Statement of Senator Tom Coburn
Wall Street and the Financial Crisis: The Role of Credit Rating Agencies
April 23, 2010

I would like to thank Chairman Levin for holding this third hearing in the subcommittee's investigation into the roots of the financial crisis.

In the eighteen months since the U.S. economy collapsed, many have asked whether anything could have been done differently. Nowhere is there a clearer "yes" to that question than in the example of the credit rating agencies.

While they were paid to forecast creditworthiness, the rating agencies proved they were not up to the task.

They failed to see the coming subprime mortgage meltdown, and kept AAA ratings on what should have been junk. This provided a false sense that the economy was stronger than it really was. It is not an exaggeration to say that the errors of the credit rating agencies prolonged the housing bubble, and quite possibly delayed the economic correction.

Unfortunately, their mistakes have cost many Americans dearly. To understand what happened we have to go back to the events leading up to July 2007.

In July 2007, Moody's, Standard and Poor's and Fitch all at once massively downgraded subprime residential mortgage backed securities or put them on notice for downgrade.

Moody's downgraded 399 subprime securities, while S&P and Fitch put out warnings on hundreds more.

In what was to that point the biggest downgrade event in history, the rating agencies rocked the financial industry that had heavily invested in housing.

Investments in subprime mortgages that were once given AAA ratings were revealed to be worthless. Investors and banks worldwide that had amassed mortgage-backed securities, collateralized debt obligations and more were suddenly all looking to sell at once. Only there were no buyers.

For the rating agencies it was also a devastating blow to their credibility, and for good reason. Never before had they gotten it so wrong.

But, what if they had made the right call? What if they accurately forecasted the housing crisis?

Moody's and S&P could have downgraded a significant number of residential mortgage backed securities in late 2006, rather than in mid-2007. E-mail evidence clearly shows that employees in these companies were growing increasingly uncomfortable with the ratings as they watched subprime loans deteriorate.

In February 2007, one S&P analyst projected that "the ratings are not going to hold through 2007." Instead of downgrading RMBS at that point, the firm waited more than four months.

In the meantime, during that four month period S&P rated more than 900 securities based on mortgage loans and gave each of them an "investment grade" rating. In every case, the securities rated in that time period would be downgraded to "junk," showing that the original ratings were far off base.

One of those securities was ABACUS 2007-AC1, the synthetic CDO at the heart of a current SEC fraud complaint. It was one of the worst performing CDOs in the market.

Had S&P or Moody's acted faster, none of these securities would likely have been rated so highly to begin with—and many investors could have been spared enormous losses. After all, synthetic CDOs like ABACUS 2007-AC1 were built on top of highly rated, but ultimately shaky, RMBS structures.

Instead, the downgrades were delayed until the rating agencies could not wait any longer. And as soon as S&P made the first move, a torrent of downgrades followed from the others.

Yet, as with so many of the problems in the financial industry, trouble in the credit rating industry traces its roots to a misguided federal "reform." By designating three rating agencies as National Recognized Statistical Rating Organizations—or NRSROs—the SEC unwittingly sowed the seeds of our problems today.

The purpose of the NRSRO designation was a noble one—to help regulated entities invest in safe capital and protect depositors or taxpayers. Rather than decide what exactly was "safe capital" for investment, regulated entities were simply told that they had to invest in AAA assets.

But the impact was perverse.

The NRSRO designation has become for many investors a "government seal of approval." The ratings they assign have received the tacit blessing of the government—whether they were right or wrong.

By requiring investors to purchase only AAA assets, it created an incentive for ratings to be *high*, though not necessarily *accurate*.

Our hearing today will be an important step in documenting exactly what went wrong.

If we are ever going to fix these problems we are going to need to start by ending the regulatory use of ratings.

Second, we need to tear down the NRSRO designation and open up ratings to competition where reputation is more important than in being in a government-approved club.

These simple steps would do more to help our financial markets than almost any other step.

I appreciate our witnesses being here today and look forward to their testimony.