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Opening Statement of Senator Carl Levin
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Wall Street and the Financial Crisis:
The Role of Credit Rating Agencies

Today's hearing is the third in a series of Subcommittee hearings focusing on some of the causes and consequences of the 2008 financial crisis, a man-made economic assault on our country that is still foreclosing on homes, shuttering businesses, and driving unemployment. We saw the beginning of the assault in our first two hearings, which examined how U.S. financial institutions turned to high risk lending strategies to earn quick profits, dumping hundreds of billions of dollars in toxic mortgages into the financial system, like polluters dumping poison upstream in a river. At the second hearing, we showed how regulators saw what was going on, understood the risk, but sat on their hands or fought each other rather than stand up to the banks profiting from the pollution.

Those toxic mortgages were scooped up by Wall Street firms that bottled them in complex financial instruments, and turned to the credit rating agencies to get a label declaring them to be safe, low-risk, investment grade securities. Today, we are focusing on the role played by the credit rating agencies. Next week, we will look at the last stage of the economic assault, when Wall Street investment bankers magnified and spread the risk posed by toxic mortgages through the use of complex structured finance transactions.

For a hundred years, Main Street investors trusted U.S. credit rating agencies to guide them toward safe investments. Even sophisticated investors, like pension funds, municipalities, insurance companies, and university endowments, have relied on credit ratings to protect them from Wall Street excesses and distinguish between safe and risky investments.

But now, that trust has been broken. We used as case histories the two biggest credit rating agencies in the United States, Moody's and Standard & Poor's, and the ratings they gave to the key financial instruments that fueled the financial crisis -- residential mortgage backed securities, or RMBS, and collateralized debt obligations, or CDOs. The Subcommittee investigation found that those credit rating agencies allowed Wall Street to impact their analysis, their independence, and their reputation for reliability. And they did it for the money.

This chart, Exhibit 1g, shows that from 2002 to 2007, the 3 top credit rating agencies doubled their revenues, from less than $3 billion to over $6 billion per year. Most of this increase came from rating complex financial instruments. According to Standard & Poor's, between 2000 and 2006, investment banks underwrote nearly $2 trillion in mortgage-backed securities, $435 billion or 36% of which were backed by subprime mortgages. All of those securities needed ratings. Moody's and S&P each rated about10,000 RMBS securities over the course of 2006 and 2007. Credit rating executives got paid Wall Street sized salaries.

At the same time, the credit rating agencies were operating with an inherent conflict of interest, because the revenues they pocketed came from the companies whose securities they rated. It's like one of the parties in court paying the judge's salary, or one of the teams in a competition paying the salary of the referee. The credit rating agencies assured Congress and the investing public that they could "manage" this conflict, and that their ratings were independent and rigorous. But the documents tell a different story.

First, some background. Credit ratings assess the creditworthiness of a particular financial instrument like a corporate bond, mortgage backed security, or CDO. Essentially, they predict the likelihood that the debt will be repaid. We've all heard of AAA ratings, which are at the top of the credit rating scale and are supposed to designate the safest investments. The ratings below that, which range from AA down to C, designate investments at greater risk of default. Investments with AAA ratings have historically had an expected loss rate of less than .05 percent, while the expected loss rate for BBB investments is under 1 percent. That's why financial instruments with AAA through BBB ratings are generally called "investment grade," while those with ratings of BBB- or Baa3 or below are referred to as "below investment grade" or sometimes "junk" investments.

A variety of U.S. laws and regulations rely on credit ratings to gauge risk. For example, the amount of risk-based capital that a bank must hold is determined in part by the credit ratings of its investments. Some investors, like pension funds, are barred from holding below investment grade assets. Because so many statutes and regulations reference ratings, issuers of securities and other financial instruments work hard to obtain favorable credit ratings to ensure more investors can buy their products.

Over the last ten years, Wall Street has engineered ever more complex financial instruments for sale to investors. Because these so-called "structured finance products" are so hard to understand, investors often place heavy reliance on credit ratings to determine whether they can or should buy them.

Residential mortgage backed securities, or RMBS, are one of the oldest types of structured finance. To create these securities, issuers bundle up large numbers of home mortgages into a pool, figure out the total revenue coming into the pool from all the mortgages, and then design a "waterfall" that assigns portions of the total incoming revenue to what are called "tranches." Tranches are not collections of mortgages, they are simply recipients of income from the waterfall of mortgage payments coming into the pool.

Each tranche is used to issue a mortgaged backed security that receives a credit rating and is then sold to investors. The tranches that are first in line to receive revenues represent the safest investments in the pool, and are designed to get AAA ratings. Tranches lower down the line get

their revenues only after the more senior tranches are paid, and their securities get lower credit ratings.

Wall Street didn't stop there. They collected securities from RMBS transactions, put those into a pool, and resecuritized them into what are called collateralized debt obligations or CDOs. A CDO might contain, for example, BBB rated securities from 100 different residential mortgage pools. CDOs often also contain other types of assets, such as corporate bonds or credit default swaps. Wall Street firms also created so-called "synthetic CDOs" which did not contain actual assets, but simply referenced them. Like RMBS mortgage pools, CDOS were sliced and diced into tranches, and the resulting tranches used to create securities. The securities were rated – some AAA – and then sold to investors.

In exchange for large fees, Wall Street firms helped design the RMBS and CDO securities, worked with the credit rating agencies to obtain favorable ratings, and then sold the securities. Without credit ratings, Wall Street would have had a much harder time selling these products, because each investor would have had to rely on themselves to figure them out. Credit ratings helped make the sales possible by labeling certain investments as safe, using their trademark AAA ratings.

Wall Street firms also used financial engineering to combine AAA ratings – normally reserved for ultra-safe investments – with riskier securities, such as RMBS securities backed by high risk mortgages. Because the underlying mortgages were high risk, those RMBS paid out a higher return than safer loans. When those higher-paying securities also got AAA ratings, investors snapped them up. For awhile, everyone made money -- banks and mortgage brokers got rich selling high risk loans, Wall Street investment banks earned big fees creating and selling mortgage based securities, and investors profited from the higher returns.

But those AAA ratings created a false sense of security. High risk RMBS and CDOs turned out not to be safe investments. We heard in our first hearing how many of the high risk mortgages backing those securities were riddled with poor quality loans, contained fraudulent borrower information, or depended upon borrowers being able to refinance their loans before higher loan payments kicked in. When housing prices stopped climbing, and many borrowers could no longer refinance their loans, delinquency rates skyrocketed. RMBS and CDO securities rated as investment grade began incurring losses and were sharply downgraded.

Take, for example, a CDO known as Vertical ABS CDO 2007-1. In early 2007, UBS, which is a major bank, asked S&P and Moody's to rate this CDO. The UBS banker, however, failed to cooperate with the analysts. One S&P analyst wrote in an email to colleagues: "Don't see why we have to tolerate lack of cooperation. Deals likely not to perform." That's Exhibit 94b.

Despite the analyst's judgment that the CDO was unlikely to perform, S&P rated it. So did Moody's. In April 2007, both agencies gave AAA ratings to the CDO's top 4 tranches. Six months later, both agencies downgraded the CDO which later collapsed. One of the purchasers, a hedge fund called Pursuit Partners, sued over the CDO's quick demise. S&P and Moody's were dropped from the lawsuit since current law does not authorize private lawsuits against them even for reckless or unreasonable ratings, but the court ordered UBS to set aside $35 million for a possible award to the investor. The legal pleadings included internal emails at UBS referring

to the supposedly investment-grade Vertical securities as “crap” at the same time the bank was selling them.

Take another example. In January 2007, S&P was asked to rate an RMBS being assembled by Goldman Sachs using subprime loans from Fremont Investment and Loan, a subprime lender known for loans with high rates of delinquency. On January 24, 2007, an analyst wrote seeking advice from two senior analysts: “I have a Goldman deal with subprime Fremont collateral. Since Fremont collateral has been performing not so good, is there anything special I should be aware of?” One analyst responded: “No, we don't treat their collateral any differently.” The other asked: “are the FICO scores current?” “Yup,” came the reply. Then “You are good to go.” In other words, the analyst didn’t have to factor in any greater credit risk for an issuer known for poor quality loans, even though three weeks earlier S&P analysts had circulated an article about how Fremont had severed ties with 8,000 brokers due to loans with some of the highest delinquency rates in the industry. In the spring of 2007, Moody’s and S&P provided AAA ratings for 5 tranches of RMBS securities backed by Fremont mortgages. By October, both companies began downgrading the CDO. Today all five AAA tranches have been downgraded to junk status.

These are just two examples of securities given AAA ratings that turned out not to be worth the paper they were written on. There are many more.

In fact, throughout 2006 and 2007, the toxic mortgages flooding the financial markets began going bad in record numbers. Delinquency rates skyrocketed. It became more and more apparent that the investment grade ratings given to subprime RMBS securities couldn’t hold. Finally, in July 2007, within days of each other, Moody’s and S&P announced mass downgrades of hundreds of subprime mortgage backed securities. The mass downgrades shocked financial markets, and the subprime secondary market dried up overnight. Banks, securities firms, pension funds, and others were left holding billions of dollars of suddenly unmarketable securities. The value of those securities began dropping like a stone. The financial crisis was on.

Two months later, in October, Moody’s began downgrading over $10 billion of CDOs. On January 30, 2008, S&P downgraded over 8,000 securities, including 6,300 RMBS and 1,900 CDO securities, an unprecedented onslaught of downgrades. The CDO market, like the RMBS market, evaporated. Financial firms around the world were suddenly stuck with even more unmarketable securities. By September 2008, major global financial institutions like Lehman Brothers, AIG, Citibank, Goldman Sachs, and Morgan Stanley were bankrupt, bailed out, or struggling.

Looking back, if any single event can be identified as the immediate trigger of the 2008 financial crisis, my vote would be for the mass downgrades starting in July 2007, when the credit rating agencies realized their AAA ratings wouldn’t hold and finally stopped labeling toxic mortgages as safe investments. Those mass downgrades hit the markets like a hammer, making it clear the investment grade ratings had been a colossal mistake.

This chart, Exhibit 1i, shows just how big a mistake it was. It shows that 91% of the AAA subprime RMBS securities issued in 2007, and 93% of those issued in 2006, have since been downgraded to junk status. The numbers for Option ARM mortgages are even worse. Option ARMs, which we examined at our first hearing on Washington Mutual Bank, allow borrowers to

pick from several types of payments each month, including a “minimum payment” that results in a growing, rather than declining, loan balance. The chart shows that 97% of the Option ARM securities issued in 2006 and 2007 are now in junk status.

Had the credit rating agencies taken more care in handing out their initial ratings, or had they issued downgrades in a more responsible manner, they could have reduced the impact of the toxic mortgages. But they didn’t, and there are a whole host of reasons why.

Inaccurate Rating Models. First let’s talk about the credit rating models. Credit rating agencies use complex mathematical models to predict foreclosure rates for mortgages which, in turn, are critical to determine the ratings for mortgage backed securities. The key problem was that the mortgage industry had changed drastically in the last ten years. High risk mortgages like subprime, interest-only, option ARMs, and hybrids became widespread, displacing traditional, low-risk, 30-year fixed rate mortgages. The credit rating agencies simply did not have data on how these higher-risk mortgages would perform over time. Traditional 30-year fixed rate mortgages had default rates of 1 to 2 percent; the higher-risk mortgages were expected to have higher default rates, but no one knew how high. With little real data, the credit rating agencies made assumptions in their models that turned out to be wrong.

Moody’s and S&P knew their modeling assumptions were wrong, and began revising their models. In the summer of 2005, S&P had revamped its CDO model, but put the model on hold for more than a year, as it struggled to rationalize why it would not use the new model to retest existing CDO securities. It is clear from over a year of internal emails that S&P delayed and delayed the decision, anticipating that the revised model would require existing CDO securities to be downgraded, disrupt the CDO market, and reduce public confidence in its CDO ratings. It would have also disrupted S&P profits from CDO ratings.

In July 2006, S&P made a major change to its RMBS rating model, but decided not to retest existing RMBS securities. The revised RMBS model projected much higher default rates for high risk mortgages and required greater protections against loss, including 40 percent more credit protection for BBB graded subprime securities. That meant a 40 percent larger cushion to protect against losses. Re-evaluating existing RMBS securities with the revised model would likely have led to downgrades, angry issuers, and even angrier investors, so S&P didn’t do it. Moody’s didn’t either; after strengthening its RMBS model to issue new ratings, it chose not to apply it to existing securities. Recently, S&P has adopted a policy requiring retesting of rated securities within one year of a model change.

Competitive Pressures. A second reason the credit rating agencies didn’t blow the whistle sooner on poorly performing RMBS and CDO securities was competition. The drive for market share, and the revenues from increased volumes of ratings, created pressure on both agencies to provide favorable credit ratings to the investment bankers bringing in business.

A 1995 article captures how the credit agencies used to operate. A journalist wrote: “Ask a treasurer for his opinion of rating agencies, and he'll probably rank them somewhere between a trip to the dentist and an IRS audit. You can't control them, and you can't escape them.” But all that changed as the revenues from structured finance ratings came pouring in.

Ratings and fees began to be played off each other. For example, after a Moody's analyst emailed that he could not finalize a rating until the issue of fees was resolved, an investment banker from Merrill Lynch responded: "We are okay with the revised fee schedule for this transaction. We are agreeing to this under the assumption that this will not be a precedent for any future deals and that you will work with us further on this transaction to try to get to some middle ground with respect to the ratings." Moody's assured the Merrill analyst that its deal analysis was independent from its fees. In another email, an S&P analyst commented: "Version 6.0 [of the ratings model] could've been released months ago and resources assigned elsewhere if we didn't have to massage the sub-prime and Alt-A numbers to preserve market share." Witnesses here today will describe how the environment changed from an academic culture focused on accurate ratings to one of intense pressure to get the deals done.

The documents also show how the crushing volume of ratings undermined the ratings process. Despite record profits, both credit rating agencies were understaffed and overwhelmed with complex deals that investment bankers wanted to close within days. The documents show how investment bankers argued with the credit rating analysts, substituted worse assets at the last minute, and pressured analysts to waive their procedures and standards. We even saw instances of bankers pushing to remove analysts who were not playing ball. At times, analysts who resisted banker demands or challenged ratings were restricted from deals.

A focus on short-term profits also permeated the industry. One of the witnesses here today will describe how when he once questioned a banker about the terms of a deal, the banker replied, "IBG-YBG." When asked what that meant, the banker explained, "I'll be gone you'll be gone" – in other words, why give me a hard time when we are both making a lot of money and will be long gone before the house of cards comes crashing down.

Mortgage Fraud. In addition to inaccurate models and competitive pressures, the credit rating agencies failed to adjust their ratings to take into account credit risks from the fraud and lax underwriting standards that increasingly characterized the mortgages securitized and sold on Wall Street.

In August 2006, an S&P employee wrote: "[T]here has been rampant appraisal and underwriting fraud in the industry for quite some time as pressure has mounted to feed the origination machine." In September 2006, another S&P employee wrote: "I think it's telling us that underwriting fraud; appraisal fraud and the general appetite for new product among originators is resulting in loans being made that shouldn't be made." A colleague responded that the head of the S&P Surveillance Group "told me that broken down to loan level what she is seeing in losses is as bad as high 40's – low 50% I'd love to be able to publish a commentary with this data but maybe too much of a powder keg." Not taking into account mortgage fraud and lax underwriting standards did, indeed, turn into a powder keg, one that helped blow up the RMBS and CDO markets and triggered the 2008 financial crisis.

Conclusion

In the fall of 2007, Moody's CEO Ray McDaniel called a town hall meeting to talk to his employees after the mass downgrades that shut down the subprime market. "What happened in '04 and '05," he said, "is that our competition, Fitch & S&P, went nuts. Everything was

investment grade. It really didn't matter[.] ... No one cared because the machine just kept going."

A Moody's managing director later responded our "errors make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue, or a little bit of both. … I would like more candor from senior management about our errors and how we will address them in the future."

That's what we are looking for today as well: candor not only about what went wrong, but what can be done to prevent still another credit rating disaster in the future. The House and Senate financial reform bills before Congress offer a number of measures to increase credit rating oversight. Both bills would, for example, eliminate the statutory prohibition on the SEC's evaluating rating models, though clearer language authorizing the SEC to set standards for credit rating models, methodologies, and criteria is needed. The bills would also beef up the SEC's enforcement authority toward credit rating agencies, and subject the agencies to lawsuits by investors for reckless or unreasonable ratings. The bills should be further strengthened by directing regulators to tackle the inherent conflicts of interest that arise when rating agencies are paid by the people they rate. Our investigation provides strong support for better controls on agencies whose failures contributed to the economic damage still plaguing our country.

One more matter. Yesterday, the Subcommittee was made aware of a longer version of an email included in the Exhibit Book as Exhibit 23. We were not aware of the longer version earlier. We have added it to the book as Exhibit 23 Addendum. The emails show Merrill Lynch making a direct link between the fees it paid and the ratings it received on a deal, but the longer email shows that Moody's told Merrill Lynch its deal analysis was independent of any fee discussion.

My Ranking Republican, Senator Coburn, wanted to be here today but was called away to matters in Oklahoma, so we will have to proceed without him, but I want to thank him and his staff for their ongoing support of this investigation.

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