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COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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Opening Statement of Rep. Henry A. Waxman
Chairman, Committee on Oversight and Government Reform
Credit Rating Agencies and the Financial Crisis
October 22, 2008

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

The leading credit rating agencies — Standard and Poor's, Moody's, and Fitch — are essential financial gatekeepers. They rate debt obligations based on the ability of the issuer 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 no one really understood them.

For investors, a triple-A rating became the stamp of approval that said 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 goldmine.

The leading credit rating agencies grew rich rating mortgage-backed securities and CDOs. As this chart shows, total revenues for the three firms doubled 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 five years in 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 and Poor's, Moody's, and Fitch will tell us that "virtually no one … anticipated what is occurring." But the documents the Committee obtained tell a different story.

Ray McDaniel, the CEO of Moody's, will testify today that "we have witnessed events that many, including myself, would have thought unimaginable just two months ago." 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:

> The real problem is not that the market …underweight[s] 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 downgrades; short-sighted bankers labor short-sightedly to game the ratings agencies.

Mr. McDaniel then tells his board — and I quote — "Unchecked, competition on this basis can place the entire financial system at risk."

Mr. McDaniel describes to his board how Moody's has "erected safeguards to keep teams from too easily solving the market share problem by lowering standards." But then he says: "This does NOT solve the problem." 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, "Analysts and MDs [managing directors] are continually 'pitched' by bankers, issuers, investors" and sometimes "we 'drink the kool-aid.'"

A month earlier, in September 2007, Mr. McDaniel participated in a "Managing Director's Town Hall." We obtained a copy of the transcript of the proceeding. 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's going on in the subprime market. …
>
> [W]hat happened was, 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.

The following day, a member of the Moody's management team commented:

> We heard 2 answers yesterday: 1. people lied, and 2. there was an unprecedented sequence of events in the mortgage markets. As for #1, it seems to me that we had blinders on and never questioned the information we were given. … As for #2, it is our job to think of the worst case scenarios and model them. … Combined, these errors make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue.

The documents from Standard and Poor's paint a similar picture. In one document, an S&P employee in the structured finance division writes: "It could be structured by cows and we would rate it." In another, an employee asserts: "Rating agencies continue to create [an] even bigger monster — the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters."

There were voices inside the credit rating agencies that called for change. We will hear from two of them on the first panel: Frank Raiter from Standard and 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 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 request 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 is 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: "This is the most amazing memo I have ever received in my business career."

Last November, Chistopher Mahoney, Moody's Vice Chairman, wrote Mr. McDaniel, the CEO, that Moody's "has made mistakes" and urged that "the 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 ratings agencies. The documents we reviewed show that a portfolio manager with Vanguard, the large mutual fund company, told Moody's over a year ago that the rating agencies "allow issuers to get away with murder." A senior official at Fortis Investments was equally blunt, saying: "if you can't figure out the loss ahead of the fact, what's the use of your ratings? … [I]f the ratings are b.s., the only use in ratings is comparing b.s. to more b.s."

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 "found the Moody's analyst to be arrogant and gave the indication 'We're smarter than you.'"

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's recommendation and SEC's own study, the SEC failed to issue any final rules 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 and 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. 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 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.