

Testimony of Jerome S. Fons
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United States House of Representatives
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Chairman Waxman, Ranking Member Davis, and Members of the Committee, good morning.

I am pleased to be invited to offer this written testimony on the state of the credit rating industry. Until August 2007, I worked at Moody's Investors Service where I had exposure to nearly every aspect of the ratings business. My last position at Moody's was Managing Director, Credit Policy. I was a member of Moody's Credit Policy Committee and I chaired the firm's Fundamental Credit Committee. The latter dealt with rating practices and policies affecting corporate, financial institution and sovereign ratings. Prior to my 17 years at Moody's, I was an Economist with the US Federal Reserve and with Chemical Bank. I received my Ph.D. in Economics in 1985 from the University of California, San Diego. Since leaving Moody's, I have been an independent consultant advising firms on rating agency issues. My technical area of specialization is the measurement and pricing of credit risk.

As this committee has heard before, the major rating agencies badly missed the impact on subprime mortgages of falling house prices and declining underwriting standards. Subprime residential mortgage backed securities (RMBS) with initially high ratings found their way into nearly every corner of the financial system, including collateralized debt obligations (CDOs), structured investment vehicles (SIVs), financial guarantors, insurers, and banks. Many of these institutions and vehicles purchased

subprime-related securities on the strength of assessments by the major rating agencies. They allocated capital and extended credit based on their faith in these ratings.

Market participants relied heavily on the rating agencies when purchasing subprime related assets for at least three reasons. First, subprime RMBS and their offshoots offer little transparency around the composition and characteristics of the underlying loan collateral. Potential investors are not privy to the information that would allow them to understand clearly the quality of the loan pool. Loan-by-loan data, the highest level of detail, is generally not available to investors. Second, the complexity of the securitization process requires extremely sophisticated systems and technical competence to properly assess risk at the tranche level. Third, rating agencies had a reputation, earned over nearly one century, of being honest arbiters of risk.

Evidence of falling home values began to emerge in late 2006. Yet there was no appreciable change in rating standards reflecting this reality. Market reaction forced a halt to new securitizations in the summer of 2007; the first downgrades of subprime linked securities occurred in June of 2007 (Gorton 2008).

In turn, those institutions and structures that had purchased subprime RMBS became hapless victims, many seeing declines in their own ratings, some of them pushed to the brink of failure. As the pace of downgrades accelerated, market participants began to question the reliability of ratings. In short order, faith in credit ratings had diminished to the point where no financial institution was willing to lend to another. And so we had – and are still having – a credit crisis.

Why did it take so long for the rating agencies to recognize the problem? Why were standards so low in the first place? And what should be done to see that this does not happen again?

My view is that a large part of the blame can be placed on the inherent conflicts of interest found in the issuer-pays business model and rating shopping by issuers of structured securities (Fons 2008). A drive to maintain or expand market share made the rating agencies willing participants in this shopping spree. It was also relatively easy for the major banks to play the agencies off one another because of the opacity of the structured transactions and the high potential fees earned by the winning agency. Originators of structured securities typically chose the agency with the lowest standards, engendering a race to the bottom in terms of rating quality. While the methods used to rate structured securities have rightly come under fire, in my opinion, the business model prevented analysts from putting investor interests first.

A brief historical overview may be helpful. The modern bond rating industry sprang from the 1909 publication of John Moody's *Analyses of Railroad Investments*. In that book, Moody introduced a simple grading system for classifying the investment quality of railroad bonds. In the following decades, Standard Statistics (later merged with Poor's) and subsequently, Fitch, introduced their own rating systems. As the acceptance of ratings grew, so did their application. The large rating agencies today assign credit ratings to corporate bonds, commercial paper, preferred stock, syndicated bank loans, sovereign nations, municipal obligations, infrastructure projects, structured finance transactions, bank deposits and mutual funds.

Prior to 1970, rating agencies did not accept payment from rated bond issuers. Instead, they financed their rating operations through manual sales and investment advisory services. Rating agencies were well aware of the conflicts of interest posed by the “issuer-pays” business model. By accepting payment from an issuer, a rating agency sacrifices its independence. Rather than being an impartial party, it has a vested interest in the success of a bond offering and in the welfare of the issuer.

Moody’s own reputation for independent, accurate ratings sprang from a hardheaded culture of putting investors’ interests first. This reputation helped propagate the use of ratings in regulations and investment guidelines. Up until the late 1960’s, the firm often refused to meet with rated companies. Published methodologies were all but non-existent and ratings were assigned by an inaccessible, small group of analysts and managers. Even through the mid-1990s, Moody’s was considered the most difficult firm on Wall Street to deal with.

An article in *Treasury & Risk Management*, titled “Rating the Rating Agencies” appeared in the summer of 1994 and had a profound impact on the firm’s thinking. It raised questions about who our clients were and how best to deal with them. Management undertook a concerted effort to make the firm more issuer-friendly, since issuers largely paid the bills by then. In my view, the focus of Moody’s shifted from protecting investors to being a marketing-driven organization. The company began to emphasize customer service and commissioned more detailed surveys of client attitudes. I believe that the first evidence of this shift manifested itself in flawed ratings for large telecom firms during that industry’s crisis in 2001.

Following the 2000 “spin” from Dunn & Bradstreet, in which Moody’s became a stand-alone public company, management’s focus increasingly turned to maximizing revenues. Stock options and other incentives raised the possibility of large payoffs. Managers who were considered good businessmen and women – not necessarily the best analysts – rose through the ranks. Ultimately, this focus on the bottom line contributed to an atmosphere in which the aforementioned rating shopping could flourish.

Separately, the historic track record of bond ratings, along with seemingly glacial rating changes, contributed to their over-reliance by market participants and regulators. Ratings became embedded or “hard-coded” into investment guidelines, bond indices and private contracts. So-called “triggers” in loan and swap contracts often reference rating levels, putting a firm at risk of having to raise additional funds if it were downgraded.

Because of the precarious state of today’s credit markets, a downgrade of a financial institution can lead to panic. Consequently, rating analysts may believe that they must exercise extreme caution, with the result being that many weak financial institutions have ratings fixed at inordinately high levels. In a strange quirk of fate, the over-reliance on ratings reinforced practices on the part of rating agencies that now further threatens their track record.

I see no easy fixes to the problems facing the rating industry. But, I will offer some suggestions.

First, we need to see wholesale change at the governance and senior management levels of the large rating agencies. All managers associated with faulty structured finance ratings must also depart. The new leadership, preferably from a solid public service

background, must acknowledge the mistakes of the recent past and end the defensive posture of denial brought on by litigation fears.

Second, bond ratings must serve the potential buyer of a bond and *no one else*. That is, the rating must be “correct” today in the sense that it fully reflects the views of the analyst or rating committee. There should be no forbearance or other attempts to stabilize ratings. A by-product of this behavior will be that rating *changes* eventually lose their influence. Such a situation might arise sooner if regulators and legislators cease reliance on ratings. Elimination of the SEC’s NRSRO designation would be a start in this direction.

Going forward structured finance rating practices must emphasize transparency and simplicity. The over-reliance on statistical, backward-looking methods needs to be replaced by an increased reliance on common sense. All rated structured transactions should be fully registered and subject to minimum disclosure requirements.

I believe that the reforms announced to date are grossly inadequate. For rating agencies to regain their footing and serve a useful role in the global capital markets, much more drastic measures are needed. The rating agencies need to implement concrete strategies for taming the conflicts posed by the issuer pays model. They need to articulate clearly the meaning of ratings and define rating quality. For their part, regulators must drop restrictions on unsolicited ratings. This would help to minimize rating shopping and allow competition to yield positive benefits, such as lower cost and better ratings.

It is not my intention to indict everyone working in the rating industry. Indeed, the analysts that I interacted with took their responsibilities seriously and demonstrated

high moral character. I was proud to be associated with Moody's, a feeling shared by many others at the firm, and I fervently believe that substantive reforms can restore the integrity and stature of the bond rating industry.

References

Fons, Jerome, 2008, “Rating Competition and Structured Finance”, *Journal of Structured Finance*, Fall 2008.

Gorton, Gary, 2008, “The Panic of 2007”, NBER working paper # 14358.