

Written Statement of

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On

“Credit Rating Agencies and the Financial Crisis”

Before the

Committee on Oversight and Government Reform

United States House of Representatives

October 22, 2008

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 Residential Mortgage Backed Securities Ratings at Standard and Poor's. I was responsible for directing ratings criteria development, ratings production, marketing and business development for single family mortgage and home equity loan (HEL) bond ratings and related products. My tenure at S&P coincided with 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 time frame, and Alt-A production grew to \$676 billion in 2005.

By regulation, institutional investment policy, and tradition, the sale of the associated mortgage backed securities generally required ratings from two of the nationally recognized statistical rating organization ("NRSROs"). While a necessary player in the exploding market, the ratings 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 lending institutions and investment bankers who made the loans and packaged them into securities, and the rating agencies were the oilers who kept the wheels of the train greased.

To appreciate the unique role the rating agencies performed in the residential mortgage market, it is necessary to understand the ratings process. A mortgage backed security consists of a pool of individual mortgage loans. Depending on the type of mortgage product (i.e., prime-jumbo, subprime, Alt-A or HEL) underlying a given security, the pool could consist of 1,000 to 25,000 loans. The ratings process consists of two distinct operations--the credit analysis of 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 a default. These, in turn, establish the expected loss for the entire pool and determine the amount of AAA bonds that can be issued against the pool. It is analogous to your equity position in your home and the underlying mortgage. The loss estimate determines the equity needed to support the bond—it is intended to protect the AAA bonds from experiencing any losses, much the same as the homeowner's equity stake in a house protects the lender from loss in the mortgage loan.

In 1995 S&P used a rules-based model for determining the loss expected on any given bond. Late that year, the decision was made to develop a more sophisticated

statistically- based approach to estimating the default and loss of individual loans and pools. A new model was built based on approximately 500,000 loans with performance data going back 5 or more years. This new version of what is known as the LEVELs model was implemented in 1996<sup>1</sup> and made available for purchase by originators, investment banks, investors and mortgage insurance companies. By making it commercially available, S&P was committed to maintain parity between its own ratings model and the one distributed to external parties. In other words, S&P promised model clients they would always get the same answers from the LEVELS models that the rating analysts got when running the same pool through its internal analytics. 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 growing data bases. An update was accomplished in late 1998 or early 1999 when the second version of LEVELs was released. This version was built with a data base of approximately 900,000 loans with 6 to 8 years of performance information. Each version of the model was better than its predecessor in determining default probabilities. Each new version was built with growing data on traditional as well as new mortgage products, particularly the growing subprime market. It was critical to maintain the best models as they were the linchpin of the rating process. During this time frame, the

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<sup>1</sup> All dates referencing modeling-related matters are approximate and to the best of my recollection.

analytical staff in the RMBS group at Standard and Poor's enjoyed the full support of senior management. That was critical as acquiring data, performing the statistical analysis and utilizing information technology to put the model into the rating process was expensive and required significant staff support.

Things began to change in 2001 as the housing market took off—a new version of the model was developed using approximately 2.5 million loans with significant performance information. This model was by far the best yet developed, but it was not implemented due to budgetary constraints. Extraordinarily large volumes of transactions requiring ratings put a strain on the analytical staff resources, and requests for more staffing were generally not granted. The model development team continued to collect data, and in late 2003 or early 2004 a 4<sup>th</sup> version of the model was developed based on approximately 9.5 million loans. These loans covered the full spectrum of new mortgage products, particularly in the Alt-A and fixed/floating payment type categories. To my knowledge, that model has yet to be implemented.

The point of this rather long recital is that the analysts at S&P had developed better methods for determining default which did capture some of the variations among products that were to become evident at the advent of the crisis. It is my opinion that had these models been implemented we would have had an earlier warning about the performance of many of the new products that subsequently lead to such

substantial losses. That, in turn, should have caused the loss estimates mentioned above to increase and could have thus caused some of these products to be withdrawn from the market as they would have been too expensive to put into bonds.

This inevitably begs the question: why didn't management see the need to keep the model current? The answer is complex. First and foremost, it was expensive to build or acquire the growing data bases, perform the necessary statistical analyses, complete the IT code modifications and implement and distribute new versions of the model - this process also required significant additions to staff. By 2001, the focus at S&P was profits for the parent company, McGraw-Hill- it was not on incurring additional expense. Second, there was an intense debate within the ratings groups as to whether we needed loan level data and related analyses. The Managing Director of the surveillance area for RMBS did not believe loan level data was necessary and that had the effect of quashing all requests for funds to build in-house data bases. A third reason given was that the RMBS group enjoyed the largest ratings market share among the three major rating agencies (often 92% or better), and improving the model would not add to S&P's revenues.

An unfortunate consequence of continuing to use out- dated versions of the rating model was the failure to capture changes in performance of the new non-prime products. As a result, expected loss estimates no longer provided the equity

necessary to support the AAA bonds. This, in turn, generated the unprecedented number of AAA downgrades and subsequent collapse of prices in the RMBS market.

In addition to problems with maintaining adequate ratings criteria and models, there were other aspects of rating agency procedures that contributed to the current crisis. Foremost amongst these was the lack of adequate surveillance on the bonds previously rated. At S&P, there was an ongoing, often heated discussion that using the ratings model in surveillance would allow for re-rating every deal monthly and provide significantly improved measures of current and future performance. Had this suggestion been implemented in 2004, we might not have had to wait until 2007 for the poor performers to come to light. Again, had the best practices been in place, some of the worse performing products might have been extinguished before they grew to such a size that they disrupted financial markets.

Another area that deserves attention as the rating agencies re-make themselves is in the document reviews, the “structure” in structured finance. The foundation of the rating analysis is the data relied on for determining credit enhancement levels.

Rating agencies do not perform “due diligence” on the data, rather they rely on representations and warranties (guarantees) from the issuer that the data submitted is indeed accurate. In the event a loan goes bad and it is discovered that the data was inaccurate (say for example, the appraisal was inflated), the issuer is required

to buy the loan back with no loss to the investor. The rating agencies select those companies from whom they will accept these guarantees—it is not the entire population of all mortgage originators. Unfortunately, there were no clear criteria used to identify this population and then differentiate among providers of these “reps & warranties” other than they are all assumed to be that “too big to fail.” There was also no attempt to systematically track the performance of the companies regarding breaches of “reps & warranties”. The growing potential liability was not tracked to be assured these companies actually had the ability to meet their obligations. That raises the question, “Who is going to honor “reps & warranties” in the case of insolvent institutions recently rescued or acquired? “Reps & warranties” were provided by such notable companies as Countrywide, WaMu, IndyMac, Lehman and Bear Stearns.

One possible remedy to the issue of data accuracy might be to have the firms that provide due diligence reviews for the issuers share their reports and findings with the rating agencies. Their reviews could be expanded to include samples with appraisal reviews and verification of key fields on the tapes provided the rating agencies.

The three primary rating agencies, Moody’s, S&P and Fitch have enjoyed a unique position in the financial markets. The NRSRO designation has allowed them to operate virtually without competition, a situation that fostered a culture of



complacency regarding their responsibilities to provide reliable and timely information to the financial markets. Rather, they have concentrated on maximizing short-term profits rather than maximizing longer term financial benefit from accuracy of their credit ratings and surveillance reviews. I do not believe any meaningful improvement will occur until this culture is dramatically refocused on analysis and providing accurate and timely information on the performance of outstanding ratings.

In closing, I would like to thank the Committee for inviting me to join them today and hear my thoughts on this subject. At this time, I would be glad to answer any questions you might have for me.