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HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS COMMITTEE

Carl Levin, Chairman
Tom Coburn, Ranking Minority Member

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Senate Subcommittee Holds Third Hearing on Wall Street and the Financial Crisis: The Role of Credit Rating Agencies

WASHINGTON – Credit rating agencies that investors relied on to provide impartial and accurate analysis of thousands of mortgage-linked securities instead used outdated models and inadequate data, were too influenced by investment bankers, allowed chronic resource shortages to undermine ratings, and delayed downgrading investments once problems in the mortgage market became clear, an inquiry by the Senate Permanent Subcommittee on Investigations has found.

The findings, the result of an 18-month investigation into some of the causes and consequences of the financial crisis, will be examined Friday at the third in a series of hearings held by the Subcommittee, whose Chairman is Carl Levin, D-Mich., and Ranking Member is Tom Coburn, R-Okla. Previous hearings have examined the role of high-risk mortgage lending and the failings of federal bank regulators. A fourth hearing, on April 27, will examine the role of investment banks.

"Investors trusted credit rating agencies to issue accurate and impartial credit ratings, but that trust was broken in the recent financial crisis," said Levin. "A conveyor belt of high risk securities, backed by toxic mortgages, got AAA ratings that turned out not to be worth the paper they were printed on. The agencies issued those AAA ratings using inadequate data and outmoded models. When they finally fixed their models, they failed for a year -- while delinquencies were climbing -- to re-evaluate the existing securities. Then, in July 2007, the credit rating agencies instituted a mass downgrade of hundreds of mortgage backed securities, sent shockwaves through the economy, and the financial crisis was on. By first instilling unwarranted confidence in high risk securities and then failing to downgrade them in a responsible manner, the credit rating agencies share blame for the massive economic damage that followed."

Friday's hearing will examine case studies involving the two largest U.S. credit rating agencies, Standard & Poor's and Moody's. The Subcommittee investigation found that these agencies relied on ratings models that failed to predict default rates for high risk home loans, such as subprime, Option ARM, and interest-only mortgages, that made up an increasingly large part of the market. Documents obtained by the Subcommittee show credit rating analysts also often acted with unclear guidance, uncertain criteria, and incomplete understanding of the complex investments they had to evaluate. The agencies also failed to respond to the higher credit risk posed by mortgage fraud, lax lending standards, and poor quality loans in the marketplace.

From 2002 to 2007, the credit rating agencies earned record profits, reporting $6 billion in gross revenues in 2007. They also allowed the drive for profits and market share to affect ratings. Knowing that Wall Street firms might take their business elsewhere if they didn't get investment-grade ratings for their products, the agencies were vulnerable to pressure from issuers and investment bankers. As one Moody's executive wrote in October 2007: "It turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don't want rating downgrades; short-sighted bankers labor … to game the rating agencies."

After it became clear that their models failed to accurately predict the performance of securities tied to risky mortgages, the agencies began revising those models. But they took until July 2006, and in a decision with severe consequences for the market and the economy, refused to apply the revised model to existing securities. Instead of sending an early signal to the market in July 2006 of the deepening problems with high risk mortgages and securities tied to them, the agencies waited until July of 2007, to begin a series of mass downgrades. The sudden shock of those downgrades contributed to the collapse of the secondary markets for subprime residential mortgage backed securities (RMBS) and collateralized debt obligations (CDOs), left investors holding suddenly unmarketable securities, and helped precipitate the financial crisis.

The Subcommittee investigation led to the following formal findings of fact with regard to the credit rating agencies.

1) **Inaccurate Rating Models.** From 2004 to 2007, Moody's and Standard & Poor's used credit rating models with data that was inadequate to predict how high risk residential mortgages, such as subprime, interest only, and option adjustable rate mortgages, would perform.
2) **Competitive Pressures.** Competitive pressures, including the drive for market share and need to accommodate investment bankers bringing in business, affected the credit ratings issued by Moody's and Standard & Poor's.
3) **Failure to Re-evaluate.** By 2006, Moody's and Standard & Poor's knew their ratings of residential mortgage backed securities (RMBS) and collateralized debt obligations (CDOs) were inaccurate, revised their rating models to produce more accurate ratings, but then failed to use the revised model to re-evaluate existing RMBS and CDO securities, delaying thousands of rating downgrades and allowing those securities to carry inflated ratings that could mislead investors.
4) **Failure to Factor In Fraud, Laxity, or Housing Bubble.** From 2004 to 2007, Moody's and Standard & Poor's knew of increased credit risks due to mortgage fraud, lax underwriting standards, and unsustainable housing price appreciation, but failed adequately to incorporate those factors into their credit rating models.
5) **Inadequate Resources.** Despite record profits from 2004 to 2007, Moody's and Standard & Poor's failed to assign sufficient resources to adequately rate new products and test the accuracy of existing ratings.

6) **Mass Downgrades Shocked Market.** Mass downgrades by Moody's and Standard & Poor's, including downgrades of hundreds of subprime RMBS over a few days in July 2007, downgrades by Moody's of CDOs in October 2007, and downgrades by Standard & Poor's of over 6,300 RMBS and 1,900 CDOs on one day in January 2008, shocked the financial markets, helped cause the collapse of the subprime secondary market, triggered sales of assets that had lost investment grade status, and damaged holdings of financial firms worldwide, contributing to the financial crisis.
7) **Failed Ratings.** Moody's and Standard & Poor's each rated more than 10,000 RMBS securities from 2006 to 2007, downgraded a substantial number within a year, and, by 2010, had downgraded many AAA ratings to junk status.
8) **Statutory Bar.** The U.S. Securities and Exchange Commission is barred by statute from conducting needed oversight into the substance, procedures, and methodologies of the credit rating models.
9) **Legal Pressure for AAA Ratings.** Legal requirements that some regulated entities, such as banks, broker-dealers, insurance companies, pension funds, and others, hold assets with AAA or investment grade credit ratings, created pressure on credit rating agencies to issue inflated ratings making assets eligible for purchase by those entities.

Friday's hearing will take place at 9:30 a.m. in Room G-50 of the Dirksen Senate Office Building. Witnesses will include current and former analysts and managers at both agencies, as well as Raymond W. McDaniel Jr., chairman and chief executive officer of Moody's Corp., and Kathleen A. Corbet, former president of Standard & Poor's.

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