Written Statement of

Frank L. Raiter

On

"Wall Street and the Financial Crisis: The Role of Credit Rating Agencies"

Before the

Permanent Subcommittee on Investigations

United States Senate

April 23, 2010

Good morning Senator Levin and Senior Minority Member Dr. Coburn. My name is Frank Raiter. From 1995 until my retirement in 2005, I was a Managing Director at Standard & Poor's and head of the Residential Mortgage Rating Group. As such, I had an inside view of the role of rating agencies in the recent economic crisis.

The failure of the major rating agencies-Fitch, Moody's and S&P- to adequately assess the risks associated with new mortgage products introduced in the past decade is a result of several factors. The first was the lack of oversight of the rating agencies by the SEC and the various financial regulatory bodies that wrote regulations requiring ratings, the second was the impact these decisions had on management of the rating agencies and the third factor was the disconnect between senior managers and the analytical managers responsible for assigning ratings. The final factor was the separation of the initial ratings process from the subsequent surveillance of performance of the rated bonds.

The first factor, a lack of regulatory oversight, resulted from the failure of regulators to appreciate the unique position the rating agencies assumed in the financial markets. The rating agencies were granted their preferred status by the SEC. Other regulators followed suite and incorporated ratings into their investment and capital rules. There was no regulatory oversight nor were standards established to measure the performance or quality of the ratings.

The preferred position of the rating agencies lead directly to the second factor. Management of the rating agencies came to believe that the increasing revenues and profits they were enjoying were the result of superior management skill and insight rather than the oligopoly granted them by various regulators and accommodative Fed interest rates. Thus success bred complacency and an aversion to change.

This resistance to change was a primary cause of the failure of the ratings and the ultimate financial crisis. Analytical managers were driven by the desire to create and implement the best risk analytical models and methodologies possible. Senior management, on the other hand, was focused on revenue, profit and ultimately share price. Management wanted increased revenues

and profit while analysts wanted more staff, data and IT support which increased expenses and obviously reduced profit.

In the residential mortgage group, as in all the rating groups in structured finance, the analysts were responsible for both producing ratings and developing and maintaining rating criteria. Balancing these two missions was a significant issue in the residential ratings group where revenues grew tenfold between 1995 and 2005 and rating volumes grew five or six fold without similar increases in staffing. Rating production was achieved at the expense of maintaining criteria quality.

Adequate staffing was not the only challenge faced in trying to maintain the quality of the rating process. The accuracy of the predictive models used to evaluate risk was also critical to the quality of the ratings. The version of LEVELS model developed in 1996 was based on a data set of approximately 250,000 loans. It was, I believe, the best model then used by a rating agency. As new models were programmed and tested, analysts continued to collect larger data sets for the next versions of the model. In late 2002 or early 2003, another version of the model was introduced based on approximately 650,000 loans. At the same time, a data set of approximately 2.8 million loans was collected for use in developing the next version of the model. By early 2004 preliminary analysis of this more inclusive data set and the resulting econometric equation was completed. That analysis suggested that the model in use was underestimating the risk of some Alt-A and subprime products. In spite of this research, the development of this model was postponed due to a lack of staff and IT resources. Adjustments to the model used in 2004, with the identified problems, were not made until March, 2005. To my knowledge a version of the model based on the 2.8 million loan data set was never implemented.

The final condition contributing to the failure of the rating agencies was the separation of the initial ratings process from the subsequent surveillance of rating performance. While the rating process utilized ever improving models, surveillance operated under their own criteria. At S&P, the manager of surveillance refused to use the rating model in reviewing the performance of outstanding bonds. In fact, the resistance to "re-rating" bonds with each new model came from upper management. The concern was that "re-rating" outstanding deals with new information would significantly increase rating volatility and possibly result in lost revenue. By 2005, when adjustments were made to the model, it should have been intuitively obvious that some bonds rated in 2004 did not provide the necessary protection to support the assigned ratings.

In conclusion, it is my opinion that if S&P had vigorously pushed to implement the version of the model based on the 2.8 million loan data set in late 2004 or early 2005, the economics of deals incorporating the lowest quality subprime and Alt-A loans would have disappeared. In addition, the riskiest transactions submitted for ratings in 2005, 2006 and 2007 would likewise have been assigned much higher enhancement requirements which might have made it unprofitable for lenders to make additional loans. If the surveillance department had "re-rated" existing deals each time ratings criteria were adjusted, transactions would have been put on Credit Watch or been downgraded in 2005 which would certainly have sent an early warning to investors and tempered their demand for similar bonds.

This concludes my opening comments. Detailed responses to the committee's questions are provided in the written statement I have provided.

The Residential Mortgage Bond Rating Process

There is a significant difference between the rating process associated with traditional credits, corporate bonds, municipal bonds, and sovereign bonds and the process for rating structured products, including mortgages.

Traditional credit analysis looks at financial ratios, business practices, products, markets and management and a myriad of other factors. In rating corporate bonds a committee, made up of analysts from the same industry as well as analysts from associated industries, reviews the rating proposal and analysis and the committee vote is a significant factor in establishing a published rating.

Structured finance, covering residential mortgages, commercial mortgages, asset backed paper (credit cards, auto loans, etc.) has two distinct parts, the analysis of the collateral supporting the transaction and the review of the legal documents that structure the flow of returns to the investors. In mortgage ratings the initial analysis is of the tape sent in by mortgage bankers or investment bankers who are requesting the rating.[1] The tape provides loan level detail on each mortgage in the pool which is then run through the rating model. By 2003, tapes typically included a thousand loans and, in the case of home equity pools, could include ten thousand or more loans. Each loan on a tape had 85 or more data points. Thus, models were absolutely necessary to analyze this huge volume of information. The model assesses the expected credit performance of each loan and then aggregates this information for the pool as a whole. The output of the model establishes the enhancement or credit support for each bond in the proposed issue (AAA down to B and the first loss non-rated tranche). The model also provides a quality check to assure that the information on the tape is consistent with criteria. Loans that fail the quality control check are eliminated from the analysis and if not corrected, not included in the final pool analysis.

It is important to note that the rating process does not include a "due diligence" review of the accuracy of the information on the tape. (We were discouraged from even using the term "due diligence" as it was believed to expose S&P to liability.) Rather the ultimate issuers of the bonds were required to provide Representation and Warranties on the accuracy of the information on the tapes and were required to repurchase any mortgages that were subsequently found to have incorrect data.

Once the pool analysis is completed, a committee is convened to verify the quality control of the pool run. There is no vote on the results of the analysis; rather, the chair verifies that all the steps

---

[1] In 1999, nine of the top ten issuers of mortgage backed securities were mortgage banks or mortgage affiliates of commercial and savings banks, some of which had their own securities affiliates which requested the ratings and sold the bonds, while others used investment bankers to structure and sell the bonds. By 2005, five of the top ten issuers were investment banks or their mortgage company affiliates.

for an accurate pool analysis were followed. The enhancement requirements are then given to the mortgage or investment banker who requested the rating. If they accept the analysis they award the rating to the agency and follow up with draft documents (the structure) for review. Typically, the pool analysis takes place several weeks before the documents begin to surface. The usual schedule was for the tape to arrive in the middle of month 1, with the documents following in the middle of month 2 and the closing expected at the end of month 2. The challenge facing the managers of the rating groups was scheduling a fixed number of rating analyst to support a growing volume of ratings requests. The situation was particularly difficult at month end when the flow of documents at its peak with new drafts and responses often arriving in the dark hours of the morning with closings scheduled for the same day. In addition to the stress of meeting the closing schedules established by the issuer there was the requirement for a final committee meeting on each mortgage rating to review the legal (structure) analysis and final pool analysis (if the issuer had substituted mortgages for those with anomalies from the first committee.) All in all, as volumes grew in the middle years of the decade the residential mortgage group (as well as other structured groups) were aggressively pushing for more staff analysts.   In fact, a number of Managing Directors asked the Chief Criteria Officer for structured finance to render an opinion on the number of ratings an analyst could be expected to handle in a month while maintaining the quality of the rating. This would have tied staffing to volumes and (we thought) force senior management to meet our requests for additional staff. No opinion was ever delivered.

Residential Mortgage Rating Model Development

In 1995, the model used by S&P in rating residential mortgage pools was "rules based", meaning the enhancement requirements for a pool were calculated from a number of "scores" assigned to the various characteristics of each loan as provided on the tape submitted by the mortgage company or investment bank requesting the rating. The model introduced in 1996 was instead based on a rigorous analysis of the performance of approximately 250,000 mortgage loans. The "rules" were replaced by a statistically determined econometric formula that calculated the probability of default for each loan in a pool based on the characteristics of the loan. A major variable incorporated in the new model was the individual borrower's FICO score. This allowed the model to determine the expected credit score of the loan. This was significant as in the past the rules based model relied on the loan score provide by the banker (the old model used the then standard designation for loan quality, A, A-, B, etc.). The quality of the new model (and all subsequent models) was based on the amount of data available to update the econometric equation driving the credit analysis. When I joined S&P, I believed that the rating agencies had enormous amounts of data that were used to develop criteria. In fact, S&P had no loan level performance data. We relied on our rating customers to provide the data sets to build the 1996 model. Subsequently we purchased data from vendors.

While the econometric equation was based on the analysis of historic loan performance the modeling team was continuously looking to incorporate more forward looking variables to improve the forecasting capabilities of the model. To this end the team met with members of the S&P economic group to pursue the development of macroeconomic indices for the MSAs covered by the house price index already embedded in the model. (A house price index was incorporated in the "old" model as well. It had been included to capture declines in house prices

but was used to adjust for both declines and increases in prices for the MSAs tracked by OFHEO.)   There were also meetings held with the corporate rating group to assist in developing credit scores for the providers of the Representations and Warranties supporting rated mortgage bonds. Many of these providers where considered "too big to fail", including WaMu, Countrywide, IndyMac, Ameriquest, Lehman Brothers, Merrill Lynch and Bear Stearns. While admitting that economic indices and corporate scores would improve the quality of residential bond ratings, neither group had the resources to dedicate to the development of criteria in another area.

Market Share, Profitability and Budgeting for Criteria Development

By 2004 the structured finance department at S&P was a major source of revenue and profit for the parent company, McGraw-Hill. Focus was directed at collecting market share and revenue data on a monthly basis from the various structured finance rating groups and forwarded to the finance staff at S&P.   Market share was not a problem for the residential mortgage group as by that time the share ranged between 92 and 96%. The annual budgeting process was likewise focused on revenue projections. From 2000 to 2004, the residential rating group's budget submissions included requests for additional staff as well as funding for purchasing data and IT programming support. Staff requests were routinely reduced below levels required to meet rating volume increases. As a result criteria development had to be postponed or cancelled. Support for model development and data ran out in 2002, when the 2002/2003 version of the model was implemented. Requests for funding the development of the version of the model, based on the 2.8 million loan data set, were denied in the 2003, 2004 and 2005 budget submissions. No reasons were provided for the denials.

# # #