Statement Of
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Hearing On
Wall Street and the Financial Crisis: The Role of Credit Rating Agencies
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I would like to thank Chairman Levin, Ranking Member Coburn and the members of the sub-committee for holding this hearing on the role the rating agencies played in the financial crisis.

My name is Eric Kolchinsky, and during the majority of 2007, I was the Managing Director in charge of the business line which rated sub-prime backed CDOs at Moody's Investors Service. More recently, I was suspended by Moody's after warning the compliance group regarding what I believed to be a violation of securities laws within the rating agency.

In my opinion the cause of the financial crisis lies primarily with the mis-aligned incentives in the financial system. Individuals across the financial food chain, from the mortgage broker to the CDO banker were compensated based on quantity rather than quality. The situation was no different at the rating agencies

It is my firm belief that the vast majority of the analysts at Moody's are honest individuals who try hard to do their jobs. However, the incentives in the market for rating agency services favored, and still favor, short term profits over credit quality and quantity vs. quality.

At Moody's, the source of this conflict was the quest for market share. Managers of rating groups were expected by their supervisors and ultimately the Board of Directors of Moody's to build, or at least maintain, market share. It was an unspoken understanding that loss of market share would cause a manager to lose his or her job.

Prior to the crisis, it may have been reasonable to believe that the pursuit of market share could be unrelated to credit quality. People would say, "we are credit specialists – it is our job to be able to analyze anything we are asked to." After the crisis, it became clear that the drive for market share was the main cause of the deterioration in credit standards in the ratings of structured finance.

As a former head of compliance testified, Moody's had an unofficial policy of never committing controversial items to paper or email. Instead, people were encouraged to walk over and have a conversation or to have a conference call. However, because of its importance, market share information was an exception.

Senior management would periodically distribute emails detailing their departments' market share. These emails were limited to Managing Directors only. Even if the market share dropped by a few percentage points, managers would be expected to justify "missing" the deals which were not rated. Colleagues have described enormous pressure from their superiors when their market share dipped.

While, to my knowledge, senior management never explicitly forced the lowering of credit standards, it was one easy way for a managing director to regain market share. I do not believe that this was done in a deliberate manner. Instead, during the bubble years, it was quite easy to rationalize changes in methodology since the nominal performance of the collateral was often quite exceptional. Easier still was avoiding the questioning whether the collateral provided by the bankers was really of the same quality assumed by the model, whether the collateral standards declined or whether some of the parties had ulterior motives in closing the transaction.

I began to receive these emails when I was promoted to Managing Director. They would list all the deals in the market for the relevant period and the amounts rated by Moody's, S&P and Fitch. At the bottom of the spreadsheet, the market share for each agency was calculated.

I believe that my 2007 dismissal from the rating agency was a consequence of placing credit quality above market share. I was a Managing Director in the Derivatives group, which was responsible for rating CDOs. CDOs were an extremely lucrative area for Moody's – in the first two quarters of 2007, the group generated over $200 million of revenue. This amount accounted for approximately one-fifth of the total revenue of the entire rating agency for that period.

However, trouble for the securitization was already brewing. In early 2007, New Century, a major sub-prime lender, imploded. During the course of the year, the prices of synthetic subprime bonds precipitously declined. The end of this initial phase of the crisis was heralded by the fall of two Bear Stearns hedge funds which heavily invested in CDOs in July of 2007. The resulting price dislocation sent bankers hurrying to finish CDOs already in progress and to clean up their balance sheets.

As Managing Director, I ignored the market share priority as much as I could. I refused to rate a complex CDO that I believed we did not have the tools to model appropriately. I continued to upset bankers, and my own management, by insisting on following long established rules and procedures which became inconvenient as the market began to fall apart.

However, the incident which I believe caused me to lose my role at the rating agency occurred in September of 2007. During the course of the year, the group which rated and monitored subprime bonds did not react to the deterioration in their performance statistics. That changed by the late summer of 2007. In early September, I was told that the ratings on the 2006 vintage of subprime bonds were about to be downgraded severely. While the understaffed group needed time to determine the new ratings, I left the meeting with the knowledge that the then current ratings were wrong and no longer reflected the best opinion of the rating agency.

This information was critical for the few CDOs in my pipeline, which were being hyper-aggressively pushed by the bankers. Our rating methodology for these transactions used the ratings which were about to be downgraded as a basis for our ratings. If the underlying ratings were wrong, the ratings on these CDOs would be wrong too. I believed that to assign new ratings based on assumptions which I knew to be wrong would constitute securities fraud. I immediately notified my manager and proposed a solution to this problem.

My manager declined to do anything about the potential fraud, so I raised the issue to a more senior manager. As a result of my intervention, a procedure for lowering subprime bond ratings going into CDOs was announced on September 21, 2007. I believe that this action saved Moody’s from committing securities fraud. Because of the culture, I knew what I did would possibly jeopardize my role at Moody’s.

Just about a month later, in mid-October, another periodic market share email was sent to the Managing Directors in my group. Along with the email, our business manager noted that our market share dropped from 98% plus to 94% in the third quarter. My manager immediately replied to the email and demanded an accounting of the missing deals.

This was the most disturbing email I had ever received in my professional career. A few days before, Moody’s had downgraded over $33 billion in subprime bonds. At the time, this was the largest ever single downgrade at Moody’s. However, as a direct result of the October 07 and additional downgrades, over $570 billion of ABS CDOs would be downgraded through the end of 2008.

Despite the massive manifest errors in the ratings assigned to structured finance securities and the market implosion we were witnessing, it appeared to me that my manager was more concerned about losing a few points of market share than about violating the law.

In late October, less than a month after that email and less than two months after I intervened, my manager asked me to leave the group. I was given a smaller position with less responsibility and less pay in another group. I believe that this demotion was in retaliation for my earlier actions in September.

While Moody’s has acknowledged that the rating situation in September 2007 constituted a "problem", they failed to act to prevent a nearly identical situation in January of 2009 in connection with a transaction called Nine Grade Funding II. Instead of following some common-sense steps to prevent a violation of the law, Moody’s management chose to suspend me after pointing out the breach.

Recent rating activity indicates that market participants still prefer the most aggressive ratings. Rating firms which have taken conservative positions have seen their market share tumble. We will no doubt see the results of this lesson when the regulatory spotlight is turned off. Credit standards will once again plunge as rating agencies race to build their market share.

The only way to prevent this from occurring is to recognize that the function which the rating agencies perform is a quasi-regulatory one, much like accountants. A single set of public standards needs to be implemented, to be used for regulatory purposes only. This will allow rating agencies to compete for clients without being forced to lower credit standards.