

Testimony of Brian Clarkson
Before the Financial Crisis Inquiry Commission

**Credibility of Credit Ratings, the Investment Decisions Made Based on those Ratings, and
the Financial Crisis**

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INTRODUCTION

Good afternoon Chairman Angelides, Vice Chairman Thomas and members of the Commission. I am Brian Clarkson and I worked for Moody's Investor Service ("**Moody's**") for 17 years, where I served as president from August 2007 until my retirement from the company in August 2008. I appreciate this opportunity to provide the Commission with my views on the fast-changing market of 2007, and the role of the credit rating agency ("**CRA**") industry in general and Moody's in particular, during a period of unprecedented challenges.

Various factors contributed to the turmoil in the United States housing market that began in the subprime mortgage sector. By now, a number of these have been well debated and documented. These factors include historically low interest rates; policies that promoted home ownership; a sudden and severe nationwide decline in home prices; and an equally sudden and severe contraction of refinancing credit. Taken together, these factors had the effect of increasing default rates among borrowers to levels far higher than Moody's and others in the market anticipated. As the rising delinquency trend on 2006 subprime loans started to become apparent, the resulting volatility in the capital markets was exacerbated by, among other things, the short positions taken by some hedge funds on certain securities and indices, and a general lack of transparency about who held what securities.

With respect to Moody's analysis of subprime residential mortgage-backed securities ("**RMBS**"), my observations are limited by the fact that Moody's rated only a portion of the securitized residential mortgage market. Some transactions were rated by other CRAs, some transactions were securitized but not rated, and, more significantly, a large portion of residential mortgages were not securitized at all.

Notwithstanding this limitation, during the run-up to the financial crisis, Moody's observed the broad trends of loosening underwriting standards and escalating home prices. Moody's highlighted these trends in published reports and incorporated them into the analysis and rating of RMBS securities. Subprime loans in particular, by their very nature, involve higher risk and a higher level of delinquency and default. This was well understood by Moody's, and therefore, more credit protection was required in subprime transactions to account for that increased risk.

The growing risks over time in the mortgage market led Moody's to adjust its assumptions for the portions of the RMBS market that the company rated. More specifically, our loss expectations and credit protection levels rose by about 30% between 2003 and 2006.

During this period, Moody's was among the most conservative commentators on the sector and Moody's believed that it was providing the best opinion available. As conditions in the United States housing market began to deteriorate beyond anyone's expectations, Moody's analytical teams and committees took the rating actions that Moody's believed, given the changing circumstances, were appropriate. Unfortunately, Moody's, like many others, did not anticipate the magnitude or severity of the downturn. Moody's was far from alone in that regard.

In my statement I will offer my perspective on the following topics:

- The weakening U.S. subprime housing market;
- Moody's views on increasing risks in the subprime market;
- The role of CRAs in the capital markets;
- Moody's culture of candor, transparency and responsiveness to market dynamics; and
- Efforts to enhance the transparency of the markets.

I. THE WEAKENING U.S. SUBPRIME HOUSING MARKET

Subprime mortgages have been part of the broader residential mortgage market for over two decades and, as a group, have performed differently at various stages of the credit cycle. The poor performance of 2006 subprime loans initially followed a pattern that is not uncommon in a residential housing credit cycle. A number of extraordinary factors, however, made the turn in this cycle much more dramatic than in prior slowdowns.

During periods of growth in the housing and mortgage markets, increased borrowing demand allows existing mortgage lenders to expand their business and new lenders to enter the market. Eventually, these trends create an overcapacity in the mortgage lending market as borrowing demand slows or falls. As the lending market begins to decelerate (*e.g.*, when interest rates rise, home price appreciation slows, or the economy slows), competition among lenders for the reduced pool of borrowers increases and lenders may lower credit requirements (*i.e.*, make riskier loans) in order to maintain origination volume. These loans are more likely to become delinquent and potentially default.

Lending behavior in the subprime mortgage market followed this pattern in the years leading up to 2006 - 2007. Through 2005 and 2006, in an effort to maintain or increase loan volume, some lenders introduced alternative mortgage products that made it easier for borrowers to obtain a loan. Such products included:

- Loans made for the full (or close to the full) purchase price of the home, resulting in the borrower having little or no equity in the home;
- Loans with less rigorous documentation, such as those allowing borrowers to state their income and asset information without providing documented proof;
- Loans that exposed borrowers to yearly payment increases; and
- Longer-tenure loans, which have lower monthly payments that are spread out over a longer period of time (40 years and longer).

Often, loans made during this time had a combination of these features. In situations commonly referred to as "risk layering," a borrower could get a low initial payment, without documenting income or assets, and put no money down. Although the \$640 billion of subprime mortgages originated in 2006 comprised a relatively small portion of the nearly \$3 trillion of residential mortgages originated during that same year, the subprime sector was steadily becoming a larger proportion of overall mortgage originations by dollar volume.

II. MOODY'S VIEWS ON INCREASING RISKS IN SUBPRIME MORTGAGES

Beginning in 2003, Moody's began publishing on the increasing risks it observed and incorporated these risks into its analysis of RMBS. Between 2003 and 2006, Moody's steadily increased loss expectations on pools of subprime loans and the levels of credit protection required for a given rating level by about 30 percent. In practical terms, this meant that for the 2006 RMBS vintage rated by Moody's, more than half of the mortgages in a pool would have to default and recover less than half the amount loaned on the home before a Moody's Aaa-rated bond would suffer its first dollar of loss. In the end, even this increased credit protection was not sufficient to maintain ratings stability due to unprecedented levels of mortgage delinquencies coupled with home price depreciation.

III. THE ROLE OF CREDIT RATING AGENCIES

The role of CRAs in the market is one of an opinion provider – to provide an opinion on the risk of credit default – regardless of whether CRAs are asked to rate a structured security, a municipal security, sovereign issuance or a corporate or bank security. CRAs do not participate in the origination of loans; they do not receive or review individual loan files; they do not conduct due diligence or audits; they do not structure the security; they do not assist in the drafting, editing or “fine tuning” of legal documents or the terms of the debt contracts; and CRAs do not participate in the marketing of a security. CRAs do not make buy, sell or hold recommendations. Rather, CRAs provide a public opinion based on both qualitative and quantitative information that speaks to one aspect of a securitization, specifically, the relative credit risk associated with the security.

CRA opinions help alleviate some of the information asymmetry that exists between issuers of debt on the one hand, and investors and the rest of the market on the other. In this context, CRAs compete with one another, with other market commentators and observers and with other sources of information and insight. I have been asked whether I believe there is a conflict between the goals of growing market coverage and maintaining ratings quality. I do not. These goals are fundamentally intertwined.

Quality and coverage attributes together make credit ratings relevant tools to the market. These attributes include:

- **Predictive Content:** Credit ratings performance can be and has been tested. Default studies and other measures of rating performance can demonstrate whether a strong relationship exists between the level of a CRA's ratings and actual subsequent default and/or loss experience of debt instruments. Generally, the market has looked to CRAs whose opinions about future credit risk have proven predictive over time.
- **Broad Coverage that Allows for Greater Comparability:** The market places greater value on individual ratings by a CRA if that CRA is able to provide ratings on a large segment of the market. Broad coverage is an important attribute as it enables users of ratings to compare and contrast debt securities across regions, industries and sectors.

Consequently, the broader the coverage of a CRA, the more relevant that CRA is as an opinion provider.

- **Common Language for Credit:** Users of ratings desire consistency in credit opinions. Put differently, the more widely a CRA's ratings are used and accepted by market participants, the greater the utility of that CRA's ratings to investors, issuers, regulators and other ratings users.

In purely practical terms, market coverage is essential to the relevance of a CRA as an opinion provider because it allows users of ratings to compare a CRA's opinion about the creditworthiness of one security against another; for example, the timber industry in Europe against the auto industry in the U.S., the financial institutions industry in Latin America or the securitization market in Australia. Such comparability became more important with the growth of the global credit markets.

IV. MOODY'S CULTURE OF CANDOR, TRANSPARENCY AND RESPONSIVENESS TO MARKET DYNAMICS

During my tenure at Moody's, the rating processes were similar across the various corporate, municipal and structured finance sectors. Ratings are assigned by committees when securities are first issued and then monitored over the life of those securities. Upward or downward rating adjustments result from deviations in performance from the assumptions held at the time the initial rating was assigned – assumptions regarding the performance of the underlying asset pool in the case of securitizations and expectations regarding the realized business or financial plan in the case of corporations. Until the recent crisis, Moody's ratings performance reports – posted on the company's website, www.moody.com – showed a high degree of consistency between the performance of structured finance ratings and that of corporate ratings.¹

Moody's has fostered a culture of debate and dialogue where individuals are asked to provide their opposing views, to play devil's advocate, but always to vote their conscience and to allow a majority of the appropriate analytical professionals to decide the course of action in rating securities. Moody's analysts hold very strong views and work extremely hard to express their views to their colleagues and also to appreciate the views of others. I deeply believe that the people who choose to work at Moody's are individuals of the highest caliber, candor and insight, and I am proud to have called them my colleagues for 17 years.

Moody's credit rating opinions are determined by a majority vote of the members of a rating committee, and not by an individual analyst. The rating committee system is the heart of Moody's rating system. The committee system promotes the quality and consistency of the

¹ These publications contain a wide variety of metrics, including a measure of the accuracy of ratings as predictors of the relative risk of credit losses. See, for example, the following Moody's *Special Comments*, "Default and Recovery Rates of Corporate Bond Issuers, 1920-2005" (January 2007), "The Performance of Moody's Corporate Bond Ratings: March 2007 Quarterly Update" (April 2007), "Default & Loss Rates of Structured Finance Securities: 1993-2006" (April 2007), and "The Performance of Structured Finance Ratings: Full-Year 2006 Report" (May 2007).

rating process. Rating committee composition varies based on the structure and the industries or sectors that are relevant to the rating being assigned. Members are also selected based on expertise and diversity of opinion, and are encouraged to express dissenting or controversial views and discuss differences openly. The committee includes (i) the chair, who acts as the moderator of the committee; (ii) the assigned analyst, who presents his or her views and the analysis supporting them; and (iii) other participants who may include support analysts, other specialists (such as accounting or risk management specialists) and/or senior-level personnel with analytical responsibilities. Once a discussion has taken place, the members then vote, with the most senior members voting last so as not to influence the votes of the junior members. Each member's vote carries equal weight, and decisions are based on a simple majority of votes.

In rating any security, analysts may hold analytical discussions with issuers or their advisors. As part of this dialogue, an issuer underwriting a mortgage-backed security, for example, provides the composition of a pool of mortgages and the details of a particular structure and asks for the rating implications in light of Moody's methodologies. Analysts may explain the application of a methodology, particularly for asset classes that are new to the market or structures that are different from those that have been set forth in published methodologies. What the issuer does in response to the analyst's feedback -- whether it decides to seek a rating of the structure presented, modify the structure as it sees fit, or not seek a Moody's rating at all -- is determined entirely by the issuer or its advisor.

During the period of 2000 to 2006, Moody's structured finance revenue grew from approximately 35% to 43% of Moody's Corporation's overall revenue.² This is significant growth. I reject any suggestion, however, that Moody's sacrificed ratings quality in an effort to grow market share. In fact, the growth of Moody's structured finance revenue was primarily attributable to the expansion of the overall global structured finance market.

V. EFFORTS TO ENHANCE THE TRANSPARENCY OF THE MARKETS

Chairman Angelides, Vice Chairman Thomas and members of the Commission, I believe that addressing some of the problems that have become apparent will require action on the part of many, if not all, market participants as a new regulatory regime is developed for financial markets. For its part, beginning in 2007, Moody's considered and began implementing substantial initiatives to enhance the quality, independence and transparency of its ratings. Other witnesses are better positioned today to explain the extent and impact of these important changes.

I do note, however, that in addition to the changes that CRAs can implement unilaterally, reforms involving the broader market and its participants would enhance the usefulness and effectiveness of credit rating opinions. In particular, the quality of the opinions CRAs provide to the market is in large part a function of the quality of information to which they have access when formulating their opinions. As a result, the role CRAs play in any market is either augmented or hindered by the quality and completeness of the financial information provided by market participants. As one of the largest consumers of financial information, Moody's has long supported the efforts of policy makers to increase and improve disclosure. Measures that improve the availability, reliability and quantity of information in the structured finance market are especially beneficial to restoring confidence in that market. Further, for most Americans,

² The source of all data is Moody's Corporation's 10-K SEC filings.

their home will be the largest investment they ever make. And yet, there is inconsistent state-level regulation of mortgage brokers and underwriters. Unlike most financial professionals responsible for selling investment products, mortgage brokers and underwriters are not required to register with any federal regulatory authority. I would suggest that uniform and meaningful standards for brokers and underwriters are something for this Commission to consider.

On a more personal level, I am certainly disappointed that Moody's rating opinions on subprime structured finance securities did not prove to be as predictive as they were thought to be when issued. The assumptions and methodologies underlying those ratings were developed based upon the information and analytics available at the time, but those assumptions and methodologies were overwhelmed by the magnitude and velocity of the unprecedented economic deterioration that we experienced in 2007. I have always had, and continue to have, the greatest respect and admiration for the rating analysts that I was privileged to work with during my time at Moody's. In my view, their integrity is beyond dispute.

VI. CONCLUSION

Chairman Angelides, Vice Chairman Thomas and members of the Commission, I would like to thank you for the opportunity to share my views today, and I am happy to answer your questions.