Prepared Statement of
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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 real 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 ever 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 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 or insure 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 analyses the many risks posed by subprime mortgages and the rapidly changing underwriting environment in the U.S. housing market, we did not foresee the magnitude or velocity of the decline in the U.S. housing market, nor the dramatic shift in borrower behavior brought on by the changing practices in the market. Nor did we appreciate the extent of shoddy mortgage origination practices and fraud in the 2005-07 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 our experience to complement the “science” of quantitative analytics. 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 new securities.

Problems in subprime mortgages and CDO assets represent a major portion of asset losses and write-downs. They are one of the original catalysts for today’s financial crisis, but that is not a complete picture. Derivative exposure relating to these assets, but also other assets, has 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 from synthetic exposures that normally is not transparent has become painfully transparent as counterparties lose confidence in each other and require physical collateral to protect positions.

It has been difficult to find balance in assigning ratings of major global financial institutions during the 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 financial companies despite market stresses from capital raising, liquidity, and profitability, anticipating government support that has been largely forthcoming.

Having addressed some limitations of ratings, 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 hearings is to focus on the crisis, problems, and hopefully forward-moving solutions. With that in mind, how is Fitch functioning in the market today?

We have reviewed our original ratings on entire vintages of subprime mortgage and CDO securities, and, with the benefit of hindsight, have now found that many were too high. Our continuous goal has been to undertake new analysis that provides investors with our latest opinion about the risk 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 in their 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 that many junior securities may have significant (or total) losses. The variance in projected repayment and the related valuation of highly rated securities (AAA's) is a critical market problematic. Some may have sizable losses, but many large balance AAA securities may receive full payment or experience relatively small percentage losses. We are shifting our analytic resources and modeling to provide information to investors and other interested parties such as the Federal Reserve and 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 rating opinions must be more predictive and our research and analysis must be insightful and forward-looking. We must tell the market about what might happen tomorrow instead of what has happened yesterday. This applies to all of our ratings – structured and corporate. We remain committed to the highest standards of integrity and objectivity.