Testimony of Richard Cantor
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Committee on Oversight and Government Reform

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I. INTRODUCTION

Good morning, Chairman Towns, Congressman Issa and Members of the Committee. I am Richard Cantor, the Chief Credit Officer for Moody's Investors Service ("**Moody's**"). I have provided my profile to the Committee under separate cover but as a general background, I hold a Ph.D. in Economics from The Johns Hopkins University and, prior to joining Moody's, held various positions in the research group and was Staff Director at the discount window of the Federal Reserve Bank of New York. I have been in the employ of Moody's for 12 years primarily focusing on credit policy and credit research. On behalf of Moody's, I would like to thank the Committee for inviting us to contribute to the Committee's discussion on the credit rating agency ("**CRA**") industry. Moody's supports examination of our industry with a view to encouraging best practices and the integrity of the products and services our industry uses and provides.

It is widely recognized that the current economic downturn has exposed vulnerabilities in the infrastructure of the financial system. Important lessons for CRAs and other market participants have emerged from the rapid and dramatic changes. In response, we have undertaken a number of initiatives to enhance the quality, independence and transparency of our ratings.[1] These enhancements build on Moody's existing practices and processes through which we continually seek to ensure the integrity and credibility of our ratings. We also have been working to adapt, as needed, our policies, systems and organization to implement rules adopted by the Securities and Exchange Commission ("**SEC**") for nationally recognized statistical rating organizations ("**NRSROs**").

In this submission I will look to provide the Committee with an overview of the rating process at Moody's and how it relates to our current and potential future operating environment. I will address this through a summary of:

1. Moody's rating process including the role of the Credit Policy and Compliance functions;
2. Moody's efforts over the past 24 months to further enhance the quality and transparency of our credit ratings;
3. Moody's view on additional reform recommendations, including the critical need for increased information disclosure in the structured finance markets.

Moody's is committed to maintaining a productive dialogue with this Committee, the entire Congress, the SEC and other regulators and market participants about the necessary steps to restore confidence in our industry and ensure the effective operation of the global credit markets. We are committed to taking whatever steps are necessary to achieve those important goals.

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1 Please see our updates on *Strengthening Analytical Quality and Transparency* (available through moodys.com), which we began publishing in August 2008 and continue to update. The main elements are summarized in Section III below.

II. MOODY'S CREDIT RATING PROCESS

Moody's operates under an established Code of Professional Conduct **("Moody's Code")** modeled closely on the International Organization of Securities Commission's **("IOSCO")** Code of Conduct Fundamentals for Credit Rating Agencies. The principles in the Moody's Code which seek to secure the quality, integrity and transparency of the rating process, its independence and the avoidance of conflicts of interest, amongst others, are deeply ingrained in our operational policies and practices.

Within the broad, overarching framework of Moody's Code, Moody's has developed policies, practices and procedures over time to govern the rating process and promote ongoing quality and integrity in that process. Moody's supplements this framework with various control functions, including the Credit Policy Group and the Compliance Group.

A Credit Rating Process

Moody's has a rigorous process for determining its opinion of any security that it rates. This process broadly includes the following components:

- *Gathering Information*: The analyst or analysts assigned to a particular issuer or obligation ("**Assigned Analyst**") begin the credit analysis by assembling the relevant information. This information comes from various sources, which may include information from the issuer in meetings or through other communications with the Assigned Analyst, as well as from public sources. The information may be supplemented with information generated by Moody's, including macro-economic and sector-specific data.
- *Credit Analysis*: Once information has been gathered, the Assigned Analyst analyzes the issuer or obligation and formulates his or her view for the rating committee to consider. In doing so, the Assigned Analyst will apply relevant Moody's methodologies, which likely will include consideration of both quantitative and qualitative factors. For example, in our Structured Finance Group, quantitative factors may include the degree of credit enhancement provided by the transaction's structure, the historical performance of similar assets created by the originator and macro-economic trends. Qualitative factors could include an assessment of the bankruptcy remoteness of the entity holding the assets, the integrity of the legal structure and management and servicing quality of the parties to the transaction. The Assigned Analyst considers the relevant factors necessary for his/her analysis with a view to presenting an opinion to the rating committee, where members are encouraged to form independent opinions. This rating committee process (discussed in greater detail below) is designed to test the robustness of the opinion reached by the Assigned Analyst in order for the entire rating committee to reach an independent opinion.
- *Utilization of Rating Methodologies*: Moody's rating methodologies address our analytical approach to a particular substantive functional area, industry or sector. For example, a methodology may address a specific approach to analyzing the credit risk of a collateralized debt obligation, while another could describe a general approach to the use of the lognormal method in the analysis of asset-backed securities. Our rating

methodologies as applied to our credit rating analysis are available to the public free of charge on moodys.com. All recently assigned credit ratings include a reference to the principle rating methodology used for the analysis of that credit. The publication of our rating methodologies provides important transparency about our ratings by providing all market participants, and the general public, an explanation of how we rate a given security.

All new methodologies or significant changes to existing methodologies are approved by the Credit Policy Committee. In addition, the Credit Policy Group (which is discussed in more detail below) engages in systematic reviews of the key methodologies used to assign ratings, including validation of the conceptual frameworks and the models used as tools in the rating process. After a new or revised methodology has been developed internally, Moody's may publish it as a Request for Comment to solicit the views of market participants prior to final adoption and implementation. This process enables us to arrive at a more fully informed methodology and also promotes our objective of being transparent in the formulation of our credit ratings. As we continue to refine our methodologies, with all relevant factors taken into account, drafts of new methodologies may circulate internally and will be subject to change until such time as they are finally adopted and published. A new methodology will, therefore, not be applied formally to any rating process until such time as it has been publicly released in final form. However, a rating committee is free to consider the same factors that might be driving a refinement of a methodology prior to that methodology being adopted.

- *The Rating Committee*: Moody's credit rating opinions are determined through rating committees, by a majority vote of the committee's members, and not by an individual analyst. These rating committees are a critical mechanism in promoting the quality, consistency and integrity of our rating process. Once the Assigned Analyst has arrived at a view after applying the relevant rating methodology/ies, he or she presents it to the rating committee. Rating committee composition varies based on the structure and complexity of the security being assigned a rating. Members are also selected based on expertise and are encouraged to express dissenting or controversial views and discuss differences openly. The committee includes the Chair, who acts as the moderator of the committee; the Assigned Analyst, who presents his or her views and the analysis supporting them; and other participants, who may include support analysts, other specialists (such as accounting, legal or risk management specialists) and/or senior-level personnel with analytical responsibilities. Other than analytical staff directly involved in the preparation of the analysis, Moody's does not disclose the names of persons involved in the rating committee. This serves to further protect the independence of our credit opinion from potential undue influence from an issuer or its related persons.

  Once a full discussion has taken place, the members then vote, with the most senior member voting last so as not to influence the votes of the junior members. This voting process is founded upon the core principle that based on a given set of facts, it is entirely legitimate for different analysts to hold different views on the credit risk associated with any issuer or obligation and that ultimately credit ratings are subjective opinions that reflect the majority view of rating committee members.

Once a rating committee has determined what it believes is the appropriate credit ratings to be assigned to an issuer's debt classes, or to debt issued under specific program documents, Moody's will not change these credit ratings unless and until a subsequent rating committee determines otherwise or a rating is withdrawn under Moody's Withdrawal Policy.

- *Dissemination of Credit Rating Announcements*: When a rating committee forms its opinion, we typically contact the issuer or its agent to inform them of the rating. The rating decision is not communicated to any other external party before it is published. Where feasible and appropriate, Moody's may also give the issuer or its agent an opportunity to review a draft of the rating announcement to verify that it does not contain any inaccurate or non-public information. The issuer may agree or disagree with the rating outcome. If the rating opinion relates to an existing published credit rating, we will publish the new opinion in any event unless the issuer or its agent provides us with new credit information that reasonably may change the assumptions underlying our analysis and therefore our conclusion. In such circumstances, a Moody's rating committee would reconvene and consider the new information, determine what it believes is the appropriate rating in light of that information and publish our opinion. Credit ratings are communicated simultaneously to all market participants and to the general public free of charge via credit rating announcements that are published on our website, www.moodys.com, and are distributed to major financial newswires.
- *Ongoing Monitoring of Ratings*: Once a credit rating is published, we monitor the rating on an ongoing basis and will modify it as appropriate to respond to changes in our view of the relative creditworthiness of the issuer or obligation. As part of this monitoring process, analysts may review public information as well as non-public information provided by the issuer or its agent. Analysts also use a range of tools to monitor and track rated issuers and obligations. These include comparisons of Moody's ratings with other measures of credit risk, including measures derived from the market prices of bonds and credit default swaps and accounting ratio-implied ratings based on default prediction. In most of Moody's U.S. Structured Finance groups, monitoring is performed by dedicated surveillance analysts under the leadership and oversight of our Group Managing Director – Structured Finance Global Surveillance Coordinator. In general terms, the surveillance analyst receives and processes data from regular servicer and/or trustee reports. The surveillance analyst then assesses the data and, if necessary (*e.g.*, because the performance data is not in line with expected parameters), conducts a rating analysis. Finally, where necessary, the surveillance analyst (or his or her manager) convenes a rating committee to vote on and authorize the publication of a rating action.

B Moody's Credit Policy Function

Moody's Credit Policy Group leads research on the performance of Moody's credit ratings, reviews and approves methodologies and models, and oversees various internal credit committees that formulate high level rating policies and practices for each of the rating groups. This Group operates independently from the business lines that are principally responsible for rating various classes of issuers and obligations. The independent structure is intended to ensure that decisions taken on methodological or performance related issues are independent of any non-credit business objective.

As Moody's Chief Credit Officer, I oversee the Credit Policy Group - reporting directly to the company's Chief Executive Officer and Chief Operating Officer and reporting quarterly to the Moody's Corporation Board of Directors. There is a Chief Credit Officer for each major rating group, who report to me, as well as a number of regional and group credit officers, who provide additional support and oversight. The Group is divided into two main units:

- *Credit Policy Committee and Credit Committees*. The Credit Policy Committee is made up of credit officers, senior managers of various rating groups, and the head of compliance. It is chaired by me in my capacity as Chief Credit Officer. The Committee is responsible for setting overall standards that govern Moody's rating process. The Committee oversees credit committees specializing in Moody's key business areas – the Fundamental Credit Committee, the Public Sector Credit Committee, and the Structured Finance Credit Committee. Each of these Committees is chaired by the Chief Credit Officer for the relevant rating group.
- *Credit Policy Research*. The Credit Policy Research Group facilitates rating analytics by providing empirical analysis and quantitative tools to Moody's rating personnel and conducts research on defaults, loss-given-default and rating transitions, and develops quantitative tools to support ratings and analysis. The Credit Policy Research Group also publishes studies of Moody's-rated obligations in different rating categories so that the market can understand the historical performance of rating categories. The research is also used to identify methodologies that may need to be reviewed because of evidence that ratings rated according to that methodology either outperform or underperform other ratings in the same category but rated under a different methodology.

The Credit Policy Group takes responsibility for, amongst others:

- *Reviewing Methodologies*. The Chief Credit Officer of each major ratings group (along with the various credit policy committees they chair) is responsible for approving all new methodologies and material changes to existing methodologies. In particular, the Credit Policy function conducts in-depth reviews of rating methodologies, focusing on analytical rigor and key underlying assumptions, the historical performance of the ratings, alternative methodologies (including those of other market participants), and differences between our ratings and market opinion as inferred from credit spreads.
- *Improving Model Verification and Validation*. Moody's is taking significant steps to enhance our model verification and validation processes. Conducted by the Credit Policy Group, the process reviews the key assumptions and overall conceptual framework of our structured finance models, thereby helping to ensure that the results of our models are not only mathematically accurate, but also sufficiently correspond to the real-world scenarios that we are modeling.

- *Instituting Feasibility Reviews for New Products*. Moody's has established a review process that includes one or more senior managers in the Credit Policy Group with appropriate experience to review the feasibility of providing a credit rating for any new type of structure that is materially different from the structures that we have previously rated.
- *Enhancing Analysis Within Rating Groups*. Full-time chief credit officers in the rating groups, as well as industry and regional credit officers, work with the rating groups, each other, credit committees, the Credit Policy Committee and the Chief Credit Officer to ensure that rating methodologies and policies are implemented consistently across the organization. Credit officers also provide an independent check within rating committees and rating groups.

C Moody's Compliance Function

Moody's has established and operates under a strong compliance culture. In particular, we have an independent Office of Ratings Compliance, which is primarily responsible for overseeing adherence to ratings policies and procedures within Moody's. The Chief Regulatory and Compliance Officer for Moody's Corporation has a reporting obligation to the Board of Directors of Moody's Corporation on at least a quarterly basis. Additionally, the Audit Committee of Moody's Corporation's board of directors is responsible for, among other things, assisting the board in fulfilling its oversight responsibilities related to compliance with legal and regulatory requirements. The Office of Ratings Compliance helps underscore the importance of objectivity and independence in the rating process. It does so through:

- understanding and, when necessary, augmenting the existing practices of Moody's ratings groups;
- ensuring that accepted practices are in fact appropriately implemented in the ratings groups; and
- assessing the adherence to accepted practices by the ratings groups.

As recognized in the Securities and Exchange Act,[2] the substance of credit ratings or the procedures and methodologies by which any NRSRO determines credit ratings should be protected from regulatory and/or political interference. This principle extends to protection from interference in the opinion of the rating committee from any internal control function, including a compliance function. The Moody's compliance function will therefore not interfere with the opinions of analysts nor should it be expected to do so but will look to ensure that policies, practices and processes are in place and are being followed by the analytical teams in the rating process.

[2] See Paragraph (c)(2) of Section 15E of the Securities Exchange Act of 1934.

III. MOODY'S EFFORTS TO FURTHER ADVANCE THE QUALITY AND TRANSPARENCY OF CREDIT RATINGS

The various contributors to the recent market crisis are by now well-chronicled, starting with the performance of U.S. sub-prime home mortgages and then of mortgage-backed and related securities originated primarily in 2006 and early 2007. Moreover, it is now clear that significant, latent vulnerabilities had been developing in the infrastructure of the global financial markets, and that once exposed, these weaknesses could, and would, have severe and reverberating consequences.[3]

Moody's has addressed in previous legislative and regulatory hearings the steps we took prior to and during the financial crisis to watch, warn and react.[4] Like other market participants, however, we did not fully anticipate the magnitude and speed of the deterioration in mortgage quality or the suddenness of the transition to restrictive lending. We were far from alone in that regard, but we believe that we should be the leading edge for predictive opinions about future credit risks, and we have learned important lessons from that experience.

Efforts to Restore Confidence

The past two years have reminded all market participants how rapidly and dramatically markets can change. Throughout this period, Moody's has – in an effort to enhance accountability – reached out to market participants and policymakers globally for feedback regarding the utility of our ratings and ratings system. Based on the feedback we have received and our own deliberations, Moody's has adopted a wide range of measures to enhance the quality, independence and transparency of our credit ratings, including the following:

1) **Strengthening the analytical quality of our ratings:** including creating permanent, internal methodology review and model verification and validation processes; continuing the separation of personnel involved in initial rating assignments and surveillance; reinforcing the independence of the Credit Policy function; implementing methodological modifications; enhancing our existing professional training program; and formalizing model error discovery procedures.
2) **Enhancing consistency across rating groups:** including incorporating common macro-economic scenarios in rating committees; broadening cross-disciplinary rating committee participation; and improving surveillance coordination across rating groups.
3) **Reinforcing measures to avoid conflicts of interest:** including codifying the existing prohibition against analysts providing recommendations or advice on structuring securities; prohibiting fee discussions by ratings managers as well as analysts (who were already subject to such a prohibition); changing rating committee composition to enhance independence and objectivity; conducting

[3] Some of these weaknesses include exceptional leverage and business models that relied on secondary markets for liquidity of complex instruments in periods of stress; the interaction of asset valuation and capital; insufficient risk management practices; interlinked market participants; and limited transparency.

[4] For example, see, April 15, 2009 Statement of Raymond W. McDaniel before the United States Securities and Exchange Commission, which is available on www.moodys.com.

"look-back" reviews when analysts leave to join organizations with potential conflicts; revising our Securities Trading Policy; retaining and reviewing complaints about analysts made by third parties; reinforcing independence and objectivity through analyst compensation policies; and adopting a stricter prohibition on Moody's analysts receiving gifts (to supplement our existing Moody's Corporation policy on this matter).

4) **Improving the transparency of ratings and the ratings process:** including enhancing disclosures on incremental changes to methodologies; publishing detailed summaries of our methodologies for rating U.S. RMBS and CDOs; enhancing the review of loan originators in U.S. RMBS transactions and asking issuers for stronger representations and warranties relating to those transactions; providing additional information on structured finance ratings (V Scores, Parameter Sensitivity analysis, loss expectation and cash flow analysis, and key statistics and assumptions); enhancing disclosures regarding attributes and limitations of credit ratings in each rating announcement; pursuing efforts to discourage rating shopping; beginning to publish key statistics and default assumptions for all new structured finance ratings and for surveillance rating actions in major asset classes (including information relating to underlying pool losses); and creating a structured finance "Quick Check" Report which seeks to inform the market of our latest opinions, summaries of rating activities, methodology changes and ratings transition summaries and other key information.

5) **Increasing resources in key areas:** including strengthening the global leadership of the rating surveillance function; increasing the number of rating surveillance analysts; increasing the Credit Policy group's staff; conducting a comprehensive review of our staffing model; and continuing to build out our Compliance function.

While we believe that we have made good progress with respect to augmenting the analytical framework and credibility of our ratings, we are committed to continuing to strive to enhance our policies and procedures even further.

IV. ERIC KOLCHINSKY

Finally, let me briefly turn to the allegations raised by Mr. Kolchinsky. In his August 28 memorandum, Mr. Kolchinsky restated his views that certain rating decisions were improper because Moody's should have applied a new and different methodology to assess certain aspects of certain transactions. In short, Mr. Kolchinsky asserts that because Moody's was developing and planning to implement new methodologies, the continued use of the old methodology was improper.

Mr. Kolchinsky has raised an evolving series of claims of misconduct. As our counsel has informed the Committee, Moody's Compliance Group had reviewed such allegations when they were raised and had determined them to be unsupported. In his most recent memorandum, Mr. Kolchinsky claimed that this determination was evidence that the Compliance Group was not sufficiently independent.

To assure that any concerns regarding the independence of the review of Mr. Kolchinksy's allegations were allayed, on July 29, 2009, Moody's engaged the law firm of Kramer Levin—a firm with no prior relationship with Moody's—to conduct an independent review of all of Mr. Kolchinsky's allegations.

These efforts are being led by a team of prominent and experienced lawyers, including the Co-Chair of the firm's White Collar and SEC Regulatory Practice. Moody's has given this team of independent outside counsel unfettered access to any person or document they wanted to conduct their inquiry. As far as Moody's is aware, the only person to decline to cooperate with the inquiry into Mr. Kolchinsky's claims is Mr. Kolchinsky, notwithstanding the cooperation requirement for all Moody's employees as employees of a regulated entity as expressed in our Code of Conduct. Mr. Kolchinsky was placed on suspended with pay status because he refused to speak with the independent counsel team. It was for this reason only that Mr. Kolchinsky was suspended with pay. Mr. Kolchinsky was not suspended for expressing his concerns.

Independent counsel will report their findings to the Company's most senior management and also to the Company's Board of Directors. Further, Moody's has informed the SEC of Mr. Kolchinsky's claims and independent counsel will report its findings to the SEC, regardless of what they may be. Last week, Moody's offered to have this Committee briefed on the matter and repeats that offer.

V. CONCLUSION

Moody's has always believed that critical examination of the CRA industry and its role in the broader market is a healthy process that can encourage best practices, support the integrity of our products and services, and allow our industry to adapt to the evolving expectations of market participants. Many necessary actions can and have been taken at both the firm and industry level, and policymakers at the domestic and international levels have proposed a host of constructive reform measures for our industry and credit markets generally. Moody's wholeheartedly supports constructive reform measures and we are firmly committed to meeting the highest standards of integrity in our rating practices, quality in our rating methodologies and analysis, and transparency in our rating actions and rating performance metrics.

I am happy to respond to any questions.