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ONE HUNDRED ELEVENTH CONGRESS
Congress of the United States
House of Representatives
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
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September 29, 2009

MEMORANDUM

TO: Members of the Committee on Oversight and Government Reform

FROM: Majority Staff, Committee on Oversight and Government Reform

SUBJECT: Full Committee Hearing entitled**,** "Credit Rating Agencies and the Next Financial Crisis."

On Wednesday, September 30, 2009, at 10:00 a.m. in room 2154 Rayburn House Office Building, the Committee on Oversight and Government Reform will hold a hearing entitled, "Credit Rating Agencies and the Next Financial Crisis."

Background and Purpose of Hearing

Inaccurate credit ratings have been cited as a major contributing factor to the current financial crisis. Investors, including pension funds, trusted that rating agencies would warn the public about issuers or financial instruments that were not creditworthy. Instead, rating agencies were complicit in the structuring and prioritizing of supposedly safe financial products that later proved to be toxic to the financial system. Previous investigations have shown that rating agencies underestimated the riskiness of structured financial products, held an overly optimistic view of the housing market, and relied on incomplete data when determining ratings.

In 2008, the Committee on Oversight and Government Reform held a hearing entitled, "Credit Rating Agencies and the Financial Crisis," which examined fraudulent, careless, and troubling practices by major rating agencies that resulted in inaccurate ratings and brought our nation to the brink of financial collapse. Now, one year later, little has changed. Documents from former employees suggest that major credit rating agencies continue to engage in questionable practices. The Committee will examine the dangers that investors continue to face and assess the need for further regulation.

The Business of Credit Rating Agencies

Credit rating agencies are a source of independent analysis and information about debt securities. Debt securities, which include bonds, or "fixed-income" securities, are issued by

governments, corporations, and other institutions. In essence, an investor who purchases a debt security lends money to an institution that promises to pay the money back with interest.

A major concern for investors is whether an issuer of debt securities will be able to make its promised payments. Credit rating agencies assess the financial condition and the creditworthiness of an issuer, as well as the particular security being issued, in order to grade the probability that the issuer will be able to make its payments.

Credit rating agencies have developed a system of letter grades to measure creditworthiness. Securities with the lowest probability of default receive the highest grades and are known as "investment-grade". Securities with a higher risk of default are called speculative grade or "junk" bonds, and receive lower grades. The lower a security's grade, the higher the interest payment an issuer must offer to attract investors. See Figure A.

Figure A

Alphabet Soup

Ratings firms use more than 20 grades to describe how likely a bond is to default. The higher the grade, the safer the bond. Many mortgage bonds have been sliding down the scale recently.

Moody's grades	S&P grades	A sampling of goverment and corporate borrowers with these ratings (S&P)	
Aaa	**AAA**	U.S. Treasury	
Aa1	**AA+**	State of Nebraska	
Aa2	**AA**	Citigroup	
Aa3	**AA–**	Goldman Sachs	
A1	**A+**	Italy	
A2	**A**	AT&T	
A3	**A–**	Malaysia	
Baa1	**BBB+**	Bulgaria	▲
Baa2	**BBB**	Sprint-Nextel	Investment
Baa3	**BBB–**	Whole Foods	grade
Ba1	**BB+**	Colombia	Speculative
Ba2	**BB**	Harrah's	grade
Ba3	**BB–**	Indonesia	▼
B1	**B+**	Pakistan	
B2	**B**	Ford Motor	
B3	**B–**	Six Flags	
Caa1	**CCC+**	Movie Gallery	
Caa2	**CCC**	Ecuador	
Caa3	**CCC–**		
Ca	**CC**		
C	**C**		
	D		

Source: How Ratings Firms' Calls Fueled Subprime Mess,
Wall Street Journal (Aug. 15, 2007).

Evolution of Rating Agencies

The role of credit rating agencies has evolved since John Moody published his first *Manual of Railroad Securities* in 1909. Originally, ratings were an independent investor resource that provided market information. However, in 1931 ratings became a tool of financial regulation when the Comptroller of the Currency ruled that bonds held by national banks which were rated BBB or higher could be held on bank books at cost while those rated lower would have to be held at a discount. Since then, further regulations have referenced credit ratings, including the Securities and Exchange Commission's (SEC) Net Capital Rule[1] and the Investment Act of 1940.[2] Today there are 13 United States Code and 80 Code of Federal Regulations references to "nationally recognized statistical rating organizations"[3] (NRSROs). Most of these references are in the area of "Banks and Banking" and "Commodity and Securities Exchanges", but references to NRSROs also exist in code and regulations relating to "Agriculture," "Education," and "Transportation." By some counts, there are more than 100 state statutes that rely on credit ratings.

Because of the references to credit ratings in statute and regulation, critics believe that rating agencies have moved from selling information to selling, in effect, "regulatory licenses" – keys that unlock the financial markets. Without high ratings, bond issuers cannot access certain markets because they don't have a "license" from the NRSROs to comply with NRSRO-dependent regulations.

In the 1970s, the three major credit rating agencies (Moody's, Standard & Poor's, and Fitch) stopped selling ratings to investors and began charging the companies that issue the debt they rate. This move from the investor-pays model to an issuer-pays model introduced significant new conflicts of interest – chiefly, the challenge for credit raters to impartially rate the securities of companies that generate the raters' revenues.

Since that time, credit rating agencies began to rate substantially greater numbers of issuers and increasingly complex instruments. In particular, over the past decade, the three major rating agencies received an increasing portion of their business by rating Asset-Backed Securities (ABS) and Collateralized Debt Obligations (CDOs). Both ABSs and CDOs are broadly referred to as "derivative" securities and "structured finance" securities. An ABS is created by pooling various types of debt, such as credit card debt, school loans, and, most notoriously, residential mortgages. These pools are then divided into shares that promise a fixed stream of income for the life of the note. CDOs are created by pooling various ABSs, which are in turn re-divided into various tranches. These tranches prioritize investors by risk, giving senior

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[1] The Net Capital Rule directs broker-dealers to compute their net capital amounts using haircuts (percentage deductions form the net worth of their capital positions). Under the rule, agencies holding investment grade securities may deduct a reduced percentage of their net worth.

[2] Rule 2a-7 of the amended act requires that money market funds invest in debt that has been rated by an NRSRO.

[3] Nationally Recognized Statistical Rating Organizations (NRSROs) are a subset of the greater universe of credit rating agencies. It is these NRSROs that have been written into U.S. Code and into the Code of Federal Regulations. The "Big 3": Moody's; S&P; and Fitch, are all NRSROs. NRSROs are discussed more in this memo under the heading "Regulation of Credit Rating Agencies". Further, see CRS Report to Congress, "Credit Rating Agencies and Their Regulation." May 29, 2009.

tranches greater credit safety by making junior class tranches take the first losses in the event that some of the securities' underlying loans default. Senior tranches are assigned a higher credit rating while lower tranches are promised a higher return on investment, assuming there are no defaults on the underlying assets.

Regulation of Credit Rating Agencies

The Credit Rating Agency Reform Act of 2006 expanded the SEC's authority to regulate the credit rating agencies. Specifically, the act explicitly required credit rating agencies to register with the SEC in order to qualify as an NRSRO. In their applications, credit rating agencies are required to disclose information about their operations, including methodologies for determining ratings, organizational structure, existence of a code of ethics, and potential conflicts of interests.

Moody's, S&P, and Fitch were immediately registered as NRSROs following implementation of the Act. Since 2007, there have been seven additional credit rating agencies designated as NRSROs: three smaller credit rating agencies; one focusing on insurance companies; two headquartered in Japan; and one based in Canada.

The Role of Credit Rating Agencies in the Financial Crisis

During the height of the housing boom in the early 2000s, credit rating agencies not only rated ABSs and CDOs, but also advised issuers on how to structure and prioritize tranches of ABSs and CDOs to squeeze the maximum profit from a CDO or an ABS by maximizing the size of its highest rated tranche. Before the credit crises of 2007 and 2008, almost all senior tranches were given the highest rating possible: AAA.

As the housing bubble burst, and foreclosures increased, mortgage-backed securities (MBSs, a type of ABS) and CDOs backed by MBSs began to crumble, despite the AAA rating that many received when they were issued. It became clear that many of the ratings issued by credit rating agencies had little or no rational foundation. Ratings were based on unfounded assumptions (e.g., that housing values would continue to increase indefinitely) or failed to perform any assessment at all of the underlying risks associated with home mortgages.[4]

In July 2008, the SEC concluded that the growth in the quantity and complexity of structured finance deals since 2002 had overwhelmed the credit rating agencies. The SEC also observed that credit ratings agencies were unable to effectively manage conflicts of interest between MBS and CDO issuers and the rating agencies.[5]

Continued Concerns

Not much has changed. During the investigation, committee staff discovered memorandums, e-mails, and letters from former credit rating agency employees. These

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[4] See FDIC Financial Institution Letters: Risk Management of Investment in Structured Credit Products, http://www.fdic.gov/news/news/financial/2009/fil09020a.html

[5] See Annual Report on Nationally Recognized Statistical Ratings Organizations; SEC, June 2008.

documents revealed that credit rating agencies continue to engage in several practices that call into question the accuracy of their ratings, including:

- Receiving money from investors for both consulting and rating services, creating significant conflicts of interest;
- Failure to apply updated financial models to previous ratings;
- Lack of timely vigilance in downgrading ratings when financial conditions change;
- Failure to examine the credit worthiness of underlying assets, such as mortgages, that may be part of a larger securities package;
- Rating of new financial instruments, without accurate historical data;
- Lack of expertise, resources, and independence within compliance sections of rating agencies; and
- Insufficient managerial resources and expertise to accurately rate complex financial securities.

Moreover, the US government continues to rely on credit rating agencies for a variety of financial programs. For example, the Term Asset-Backed Securities Loan Facility (TALF) explicitly requires the purchase of only AAA rated assets, rated by one of the top three agencies. Similarly, there are at least seven other Federal Reserve Programs that rely on credit ratings when determining the amount of collateral that must be posted for a loan. Thus, inaccurate ratings not only endanger investors, they continue to pose a threat to financial stability.

Witnesses

Panel I

Mr. Ilya Eric Kolchinsky
Former Managing Director
Moody's Investors Service

Mr. Scott McCleskey
Former Senior Vice President for Compliance
Moody's Corporation

Mr. Richard Cantor
Chief Risk Officer
Moody's Corporation
and
Chief Credit Officer
Moody's Investors Service

Panel II

Senator Alfonse M. D'Amato
Former Chairman
Senate Committee on Banking

Mr. Floyd Abrams
Partner
Cahill Gordon & Reindel, LLP

Mr. Eric Baggesen
Senior Investment Officer
California Public Employees Retirement System (CalPERS)

Professor Lawrence J. White
Leonard N. Stern School of Business
New York University

Should you have any questions, please contact Brian Eiler or Neema Guliani of the Majority staff at 5-5051.