people are the same ones that brought Enron and WorldCom to us, and now they're going to give us another list of things. And you can go back and check; a lot of things on that list they promised to do after Enron and WorldCom exploded, and they still haven't done it--so the same people still in charge of the hen house.

Chairman WAXMAN. Thank you, Ms. Speier.

Mr. Shays.

Mr. SHAYS. We passed Sarbanes-Oxley in response to WorldCom and Enron. And Oxley was pretty strong. Sarbanes was stronger, because by then WorldCom went under.

The scariest hearing that I have ever had, that rivals this by far, was that when Enron went under, the board of directors didn't direct, the administration didn't manage properly, the employees didn't speak out, the law firms were in cohoots, the rating agencies were just in left field. Every part of the system broke down.

So we passed Sarbanes-Oxley.

What I want to ask, from the three of you, how is it possible when the German company that was looking at VEBA, V-E-B-A, was looking to unite two equals of Enron that they determined that Enron had taken 70 percent of its stuff off the books and that they had about a $2 billion unfunded liability that was not recognized; and still the rating agencies rated this company like it was an extraordinary, well-run company even after that?

I happen to think the rating agencies are useless now. I think they have no brand. I wouldn't trust them if I had money to invest.

So the second part of my question is, tell me how they get their brands back. Tell me why there should just be the so-called "Big Three" when actually, had they done their job, we wouldn't be in this mess?

So walk me through that. Mr. Egan, you can start.

Mr. EGAN. Well, thank you.

First of all, I'd prefer they use an adjective in front of the noun "rating firm" because we are a rating firm, but our behavior, our actions, are significantly different than the issuer compensated--

Mr. SHAYS. I don't want to get into that. I'm sorry; you've had your chance to do that. But frankly I think buyers have had almost as much conflict as sellers, so I'm not as impressed with that point.

Just tell me why the rating agencies failed to identify what happened at Enron, why the whole banking community failed to undersee it. I don't get it.

Mr. EGAN. Well, you know, we're not geniuses. And we got it, okay? Why did we get it? Well, because in Enron's case, the business model failed. Same as in WorldCom's case. Enron's core business was--and they were smart in one way, but they didn't--

Mr. SHAYS. Was that an indication we didn't understand the business model with all these new instruments, that they are like Greek to the rating agencies even?

Mr. EGAN. I think you get rid of the people that did understand it. I think there's an incentive.

In fact, there are some articles. Aaron Lucchetti of the Wall Street Journal documented how some analysts were sounding the alarm, and they didn't maintain market share, and one way or another they were pushed out the door.

Mr. SHAYS. Mr. Raiter?

Mr. RAITER. Well, if the broader question is, how do you think they might go about--

Mr. SHAYS. I want to know first about Enron. I don't get it. I don't understand why none of the rating agencies didn't take a second look when this deal fell apart and the German company said this company has $2 billion of unfunded liabilities.

I don't get it. Why wouldn't that have shown up?

Mr. RAITER. Well, either they weren't digging deep enough or they weren't looking in the right place. I mean, there are, as Mr. Egan has suggested, human beings involved in this.

I don't believe on the S&P side there was fraud. It might have been a little less than diligent in terms of the work they did, but they come back with the fact that it's an opinion--

Mr. SHAYS. Mr. Fons, maybe you can help me with this. I don't get it.

Mr. FONS. I think the mistake was talking to those companies in the first place, instead of sitting down as a disinterested observer and looking at the financials and looking--

Mr. SHAYS. Price Waterhouse did the due diligence for the German company and said, Don't go there. Well, Price Waterhouse did it. The deal fell through, and the rating agencies still rated Enron quite significant.

Mr. FONS. There were a lot of mistakes made in the

Enron situation, and then--

Mr. SHAYS. My last question then is, is it conceivable that the rating agencies just don't understand the market that they are having to evaluate, that they don't understand these instruments? And if that's the case, do they have a moral right not to rate these businesses?

Mr. FONS. I think the overall track record of rating agencies have been, up until this time, pretty good. They have successfully differentiated defaulters from nondefaulters. That's the job of the rating system.

The track record is what allowed the reputation to grow. They built that reputation and milked it for what they could, and started lowering standards. But over time credit analysis is a reputable discipline. It think it's doable. It's just, you know--

Mr. SHAYS. They have no brand, they have no credibility whatsoever. I can't imagine any investor trusting them.

Mr. FONS. It's going to be a while to build that up, I agree.

Chairman WAXMAN. The gentleman's time has expired.

Ms. Norton.

Ms. NORTON. Thank you, Mr. Chairman. I think this hearing is about something that's been on the minds of lots of people in trying to figure out how did this happen, and they go back to the credit rating agencies and the enormous, apparently undeserved, respect they have enjoyed.

I want to ask about a word I have not heard before, "ratings withdrawal," where apparently after a credit agency rates a security, the agency can be terminated if there is a threat to downgrade the security.

Now, look, I'm not making this up. This is true. I want to refer to a few examples.

March 8, New York Times this year reports that the world's largest bond insurance company, MBIA, fired Fitch ratings because Fitch was considering downgrading the company's bonds from triple-A to some lower rating of some kind. According to the Times, all three rating agencies had rated MBIA's bonds but only Fitch was considering a downgrade.

And I'm familiar with that happening in cities and States all the time. One rating agency does one thing and the others don't.

Mr. Egan, you mentioned this specific incident, I believe, in your written testimony. How does it affect an agency's ratings if that agency knows it can be fired anytime it downgrades a bond?

Mr. EGAN. You have to assume that it's considered very carefully. If you're relying on the issuers for compensation, you hate to see that revenue go away.

In our case, we never had MBIA at triple-A. It never rose to that level. I think our current rating is down about single B or thereabouts, which is about nine notches, which is lower than the others. That's a Grand Canyon-type difference. They never fired us--that's MBIA--because they never hired us.

So far as your specific question about firing, yes, it would have a big impact.

Ms. NORTON. It seems--

Mr. FONS. We have policies that we would not withdraw a rating just because somebody said, You're fired. If we believe and we had enough information to rate the thing at Moody's, we would continue to rate it. They couldn't fire us.

They could fire us, they could not pay us, but we could still offer our opinion and express our first amendment right.

Ms. NORTON. But then you would have the situation that Fitch had where apparently it tried to keep a company called Radian, even without the company's cooperation. And don't you have to have the company's cooperation?

Mr. FONS. I don't believe so. I believe it's not helpful.

Ms. NORTON. We have quite a conundrum here, don't we?

Here's another example: Fitch--the company Radian that I was speaking of--downgraded this insurance company from A to A-; and a publication called Business Wire, the day after--that was on September 6, 2007--said that Radian sent a, quote, "formal request that Fitch immediately withdraw all of its ratings on Radian."

Now, are you concerned that this practice, first of all, when you get--is that unusual--just withdraw your ratings?

Mr. EGAN. No, it's not. In fact, sometimes you don't even get hired. It's another manifestation of the rating shopping. Basically, if you're not going to go along with the highest rating possible, there's a good chance you won't be hired initially to do the rating or you will be fired later.

Ms. NORTON. How about take all my ratings off? You have to do that if they ask for it--

Mr. FONS. We have specific policies surrounding the withdrawal of a rating, and we would only do it under certain circumstances.

Ms. NORTON. What kind of circumstances would you do it?

Mr. FONS. One would be, we didn't have enough information to rate something. We would do it there. If the issue had disappeared or the bonds no longer existed, we would withdraw the ratings, for example.

Ms. NORTON. I spoke of a conundrum. Surely there is some way out of this problem which everybody apparently knew about. It's been transparent; everybody knew it happened.

How do you deal with this problem of the issuer not giving you information that you need in order to rate and the circular problem you find yourself in, and all of us who depend upon you, therefore, find ourselves in?

Show me a way out of this problem.

Mr. FONS. If they're issuing public securities, laws are, there are disclosure requirements for companies. That should be sufficient to draw a rating assessment.

Ms. NORTON. How do you enforce that?

Mr. FONS. SEC does that. Isn't that their job?

Ms. NORTON. Has it done that before? Has SEC enforced that, to your knowledge?

Mr. EGAN. I think in the corporate area they have. But the answer here to your question is a little bit more subtle because what happens in the case of MBIA, because that's a current example, it's an important example in the industry because there are so many firms that are relying on MBIA's, Ambac's support for various securities. If they lose that support, they're going to have to mark down those securities.

What happens in the industry is that the issuer will say--in the case of Fitch or in our case, they'll say that rating firm, don't pay attention to their ratings because they don't have the additional information.

We say, Look at our track record; you know we are right. Look at other manifestations of the deterioration of the company's fall. But nonetheless, that's the company's response, that if you want the true rating, go to those that we support that we still, pay which is a little bit odd.

Ms. NORTON. How common is this practice of just saying, Just withdraw the rating? Is it an everyday occurrence?

Chairman WAXMAN. The gentlewoman's time has expired, but I would like to hear an answer.

Mr. FONS. It's unusual.

Mr. EGAN. It happens from time to time.

Ms. NORTON. I'm sorry?

Mr. FONS. It's unusual. It's unusual.

Ms. NORTON. Thank you very much.

Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Ms. Norton.

Mr. Davis.

Mr. DAVIS OF VIRGINIA. Mr. Chairman, I just have one more question. In Mr. Raiter's written testimony he states the foundation of the rating analysis is the data relied on for determining credit enhancement levels.

Rating agencies don't perform due diligence on the data; am I right? They just rely on representations and warranties that come from the issuer that the data submitted is indeed accurate; is that--

Mr. RAITER. That is--the structured side of the transaction is reading the documents and relying on the information provided, and we do not do due diligence. Our lawyers have said that is an SEC-defined term, and it's the issuers that are required to do the diligence on their filings.

So we relied on reps and warranties, the guaranties.

Mr. DAVIS OF VIRGINIA. That leads to my question. I just wanted to make sure I was right in my understanding.

Now, the rating can only be as good then as the data that's put into the models?

Mr. RAITER. Correct.

Mr. DAVIS OF VIRGINIA. But there is no independent verification that the data is accurate?

Mr. RAITER. No independent verification of the tapes, that's correct.

Mr. DAVIS OF VIRGINIA. All right.

From the loan originators and the borrowers who might have fudged home buyers' creditworthiness, employment history, to the issuers who package these mortgages and want to get the highest possible rating, it looks to me like there were a lot of places along the line where the data that ultimately makes it to the rating agencies could be made unreliable.

Mr. RAITER. That it could have been made more reliable?

Mr. DAVIS OF VIRGINIA. That it could have been made more unreliable just as it passes--

Mr. RAITER. Right.

Mr. DAVIS OF VIRGINIA. Okay.

Now, if it's not the rating agency's job to ensure the accuracy of the data it's using to rate these securities, whose job is it?

Mr. RAITER. That's correct. We determined that it was better to put the onus on the issuer as we required, as I spelled out in reps and warranties.

Mr. DAVIS OF VIRGINIA. Let me ask this: Was there a computer model that could evaluate the risks and the values if you had all of the correct info through these documents? I understand that a single prospectus for a mortgage-backed security I have looked at, they run 2,000, 3,000, 4,000 pages sometimes.

Mr. RAITER. I haven't seen one quite that large, but they are multiple hundreds of pages, and if they give you the detail on the tapes, they could run to quite an extensive length.

Mr. DAVIS OF VIRGINIA. Is there a computer model--given if you've got all the information in that, and there probably were some inaccuracies, but if you had all of that that you could have given an appropriate evaluation?

Mr. RAITER. The model would give an appropriate evaluation on the collateral, what the enhancement requirement was, how much insurance you need to put under the triple-A bond. They were calculating the default expectations for each of the mortgages and what the loss would be if the mortgage defaulted; that was the model on the data side.

The structure side of the transaction was then looking at the documents to make sure that the investors were being protected in the servicing of the loans, in the pass-through of the payments, part and parcel.

And someone asked what the next shoe might be to drop. This could be another shoe that hasn't hit yet. That was the reps and warranties that were put on the data. As these loans are going bad and the bonds have been downgraded, there are people that are going through each one of those in foreclosure; and if they find out that the appraisal was inflated or that any other information that was supplied to the rating agency was incorrect or inaccurate or just fraudulent, they have the right to put it back to the issuer.

And what we're faced with today is, a number of the institutions that have received government bailouts or have been in fact merged out of existence--Lehman, WAMU, Bear Stearns, Countrywide and IndyMac--they were all providers of huge rep and warranty guarantees; that if those loans start getting identified as having appraisal problems and put back, the question is whether the people that bailed those organizations out are going to make good on those reps and warranties, or are they going to go by the board and they just won't have any value?

Mr. DAVIS OF VIRGINIA. You anticipated where I was going.

Any comments on that, Mr. Egan or Mr.--

Mr. FONS. I think that the assumption here is that the models were right, even with the right data, and in any opinion there wasn't a strong history, first of all, with the subprime mortgage market. We didn't really know how these things--there was no good model in existence.

Mr. DAVIS OF VIRGINIA. So we don't know for sure if the model holds up, because it wasn't really utilized as much?

Mr. FONS. It hadn't been tested thoroughly, I'd say, through experience.

Mr. DAVIS OF VIRGINIA. But, you know, you could--as we go through this from here on out, you can test it and maybe refine it a little more.

Mr. FONS. Well, I think this will be a great test case for future securitizations, pointing to this episode, absolutely.

Mr. EGAN. There's been a breakdown. If you look at the old model that worked, and that is where there was the local banker who was going to hold the paper and look at it, why would that local banker make sure that the property--do some spot checks.

Let's say they were going to fund 100 mortgages. Well, you don't have to check every single one, but maybe a handful, to make sure that the properties were appraised properly. Check some of the documentation that is documented. Make sure that the mortgagees can pay--the obligors can pay their obligations. And that hasn't happened.

What has happened in the market is, because of the dominance of the major rating firms, they've constricted what they view as their job, which might serve their interests very well, but has not served the public's interests very well.

In fact, there's been a breakdown because the assumption is that if it's a triple-A, it really is a triple-A, that you've done what is necessary to ascertain that everything can be done properly. And that's not the case.

So if you go back to--and you can't micromanage it and say, Well, in this transaction do this, in the other transaction do that. That's a waste of time. What you want to do is make sure there are some agents in there that are protecting the ultimate investors. That's the key here.

Mr. DAVIS OF VIRGINIA. Thank you.

Chairman WAXMAN. Just to follow up on that point: But if the people doing the rating realized that there was no money being put in by the purchaser of the home because they were borrowing the down payment, as well as the rest of the loan, one would have assumed that they might have concluded that there's more likely to be a default, wouldn't they?

Mr. EGAN. Absolutely. And just rate it as such. That's all.

It's like the 90-year-old man that I gave as an insurance company. It's fine that there are certain segments of the population that maybe because the houses are appreciated, you know they're going to appreciate. Maybe there is a big plant going in that area and there is a bargain deal that the builder--it's fine that you actually rate those. But make sure you rate it properly. Make sure again that there is an alignment.

In fact, right now, there is a lot of opportunity to be made in the mortgage area. You don't have money flowing in there because people have seen the ratings slam down. So now when, let's say, they're being priced at about 40 cents on the dollar, you could see half the portfolio disappear and you could still make your money back.

People, institutions aren't putting money into it because, again, the ratings aren't high enough. They're BB. So we will go to investors and say, Listen, at a new money basis, it should be rated higher than what it is.

There's some interest, but the ratings are so key in this whole process. You have to fix that problem.

Chairman WAXMAN. I thank the three of you very much. Ratings are key, and they are relied on by investors. And when they see a triple-A rating, investors assume this is a good investment, even though there is no liability, if they just made up an opinion without having the facts to substantiate that opinion. And that's one of the reasons we are in the situation we are in today and why we have had this hearing.

So I thank the three of you for your presentation, and we are going to now move on to the next panel.

But before we move on to the next panel, I would like to make a clarification for the record. In my opening statement, I referenced an e-mail referenced by a Moody's employee made Christopher Mahoney. It has now come to our attention that although Mr. Mahoney was the author of the e-mail, he was forwarding the opinion of somebody outside of the company.

So I do want that to be clarified. We will be glad to give you that information.

We now move on to our second panel, and while we are making this transition, why don't we have a 5-minute recess, if that's okay. Those who are leaving will leave and those who are coming in will come in. So we will have a 5-minute recess.

[Recess.]

Chairman WAXMAN. The meeting of the committee will please come back to order.

For the questioning on Panel 2--without objection, questioning for Panel 2 will proceed as follows: The majority and minority will each begin with a 12-minute block of time with the chairman and ranking member each having the right to reserve time from this block for later use. And without objection, that will be the order.

We are pleased to welcome to our hearing for this panel Deven Sharma, who is the President of Standard & Poor's; Raymond W. McDaniel, who is Chairman and Chief Executive Officer of Moody's Corporation; and Stephen Joynt, who is President and Chief Executive Officer of Fitch Ratings. We're pleased to have you here today.

STATEMENT OF DEVEN SHARMA, PRESIDENT, STANDARD & POOR'S; RAYMOND W. McDANIEL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, MOODY'S CORPORATION; AND STEPHEN W. JOYNT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FITCH, INC.

Chairman WAXMAN. It's the practice of this committee that all witnesses who testify before us do so under oath, so I would like to ask you to please stand and raise your right hand.

[Witnesses sworn.]

Chairman WAXMAN. The record will indicate that each of the witnesses answered in the affirmative.

Mr. Joynt, why don't we start with you?

I might indicate to each of you that your prepared statement will be in the record in its entirety. What we will request, and we are not going to be very strict on this, but we request that you observe the clock that we will give you 4 minutes green, then 1 minute orange; and then after 5 minutes, it turns red, and we'd like to have you at the end of that time see if you can conclude your testimony.

STATEMENT OF STEPHEN W. JOYNT

Mr. JOYNT. Thank you very much.

Since the summer of 2007, the global debt and equity markets have experienced unprecedented levels of stress and volatility. The underlying factors contributing to the credit crisis have been many, namely, historically low interest rates, greater global demand for relatively riskier and higher yielding assets, lax underwriting standards in the mortgage origination markets, inadequate discipline in the securitization process, insufficient risk management practices at financial institutions, an outmoded global regulatory framework, and credit ratings in RMBS and CDOs backed by RMBS that have not proven as resilient as originally intended.

As I noted in my testimony before the Senate Banking Committee in April, the crisis began with severe asset quality deterioration in the U.S. subprime mortgage market and related RMBS and CDO securities that caused large market price declines because ultimate credit losses will be far greater than anyone had anticipated.

Today's market stresses, however, have become more broad based--by asset, institution, and geography--and emanate from a global reassessment of the degree of leverage and the appropriateness of short-term financing techniques inherent in today's regulated and unregulated financial companies. Deleveraging is dramatically reducing liquidity and contributing to price volatility, both for individual securities and for the institutions that own them or ensure them.

With the benefit of hindsight, it is clear that many of our structured finance rating opinions have not performed well and have been too volatile. We have downgraded large numbers of structured finance securities, particularly in the subprime mortgage and CDO areas, and in many cases by multiple rating notches. Why is this happening?

While we were aware of and accounted for in our models and analysis many risks posed by subprime mortgages and the rapidly changing underwriting environment in the U.S. housing market, we did not foresee the magnitude or the velocity or the decline in the U.S. housing market nor the dramatic shift in borrower behavior brought on by changing practices in the market, nor did we appreciate the extent of shoddy mortgage origination practices and fraud in the 2005 and 2007 period.

These dynamics were magnified in the CDO market. Structured securities are specifically designed for lower-rated, riskier and therefore higher-yielding bonds to absorb losses first. However, radically and rapidly changing markets have led to dramatic rating changes that have affected even highly rated bonds. As we now have learned, building complex highly tranched securities on historical default probabilities does not always provide enough cushion for extraordinarily variable performance.

We need to reemphasize the art, learned through experience, to complement the science of quantitative analysis. Reflecting the crisis still unfolding, we began in 2007 to build significantly more conservatism into our analytical approach as we reassess past ratings or consider rating any new securities.

Problems in the subprime mortgage and CDO assets represent a major portion of asset losses and breakdowns. They are one of the original catalysts for today's financial crisis, but that is not a complete picture. Derivative exposures relating to these assets, but also other assets, have created major stress. Balance sheet leverage is too high for the volatility we are experiencing, and the ongoing deleveraging process is dramatically pressuring markets and prices.

Further, the leverage of synthetic exposures, that normally is not transparent, has become painfully transparent as counterparties lose confidence in each other and require physical collateral to protect synthetic positions.

It has been difficult to find balance in assigning ratings to major global financial institutions during this current financial crisis. While the public ratings reflect the fundamental analysis of each company, they do not and have not anticipated completely illiquid markets. In fact, our ratings reflect the expectation that in crisis environments regulators and governments will support major banks and financial systems. With that in mind, we have continued through recent months to maintain high ratings, mostly AA category, on the majority of the top 25 largest global financial companies, despite market stresses from capital raising, liquidity and profitability, anticipating government support that has been largely forthcoming.

Having mentioned some limitations of rating at this point, I feel I should note, however, that Fitch has and continues to produce much high-quality research and ratings of value to many investors in many market segments.

I recognize the purpose of today's hearing is to focus on the crisis and the problems and, hopefully, forward moving solutions. So with that in mind, how is Fitch functioning in the market today?

We have reviewed our original ratings on entire vintages of subprime and CDO securities, and now find that many were too high. Our continuous goal has been to undertake new analysis that provides investors with our latest opinion about the risks of these securities, even though the result in many cases has been significant downgrades.

We have paid special attention to modulate our communication to the importance of our rating decisions. In calmer times, small changes in credit ratings are notable for investors. In today's crisis environment, I have directed our teams to identify important and critical changes in credit quality and immediately bring those forward to the market.

Minor changes in quality need to be communicated with balance and proper perspective. Rating changes should not be continuously contributing noise to the crisis, but instead be simple, clarifying gradations of risk or credit strength.

Returning to problem mortgage and CDO securities, ratings were designed to identify the relative probability of full repayment of these securities. Today, we expect many junior securities may have significant or total losses. The variance in projected repayment and the related valuation of highly rated securities, triple-A, is a critical market problematic. Some may have sizable losses, but many large-balance, triple-A securities may receive full payment or experience relatively small percentage losses.

We are shifting our analytical resources in modeling to provide information to investors and other interested parties such as the Federal Reserve and the U.S. Treasury to support greater transparency and price discovery to help finally define and stabilize these asset valuations. To win back investor confidence, our ratings opinions must be more predictive and our research and analysis must be more insightful and forward looking. We remain committed to the highest standards of integrity and objectivity.

I'd like to add one thing to my prepared opening remarks. Having listened this morning to the panels, I accept that our ratings did not project, as I have described, the full risk in many mortgage-backed and CDO securities. But regarding the question of intent that also this committee is discussing, I would like the committee to consider Fitch on the merits of how we've performed as a company rather than on the many colorful things that we have seen this morning from e-mails and others.

I believe that we have operated with very strong intent. I personally have operated with very good integrity, and I believe our culture has supported the effort to operate with good intent and good integrity, both; and I'm happy to describe during the questions and answers information that would, in my opinion, would support that conclusion.

Thank you.

Chairman WAXMAN. Thank you, Mr. Joynt.

[prepared statement of Mr. Joynt follows:]

******** INSERT 3-1 ********

Chairman WAXMAN. Mr. McDaniel.

STATEMENT OF RAYMOND W. McDANIEL

Mr. MCDANIEL. Good morning, Chairman Waxman, Congressman Davis, and members of the committee. I'm Ray McDaniel, Chairman and Chief Executive Officer of Moody's Corporation, parent of Moody's Investor Service.

Moody's is the oldest bond rating agency in the world, having issued its first ratings in 1909. Our company was founded on the great American traditions that encourage and protect the marketplace of ideas. Today, Moody's has 20 offices around the world and employs almost 2,500 people worldwide, including approximately 1,500 people in the United States.

On behalf of all my colleagues at Moody's, I thank the committee for the opportunity to participate in today's hearing.

Over the past several weeks, we have witnessed events that have sent shock waves around the world and undermined confidence in the capital markets. American families are directly affected by this loss of confidence. Many have lost jobs, homes or retirement savings, and they are suffering.

The problems being faced by the financial markets extend well beyond housing, and have exposed vulnerabilities in the overall infrastructure of the world's financial system. These weaknesses include exceptional leverage, loss of liquidity in periods of stress, the rapid changes of asset valuations and capital needs, insufficient risk management practices, interlinked market participants and limited transparency. We believe it is important to consider all of these issues as new regulatory structures for the financial markets are developed.

With respect to the rating agencies, many have asked what happened in the rating process that led to large downgrades in the subprime market. As is now well understood, the deterioration of the U.S. housing market began with the loosening of underwriting standards for subprime mortgages.

Moody's did observe the trend of weakening conditions. Beginning in 2003, we published warnings about the increased risks we saw and took action to adjust our assumptions for the portions of the residential mortgage-backed securities market that we were asked to rate. We did not, however, anticipate the magnitude and speed of deterioration in mortgage quality or the suddenness of the transition to restrictive lending.

We were not alone, but I believe that Moody's should be at the leading edge for predictive opinions about future credit risks, and we have learned important lessons during these fast-changing market conditions. Indeed, I believe that we now all need to consider how to improve the U.S. mortgage origination and securitization process. For our part, we have made specific changes in our processes, including, among others, seeking stronger assurances from the issuers and better third-party review of underlying assets.

Beyond the housing market, Moody's believes that the critical examination of our industry and the broader market is a healthy process that can encourage best practices and support the integrity of the products and services our industry provides.

Rating agencies occupy an important but narrow niche in the information industry. Our role is to disseminate opinions about the relative creditworthiness of bonds and other debt instruments. At Moody's, our success depends in large part on our reputation for issuing objective and predictive ratings, and the performance of our ratings is demonstrated over many credit cycles on the hundreds of thousands of securities we have rated. At the heart of our service is our long-term credit rating system that rank-orders the relative credit risk of securities.

In the most basic sense all bonds perform in one of two ways: They either pay on time or they default. If the future could be known with certainty, we would need only two ratings, "default" or "won't default." Because the future cannot be known with certainty, we express our opinions on the likelihood of default on a 21-step rating scale ranging from triple-A to C.

One common misperception is that Moody's credit ratings are statements of fact or solely the output of mathematical models. This is not the case. The process is, importantly, subjective in nature and involves the exercise of independent judgment by the participating analysts.

Although rating criteria will necessarily differ from one sector to another, we use essentially the same rating process in all sectors. The rating process begins with rigorous analysis by an assigned analyst of the issuer or obligation to be rated, followed by the convening of a rating committee meeting where the committee members discuss, debate, and finally vote on the rating. Once the rating committee has made a decision, the rating is published and subsequently monitored and adjusted as needed.

Importantly, the rating reflects Moody's opinion and not an individual analyst's opinion of the relative creditworthiness of the issuer or obligation.

In conclusion, we believe in this process, but continually strive to do better. For example, as described more fully in my written statement, we're refining our rating methodologies, increasing the transparency of our analysis and adopting new measures to reinforce and enhance existing processes and policies that address potential conflicts of interest.

The Securities and Exchange Commission recently concluded its own extensive examination of the industry and provided us with specific tasks to enhance our services, which we are in the process of implementing.

We know that there has been a loss of confidence in our industry. Moody's is committed to working with Congress, with regulators and with those affected by the markets to do our part in restoring confidence in our industry and in the broader financial system.

Thank you, and I will be happy to respond to questions.

Chairman WAXMAN. Thank you very much, Mr. McDaniel.

[Prepared statement of Mr. McDaniel follows:]

******** INSERT 3-2 ********

Chairman WAXMAN. Mr. Sharma.

STATEMENT OF DEVEN SHARMA

Mr. SHARMA. Mr. Chairman, Mr. Ranking Member, members of the committee, good afternoon.

We at Standard & Poor's appreciate the severity of the current disruption in the capital markets and its effect on the economy and American families. As events continue to unfold, the role played by leverage, liquidity, underwriting, accounting policies and other factors is becoming clearer.

Let me state up front that we recognize that many of the forecasts we use in our ratings analysis of certain structured financed securities have not borne up. We have reflected on the significance of this and are committed to doing our part to enhance transparency and confidence in the markets.

For decades, S&P's ratings have been and we believe will continue to be an important tool for investors, but it is important to recognize and appreciate how they should be used. S&P's ratings express our opinion about the ability of companies to repay their debt obligations, but they do not speak to the market value for the security, the volatility of its price, or its suitability as an investment.

At Standard & Poor's we employ a number of measures that promotes independent and analytical rigor. I have described several of these measures in greater detail in my written testimony.

Studies on rating trends and performance have repeatedly confirmed that Standard & Poor's ratings have been highly valuable in informing the markets about both the deterioration and improvement in credit quality. That legacy, which is a most valuable asset, has been challenged by recent events.

It is, by now, clear that the mortgage performance has suffered more severely than we had estimated in relation to stresses in the housing market. However, our estimates and the ratings based on them were the result of a robust analysis of the transactions themselves, our monitoring of markets, our experience in rating these types of securities and the stress test based on the historical data including market events going back 75 years to the Great Depression. While we performed analysis in good faith, events have shown that the historical data we used in our analysis significantly underestimated the severity of what subsequently occurred.

Having said that, it is important to put this issue in context. While negative performance no doubt has been significant, 1.7 percent of the U.S. Structured financial securities we rated in the worst performing period, 2005 through the third quarter of 2007, have actually defaulted and about a third have been downgraded.

RPTS BINGHAM

DCMN ROSEN

[1:00 p.m.]

Mr. SHARMA. We constantly learn from our experience and we are actively taking steps to improve our ratings process. We announced a series of initiatives earlier this year, which I have outlined in my written testimony speaking to the new governance procedures and analytical improvements, data quality and transferency enhancements to the market and education about ratings.

Recent attention to our ratings has lead to questions about potential conflicts of interest in the issuer pays business model. Of course the receipt of money from any party, whether an insurer or an investor, raises the possibility of potential conflict. At Standard & Poor's, we have measures to protect against conflicts and are implementing even still more. Indeed the evidence speaks to S&P's independence. For example, from '94 to 2006, upgrades of our U.S. RMBS ratings outpaced downgrades by a ratio of approximately 7 to 1. Evex critics gain, we are issuing inflated ratings as a result of the conflicts. One would expect year after year to see more downgrades than upgrades, as ratings are revised in light of actual performance. In addition, the issuer pays model promotes transparency as it allows us to disseminate our ratings for free in real-time to the public at large.

One final point, we are taking steps to maintain and strengthen our long tradition of professionalism. On that note, certain e-mails cited in the SEC's recent examination report are attributable to Standard & Poor's. Unfortunate and inappropriate languages used in some of these e-mails does not reflect the core values at S&P and we are redoubling our emphasis on the importance of professional conduct.

In addition, during its recent comprehensive examination, SEC staff found no evidence that we had compromised our criteria or analytics to win business.

In closing, let me say that restoring confidence in the credit markets will require a systemic effort. S&P is one part of the equation. We are committed to working together with the other market participants, Congress and policy makers to restore stability in the global capital markets.

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

[Prepared statement of Mr. Sharma follows:]

******** INSERT 4-1 ********

Chairman WAXMAN. Thank you, Mr. Sharma. I'm going to start questions myself.

Gentlemen, you're giving us assurance that while mistakes were made, you are correcting the problem, that there are a few problems in your industry, but your ratings are honest, your methods transparent and your internal controls appropriate. That is what I'm hearing from the three of you. And it's really not anything new. Because, Mr. McDaniel, in 2003 you said, rating actions will reflect judicious considerations of all circumstances and that the system is not broken. In 2005 you said, "we believe we have successfully managed the conflicts of interest and have provided objective, independent and unbiased credit opinions."

These are the things that we are hearing from you in public over the years. But Mr. McDaniel, behind closed doors you were apparently more candid because on September 10, 2007, you had a private meeting with your managing directors. You called it a town hall meeting. And you said the purpose was to speak as candidly as possible about what is going on in the subprime market and our own business. And you told the gathering of senior executives that there are a number of messages that we just frankly didn't want to write down. But a transcript was kept of that hearing, of that meeting, and we have obtained a copy of it. And this transcript has never been made public before. According to this transcript, this is what you told your managing directors and why, about why so many mistakes were made rating mortgage-backed securities. "Now, it was a slippery slope, what happened in '04 and '05 with respect to subordinated tranches is that our competition, Fitch and S&P, went nuts. Everything was investment grade. It didn't really matter. We tried to alert the market. We said we're not rating it. This stuff isn't investment grade. No one cared because the machine just kept going."

Mr. McDaniel, what did you mean when you said that Fitch and S&P went nuts and started rating everything as investment grade?

Mr. MCDANIEL. I was responding to a question that was raised in the town hall meeting, and I don't recall whether I was repeating a phrase from a question or whether this was independent commentary that I made. But what I was discussing more generally was in our opinion, the need during this period to be raising credit enhancement levels or credit protection levels which we did. And to the extent that that made the credit protection levels higher for certain instruments, it meant that we might not be rating those instruments, and in fact, that was part of the story during that period.

Chairman WAXMAN. You were saying your competitors were going nuts and rating everything. You said that the entire credit rating industry was on a slippery slope and went nuts when it started to rate everything investment grade. Maybe I should hear from Mr. Joynt and Mr. Sharma, this is what apparently he was saying about you behind closed doors. Is it accurate? Mr. Sharma.

Mr. SHARMA. Mr. Chairman, there are many instances we have chosen not to rate when either we have believed we do not have enough information from the issuer or it doesn't meet our criteria appropriately. So there have been many examples and instances and we will be happy to provide that.

Chairman WAXMAN. So you don't agree with his assessment?

Mr. SHARMA. We have continued to sort of, as I said, there are many instances not rated things, and as I said, there are things--

Chairman WAXMAN. Sometimes you didn't rate. Sometimes you didn't give a rating. Therefore, if you gave ratings inappropriately in other cases, we should take that into consideration.

Mr. SHARMA. Mr. Chairman, we also make all our criteria public. It is available to the investor. It is available to the issuers and public at large for them to look at how we rate--

Chairman WAXMAN. Let me get back to the essential issue here, because Mr. McDaniel solicited feedback from the company's top managers about that meeting, and I want to read what one of the managers said. It's a long quote. "We heard two answers yesterday. One, people lied, and two, there was an unprecedented sequence of events in the mortgage markets. As for one, it seems to me that we had blinders on and never questioned the information we were given, specifically why would a rational borrower with full information sign up for a floating rate loan that they couldn't possibly repay and why would an ethical and responsible lender offer such a loan? As for two, it is our job to think of the worst-case scenarios and model them, after all, most economic events are cyclical and bubbles inevitably burst, combined these errors make us look either incompetent at credit analysis or like we sold our soul to the devil for revenue or a little bit of both."

Mr. McDaniel, one of your top managers said Moody's was either incompetent or sold its soul to the devil. It's a serious charge. How do you respond?

Mr. MCDANIEL. I think the manager was referring to what the perception could be based on the stress that assets that had been rated in the mortgage-backed securities area were undergoing. With respect to the comment they lied, I was not referring to anyone at Moody's, or, in fact, anyone in the industry. I was referring to media reports about the deterioration in the veracity of information that was flowing through the mortgage origination process.

Chairman WAXMAN. In other words, people were claiming they could pay back the loan but they couldn't.

Mr. MCDANIEL. Yes.

Chairman WAXMAN. But that shouldn't be hard to figure out when you have loans that are being given that amount to 100 percent and no equity in the hands of the borrower.

Mr. MCDANIEL. Well, one of the--

Chairman WAXMAN. Wouldn't that be a more likely situation for a default?

Mr. MCDANIEL. Certainly to the extent that there is more leverage. In a mortgage or in the purchase of a home, there is a greater risk of default.

Chairman WAXMAN. So people are lying, or that in effect, or you weren't modeling for the worst-case scenarios. I'm trying to reconcile what you have said publicly on a number of occasions, including today, and what you said in a private meeting and it seems to me you are saying totally different things in public than you're saying in private. In public, you assure us that your industry meets the highest standards but in private, you're telling insiders that conditions in your industry could lead to a financial crisis.

Mr. MCDANIEL. I am saying both internally at Moody's and externally to the public, very consistently, that we seek to maintain the highest levels of objectivity, independence, and professionalism in assigning our ratings and I say that to both groups.

Chairman WAXMAN. I know that is what you're saying here, but it's hard to reconcile the transcript of that meeting. My time has expired and I want to recognize Mr. Davis.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Chairman. You know, the credit rating agencies have long maintained a fiction that their ratings are consist across all asset categories but according to the data published by Moody's in July 2007, we learn that not all credit ratings are not created equal. Moody's apparently found that BAA-rated corporate bonds, which is the lowest investment grade Moody's rating, defaulted in an average 5-year rate of 2 percent, but CDOs with the exact same BAA rating suffered from an average 5-year default rating of 24 percent. How do you explain giving the same rating grades to such wildly different kinds of debt?

Mr. MCDANIEL. That was research we conducted in order to evaluate, just as you cite, the consistency of our ratings. I think it is important that we do so. That is exactly the kind of research work and self-assessment that we should conduct for our firm. And there were findings that there were higher default rates at the low investment grade level in one sector versus another sector.

Mr. DAVIS OF VIRGINIA. Twelve times higher in this case.

Mr. MCDANIEL. For the period of time, that was being assessed, that's correct. For other periods of time, we have found that 12 times number, in fact, fell dramatically. And so part of what we were considering was whether there were issues about the point in time in the credit cycle or with respect to certain types of assets that were receiving those ratings that needed to be considered further.

Mr. DAVIS OF VIRGINIA. Mr. Sharma, let me ask you, Chris Cox, who is the chairman of the SEC and a former colleague of ours, will be before the committee tomorrow and he is going to testify that the credit rating agencies sometimes help to design structured mortgage-backed securities so that they could quality qualify for higher ratings. Now, you testified that Standard & Poor's doesn't do this. How would you respond to Chairman Cox if he were here? And I would like the rest of the panel to respond as well.

Mr. SHARMA. Mr. Ranking Member, I can only respond for us. We have very stringent policies and practices that our analysts will not advise any firm on structuring of deals. Though there are instances where when we look at the rating and our procedure and process where people are bringing their analysis to us and we are opine on that whether we it meets our criteria or not. That is the only thing we do is to opine on whether they meet our criteria or not. Nothing more.

Mr. MCDANIEL. We do have interaction with issuers and with investors around the credit implications our potential credit implications of securities which they are contemplating issuing into the market. Those discussions should relate solely to credit. And it is in the interests of one, understanding the information that is being delivered to us to make sure that we reduce the likelihood of misanalysis of that information and two, communicating back to those parties, information that we think may have credit implications for the securities under consideration. So that is the nature of the interaction.

Mr. JOYNT. The regular dialogue between analysts and anyone working on issuer or a banker on putting together of financing is there an iterative process that is, I think, unavoidable, so for our employees to suggest that they become involved in consulting and trying to design securities that is not part of our approach. That is not part of our business. It's not their job. So restrict them from any interaction of course is not also constructive, and so I would say it's a back-and-forth kind of iterative process. But our analyst interaction isn't designed to create securities or to create the highest ratings.

Mr. DAVIS OF VIRGINIA. When Congress passed the Credit Rating Agency Reform Act, we included language that prohibited notching as an anti competitive practice. And as I understand it, notching refers to when one credit rating agency reduces its rating for a particular structured financial asset that incorporates components like subprime mortgage-backed securities that it hadn't previously rated. Some have asserted that notching is a valid technique used by some credit rating agencies to protect their reputations and provide more accurate ratings, but others say it represents an anti competitive practice. I ask each of you, is notching an anti competitive practice and should Congress have gotten involved in this issue and what impact does the prohibition of notching have on the ratings of subprime mortgage-backed CDOs and other risky structured financial products.

Mr. JOYNT. So if I could address that first, because I think Fitch was involved in suggesting that notching could be an anti competitive practice and put that proposition forward, so today I would suggest, as I did in my testimony, that we've moved way beyond that question. In fact, notching, as referenced then, referred to the creation of securities that now we're discovering the ratings are changing by whole categories not by notches.

So the fact that reliance on ratings generally and their default probabilities specifically for some of the structured securities since they have changed so dramatically as you pointed out is a relatively small issue, not an important one. The more important one, I think for rating agencies, is to reflect on what is a steady state expectation for these securities that we're now rating and have rated in the past and that we're trying to change the ratings to make them more active on, I would say, that is our more important mission.

Mr. DAVIS OF VIRGINIA. Mr. McDaniel, do you have anything to say?

Mr. MCDANIEL. I believe it is a party of matter of intent. I think there are valid credit analytical reasons to notch in some cases and there may not be in other cases.

Mr. SHARMA. I think ultimately, it is the responsibility of the rating company on what rating they're given, what the quality is, so I think the responsibility is to make sure they're comfortable in assuming or making assumptions and that is why there are valid reasons to continue notching.

Mr. DAVIS OF VIRGINIA. Was the congressional intervention in this appropriate or not?

Mr. SHARMA. It's brought into the analytical process, and ultimately, it's the rating company that is responsible for the ultimate rating, but independence has to be allowed for the rating company.

Mrs. MALONEY. [presiding.] Thank you. I would like to welcome all of the panelists.

Mr. McDaniel, in 2002, the Senate government affairs committee recommended that the SEC begin regulating credit rating agencies. In 2003, the SEC agreed and issued what they called a concept release that would have addressed conflicts of interest at credit rating agencies. On July 30th, rather, July 28th of 2003, you sent the SEC a letter opposing this regulation. In your letter, you claim that Moody's had dealt with this conflict of interest. And I will read to you exactly what you said. You said, and I quote, "the level of ratings are not affected by a commercial relationship with an issuer." Do you remember sending this letter?

Mr. MCDANIEL. I do remember sending the letter. I don't remember the sentence, but yes, I remember sending the letter.

Mrs. MALONEY. In the letter, you made a very strong case that you had vigorous protections in place to prevent your ratings from being affected by your profits, and as a result of your categorical strong assertions, no regulations were adopted. My problem is that on October 23, 2007, you gave a presentation to your board of directors, which said absolutely the exact opposite of what you said publicly and to the SEC. And the committee has obtained a copy of that document. And in that, you described what you called, and I quote, a very tough problem. And under the heading conflict of interest, market share, you said, the document says, "The real problem is not that the market underweights ratings quality, but rather that in some sectors, it actually penalizes quality. It turns out that ratings quality has surprisingly few friends. Issuers want high ratings. Investors want ratings downgrades. Short sighted bankers want to gain the ratings of the rating agencies. And you described in this document some of the steps that Moody's has taken to square the circle." But then you said this, and I quote, "this does not solve the problem."

So would you like to comment on what you said in this document, and you also said that keeping market share while maintaining high quality, was an unsolved problem. Does this internal presentation to your board contradict years of public statements to the public and to the SEC by you and other Moody's officials? In public, you said conflicts of interest could be managed. But in private, you said your internal procedures had not solved the problem.

And let me read you another passage. You also wrote this. And I quote. "Unchecked competition on this basis can place the entire financial system at risk." To me, this is an astonishing, amazing statement. Especially in light of what is occurring in the markets now and the pain and suffering of Americans and our economy, what exactly did you mean when you said competition on this basis can place the entire financial system at risk? And how can you sleep at night knowing that these risky products that you were giving triple-A ratings could put the entire financial system at risk?

Mr. MCDANIEL. First of all, I should restate the public comments that I have made previously, which is that our ratings are not influenced by commercial considerations. Our ratings are the basis of our best opinion based on the available information at the time.

Mrs. MALONEY. But that is not what you said to your board members. That is not what you said in this document.

Mr. MCDANIEL. It's not inconsistent with what I said to my board members. What I said to the board is that it creates a problem that to maintain the appropriate standards creates a conflict potentially with maintaining market share. And that that is a conflict that has to be identified, managed properly and controlled. I think that in raising these kinds of tough questions with my senior management team with the board and publicly is exactly the job that I should be doing.

Mrs. MALONEY. But you also said that Moody's drinks the Kool-Aid. And let me quote. "Analysts and MDs, managing directors, are continually pitched by bankers, issuers and investors all with reasonable arguments whose views can color credit judgments, sometimes improving it, other times degrading it. We drink the Kool-Aid." What did you mean exactly when you said "we drink the Kool-Aid"?

Mr. MCDANIEL. It was a shorthand reference to the fact that communications from individuals may either be more persuasive or less persuasive. They may influence our subjective judgments as to whether credit quality for an instrument or an obligor is associated with a well-managed firm, or perhaps a not-so-well-managed firm. And I made the comment with respect to the potential for those assessments to affect ratings either up or down.

Mrs. MALONEY. I just would like to conclude by saying in public you were saying in in one thing, in private you were saying another. In public you were saying quote, "the level of ratings are not affected by a commercial relationship with an insured." But in private, you were telling your board that this was a huge risk, that Moody's, for years, has struggled with this dilemma end quote and it is hard for me to read this document and believe that you believed what you were saying in public. My time has expired.

Mr. Cummings.

Mr. CUMMINGS. Thank you very much. You know gentlemen, I'm sitting here and I'm trying, I'm trying to feel that honesty is coming from that table. I'm trying. But as I listen to you and I think about what has happened to the people in my district, students not able to get loans, businesses closing, seniors going back to work, people suffering, and then I listen to the testimony that we heard earlier, I'm convinced that the financial world and when I say "world," I mean world, world wide, needed the ultimate trust from your agencies. And I'm afraid to tell you and I hate to tell you this, but I believe that a lot of that trust has been lost. Whether you as intentional, unintentional, whatever, it has been lost.

And Mr. Sharma, in your testimony, you blame the models that you used in your assumptions on how the housing market would behave for S&P's failure to rate securities accurately. But then Mr. Raiter stated in his submitted testimony that part of the rationale for the failure was, the failure to implement the new model, was one, it was too expensive; two, there was a debate as to whether S&P needed that level data and three improving the model would not add to S&P's revenues. Was it any of those? You know, we're blaming everybody else for everything but people are suffering. And I just want to know what is the deal? I'm listening.

Mr. SHARMA. Mr. Cummings, first of all, it is a severe dislocation that we are all experiencing and what you're describing is something that all of us feel it, all of our

4,000 analysts around the world feel it, because it is not without pain that everyone is experiencing and seeing. What Mr. Raiter was talking about was two things, one, a model that he proposed or he was part of development when he was there, which many of our analysts tested and concluded it was not as reliable analytically. And so that is why the decision was made not to use it. The second part Mr. Raiter highlighted was that the model that he was instrumental in developing he has indicated it may not have been updated. To just give you the fact that since Mr. Raiter left, it has been updated eight times which is about 2-1/2 times per year since he left.

So we have been committed to sort of continue to update the models as the environment changes, we observe the risks changing, we observe what things we need to change a model and we make the appropriate changes. So we are continuing to make changes and we have learned from this experience as well.

Mr. CUMMINGS. Well, you know, it's interesting, you said something that was interesting. You said some of the statements do not reflect the core values of S&P and I guess that includes the statement from Chris Meyer, who says that it doesn't make sense about the CEO, you're familiar with that statement, he says doesn't it make sense that a V B synthetic triple-B synthetic would likely have a zero recovery in a triple-A scenario, and if we ran the recovery model with the triple-A recovery, it stands to reason that the tranche would fail since there would be lower recoveries and presumably a higher degree of default, and then he went on to say that rating--"rating agencies continue to create an even bigger monster," the CDO market, let's hope we all are wealthy and retired by the time this house of cards falters.

It seems to me that there was a climate, there was a climate there, of mediocrity because when we go on, we realize that there were other people saying the same thing in your organization. Now although you may not think it reflected the culture, I think it reflected the culture and my constituents think it reflected the culture, and to you Mr. McDaniel, you know this is your watch. You made a nice statement about your organization being around since 1909. But I wondered whether the folks who started your organization in 1909 would be happy with what they see today. Because there is, without a doubt, there has been a loss of trust. And somebody has to recover that. You have to get that trust back. We can never get these markets back, get them back right unless the investors feel comfortable about what is going on. And you're the gatekeepers. You're the guys. You're the ones that make all the money. You're there. That is why you're there.

And so we literally face a situation where we've got a house of cards that has fallen. And here we are trying to resurrect it. Something is wrong with this picture. And I have read the testimony. I understand all the things that you say you're going to do. But do you know the what the problem is? Once you lose trust, nobody believes you're going to do it. I see my time is up. You want to comment? Anybody?

Thank you.

Chairman WAXMAN. [Presiding.] Gentleman's time has expired. Mr. Tierney.

Mr. TIERNEY. Thank you very much, Mr. Chairman I want to talk a little bit again if I can about rate shopping on that. We've talked about that a little bit when the prior panel was up here. Here is a document that we have, an e-mail dated March 21, 2007, by an individual named Gus Harris who was managing director at Moody's, Mr. McDaniel. He sent this to several of the other officials in your company and in it he accused or complains that Fitch is using a more lenient methodology to award higher ratings and steal away business from your company. This is what the e-mail says exactly. We have heard that they, meaning Fitch, had approached managers and made the case to remove Moody's from their deals and have Fitch rate the deals because of our firm position on the haircuts. We have lost several deals because of our position. Now I think we have to explain a little of the industry jargon here. A haircut as I understand it in the jargon, is if you saw some uncertainties with the underlying value of mortgage-backed securities, you require some additional collateral and it was that additional collateral that was referred to as haircuts. Am I right?

Mr. MCDANIEL. Yes, that's correct.

Mr. TIERNEY. And apparently what he is saying is Fitch when they find those uncertainties, they don't require the additional collateral. They just proceed with the deal so they're able to get the higher rating without that so called haircut. Were you losing business to Fitch or was Fitch poaching on your business on those types of premise?

Mr. MCDANIEL. With respect to the specific comment made by Mr. Harris, I do not have any detailed information about his comments. I'm sure he was identifying information that he had seen and was communicating what he believed but I don't have specific information.

Mr. TIERNEY. Was that an isolated incident where others in your company mentioned to you that they thought that Fitch or one of the other rating companies was making overtures to your clients in competition trying to steal accounts?

Mr. MCDANIEL. Well, I would acknowledge that ratings coverage probably for all of the rating agencies waxes and wanes. We have different points of view about different industries, different sectors. Sometimes we feel more confident about a sector than our competitors. Sometimes we feel less confident about a sector. And the consequence of that is that issuers of securities may seek ratings from one or more agencies that has more--

Mr. TIERNEY. But do agencies seek out the issuers? Have you or anyone in your company ever gone to an issuer and suggested that you ought to replace one of the other rating agencies because you have a more lenient standard?

Mr. MCDANIEL. I have never done that and I'm not aware of anyone doing that.

Mr. TIERNEY. Mr. Joynt, Mr. Harris says that your company was doing that with respect to Moody's. Has anybody in your company ever gone to an issuer and said, we have a different standard over here than Moody's does, you ought to switch over to us?

Mr. JOYNT. I'm sure our business development people would have contacted issuers, bankers or investors and suggest they should use Fitch for their ratings. I would like to think, and I believe, that they would have approached that by saying we have a better quality research, a better model, a better approach, more information so.

Mr. TIERNEY. Mr. Harris seems to think they had a different approach.

Mr. JOYNT. I might also add separately that in the subprime area, in particular, our market share was significantly lower than the other rating agencies. That to me wouldn't be evidence that we were the most liberal rating agency. And in addition to that, almost the majority of the ratings that we assigned in subprime were third ratings, so we weren't replacing any one which to me was always evidence that some of us adding our rating not so much for the rating, but because they valued our research our model our presale reports and other things.

Mr. TIERNEY. Do any of you gentlemen believe that we ought to talk about the fact of not allowing issuers to actually pay the rate setters, that we ought to go to a model that allows for the investors to make the payments and not to the issuer hire the company?

Mr. JOYNT. My personal view is that the reason this developed that issuers were paying was from the Penn Central period and there was not enough analytical talent following the fixed income markets and because of that the whole industry meaning bankers and government as well got together and suggested that an issuer pay model handled well, which could be handled was more supportive of the people, talent and money that was needed to cover these markets.

Mr. TIERNEY. Do you believe that is still true?

Mr. JOYNT. I still do.

Mr. TIERNEY. Mr. McDaniel, do you belive that is true?

Mr. MCDANIEL. With respect to issuer versus investor pay model, I think the biggest mistake we could make is believing that an investor pay model does not embed conflicts of interest. So as long as rating agencies are paid by any party with a financial stake in the outcome of our opinions, and that includes investors and issuers, there are going to be pressures. And so the question is not are there conflicts of interest? There are. It's managing them properly and managing them with enough transparency that regulatory authorities and market participants can conclude that, in fact, those conflicts are being handled to the right professional standard.

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

Chairman WAXMAN. Thank you, Mr. Tierney. Mr. Issa.

Mr. ISSA. Mr. McDonald, I want to follow up on--McDaniel, I'm sorry. I'm going to follow up on the last statement you made. The second to last word you said was transparency. What is the transparency of your evaluation models?

Mr. MCDANIEL. The transparency of our--

Mr. ISSA. Your analytical computer modeling. How much transparency will I find in yours or the gentleman to your left and right?

Mr. MCDANIEL. We publish all of or methodologies and those are available on our Web site for the general public. The methodologies include a description of models that we use as well as qualitative subjective factors that may be considered in rating committees on an industry by industry basis.

Mr. ISSA. Let me ask a question because I started looking at Berkeley and other sort of software models that are saying, look you can evaluate, at least today, where we went wrong. And, I have an observation that I would like you each to comment on, and that was pick a date anywhere from the first derivative problems that occurred that led to lawsuits in '01, '02, '03, the early indications but let's take '06 and beyond, why wouldn't your models have picked up, because they are historic models, and you can't, you have to weight a historic model both on total number but also on any significant change. Why wouldn't we have seen a dramatic change in ratings of whole classes occur in a relatively short period of time as soon as home prices peaked and began falling?

And Mr. Kucinich isn't here right now, but I'm particularly sensitive to that because at the very beginning of this Congress 2 years ago, we went to Cleveland and got an earful on the foreclosure rate, on the walk away rate on the problem. So maybe each of you can respond to that because to me, that is the most important question is why didn't your models pick it up in real time and why do I believe your models today if they couldn't pick it up close to real-time then?

Mr. MCDANIEL. From Moody's perspective, one of the interesting early developments in the current problem that we have seen in the mortgage area was that the monthly performance data which we began to receive from the 2006 vintage and then the 2007, tracked very closely to what we had seen in 2000 and 2001 in the previous recession, almost exactly on top would be the way our analysts would describe it.

Mr. ISSA. Meaning the tip of it looked just like the previous event?

Mr. MCDANIEL. Exactly. And as a consequence, we did not move as quickly as we would have if the early data indicated a shift compared to the prior recession that we had been in. So there was a several month lag until we were able to see enough data to see that, in fact, it was not tracking what had occurred in the last recession because those securities were certainly robust enough to withstand the kind of recession that we saw in 2000, 2001.

Mr. ISSA. Do you all, three of you, believe today that your models have been improved such that the same event or substantially similar event or even a sneakier event if you will would not catch your models off guard the way these did?

Mr. JOYNT. I believe we've introduced significant conservatism into the models now and we need to be thinking forward because for us to rate new transactions today that is starting the beginnings of a new cycle or a new process. So I think there are changes in terms of the magnitude of the stressors that we've introduced that were greater than we would have used in the past. And then the evidence and information of delinquency and loss in mortgage and then re-reflected in CDOs is far greater than it ever was in the past. So the prior experience of very good structured finance performance from the last 15 years is going to be supplemented by quite poor performance that needs to be modeled.

Mr. ISSA. Let me ask one, and I'm very concerned because I see whole other classes of debt that are likely if we don't pull out of this recession that we're heading toward likely look to repeat what we have already seen, and I don't yet see it completely in your models. I see paper that is rated better than to be traded at 60 cents on the dollar of its face value, and yet it's trading that way. Let me just ask kind of a closing question. You're essentially all unregulated industries, you as rating organizations. And from the dais, there will undoubtedly be a call to look over your shoulder in significant ways.

Do each of you believe on behalf of your companies but also on behalf of an industry you believe belong to that a Blue Ribbon panel or commission that was independent of politics would be appropriate as an in-between step of what might originate from the dais if we didn't take that in-between step?

Mr. JOYNT. We are regulated by the SEC to whatever degree and they have started examinations in a more forceful way having, I think, been directed by Congress in that direction. So I do think that the only important protective element is our judgment and our ratings judgment. So if the oversight from regulatory bodies or some kind of panel has to do with process procedure, and those things, then I think we're open to that, at least that pitch. I don't want to speak for the industry on that. I don't see us as an industry group in that way.

Mr. ISSA. Each of you is able to answer.

Mr. MCDANIEL. I would just add that in addition to U.S., we are regulated in various jurisdictions around the world. And so, while I would agree with Mr. Joynt that to the extent that there is a review of process as opposed to our ability to develop independent opinions, I would be supportive of that. And I would hope that such a review would be able to accommodate the global nature of the work that we do.

Mr. SHARMA. We would agree also given, and SEC has come up with more rules and guidelines for oversight of the processes, and I think it's moving in the right direction.

The more transparency we put around these things it's better for the whole marketplace.

Mr. ISSA. Thank you. And Mr. Chairman I know this is particularly going to make us look forward to seeing Mr. Cox tomorrow, Chairman Cox.

Chairman WAXMAN. Thank you, Mr. Issa. Mr. Lynch.

Mr. LYNCH. Thank you very much. Gentlemen I want to ask you in continuing with Mr. Tierney's line of questioning. I want to ask about the problem of rating shopping. And we heard testimony from former employees of your firms, and in some cases, and others outside of this hearing that this occurs when investment banks take their mortgage backed securities to various credit rating agencies to see which one will give them the highest rating and for the rating agencies this creates incentives for lenient rating systems, and there is a financial incentive to beat your competitors by lowering your standards and offering higher ratings. In essence, it creates a race to the bottom.

There is an interesting example here, and we have an e-mail I would like to have put up that we sent on May 25, 2004. And it was from one of the managing directors. This is not a lower employee. This is a managing director at Standard & Poor's, to two of the companies' top executives. So this is at the very top level of the organization. The subject line of the e-mail is competition with Moody's and it says this, quote, we just lost a huge Mazullo residential mortgage-backed securities deal to Moody's due to a huge difference in the required support level.

A little further on, the Standard & Poor's official explains how Moody's was able to steal the deal away in his opinion by using a more lenient methodology to evaluate the risk. He says this again, they ignored commingling risk and for the interest rate risk they took a stance that if the interest rate rises they will just downgrade the deal." It goes on. And let me read the rest of the e-mail and you get the back and forth here.

After describing a loss to Moody's, the S&P managing director writes, this is so significant that it could have an impact on the future deals. There is no way we can get back in on this one. But we need to address this now in preparation for future deals. Goes on. He says, I had a discussion with our team leaders--sort of like what you were describing a little earlier, Mr. McDaniel--I had a discussion with team leaders and we think that the only way to compete is to have a paradigm shift in thinking especially with the interest rate risk.

So you can see this back and forth, they steal the account, they lower their standards now, now Standard & Poor's is lowering their standard and it's fairly evident. It speaks for itself.

But Mr. Sharma what was your managing director referring to when he said this is so significant that it could have an impact on future deals and that the only way to compete is to have a paradigm shift in thinking?

Mr. SHARMA. Well, Mr. Lynch, I wasn't there so I cannot speak to the specific wording in this e-mail but what I can tell you is that in this case I don't, I believe we did not rate this deal and--

Mr. LYNCH. Say that again?

Mr. SHARMA. We did not rate the detail.

Mr. LYNCH. No, I'm talking about the exchange here. It's not, I'm not interested in entering this as a legal act. I'm interested in evaluating this as a document that speaks for itself. This is a present recollection of your management, okay, and as long as you can read English, you can pretty much figure out what is going on here. This is not, we're not evaluating a CDO here. This indicates intent and then we know that each firm has modified their approach here in lowering their standards. So I'm asking you from that standpoint, just from a commonsense standpoint what you get from these statements.

Mr. SHARMA. Our criteria is public, as I believe other firms' criteria is also public. So from time to time, our analysts do look at the criteria from the other firms to see have we captured things right, are they capturing other things that we are not capturing? And so there is a look at the competition to see what are we doing, what are we not doing. So I would imagine this was sort of referring to looking at the competition 's criteria and analytics and thinking and looking at seeing if we were missing something that we should be considering. That is what I would suggest.

Mr. LYNCH. He is saying they didn't have something. They basically ignored commingling risk and for the interest rate risk they took a stance, said hey, if the interest rate rises they will just downgrade the deal. So he is not stealing good ideas here. He is not being innovative here. He is just ignoring some important factors in the deal in order to give them a higher rating and by doing so he is lowering his standards. So we're not talking about competition by innovation. We're talking about competition by Sergeant Schultz basically ignoring what is going on, looking the other way.

Mr. SHARMA. As I said, all I can speak to is the intent was to look at analytically are there things that we are not considering or we are considering that we should be looking at it differently.

Mr. LYNCH. My time essentially is expired.

Mr. McDaniel, they are talking about a managing director at Standard & Poor's who says that they ignored key risk in order to win business. Do you have any response to that?

Mr. MCDANIEL. I do not, obviously--I cannot speak to this specifically, but certainly we are not going to ignore issues or topics that have credit implications. So I'm not sure what the concern was from a member of another rating agency.

Chairman WAXMAN. Mr. Lynch your time is up.

Mr. LYNCH. Thank you, Mr. Chairman.

Chairman WAXMAN. Mr. Bilbray.

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

Gentlemen, I guess around '06, the subprime mortgage securities made up about 100 billion out of 375 almost four a quarter of CDOs sold in the United States. Please help this committee understand how, when you have a quarter subprime, that the rating agencies can qualify those securities as triple-A when they are backed by very questionable mortgage arrangements. One quarter of them were subprime. Is that the industry standard? And we kept seeing these subprime always being sort of packaged. But they were going a pretty high percentage, 25 percent is a pretty big package. Was it just the perception that real estate never goes down, you never have to worry about it, and payback will always be automatic because you can liquidate the asset?

Mr. MCDANIEL. No. It's not that at all at Moody's, and frankly, I don't believe it's that way elsewhere in the industry either. We know that subprime mortgages are going to have poorer performance than prime mortgages. And that is why high levels of credit protection are associated with those transactions. In the subprime mortgage backed securities area, for example, that 2006 vintage when we analyzed that, we analyzed it to a level at which in a pool of 1,000 mortgages, approximately 500 could default, and the triple-A bond holders would still receive their payments in full.

So the point is there were large amounts of excess protection built into protect triple-A bond holders, and we will have to see whether those triple-A bond holders, in fact, suffer credit losses in the future, and that question is still open.

Mr. BILBRAY. When we're talking about this whole rating shell game, and that is what it appears to a layman, are we talking really about the fact that the cost of insuring is determined by the rating? Is that what we're really talking about, the overall insurance and the different rating, the rating affecting those insurance rates?

Mr. JOYNT. I'm not sure I understand the question.

Mr. BILBRAY. Let me, the biggest concern I have here is that the credibility of the process has definitely been decimated over the last few months. If you were going to change a system of having ratings, the rate, basically, the rating system upgraded, everybody is talking about the conflicts that exist now. How would you negate those conflicts or minimize them so that there was more nexus between true rating and a sensitivity there and the protection of the market? Because a lot of people are talking about things that went wrong. What would you do to change the system to make it work better?

Mr. MCDANIEL. If I had one thing that I would recommend to do, it would be to make sure that there is sufficient information not in the hands of just the rating agencies but in the hands of the investing public that they can make informed investment decisions about these securities without having to rely solely on rating agencies. The problem with having insufficient information available to the investing public is that they become more reliant on rating opinions--and they are just opinions--and they also have less ability to differentiate the performance of the rating agencies because they can't look at the underlying information and make take their own independent judgments about the work. That would be my principle recommendation.

Mr. BILBRAY. Transparency.

Mr. MCDANIEL. Of the underlying information yes absolutely.

Mr. BILBRAY. Gentlemen, you agree with that?

Mr. SHARMA. Absolutely, and that is why we have made a commitment to not only increase transparency through more analytics, but also as Mr. McDaniel said more underlying information but also more information around our assumptions and the stress test scenarios that we do. Mr. Member, you said that we were looking at house pricing. The fact is, all of us look at house price declines. The only difference was in this case, unfortunately, we did not assume as severe a house price decline as has occurred. So the more we can make those assumptions clearer to the public and to investors so they can understand what stress test scenarios we are looking at and how extreme they are, the better and more informed decisions they can make about their investments.

Mr. BILBRAY. So what we have is, basically, the consumer basically there was the perception here is a rating and we can't look beyond that to find out where that number came from. And then we're told buyer beware. And frankly, the perception was it was almost worse than having none at all because there was a false sense that that rating was legitimate and could be trusted when, in fact, you weren't allowed to be able to go back and look at the data to justify that rating so that you had a confidence with it. Thank you very much, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Bilbray. Mr. Yarmuth.

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

I would like to start by posing a question that I want each of you to answer with a simple yes or no. Have you or any officials in your company ever knowingly awarded a rating that was unsupported or unjustified in order to win a deal or keep from losing one? I'm just going to go right across the line. Mr. Joynt?

Mr. JOYNT. Not that I'm aware of no.

Mr. MCDANIEL. I'm not aware of any situation like that.

Mr. SHARMA. Not that I'm aware of.

Mr. YARMUTH. Well, the documents that the committee has received and the testimony from the first panel suggests that your analysts did give unjustified ratings. And let me ask about one of these documents. During the first panel, I discussed an internal instant message that was a conversation between two S&P officials on the afternoon of April 5, 2007. From the documents we know these were two officials in the structured finance division of S&P. And it took, this was a discussion about whether they should rate a certain deal. The conversation quickly once again you are probably aware of it.

Official one: That deal is ridiculous.

Official two: I know, right model definitely does not capture half the risk.

Official one: We should not be rating it.

Official two: We rate every deal it could be structured by cows and we would rate it.

Official one: But there is a lot of risk associated with it. I personally don't feel comfy signing off as a committee member.

Mr. Sharma, is this one of the conversations that you referred to in your testimony as containing unfortunate and inappropriate language?

Mr. SHARMA. Absolutely, Mr. Member, and let me also clarify, the full context of the e-mail, as that could be made available, would show that our analysts were referring to the bank models not to our models, but to the bank models. So the bankers submit the models. Our analysts concluded it was not including enough of the risk that it should have been including. And so that is what they were talking about. It was the bankers models. And that is what they were talking about. And but you know it was only part of the e-mail that came out.

Mr. YARMUTH. I understand that may have been the case, but the S&P ended up rating it any way in spite of the questions that your analysts, your officials raised about it.

Mr. SHARMA. Yes, two things, Mr. Member, again A, the model was modified. Two, it was more referring to the CLOs and the CLOs to date are still doing okay.

Mr. YARMUTH. Well, I'm not sure that, you have officials who said they are not comfortable signing off on it.

Mr. SHARMA. Right.

Mr. YARMUTH. They didn't know the risk, but yet your company rated it.

Mr. SHARMA. Again, they were not comfortable as the model was, so they were basically asking the bankers' models to be refined and redefined to include the whole risk and when it was redefined to include the whole risk then they did rate it. And as I said it was for the CLOs which are still performing to the normal expectations that we have.

Mr. YARMUTH. Sounds pretty suspicious.

Mr. SHARMA. Well, Mr. Member, we are happy to share more facts on that with you.

Mr. YARMUTH. Thank you. We would appreciate that.

Chairman WAXMAN. We will hold the record open to receive more information from you.

Mr. YARMUTH. I focused that question on you, Mr. Sharma, but the problems aren't limited to S&P. There was a New York Times article earlier this year that reported that Moody's gave one of its analysts a single day to rate a security that compromised almost 2,400 subprime mortgages worth $430 million. There seems to be no way that you could do an effective job of rating a portfolio that large in 1 day. Mr. McDaniel would you like to comment on that?

Mr. MCDANIEL. First of all, I have to say I don't know what The New York Times was referring to, so I have to answer this in the abstract. But to the extent that a transaction had already been reviewed for its structure, that we had looked at the assets underlying the transaction and were simply running those assets in a computer ready form through a model so that we could take them to a rating committee, it may be possible that that could be done in a day. As I said, I can only answer that in the abstract though because I'm not sure what that was referring to.

Mr. YARMUTH. But you think, you're basically saying that a hypothetical, let's make it a hypothetical portfolio of that could be evaluated with sufficient scrutiny that it would form a reliable basis for making an investment decision for somebody else?

Mr. MCDANIEL. It depends on whether other aspects of the transaction had already been analyzed and taken care of and whether we were simply looking at the pool of mortgages that had to be assessed with the assistance of computer tools.

Mr. YARMUTH. Let me ask you one other question, and you responded in relation to Congresswoman Maloney's question of trying to reconcile the two statements the public one and the private one to your internal communication. The implication to me, if I accept your explanation which I will be happy to accept it, is that there, that the other rating companies are doing something that is not crooked. Is that what you meant?

Mr. MCDANIEL. What I meant, and what I have discussed with our board and our management team is there are difficult issues that have to be reconciled in this business in doing the proper job. I think every business has those kinds of challenges.

Mr. YARMUTH. But that comment was related, it seems, to me specifically to the competitive situation in your field. So you're talking, you have got 90 percent of the business sitting at that table and so I can't take your explanation any other way that you think one of those other two is basically doing something that doesn't meet the standards that you had.

RPTS HUGILL

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Mr. MCDANIEL. As I said earlier, we have different points of view about different securities, different sectors, industries in different geographies. And it is inevitable that we are going to hold different views, some of them more liberal and some of them more conservative, than our competitors. Those have competitive implications, and we have got to be cognizant and candid and discuss those issues in order to keep our eye on the core of our business which is a standards business.

We can't hide from that. We have to address it.

Mr. YARMUTH. Thank you.

Chairman WAXMAN. I'm going to yield myself 3 minutes here because what you're saying is not what you said. What you're saying now is not what you said then, because your words were that--your accusation was about these other companies. You said they are placing the entire credit rating industry on a slippery slope, and you said they're going nuts and they are starting to rate everything investment grade.

That's not the same as your interpretation of it now.

Mr. MCDANIEL. I apologize. I may have misunderstood. I thought you were asking about my communications with our board of directors, and I think this was a communication on the town hall meeting.

But to answer the question on the town hall meeting, again, I believe I was responding to a question that had to do with standards and the challenge of maintaining standards, especially in good times when the marketplace may not be as attentive to identified risks.

Chairman WAXMAN. Well, the other thing I can't understand now, the interpretation of words that sound pretty clear to me, is, Mr. Sharma, you're saying if we can get that colloquy up of the two officials, one guy said, The idea is ridiculous. The other one said, I know, right, the model definitely doesn't capture half the risk. The other one said, We should not be rating it. And then the answer to that is, We rate every deal; it could be structured by cows, and we would rate it.

That doesn't sound to me like a discussion of, perhaps we can have a reevaluation of and find out through another modeling that it does deserve rating. It sounds like a statement by one of the people who works for you that said, We rate everything. Even if it were, as he said, structured by cows, we would rate it.

How do you explain that?

Mr. SHARMA. Mr. Chairman, first of all there was unfortunate, inappropriate language used--

Chairman WAXMAN. No, it's not inappropriate at all.

Maybe it's more honest than what we're hearing from you and others today.

Mr. SHARMA. But as I was sharing with the Congressman before, the full context of e-mails would highlight that they were referring to the bankers' models; and the fact is that we do ask that more risks be considered than the models that were originally proposed by the bankers. So this is exactly what we want our analysts to do is to challenge and raise questions when they don't feel comfortable.

Chairman WAXMAN. One man is saying, I don't feel comfortable with it; I don't think it deserves any kind of rating. The other man is saying--both working for you--You've got to rate it; we rate everything. We rate everything; even if a cow structured it, we would rate it.

That doesn't sound to me like we could rate it if it had a different model. It sounds like, Don't give me any trouble, we're rating everything.

Mr. SHARMA. Mr. Chairman, again, we make all the criteria public. And then when we rate to it, we make it very transparent to the investors and to everybody else.

Chairman WAXMAN. What do you make transparent?

Mr. SHARMA. Our criteria which we rate. So that is publicly available. And when we do the ratings decision, we make the rationale as to why we concluded the rating also transparent to the marketplace that says, Here's the criteria, here's how we rate it, here's the rationale for it.

Chairman WAXMAN. It's hard to understand how transparent it is when you don't even go back and look at the underlying securities upon which this whole house of cards is based.

Mr. SHARMA. We do--have made that commitment to continuous look for more underlying securities.

If I may just mention, the SEC staff in its examination of us while these e-mails were brought out--and they were unfortunately inappropriate--they did not find any misconduct even in this case that they examined.

Chairman WAXMAN. Well, it's hard to find any misconduct if there is no standard for misconduct.

Mr. Issa, did you want some of the time?

Mr. ISSA. I will take 3 minutes. Thank you, Mr. Chairman. I'm going to try to hit on just a couple of quick points.

First of all, are all of you familiar with the Superior Bank failure and River Bank failure?

Mr. JOYNT. No.

Mr. ISSA. Both occurred in the early 2000s. Both were subprime lending related. Hopefully, you will become familiar with them so that your companies can look and say, Why didn't our model pick up these significant failures related to subprime in that earlier recession you talked about? Because whole banks went down because they were excessively invested in this type of instrument, and I think that should have been a warning that didn't fit into your models.

You may want to look at the question of--it's a little bit like, I mentioned airplanes one time in a hearing and I lost people. But an airplane can fly precisely all the time except the one time it crashes. It doesn't do any good to say it had 10,000 good hours. If every 10,000 hours a plane falls out of the sky, Boeing would be out of business; McDonnell Douglas never would have gotten, so to speak, off the ground. You have to have a much better capability to deal with when something goes wrong, if you will, a failure that doesn't lead to a crash.

So I will just leave you with that. I don't want to go further into it other than to say, there were indications 8 years ago that subprime--these now so-called toxic loans--could lead to catastrophic events.

I want to put you on the spot though today as to the overhang of the LBO market. We've been talking and people have been implying here that if you take somebody's money, you automatically do their bidding to their preference.

I find it a little interesting that Members of Congress pride themselves on taking a million dollars every 2 years from people who want us to do certain things; and then we often, rightfully so, vote against their interest. And somehow we can't see that we are asking you to do substantially the same thing as an organization.

But having said that, we have hundreds of billions of dollars--probably several trillions; I don't have the exact number--in these leveraged loans that corporations did. They are still on the books. They're trading at 50 and 60 cents even if they are fully performing.

How do you view your ratings today as predictive of whether or not these are going to become nonperforming, particularly--and I go back to what was said on the other side of the aisle, particularly when you have indexing of two points or more--actually, 11 over LIBOR, if you bust a covenant, today would probably be what you'd get. With those kinds of increases that would evaporate the ability to repay a loan, how do you see that and how are you rating them so that we can understand with confidence that those trillions aren't going to need a bailout from Washington?

Mr. JOYNT. So, speaking of most highly leveraged companies that would have to leverage loans that you're referring to, probably their ratings are speculative grade today. Probably their original ratings were not highly rated or investment grade.

But I take your point well that in this kind of environment, I think companies that thought they would have stable cash flows, that have introduced tremendous leverage into their business, are much more susceptible to failures. So I think we need to be addressing the ratings on those, although they're already speculative grade, by moving them down. But I think it's more important that we find a way, or the management of those companies, find a way to reduce the leverage, especially in this environment.

Mr. MCDANIEL. We expect that the default rates for these highly leveraged corporations are going to rise in 2009 and 2010. We do have them graded in the speculative grade range, many of them deep into the speculative grade range.

But I agree with Mr. Joynt that the ability of these companies to delever or access capital in a very difficult market is going to be very important to the ultimate default rates we see in this sector.

Mr. SHARMA. I agree with Mr. Joynt and Mr. McDaniel.

We also--for example, most of the ratings are speculative grade, and our average defaults for them are 1 percent and we are now projecting it to go as high as 5 to 6 percent, which will put more strains and pressures. And the deeper the economic recession, the greater the risk.

Mr. ISSA. Thank you.

Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Issa.

Ms. McCollum.

Ms. MCCOLLUM. Thank you, Mr. Chair.

Well, today I have been listening of culpability, incompetence, and in any opinion, corruption. This Member of Congress has downgraded your AAA rating. Your industry and financial system is based on trust. A former Moody's analyst is quoted by Bloomberg.com last month saying, and I quote, "Trust and credit is the same word. If you lose that confidence, you lose everything because confidence is the way Wall Street spells God."

Mr. Chairman, in the last few weeks we have seen what happens when Wall Street loses religion.

Mr. McDaniel, in 2005, you testified before the Senate Banking Committee, and I want to quote you. You said, "Moody's integrity and performance track record have earned the trust of capital participants worldwide."

Mr. McDaniel, documents obtained by the committee tell a very different story. On July 10, 2007, Moody's downgraded over 540 mortgage-backed securities and placed 239 for possible downgrade.

The committee has an e-mail that was sent 2 days later, on July 12. This e-mail says that Fortis investors raised concern with your organization. Publicly you say you have the trust of the market. But privately many market participants say they don't have trust in your ratings.

Now, here's a few of the quotes from the e-mail. Quote, "If you can't figure out the loss ahead of the fact, what's the use of using your rating?" Another quote: "You have legitimized these things." That's referring to subprime, asset-backed CDOs. In other words, I'm going to put it together, and it says, quote, "You have legitimized these things that are leading people into dangerous risks."

Another quote: "If the ratings are BS, then the only use in the rating is comparing BS relative to more BS." That's not a satisfied customer, Mr. McDaniel, and it does not sound to me like you have the trust of the market.

Without the trust of the market, what value do any of your organizations add to the financial system? It appears to be none.

Mr. McDaniel, do you have the trust of the market?

Mr. MCDANIEL. The trust in rating agencies and in Moody's has obviously eroded during this period of credit turmoil. I think it would be disingenuous not to acknowledge that, and I do.

We are working very hard to make sure that we can reinstill a sense of trust in the market to support the confidence that the market needs for the free flow of capital. That is absolutely critical, and that is what we are focused on as an organization very, very deeply.

Ms. MCCOLLUM. Mr. Chairman, I have only 5 minutes, so I would like to hear from the other gentlemen if they think that their investors, my constituents--the word "credit" comes from the Latin word "credo," belief. They had belief in you. They had belief in your rating systems, and instead they have lost, some of my constituents, their entire retirements, their grandchildren's college funds.

So I'm asking you, do you believe that my constituents have trust in your ratings?

Mr. SHARMA. We absolutely have to earn the credit back; and as you said, the credibility back and the trust back. We absolutely believe that, and that's why we have announced a number of actions that we believe we need to continue to add transparency, bring more transparency in the marketplace to re-earn the trust of the investors, because ultimately it's the investors who use our ratings; and that's who we need to earn our trust back from.

Ms. MCCOLLUM. Sir?

Mr. JOYNT. I'm also very disappointed in our inability to project losses and foresee the problems in the mortgage area and the CDO area. It's resulted in a lot of rating changes that have changed valuations and prices and have impacted many people. So I realize our credibility has been damaged in that way.

I--hopefully, people recognize that our--at least my view is that Fitch--that we have operated with objectivity, with best intentions, with no malintent, although we weren't successful in projecting them. So, hopefully, that's a foundation on which we can build credibility again.

Ms. MCCOLLUM. It's my understanding from the earlier testimony that Standard & Poor's had in front of it an opportunity to upgrade its model in 2001.

Mr. SHARMA. Sorry. Say--

Ms. MCCOLLUM. That Standard and Poor's had in front it a new modeling system. They knew the modeling system that they had didn't work, and in 2001 made a decision, because they didn't have enough money for staff and they didn't have enough money for the computer upgrade to do the model, to do that.

So was Standard and Poor's lacking in profits during that time.

Mr. SHARMA. Congresswoman, Mr. Raiter had raised that point and let me address--there were two points he raised.

One was that there was a new model that he was part of in terms of his development. But that model, a number of other analysts looked at it and they did not conclude conclusively they it could improve their reliability or was a valid analytical approach; and so that was why we didn't choose to use it.

The other point he raised was that the model that he was part of, we have updated that about eight times since he has left Standard & Poor's. That's about two and a half times a year. So we updated almost two to three times a year, and we continuously update it.

And we will update that as frequently as the environment changes, assumptions change. We will continue to update that. That's our commitment.

Ms. MCCOLLUM. Mr. Chair, if the staff could get that information that, in fact, they had aggressively pursued constantly updating their models to meet the needs of what they saw in the changing marketplace, that would be very helpful for the committee.

Chairman WAXMAN. We'd like to share what information we have about your operations so you can respond to the facts that we know about your company that you're not aware of.

Mr. Sarbanes.

Mr. SARBANES. Thank you, Mr. Chairman.

Thank you to the witnesses.

Would you say that the failure on the part of your companies to accurately assess the risk of these securities has contributed to the collapse of the financial markets that we have seen? Yes? No?

Mr. SHARMA. There are assumptions as we have seen, for example, in house price declines that we made that would decline by 10, 12, 15 percent; certainly the house price declines have been much more severe than we had anticipated. So, in that context, the risks embedded in these instruments at a 30 percent house price decline are certainly higher than 15 percent house price declines.

Mr. JOYNT. I would suggest that having ratings move with the volatility that they have in CDO and mortgage space impacts prices and has brought people concerns about whether they'll remain volatile or not. That's impacted many people's valuations, banks, and of course has been a portion of the pressure put on them, yes.

Mr. SARBANES. I guess I was suggesting something else. I'll just draw the conclusion myself, which is that you encouraged risky behavior because you rated these things as AAA or reasonable investments when they weren't; and that set off a whole chain of events which resulted in the collapse of the financial markets, and it had the human effect of a lot of people losing their homes, of increased tightening of credit and all the things that we're seeing.

I looked through the testimony of each of you. It didn't say, but I was just curious how long each of you have been in the positions that you hold right now.

Mr. JOYNT. I started in the ratings business in 1975. I started at Fitch in 1989, and I became President in 1994.

Mr. MCDANIEL. I began with Moody's in 1987, and I became CEO just over 3 years ago.

Mr. SHARMA. I took on the role of President at Standard & Poor's just last year in September.

Mr. SARBANES. Last year, okay. At least two out of three of you were there when a lot of this bad assessment was occurring, and let me ask you this question:

Would you say that people inside your agencies--that these securities were so exotic, so unusual, so fast moving in their design that the fact of the matter is that there was really nobody who understood them completely? Is that a fair characterization?

Mr. JOYNT. In the case of mortgage securities, I think they grew in complexity, but I believe our teams understood them well.

In the case of CDOs, they also started more simply and got more complex. The requirement to model their sophistication became more difficult, but if we were uncomfortable with our judgment on that, we would not have assigned ratings to them.

My final example would be CPDOs, which also has been mentioned in the press as problematic instruments; and there our teams studied those for more than 6 months. We had great debates within the organization between the quantitative people who thought we could model the risk and some of our senior credit people who felt like the price performance was too short and the instruments too volatile; and after 6 months of healthy analytical debate, we chose not to rate them with either of our highest ratings and, therefore, we did no ratings.

Mr. SARBANES. I'm glad to hear you say that, because it's become a popular refrain in this to sort of say nobody really understood these things. I've heard a number of you say today, Well, we built the models, but the models didn't pick up on certain things, they were the wrong models, and so forth. And I was counseled the other day by somebody to resist that characterization and to believe that, in fact, there were people at all the various levels of this drama who knew exactly what these instruments were, understood exactly what the risks of them were, but nevertheless proceeded to put a stamp on them at some level and just pass them along.

And what I'm curious about is, there had to be people inside of your agencies who were getting a sick feeling in the pit of their stomach as these things were coming across their desks. And I don't understand why the company didn't have a culture that would trap that uneasiness and convert it into some real resistance to giving these high ratings to these securities.

Can you explain that?

Mr. JOYNT. Sir, I'd like to address that if I could, because I asked earlier if I could at least represent Fitch's position in this matter.

So I think there are a lot of examples where our credit culture has had us decline to rate securities many times. So earlier it was suggested in 2004 that we were nuts, I think was the term. I don't think so. In early 2003 or 2004, our credit teams decided that we were uncomfortable assigning our highest ratings to all base securities, and so we weren't asked to rate any.

Our market share dropped to zero as a consequence, which I think, to me--and I certainly accept that and was aware of it, and it was a consequence of the healthy analytical conclusion we reached--nothing to do with business.

So there are structured investment vehicles that were rated. I think the other rating agencies rated 40 or more. We rated five, I believe, because it was well known in the market our credit views were more conservative, and so we couldn't reach the higher rating conclusions that they expected.

So I think there are many examples.

Ms. Norton, Congresswoman Norton, suggested earlier MBIA. We changed our rating at MBIA. I personally was involved in a quite contentious--contentious public debate with the chairman of that company as to why we're changing our ratings.

So I think there are a lot of examples where our firm, at least, has demonstrated that when we have clear credit concerns; then we either lower our ratings, or we don't move forward with ratings.

Chairman WAXMAN. Thank you, Mr. Sarbanes. Your time has expired.

Mr. ISSA. Mr. Chairman, how much time do I have remaining?

Chairman WAXMAN. You have 3 minutes and we have one, two, three members--

Mr. ISSA. I will reserve. Thank you.

Chairman WAXMAN. Ms. Watson.

Ms. WATSON. Thank you so much. I just--and the committee just received a letter from our treasurer, Bill Lockyer, from the State of California, my State; and in this letter Lockyer is extremely critical of the way credit rating agencies are rating municipal bonds in California. Mr. Lockyer tells us that at the beginning of June of this year, S&P rated the creditworthiness of both Lehman Brothers and the State of California. S&P gave them both A+ ratings. We were 85 days before we got our budget, and with a $14 billion shortfall. However, just 3 months later, Lehman Brothers filed for bankruptcy.

Now here's what Lockyer says in the letter: "How could any rational person believe that a long-term investment in Lehman Brothers was as safe as a long-term investment in California?" That sounds kind of quirky. Because we're in a little trouble, but something is amiss if a credit rating agency can give the same assessment.

So I would like to start with Mr. Sharma. Can you please explain to me how S&P thought Lehman Brothers was such a safe bet that they gave it the same chances of defaulting as California?

Mr. SHARMA. Thank you, Congresswoman. As you very well pointed out, at that point in time, California's deficit and budget shortfall was rising from up to about $22 to $23 billion--

Ms. WATSON. How did we get an A+?

Mr. SHARMA. But, again, there was the ability to raise the capital.

There are two things we look at. One is the capacity to pay and the other is the willingness to pay.

Same thing, turning to Lehman. Lehman, until that Friday before they went bankrupt, they were trying to raise capital. They were trying to diverse some of their assets, and then they had the Federal Government, Federal Reserve, as a backstop; and those were the reasons why they thought they could still be an ongoing entity.

Ms. WATSON. Let me read you something that Mr. Lockyer said in this letter: "Without doubt, the rating agencies too freely assigned their highest ratings to structured investment products backed by market shares and the debt of financial institutions, many of which have now collapsed. Some evidence suggests that the agencies may have cut corners and violated their own standards in doling out their ratings."

So do you have a double standard where you give corporate bonds preferential treatment compared to municipal bonds, Mr. Sharma?

Mr. SHARMA. No, Congresswoman. We have a single, global, consistent scale, and we strive to get a global consistency across all our asset classes over a long period of time. At any point in time there are different credit cycles, different market cycles across different asset classes; so there may be some differences.

Ms. WATSON. I know we were in trouble in California with the largest State majority of minorities. People come from Southeast Asia, over the border, with different needs that have to be met by government. And you knew all the factors that were affecting California.

Do you not do that same thing with Lehman Brothers? Because what I'm finding out, they misrepresented their standing, their liquidity and factors, and so I'm wondering if you evaluate them differently.

Mr. SHARMA. We do look at different criteria. However, from a scale point of view, we look at them with the same level of criticality.

We had downgraded Lehman several weeks ago, and then we had even put them on grade Watch Negative, I believe, and we can confirm that to you. And the day before they went bankrupt, again they were trying to raise capital and they assured us that they had access to capital.

Ms. WATSON. So were we.

Mr. SHARMA. I understand. Even in California the reason we put them at Negative; and we changed the rating yesterday, madam, because we saw they were able to raise the capital.

Ms. WATSON. Very good.

But I also understand from Mr. Lockyer that out of all the States there has only been one State that defaulted; so I would think that our bonding rate would be higher.

Now, Mr. Chairman, one of the issues that concerned many investors, particularly in the midst of the financial crisis, is the seemingly arbitrary meaning of credit ratings given by S&P, Moody's, and Fitch. I don't know how we are supposed to trust these ratings when junk bonds based on subprime mortgages receive AAA ratings, the same rating as the Federal Treasury.

And I would ask all of you, but my time is up, if the ratings have no meaning in relationship to each other, what really is their use? So, because my time is up, maybe we can send out and ask what these standards are or how they apply to municipal bonds. And if you can all answer that in writing, we will send you the question in writing.

Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Ms. Watson. We will hold the record open for a response.

[The information follows:]

******** COMMITTEE INSERT ********

Chairman WAXMAN. Ms. Norton.

Ms. NORTON. Thank you, Mr. Chairman. Thank you very much, Mr. Chairman.

I would like to get some clarification as to the real meaning you intend of ratings, particularly in light of the disclaimers that are found in the works--in the documents of all of you.

Your companies are very profitable for the reasons that people put their money on you, in effect, and you see how profitable you are. The three firms doubled from 2002 to 2007, increasing from 3 billion to 6 billion. This will go down in history. This was the period during which the government flushed down into the you-know-what.

At Moody's the profits quadrupled between 2000 and 2007. In fact, Moody's had the highest profit margin of any company on the S&P for 5 years in a row. And the reason that you're so profitable is because so many investors rely on your expertise and your ratings as virtual gospel, scripture, whatever you want to call it. They point to them time and again.

But to hear the disclaimers and the caveats and the qualifications, you would think that the credit ratings aren't worth the paper they're written on. Let me find out.

Mr. Sharma, here's is a disclaimer from--S&P includes in its materials: "The credit ratings and observations contained herein are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions." Written by somebody in my law school class, I'm sure.

But from the point of view of an investor, what does it mean?

Here is Mr. McDaniel's disclaimer from Moody's, similar statement: "The credit ratings and financial reporting analysis observations are and must be construed solely as statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities."

My, my, my.

Now, Mr. Joynt, not to leave you out, Fitch's code of conduct goes perhaps the furthest. This is what it says: "Rulings are not themselves facts and therefore cannot be described as either accurate or inaccurate."

Now, from where I come from, this sounds like doublespeak.

Mr. Joynt, how can you say that your ratings are neither accurate or inaccurate?

Mr. JOYNT. Well, I'm not sure of the legal definition and why it was created in that way, accurate or inaccurate. I think we're emphasizing the fact that our ratings are opinions and they're formulated by people that have done the best they can with good faith to look at all the analysis they can. The ratings can change over time, and they do; and it's better that we disclose the fact that they are opinions as clear as we can.

Ms. NORTON. Well, anything anybody says is an opinion unless it's a scientific fact. We do understand that.

But, Mr. Joynt, let me give you a hypothetical. If you rate a group of bonds as AAA and those bonds fail, would you say that that rating was accurate or inaccurate?

Mr. JOYNT. I would say that it did not project the kind of risk that investors--that our ratings were intended to project.

Ms. NORTON. I'm asking you about your rating. Would you say it was accurate or inaccurate?

Mr. JOYNT. I would say it did not reflect the risk that AAA was designed to reflect, a high degree of likelihood of repayment of principal and interest--

Ms. NORTON. Was it inaccurate or accurate?

Mr. JOYNT. I suppose inaccurate.

Ms. NORTON. I mean, just ask that because most investors will approach this with a high degree of reliance. And the three of you seem to be having not both ways, but all ways. On the one hand, the legal disclaimers saying people shouldn't rely on what you say because it's your opinion, they can't possibly be accurate or inaccurate. On the other hand, you are telling investors and they are paying because they believe you--that's why I quoted how profitable you are--that you have the best methodology and the best rating record and the most expertise, so they should pay you billions of dollars. And they comply.

So let me ask each of you a question. Do you think your companies in any way are responsible for what has happened to our economy?

Mr. JOYNT. Well, I attempted to answer that question earlier from the standpoint of the ratings volatility; and the downgrades, since we weren't able to project forward this crisis in housing coming, would have impacted prices of securities and that would have contributed to the volatility in the market, which has contributed to the crisis.

So I certainly--

Ms. NORTON. So do you all accept some responsibility for what has happened to the economy given the reliance of investors, ordinary people and others, on your ratings? Do you accept some responsibility?

Chairman WAXMAN. The gentlewoman's time has expired, but I want to give each of you an opportunity to further answer the question.

Mr. MCDANIEL. With respect to this crisis, I think there are responsible parties throughout the marketplace--

Ms. NORTON. Including yourselves?

Mr. MCDANIEL. That includes the credit rating agencies and Moody's. Our opinions were best opinions based on information we had at the time, but they had to change rapidly and on much more of a wholesale basis than what we would like to see, obviously.

Ms. NORTON. Mr. Sharma?

Mr. SHARMA. Absolutely. When you look at the role we play, which is to provide credit opinions and assumptions we made that underlie that, it did not turn out the way we expected it to be.

Ms. NORTON. Thank you, Mr. Chairman.

Chairman WAXMAN. Ms. Speier.

Ms. SPEIER. Thank you, Mr. Chairman.

And thank each of you for participating today.

Consumer Reports is a rating agency, and it rates appliances and cars and electronics; and it's well regarded by the consuming public because it's scrupulous about not engaging in conflicts of interest. So I'm going to ask you a couple of questions.

Who do you owe a fiduciary duty to, the issuer or the investor? Just answer it with one word.

Mr. Joynt.

Mr. JOYNT. I don't know. Fiduciary responsibility, I'm not sure I can answer that question. So I feel quite responsible to provide our best opinion to investors and everyone in the market.

I don't feel a special responsibility to issuers.

Ms. SPEIER. Mr. McDaniel?

Mr. MCDANIEL. The responsibility is ultimately to the marketplace.

Ms. SPEIER. To the investor?

Mr. MCDANIEL. To the market. The investor is an absolutely critical component of an effectively functioning marketplace, so we must be responsible to the investor.

We also have a responsibility to the overall good operation of the markets themselves.

Ms. SPEIER. Mr. Sharma?

Mr. SHARMA. Trust is the life blood of our franchise, and we see ourselves as the bridge between the issuers and the investors--

Ms. SPEIER. Just answer the question.

Mr. SHARMA. Responsibility to the investors is the most critical thing for us.

Ms. SPEIER. Do any of you accept gifts from issuers--dinners, golfing, trips, contributions to your conferences?

Mr. JOYNT. We have a gift policy which I believe we provided to the committee as well.

Ms. SPEIER. Well, what is it?

Mr. SPEIER. I believe it limits gifts to $25 or--

Ms. SPEIER. So you don't go out to dinner with any of those that are your clients? You don't go golfing? You don't--they don't contribute to conferences you host around the country?

Mr. JOYNT. I'm not sure about contribute to conferences or whether we've ever cohosted conferences with either investors or issuers or industry groups. I'm not certain about that.

Ms. SPEIER. Mr. McDaniel.

Mr. MCDANIEL. I do have meals occasionally with investors and issuers, including issuers who are themselves governments around the world. I do not engage in any other entertainment or accept gifts from--

Ms. SPEIER. I'm talking about your company. Do you allow--

Mr. MCDANIEL. Yes. We have a gift policy similar to what Mr. Joynt just described. And I believe we have made that available, and my recollection is, it's a $100 limit on gifts.

Ms. SPEIER. And they don't contribute to conferences you have around the country?

Mr. MCDANIEL. I don't believe they do, but I would have to go back and check to see if there is any--

Ms. SPEIER. We'll ask you to do that.

Mr. Sharma?

Mr. SHARMA. Similarly, as Mr. McDaniel said and Mr.

Joynt, we have a gift policy, which we made available to you.

[The information follows:]

******** COMMITTEE INSERT ********

Ms. SPEIER. All right.

Is it true that as a result of legislation you sought and supported--I believe in 2007, maybe in 2006--that as a result of that legislation, you no longer can be sued by the taxpayers?

Mr. SHARMA. Say that again.

Mr. MCDANIEL. I'm sorry. I don't know the answer to that.

Ms. SPEIER. Thank you. Let's move on then to AIG. Each of you, or one of you, rated AIG as AA 2 days before it went bankrupt. How can you square that rating with the condition of the company at the time?

Mr. Sharma?

Mr. SHARMA. First of all, AIG rating has continued to be changed over the last several years. Three years ago it was AAA, and then it was downgraded to AA.

Ms. SPEIER. But let's just talk about it in that week before it went bankrupt. And the taxpayers in this country are now on the hook for over $100 billion. You had rated them as A or AA.

Mr. SHARMA. Our analysts had projected some economic losses for AIG which they had gotten a similar independent view from a third party as to what those economic losses were. But then when the Fannie and Freddie Mac issues happened, the spreads widened, and as the spreads widened, they had to report greater mark-to-market losses on their books. As they did that, that created more pressure on them, and as a result, they had to raise more capital.

Ms. SPEIER. We understand all that. But did you raise any questions about the credit default swaps?

Mr. SHARMA. We do. We had taken into account of that and put a capital charge against them. But as our markets unfolded so quickly, their ability to raise capital and liquidity quickly shut off from them; and as a result, the spreads widened on them, and they had to put more losses on their books.

So things moved very quickly on them, and as it moved quickly--and, in fact, the Friday of that week I believe we already sort of put them on grade Watch Negative, recognizing these issues were starting to come up.

Ms. SPEIER. Two days before they were AA.

Chairman WAXMAN. Thank you, Ms. Speier.

Mr. Shays.

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

Gentlemen, thank you for coming. When the story is told about this debacle, there will be a lot of blame to go around to the private sector, the public sector, the HUD, Congress; but it doesn't relieve any of us from the particulars of what each of our roles were.

Tell me, first off, do you believe that your company's brand, that you've lost because of the incredible failures that have taken place--that your company brand is pretty low, number one? And I want to know if each of you think that. I think you've lost your brand.

I will tell you what I think; I want to know if you agree: that you have no credibility, that you have so screwed up the ratings as to not be believable anymore.

Do you think that's true? I will ask each of you.

Mr. JOYNT. So, I said earlier I think our reputation has been damaged by our inability to project the ratings and the risk of mortgages and CDOs.

I also feel like we accomplished a lot of credible work in other areas.

Mr. SHAYS. That's not what I asked you.

Mr. JOYNT. It's been damaged, yes.

Mr. MCDANIEL. Yes. I think there has been reputational damage and--

Mr. SHAYS. Serious or little reputational damage?

Mr. MCDANIEL. Serious reputational damage in the areas that have been under stress, absolutely.

Mr. SHAYS. Mr. Sharma?

Mr. SHARMA. Certainly. And we have to have that credibility back.

Mr. SHAYS. What makes us feel comfortable that you can gain it back?

One of the things that has come across to me is the comment that these instruments, CDOs, are so complex and that each of you view them differently--and, and, and.

What makes us think that you can get on top of this, Mr. Sharma?

Mr. SHARMA. We have announced a number of actions earlier this year to improve our analytics and bring more transparency and information disclosure to the marketplace, and put new governance and control procedures in place to make sure that there's a confidence in our process; and also go to the marketplace with some education to the investors as to what we are doing.

Mr. Chairman, I would like to sort of put our recommendations, our actions, into the record.

Chairman WAXMAN. We'd be happy to receive it.

[The information follows:]

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Mr. SHAYS. Would any of your answers be different?

Mr. MCDANIEL. Not substantially different.

Mr. JOYNT. I think I would answer by saying that we at Fitch also now have a healthy skepticism about the complexity of instruments and the use of quantitative models to try to assess those.

So, I said earlier in my testimony that we need to both revisit our models, seek to rate less complex instruments and bring a healthy degree of experience and art to the process.

Mr. SHAYS. Let me ask you what is the guarantee that you won't, in order to try to prove your worth, go in the exact opposite direction? You all were on a feeding frenzy.

I mean, Moody's went from 30 million to 113 million in just 4 years, dealing with CDOs, asset-backed securities. I mean, this was a feeding frenzy.

What is there to convince us that you won't now--to compensate for being so wrong, that you won't be so wrong the other way?

Mr. MCDANIEL. I think the first and best means of judging the balance of our opinions will be to look to the methodologies, for investors and the marketplace to judge the quality of those methodologies and to whether we are adhering to them; and that, over time, will show whether we have achieved the proper balance.

I agree with you, we cannot go overboard the other direction. That is not helpful either.

Mr. SHAYS. Let me understand. Would you all agree with that answer?

Mr. SHARMA. Yes. And, in fact, if you look at--even now in today's environment, when things are so fragile and unstable, we get calls that we are too quick in some cases and not too quick in other cases.

So we get sort of comments on both sides: You're not taking enough rating action; and in other cases, you're taking too many rating actions.

So we have to stay consistent and objective.

Mr. SHAYS. Is it conceivable that you will look at an instrument and say, we just simply don't understand it?

Mr. SHARMA. We have and we have chosen not to rate instruments where we have not felt comfortable.

Mr. SHAYS. I made reference to Moody's increases in revenues from 30 million to 113 million by 2007, from 2004. Would those percentages be the same, a tripling be about the same with you, Mr. Sharma?

Mr. SHARMA. I'm sorry, Congressman. Can you ask the question again?

Mr. SHAYS. In other words, Moody's had an increase in revenues of $29.8 million so on, up to 113.17 million. So from 29 million to 113 million on its CDOs in income.

Has yours gone up? It's a huge increase and it suggests that there was a feeding frenzy.

Mr. SHARMA. I cannot answer this. We can get back the data specifically to you, but we did see an increase during that time period. I can't say--

[The information follows:]

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Mr. SHAYS. Is that true, as well, for you, Mr. Joynt?

Mr. JOYNT. We had submitted this data, I think, to the committee. In looking at what we had submitted and for U.S. CDOs, I believe our revenues were 24 million in '01 and 22 million in '02, and in 2007 it was 37 million.

Mr. SHAYS. That's all?

Mr. JOYNT. Yes. That's what we submitted.

Mr. SHAYS. It may be, we're not comparing apples to apples on this?

Mr. JOYNT. Pardon me?

Mr. SHAYS. It may be we're not comparing apples to apples?

Mr. JOYNT. I believe our market share was significantly lower. It was a third of the market share using Standard & Poor's.

Mr. SHAYS. With companies--right now, you rate instruments, you rate companies. Could you just withdraw everything since you were so wrong?

And by the way, I'm speaking as someone who is part of an institution that has an unfavorable rating--lower than yours. So I realize I'm here, looking down, but it's not lost on me where we're at.

But given that you were so wrong, do you go back--are you going back and looking at past appraisals and reexamining them, or are you just saying we are starting fresh from here?

Mr. JOYNT. If I could address that, Congressman Shays, I tried to address it in my testimony as well.

The ratings themselves, having been lowered dramatically, were reflective of the probability of full repayment of principal and interest. Once they become below investment grade, they are less useful to investors. They have lost the confidence of full repayment. So what we've tried to do is focus our analysis on what is the portion of likely payment. And there are widely divergent likelihoods on different securities--90 cents, 85, 62. So I think that can be more a shift that could be helpful in illuminating for investors the risk.

Mr. SHAYS. What I'm asking though is, I'm asking damage done. Are you going back and looking at how you have rated different instruments and saying, we need to take a second look at them?

And I'm asking each of you.

Mr. JOYNT. Absolutely.

Mr. SHARMA. We are looking at the methodology. We've learned from the experience and--

Mr. SHAYS. I'm not asking if you're getting paid again to do it. I'm asking if you're going back and saying, we were so wrong, we didn't earn that payment. We need to go back and check so that those who rely on our information will have better information.

Mr. SHARMA. It's part of our same commitment to them to continue to do what we had agreed to do for the great debt related.

Mr. MCDANIEL. As conditions change and credit indicators change, we absolutely must go back and change ratings to accommodate that. I agree.

Mr. SHAYS. Thank you.

Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Shays.

Gentlemen, I want to thank you very much for being here and for your testimony.

I want to conclude by commenting on the fact that between 2002 and 2007 we have seen this explosion of securities and collateralized debt obligations backed by risky subprime loans. And it was important to those who were involved in these new, very complicated securities to get the ratings that would allow them to sell them. And in doing so they didn't simply ask you for the ratings. They worked very closely in designing the way they would structure the finance deals so that they could get the ratings; and you gave them ratings and in many cases AAA ratings that people relied on.

Now the bottom has fallen out, and we are paying an enormous consequence in our economy. And I do submit to you that this has been very profitable for the rating companies and for the executives as well, because you've got higher fees when you rated some of these securities backed by a pool of home loans.

But I think we have seen this failure of the credit rating agencies to help the consumers make a decision, and I just want to review some of the key phrases used in your own documents:

"We drink the Kool-Aid."

"Fitch and S&P went nuts."

"No one cared because the machine just kept going."

"We sold our soul to the devil for revenue."

"It could be structured by cows, and we would rate it."

"Let's hope we are all retired by the time this house of cards falters."

"Any requests for loan level tapes is totally unreasonable."

Well, these are the things we got from the documents from your businesses, and each one shows a complete breakdown in the credit rating agencies. So I think that we have a very disturbing picture.

You weren't the only ones at fault, but you were the gatekeepers, and you worked very closely with others who were benefiting as well.

The explosion of these new, very complicated securities is something very new, but we also have something that's very old: greed and self interest pushing forward a lot of people to do things that in hindsight certainly they regret having done. But also you would have thought that, since this was all based so much on very shaky undergirdings of these loans, one would have thought that maybe somebody should have stood back and said, Well, wait a minute--as did some of the people in your companies.

We are holding these hearings because we want to learn what happened and get something worthwhile out of all of this for reforms for the future. And I think as you've all indicated. Reaching reforms will be needed to restore any confidence in the credit rating business.

Mr. Shays, do you want to make any comment?

Mr. SHAYS. I just want to thank you, Mr. Chairman, for holding these hearings. I think the quotes you read are just the essence of why we have no faith in this process, and you should be congratulated for holding these hearings and for the conduct of all your members. Thank you.

Chairman WAXMAN. Thank you very much, Mr. Shays, for your kind words. And I do appreciate the conduct of all of our members in pursuing these issues. They are very important.

I know this has not been a comfortable day for you, but I think you are well aware that we have got to work together to restore the system that will benefit the economy and the people who make the investments. So I thank you again.

That concludes our business, and we stand adjourned.

[Whereupon, at 2:59 p.m., the committee was adjourned.]

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