TESTIMONY of
ERIC KOLCHINSKY

Good morning.

I want to thank Chairman Towns, Ranking Member Issa and all the members of the committee for giving me an opportunity to speak this morning.

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 as a result of a warning I sent to the compliance group regarding what I believed to be a violation of securities laws within the rating agency.

I am grateful for the opportunity to speak in front of you on the need for rating agency and financial markets reform. Despite the circumstances of my separation, I still believe that Moody's is a good company and the vast majority of analysts there are smart, capable and want to do a good job of analyzing financial products.

Unfortunately, these ingredients are not sufficient to produce quality ratings or to safeguard the financial system. While I do not believe that the rating agencies were the main cause of the credit crisis (there are other parties who were far more responsible), there are still unresolved problems which will lead to continuing poor ratings performance:

1. Conflicts of Interest. The conflicts of interest which ail the ratings industry remain unmanaged. Senior management still favors revenue generation over ratings quality and is willing to dismiss or silence those employees who disagree with these unwritten policies.

2. Credit Policy Group Lacks Independence. The Credit Policy Group is a team of analysts whose role is to ensure that the methodologies and procedures used in the rating process are sound and meet minimum credit standards. Unfortunately, the Credit Policy Group at Moody's remains weak and short staffed. The group's analysts get routinely bullied by business-line managers and their decisions are over-ridden in the name of generating revenue.

3. Inadequate Methodologies. Methodologies produced by Moody's for rating structured finance securities are inadequate and do not realistically reflect the underlying credits. Rating models are put together in a hap-hazard fashion and are not validated if doing so would jeopardize revenues.

4. Compliance Group Lacks Independence. The Compliance Group is entrusted with enforcing laws and internal policies. The group is understaffed and has little professional

compliance experience. Instead of ensuring that the ratings process is free from conflict this group sits idly by while these transgressions occur.

In many ways the incentives for rating agencies have become worse since the credit crisis. There are now more rating agencies and they are all chasing significantly fewer transaction dollars. The new controls put in place by regulators are too weak to significantly alter this dynamic.

As an example of how little things have changed, ABS CDOs are being rated once again. These are the same products which are responsible for hundreds of billions of dollars of losses at major financial institutions. They were significant contributors to the problems at Citibank, Merrill Lynch and AIG. While the CDOs held by there institutions had the highest ratings possible, they still ended up being nearly worthless. I firmly believe that ABS CDOs cannot be rated with any certainty and especially not during this volatile period in the capital markets.

The "new" methodologies used to rate ABS CDOs have not improved their poor credit performance – many of the recent deals have been downgraded or have had to resort to restructuring to maintain their ratings. This toxic product needs to be consigned to the dustbin of bad ideas, but unfortunately, there are still no incentives for rating agencies to say "No" to a product no matter how poorly thought through.

Investors, like pension funds, insurance companies and the Federal Reserve, who are required to purchase securities with certain ratings deserve better than this. They need ratings which reflect an analyst's best judgment and not the profit targets of the agency.

However, I believe that there is a very simple and straight forward solution for the ills which haunt the ratings industry. It begins with the admission that the function which the agencies perform is quasi-regulatory. Bank capital requirements and mutual fund holdings are just a few of the areas where regulators rely on ratings. Additionally, there is also a consensus that robust competition is needed in the industry.

Fortunately, a model already exists which combines quasi-regulatory authority with private competition – it is the accounting industry. While accountants have not been free from scandal, the profession has not suffered the free-fall in standards which have befallen the ratings industry. The key limitation has been the existence of a single set of standards or methodologies which all accountants need to abide by (e.g. GAAP). While CPAs are free to compete on price and service, they cannot change much the definition of revenue or loss.

A single set of standards makes a lot of sense from a market and a regulatory point of view. It is much easier for regulators to learn and to pass judgment on a single set of policies, rather than understanding the minutia and the particulars of multiple approaches. The same benefit applies to investors – a single set of criteria which is debated and promulgated in a public manner will greatly add to the cause of transparency. I have

witnessed too many instances of rating agencies talking their way out of a poor decision by confusing the listener by with esoteric details of their particular methodology.

I suggest that an independent body set public standards for “regulatory ratings”. The agencies would still be free to publish their own ratings, but would have to follow the public standards for any rating used in a regulatory manner. This body, based on FASB, could start with simple things like the definition of the term “AAA”. The term is used extensively in regulations and by market participants and yet it has very different, but specific definitions at every rating agency. It makes no sense to use AAA interchangeably if the meanings are completely different. The public body could also determine what kinds of products are “rate-able” and what kind of information is required of issuers for rating purposes.

If I were a doctor, I would diagnose the rating agency patient as very curable. But treatment needs to be urgently applied to avoid further damage. Rating agencies can once again be productive members of the financial community, but they cannot do this by themselves. They need a helping hand to get back on the right track.