

**TESTIMONY OF PETER D'ERCHIA
BEFORE THE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS**

APRIL 23, 2010

Mr. Chairman, Members of the Subcommittee, good morning. I am Peter D'Erchia, a Managing Director of Standard & Poor's Ratings Services ("S&P"). From 1997 through 2008, I was the Global Practice Leader for Global Structured Finance Surveillance at S&P. I appear today to discuss the following topics:

- The organization of the Structured Finance Surveillance group at S&P and the people and resources of the group, particularly with respect to the surveillance of U.S. residential mortgage backed securities ("RMBS");
- The process for conducting surveillance of U.S. RMBS, including the process of surveilling existing ratings after the criteria used to rate new transactions are modified;
- Rating actions on U.S. RMBS taken by S&P from 2006 through 2008.

The Surveillance Group at S&P

I joined S&P's Structured Finance Surveillance group in 1997. Prior to joining Structured Finance, I worked at S&P for approximately fifteen years in its Public Finance Group. As the Head of Structured Finance Surveillance, I supervised Surveillance for 5 major Structured Finance rating and ranking categories: RMBS, Commercial Mortgage Backed Securities (CMBS), Collateralized Debt Obligations (CDOs), Asset Backed Securities (ABS), and Servicer Evaluations (SE). Each of those groups was headed by a separate manager, who reported to me as a member of my management team.

The portfolio of S&P's Surveillance group grew substantially during my time in Surveillance. From the beginning of 2003 through 2006, the number of RMBS transactions

under surveillance increased by 65%. S&P's RMBS Surveillance resources grew to meet this increasing workload, and our growth out-paced the increase in transactions, with headcount increasing by 75% during the same period. In 2007, the number of deals under surveillance increased by another 10%. Responding to the unprecedented deterioration in performance that was just starting to develop, the group's headcount increased an additional 57% in 2007.

In addition to the designated RMBS Surveillance staff, the group was also supported by additional personnel from information technology, data, and criteria. In 2007, eight additional employees of an affiliate provided data support, all working on the performance of subprime and other RMBS, particularly the 2005 through 2007 vintages.

The Tools and Data Used in U.S. RMBS Surveillance

After a rating is issued on an RMBS transaction (a "New Issue" rating), it is transferred to the Surveillance group for monitoring. Prior to the transfer to Surveillance, S&P uses its Loan Evaluation and Estimate of Loss System (LEVELS[®]) model, which projects default likelihoods for individual mortgages based on up to 70 data points such as the FICO score of the borrower and the applicable loan-to-value ratio. These data points may bear on the likelihood of repayment and loss severity in the event of a default. Historically, certain of these data points have corresponded more closely with repayment behavior than others. S&P's LEVELS[®] model is a tool used to reflect and implement S&P's analytical assumptions and conclusions about these data points and their relationship to the likelihood of a mortgage default and the severity of losses upon default.

In contrast, the focus in S&P's surveillance analysis is to take information relating to the actual performance of the rated pool over time and use that performance data in assessing whether the rating is appropriate in light of our view of the credit support. S&P's RMBS surveillance approach focuses on a review of actual loan performance in the particular collateral pool backing each RMBS, in order to project expected losses and measure the sufficiency of existing credit support based on that transaction's actual performance. Historically, S&P has looked for approximately one year's worth of performance data in connection with this analysis. The data is delivered monthly, by trustees and various third-party vendors, to S&P and other market participants.

Distinctions Between New Issue and Surveillance Methods Are Beneficial

The different approaches used by S&P's Surveillance and New Issue groups serve an important function in providing a form of analytical check and balance. Each issuance is subjected to two analytical processes, providing for more robust analysis than would a simple re-application of the same initial method over time. Moreover, the group's distinct operations permit additional personnel to review the same transactions, bolstering the analytical rigor of the overall rating process.

The strength of each of these two approaches for its purpose also renders it in many ways inappropriate for the purpose of the other. A major strength of S&P's RMBS surveillance approach is that it focuses on the actual performance of the loans for the transaction being analyzed. Such a "track-record", of course, generally does not yet exist when the transaction is first issued. Similarly, a number of the key data points used in the

New Issue analysis are not useful for surveillance because they are generated as part of each loan origination, and quickly become stale or unavailable. For example, the New Issue analysis relies on borrowers' credit scores, and on loan-level data such as the home's value, among other loan characteristics. All of this data is collected for each loan during the mortgage loan origination process. After the borrower has received his mortgage, however, there has been no industry-standard means of acquiring updated credit scores and appraisals. Moreover, because borrowers refinance and/or sell their homes, the make-up of any given loan pool is constantly changing, reducing the value of the transaction's original data. S&P would need all of this information for entire pools of loans in order to support continuing use of the LEVELS[®] model. Because this information has not been reliably available, the utility of the New Issue model for any surveillance analysis deteriorates rapidly with time as the original data becomes stale.

S&P's Monitoring of U.S. RMBS

As I have noted, the volume of RMBS rated transactions under surveillance at S&P increased throughout the years 2003 to 2007. S&P's primary method of monitoring the performance of U.S. RMBS has historically been annual "shelf reviews" in which the securitizations of particular issuers are reviewed based on the date of issuance and the type of underlying collateral. Historically, S&P looked for at least 12 months of performance data – or "seasoning" – in its surveillance analysis.

Surveillance's goal was to review deals within 12 months for most issuers, with a focus on the industry's largest issuers. In addition, Surveillance devoted increased attention

to deals that had been flagged for closer scrutiny via placement on a watch list. In order to meet this objective, Surveillance's primary tools were Age Reports, CreditWatch and Internal Watch. Age Reports identify active deals and isolate those deals aged 6 months or more in order to identify issuances for upcoming review according to the annual review cycle. CreditWatch and Internal Watch lists identify particular deals that, because of their performance, had been targeted for monthly, quarterly, or other review. RMBS Surveillance had personnel specifically devoted to monitoring the CreditWatch and Internal Watch lists on a monthly basis. RMBS Surveillance also employed a number of tools to identify particular transactions for review in addition to its standard periodic reviews and watch lists. Those tools included, at various times, Credit Exception Reports, Default Reports, and other event-driven surveillance.

In late 2006, as the performance of the 2006 (and to a lesser extent 2005) vintage of U.S. RMBS experienced broad deterioration out of line both with our own expectations and historical experience, the Surveillance group began a process of "vintage reviews" to prioritize its review of RMBS transactions issued in 2005 and 2006 and to monitor those entire annual vintages of rated RMBS on a monthly basis as each month's data came in. As a result, S&P's review of the 2005 and 2006 vintages was accelerated to track performance as it happened, enabling us to take action on those vintages much earlier than we had historically looked to do.

S&P Monitored and Reacted to Deteriorating U.S. RMBS Performance

From 2005 to 2007, through its publications, S&P repeatedly and consistently informed the market of its concerns about the deteriorating credit quality of RMBS transactions. For example:

- In an April 20, 2005 article entitled *Subprime Lenders: Basking In The Glow Of A Still-Benign Economy, But Clouds Forming On The Horizon*, S&P observed that increased competition among subprime lenders threatened a relaxation in underwriting standards and warned that the growing popularity of “affordability” mortgage products “suggests that Standard & Poor’s concerns are justified.” We singled out interest-only mortgages as “[e]specially worrisome,” noting that “these loans are more likely to feature adjustable rates . . . setting borrowers up for potential problems should mortgage rates rise dramatically.”
- Following an internal Housing Market Simulation that it conducted in 2005, S&P published a study concerning the potential impact of a housing downturn on RMBS, using the following assumptions:
 - 20% national decline in home prices over a two year period, including a 30% decline on the East and West coasts and 10% in the middle of the country.
 - Unemployment rate peaking at 6.5% in 2007,
 - Gradual slowing of GDP to 1.2%.

The results of the study showed that S&P’s existing models captured the risk of a downturn of this magnitude and concluded that most investment-grade RMBS would weather a housing downturn without suffering a credit-rating downgrade.

The 2005 Housing Simulation was also presented to investors at a Hot Topix conference in November 2005, by RMBS Surveillance personnel.

- In a January 19, 2006 article entitled *U.S. RMBS Market Still Robust, But Risks Are Increasing And Growth Drivers Are Softening*, we said: “Standard & Poor’s expects that some of the factors that drove growth in 2005 will begin to soften in 2006 Furthermore, Standard & Poor’s believes that there are increasing risks that may contribute to deteriorating

credit quality in U.S. RMBS transactions; it is probable that these risks will be triggered in 2006.”

- On May 15, 2006, in an article entitled *A More Stressful Test Of A Housing Market Decline On U.S. RMBS*, we reported on the results of our follow-up analysis to our September 2005 housing-bubble simulation. We stated: “[t]he earlier simulation had concluded that most investment-grade RMBS would weather a housing downturn without suffering a credit-rating downgrade, while speculative-grade RMBS might not fare so well In the updated simulation . . . [S&P used] more stressful macroeconomic assumptions [which] lead to some downgrades in lower-rated investment-grade bonds.” The study still indicated, however, that higher-rated bonds were unlikely to be downgraded in such a scenario.
- On July 10, 2006, in an article entitled *Sector Report Card: The Heat Is On For Subprime Mortgages*, we noted that downgrades of subprime RMBS ratings were increasing due to “collateral and transaction performance.” The article also identifies “mortgage delinquencies” as a “potential hot button,” and notes that such delinquencies “may become a greater concern for lenders and servicers.”
- On July 17, 2006, we noted a 38% increase in downgrades in U.S. RMBS, a significant number of which came from the subprime market. *Structured Finance Global Ratings Roundup Quarterly: Second-Quarter 2006 Performance Trends*.
- On Oct. 16, 2006, in our *Ratings Roundup: Third-Quarter 2006 Global Structured Finance Performance Trends*, we reported that the number of downgrades more than tripled compared to the same period in 2005. We also noted that the quarter’s ratings actions among RMBS transactions had set a record for the most performance-related downgrades.
- Then, on December 8, 2006, in an article entitled *Credit Trends: 2007 Global Credit Strategy: Asset Class Outlook*, we informed the market of our view that “[c]redit quality in the RMBS sub-prime market has been under scrutiny this year. Standard & Poor’s RMBS surveillance group sees the environment ahead as portending greater downgrade potential along with lower upgrade potential.” We also stated that “the jump in third-quarter downgrade activity for the sub-prime market raises some risk flags for this segment; with 87 third-quarter downgrades adding to the 46 downgrades of the second quarter and 34 in the first.”

- On January 16, 2007, in an article entitled *Ratings Roundup: Fourth-Quarter 2006 Global Structured Finance Performance Trends*, we stated: “Rating activity among subprime transactions has started to shift to being predominantly negative from being predominantly positive. . . . We expect this trend in subprime rating performance to continue during 2007.”
- Ten days later on January 26, 2007, in our *Transition Study: U.S. RMBS Upgrades Are Down And Downgrades Are Up In 2006*, we reported that for 2006 “[d]owngrades overwhelmed upgrades for subprime mortgage collateral” and that we expected “losses and, therefore, negative rating actions to continue increasing during the next few months relative to previous years.”
- Our statements to the market continued throughout the first half of 2007. On March 22, 2007, in an article entitled *A Comparison Of 2000 and 2006 Subprime RMBS Vintages Sheds Light On Expected Performance*, we stated: “[w]hile subprime mortgages issued in 2000 have the distinction of being the worst-performing residential loans in recent memory, a good deal of speculation in the marketplace suggests that the 2006 vintage will soon take over this unenviable position.”
- In an April 27, 2007 article entitled *Special Report: Subprime Lending: Measuring the Impact*, we stated: “The consequences of the U.S. housing market’s excesses, a topic of speculation for the past couple of years, finally have begun to surface. . . . Recent-vintage loans continue to pay the price for loosened underwriting standards and risk-layering in a declining home price appreciation market, as shown by early payment defaults and rising delinquencies.”
- Then, on June 26, 2007, in an article entitled *Performance of U.S. RMBS Alt-A Loans Continues To Deteriorate*, we reported: “The most disconcerting trend is how quickly the performance of these delinquent borrowers has deteriorated. We continue to see migration from 60-plus-day to 90-plus-day delinquencies within the 2006 vintage, suggesting that homeowners who experience early delinquencies are finding it increasingly difficult to refinance or work out problems, as opposed to being able to ‘cure’ falling behind on payments.”

S&P’s efforts to prioritize surveillance of the 2005 and 2006 RMBS, and the particular attention paid to subprime RMBS, ensured that S&P was monitoring the leading edge of the

trend where deteriorating performance first became evident. The performance of the 2005, and especially 2006, vintages that S&P was focused on bear no resemblance to historical precedent. The first signs of this trend in the actual performance data began in late-2006, when S&P saw the rising delinquencies and focused its surveillance accordingly.

Starting in late-2006 and through the first half of 2007, delinquency data coming in each month did not resemble anything seen before. At that point, however, there were not yet any significant realized losses. Moreover, historically delinquencies did not always lead to losses. Accordingly, there was a lot of analysis and debate at S&P trying to determine what the data meant. It was unclear, for example, whether this was a timing issue and the number of delinquencies that were expected to occur over the course of the deal were instead all occurring at the beginning, or whether the delinquencies were going to follow the historical pattern except on a much larger scale. Understanding this trend and trying to estimate where it would end required analysis and data collection for a meaningful assessment. Early 2007 was a period of much analysis and discussion among S&P's New Issue, Surveillance, and Criteria personnel, working together to understand what was happening and how to respond.

During our ongoing analysis in early 2007, S&P took numerous significant steps to react to the deteriorating RMBS performance and to inform the market of our analysis:

- In February 2007, we took the unprecedented step of placing on CreditWatch negative (and ultimately downgrading) transactions that had closed as recently as 2006. As we informed the market in the accompanying release: "Many of the 2006 transactions may be showing

weakness because of origination issues, such as aggressive residential mortgage loan underwriting, first-time home-buyer programs, piggyback second-lien mortgages, speculative borrowing for investor properties, and the concentration of affordability loans.” The market recognized this as an important step. In a February 16, 2007 Los Angeles Times article, S&P’s announcement was described as “‘a watershed event’ because it means S&P is now actively considering downgrading bonds within their first year.” *See S&P to Speed Mortgage Warnings*, Los Angeles Times, Feb. 16, 2007.

- We continued taking downward action through the Spring. In May 2007 we announced that “Standard & Poor’s Ratings Services took 103 rating actions affecting 103 classes of residential mortgage-backed securities (RMBS) transactions backed by subprime, closed-end second-lien, and Alt-A loan collateral originated in 2005 and 2006; we lowered 92 ratings . . . and placed 103 ratings on CreditWatch negative These rating actions were due to collateral performance.” We also noted that “[m]ost of the transactions affected by CreditWatch placements (and no downgrades) have not experienced significant losses. The placement of our ratings on CreditWatch when a transaction has not experienced significant losses represents a new methodology derived from our normal surveillance practice.”

- On June 22, 2007, we announced further ratings actions in an article entitled *133 Subordinate Second-Lien, Subprime Ratings From 2006, 2005-Vintage RMBS On Watch Neg. Cut*. We explained in our announcement of these actions that “[t]he downgrades and CreditWatch placements reflect early signs of poor performance of the collateral backing these transactions.”
- Then, in July of 2007, we took further action in response to increasingly bad performance data. Specifically:
 - We increased the severity of the Surveillance assumptions we used to evaluate ongoing creditworthiness for RMBS transactions issued between the fourth quarter of 2005 and the fourth quarter of 2006. We downgraded those classes that did not pass our heightened stress test scenario within given time frames.
 - We modified our approach for ratings on senior classes in transactions in which subordinate classes had been downgraded.

- We also announced that, with respect to transactions closing after July 10, 2007, we would implement changes that would result in greater levels of credit protection for rated transactions.
- We applied our changed criteria for rating and surveilling RMBS, leading to significant Credit Watch and downgrade actions on July 10th and July 12th, with subsequent significant actions following as we continued to revise our criteria based on the developing performance data.

While S&P's Historical Surveillance Approach Was Well-Founded, S&P Changed That Approach as Developments Warranted

S&P recognized the unprecedented nature of the early delinquencies occurring in the 2006 vintage, and it fundamentally changed its practice in February 2007 to place issuances on CreditWatch without waiting for losses to develop. S&P continued to evaluate the evolving data over the following months while downgrading scores of issuances as it determined the appropriateness of such downgrades on an ongoing basis. By July 2007, S&P had adapted its practices sufficiently to issue substantial numbers of downgrades without waiting for losses to develop according to previous practice. That evolution continued after July 2007, resulting in further downgrades as the subsequent performance data and criteria adjustments warranted.

Conclusion

In conclusion, I would like to thank the Members and Staff of this Subcommittee for giving me the opportunity to participate in this hearing. In my experience at S&P, we have always been committed to doing the best we can to develop and maintain appropriate ratings, and I am proud of the hard work that my team put in trying to understand and respond to a historic market disruption to the best of our abilities. I would be happy to answer any questions you may have.