

MEMORANDUM

To: Members of the Permanent Subcommittee on Investigations

From: Senator Carl Levin, Subcommittee Chairman
Senator Tom Coburn, Ranking Member

Date: April 23, 2010

Re: **Wall Street and the Financial Crisis: The Role of the Credit Rating Agencies**

On Friday, April 23, 2010, beginning at 9:30 a.m., the Permanent Subcommittee on Investigations will hold the third in a series of hearings examining some of the causes and consequences of the recent financial crisis. This hearing will focus on the role played by credit rating agencies (CRAs), using as case histories Moody's and Standard & Poor's, the two largest U.S. credit rating agencies which, together, from 2004 to 2008, rated tens of thousands of residential mortgage backed securities (RMBS) and collateralized debt obligations (CDOs) referencing high risk home loans.

Subcommittee Investigation. The Permanent Subcommittee on Investigations initiated its investigation. In November 2008. Since then, the Subcommittee has engaged in a wide-ranging inquiry, conducting over 100 interviews and depositions, collecting and reviewing millions of pages of documents, and consulting with dozens of government, academic, and private sector experts on banking, securities, financial, and legal issues.

To provide the public with the results of its investigation, the Subcommittee is holding a series of hearings addressing the role of high risk lending, bank regulators, credit rating agencies, investment banks, and others in the financial crisis. After the hearings, a report on the investigation will be prepared.

Credit Ratings Generally. Credit ratings, which first gained prominence in the late 1800s, provide assessments of the creditworthiness of particular financial instruments, such as a corporate bond, mortgage backed security, or CDO. Essentially, credit ratings predict the likelihood that a debt will be repaid.¹

Credit ratings use a scale of letter grades, from AAA to C, with AAA ratings designating the safest investments and the other grades designating investments at greater risk of default. Investments with AAA ratings have historically had an expected loss rate of less than .05 percent. The expected loss rate for BBB investments was about 1 percent. Financial instruments bearing AAA through BBB- ratings are generally called "investment grade," while those with ratings below BBB- (or Baa3) are referred to as "below investment grade" or sometimes as "junk" investments. Financial instruments that default receive a D rating from Standard & Poor's, but no rating at all by Moody's.

¹ Congressional Research Service, Credit Rating Agencies and Their Regulation, September 3, 2009.

Investors often rely on credit ratings to gauge the safety of a particular investment. Some institutional investors design an investment strategy that calls for acquiring assets with specified credit ratings. Some state and federal laws restrict the amount of below investment grade bonds that certain investors can hold, such as pension funds and insurance companies. Banks are also limited by law in the amount of non-investment grade bonds they can hold, and are typically required to post additional capital against higher risk investments. Because so many federal and state statutes and regulations reference ratings, issuers of securities and other financial instruments work hard to obtain favorable credit ratings to ensure more investors can buy their product.

The Securities and Exchange Commission (SEC) regulates credit rating agencies. In September 2006, Congress enacted the Credit Rating Agency Reform Act, P.L. 109-291, to strengthen SEC oversight of the credit rating industry. The law took effect in June 2007, which is also when the SEC issued implementing regulations. Among other provisions, the law charges the SEC with designating Nationally Recognized Statistical Rating Organizations (NRSROs) and defines that term for the first time. At the same time, the law prohibits the SEC from regulating the substance, criteria, or methodologies used in credit rating models.

The United States has three major credit rating agencies: Moody's, Standard & Poor's (S&P), and Fitch. By some accounts, these three firms issue about 98% of total credit ratings and collect 90% of total credit rating revenue.²

Structured Finance. Over the last ten years, Wall Street firms have devised ever more complex financial instruments for sale to investors. These instruments are often referred to as structured finance. Because these products are so complicated and opaque, investors often place particular reliance on credit ratings to determine whether they can or should buy them.

Residential mortgage backed securities (RMBS) are one of the oldest types of structured finance. To create these securities, issuers bundle up large numbers of home loans into a loan pool, calculate the revenue stream coming into the loan pool from the individual mortgages, and then design a "waterfall" that assigns the pooled revenues to specific "tranches" set up in a specified order. The first tranche is at the top of the waterfall and is the first recipient of revenues received from the mortgage pool. Since that tranche is guaranteed to be paid first, it is the safest investment in the pool. The issuer creates a security, often called a bond, linked to that first tranche. That security is rated AAA since its revenue stream is the most secure. The next tranche in the waterfall is the second to receive revenues from the mortgage pool, and is linked to a security that might receive a AAA or lower rating.

The next tranche is used to create a security that might have an A or BBB rating, and so on until the waterfall reaches the equity tranche at the bottom. The equity tranche typically receives no rating, since it must cover the pool's initial losses, and virtually

² Id.

every mortgage pool has at least some mortgages that default. Due to the risks associated with it, the equity tranche is often promised a high rate of return on investment and can be profitable. One mortgage pool might produce a dozen or more tranches, each of which is used to create a residential mortgage backed security that is rated and then sold to investors.

CDOs are even more complex. CDOs typically include RMBS securities from multiple mortgage pools. For example, a CDO might contain BBB rated securities from 100 different residential mortgage pools. CDOs often also contain other types of assets, such as commercial mortgage backed securities, corporate bonds, or credit default swaps. These CDOs are often called “cash CDOs,” because they receive revenues from the underlying RMBS bonds and other assets. Issuers can also create “synthetic CDOs” which do not contain actual assets, but simply reference them. The investors in that type of CDO receive revenues from one or more counterparties who pay premiums in exchange for obtaining “insurance” that pays off in the event of a default or other credit event involving the referenced assets. Like RMBS mortgage pools, both cash CDOs and synthetic CDOs are sliced into tranches, the tranches are used to create securities, and the securities receive credit ratings. CDO securities are typically sold in private placements, usually to institutional investors. Issuers can also create financial instruments called CDO squared or cubed, which contain or reference tranches from other CDOs. The more resecuritizations, the more opaque and complex the instruments become, and the more reliant they are on high credit ratings to be marketable.

For a fee, Wall Street firms helped design RMBS and CDOs, worked with the credit rating agencies to obtain ratings, and sold the securities to investors like pension funds, insurance companies, university endowments, municipalities, and hedge funds. Without investment grade ratings, Wall Street firms would have had a more difficult time selling structured finance products to investors, because each investor would have had to perform its own due diligence review of the product. Credit ratings simplified the review and enhanced the sales. Here’s how one federal bank handbook put it:

“The rating agencies perform a critical role in structured finance — evaluating the credit quality of the transactions. Such agencies are considered credible because they possess the expertise to evaluate various underlying asset types, and because they do not have a financial interest in a security’s cost or yield. Ratings are important because investors generally accept ratings by the major public rating agencies in lieu of conducting a due diligence investigation of the underlying assets and the servicer.”³

In addition to making structured finance products easier to sell to investors, Wall Street firms used financial engineering to combine AAA ratings – normally reserved for ultra-safe investments with low rates of return – with high risk assets, such as the AAA tranche from a subprime RMBS paying a relatively high rate of return. Higher rates of

³ Comptroller of the Currency Administrator of National Banks, Comptroller’s Handbook, *Asset Securitization*, November 1997.

return, combined with AAA ratings, made subprime RMBS and related CDOs especially attractive investments.

The Rating Process. The rating process for RMBS and CDOs works generally as follows. An issuer, often called the arranger, begins the rating process by sending to the credit rating agency (CRA) information about a prospective RMBS or CDO, with data about the mortgage loans and other assets included or referenced in the pool. Sometimes the data identifies the characteristics of each loan in the pool; other times it provides statistical information about the pool as a whole. CDOs that are still assembling assets sometimes provide data about the assets they intend to acquire, and supply data about the actual assets a day or two before the CDO closing.

A CRA analyst is assigned to examine the proposed financial instrument. CRA analysts typically rely on their company's credit rating models to evaluate risk, and do very little additional credit risk analysis; instead they focus on reviewing the legal structure of the financial instrument to understand how it works. The RMBS credit rating model at Moody's is called M3; the S&P model is called LEVELS. Both models use actual data gathered from large numbers of actual mortgages to predict loan performance.

To obtain ratings for individual tranches in an RMBS or CDO, the analyst typically feeds the "loan tape" provided by the issuer into the credit rating model. The model then selects certain data points from the loan tape, such as borrower credit scores or loan-to-value ratios, and compares that information to past mortgage data using various assumptions, to determine the likely "frequency of foreclosure" for the particular mortgages under consideration. The model then produces an overall "expected loss" for the pool, and projects the cushion – or "credit enhancement" – needed to protect investment grade tranches from loss. The larger the cushion, the more loss protection is afforded to investment grade tranches. The model suggests how big the equity tranche should be to provide the needed cushion and may also specify lower payments to investors compared to the total mortgage payments coming into the pool to "overcollateralize" it against loss.

It is common for the ratings analyst to speak with the issuer to gather additional information and understand how the financial instrument works. Among other tasks, the analyst works with the issuer to evaluate the cash flows, the number and size of the tranches, and the rating each tranche will receive. The documents show that issuers and analysts often negotiate over how specific deal attributes will affect the credit ratings.

After completing the analysis, the analyst develops a rating recommendation and presents it to a rating committee composed of other analysts and managers within the CRA. The rating committee votes on the analyst's recommendation. If approved, the ratings for the tranches are provided to the issuer, and the CRA makes the ratings available publicly. The entire rating process typically takes two to six weeks.

After a product is rated, both Moody's and S&P conduct ongoing surveillance to evaluate the rating and determine whether it should be upgraded or downgraded over the life of the security.

Record Revenues. From 2004 to 2007, Moody's and S&P produced a record number of ratings and a record amount of revenues, primarily because of RMBS and CDO ratings. From 2004 to 2007, for example, S&P issued ratings for more than 5700 RMBS transactions and 835 CDO transactions, each of which had multiple securities.⁴ It also increased the ratings it issued each year, going from ratings for about 700 RMBS and 80 CDO transactions in 2002, to more than 1,600 RMBS and 340 CDO transactions in 2006. Over the same time period, Moody's issued ratings for nearly 4,000 RMBS transactions and 870 CDO transactions, each of which, again, had multiple securities.⁵ Moody's also increased its annual ratings, going from over 500 RMBS and 45 CDO transactions in 2002, to more than 1200 RMBS and 360 CDO transactions in 2006. The numbers are even more dramatic when considering ratings issued for individual securities. From 2006 to 2007, for example, Moody's and S&P each issued ratings for over 10,000 RMBS securities.⁶

The CRAs charged substantial fees to rate a product. To obtain an RMBS or CDO rating during the height of the market, for example, CRAs charged issuers from \$50,000 to more than \$1 million. Surveillance fees, which may be imposed at the initial rating or annually, ranged from \$35,000 to \$50,000 per RMBS or CDO.

Revenues increased dramatically over time as well. Moody's gross revenues from RMBS and CDOs increased from just over \$61 million in 2002 to over \$208 million in 2006.⁷ S&P's net annual revenues from ratings nearly doubled from \$517 million in 2002, to \$1.16 billion in 2007.⁸ During that same period, the structured finance group's revenues tripled from \$184 million in 2002, to \$561 million in 2007.⁹ In 2002, structured finance contributed 36 percent to S&P's bottom line; in 2007, it contributed 48 percent – nearly half of all S&P revenues.¹⁰ In addition, from 2000 to 2007, operating margins at the CRAs averaged 53 percent, far outpacing companies like Exxon and Microsoft, which had margins of 17 and 36 percent respectively in 2007.¹¹

Top CRA executives were also compensated handsomely. Moody's chief executive, Raymond McDaniel, earned \$8.8 million in 2007, and received a stock option award worth more than \$2.3 million.¹² Brian Clarkson, the head of Moody's structured finance group received \$3.2 million in total compensation in 2007.¹³ In addition, upper and middle managers did well, with Moody's managing directors making approximately

⁴ Compliance letter from S&P to SEC, Mar. 14, 2008.

⁵ Compliance letter from Moody's to SEC, Mar. 11, 2008.

⁶ SEC database of credit ratings assigned to RMBS securities issued in 2006 and 2007.

⁷ Id.

⁸ Compliance letter from S&P to SEC, Mar. 14, 2008.

⁹ Id.

¹⁰ Id.

¹¹ "Debt Watchdogs: Tamed or Caught Napping?" New York Times, Dec. 7, 2008.

¹² Moody's 2008 Proxy Statement.

¹³ Id.

\$400,000 to \$500,000 with stock options on top of that. S & P managers received similar compensation.

The fact that CRAs receive revenues from the issuers who pay them for rating the products they sell creates an inherent conflict of interest. Not only are CRA personnel encouraged by clients to provide them with favorable ratings, but the situation encourages ratings shopping, in which an issuer can choose the CRA offering the highest rating. Ratings shopping can weaken standards as each CRA seeks to provide the most favorable rating to win business. Moody's Chief Credit Officer told the Subcommittee staff that ratings shopping was commonplace. In September 2007, Moody's CEO described the problem this way: "What happened in '04 and '05 with respect to subordinated tranches is that our competition, Fitch and S&P, went nuts. Everything was investment grade."¹⁴ In 2003, the SEC reported that "the potential conflicts of interest faced by credit rating agencies have increased in recent years, particularly given the expansion of large credit rating agencies into ancillary advisory and other businesses, and the continued rise in importance of rating agencies in the U.S. securities markets."¹⁵

Downgrades. Investors who relied on the credit agencies' ratings of mortgage based securities suffered heavy losses when many RMBS securities and CDO securities that were initially rated investment grade were sharply downgraded. Moody's and S&P began downgrading RMBS and CDO products in 2006, when delinquency rates and losses increased. In July 2007, both S&P and Moody's initiated the first of several mass downgrades that shocked the financial markets. Within days of one another, S&P downgraded 612 subprime RMBS with an original value of \$7.3 billion, and Moody's downgraded 399 subprime RMBS with an original value of \$5.2 billion. After these rating downgrades, the subprime secondary market collapsed, and financial firms around the world were left holding suddenly unmarketable subprime RMBS securities.

In October 2007, Moody's began downgrading CDOs on a daily basis, downgrading more than 270 CDO securities with an original value of \$10 billion. In December 2007, Moody's downgraded another \$14 billion in CDOs, and placed another \$105 billion on credit review. Moody's calculated that, overall in 2007, "8725 ratings from 2116 deals were downgraded and 1954 ratings from 732 deals were upgraded."¹⁶ On January 30, 2008, S&P downgraded over 6,300 subprime RMBS securities and over 1,900 CDO securities, an unprecedented mass downgrade. These downgrades created significant turmoil in the securitization markets, as investors like pension funds and insurance companies were required to sell off assets that had lost their investment grade status, holdings at financial firms plummeted in value, and new securitizations were unable to find investors. The financial crisis had begun.

¹⁴ Raymond McDaniel at Moody's MD Town Hall Meeting, 09/10/07, Moody's-COGR-0052143.

¹⁵ SEC, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, January 2003, As Required by Section 702(b) of the Sarbanes-Oxley Act of 2002. The report continued: "[C]oncerns had been expressed that a rating agency might be tempted to give a more favorable rating to a large issue because of the large fee, and to encourage the issuer to submit future large issues to the rating agency."

¹⁶ Moody's Credit Policy Special Comment, *Structured Finance Ratings Transitions*, 1983-2007, Feb. 2008.

Ratings Problems. The Subcommittee’s investigation uncovered a host of problems with the credit ratings assigned to RMBS and CDO products.

--Inaccurate Models. The models used by Moody’s and S&P provided thousands of ratings that turned out to be inaccurate. They did so, in part, because the models did not contain adequate performance data for subprime, interest-only, option ARM, and other high risk mortgages that had come to dominate the housing market, and did not contain adequate data for higher risk borrowers. According to the Congressional Research Service, the models failed to understand the likelihood of falling house prices, attached the wrong weights to the effect of falling house prices on loan default rates; and miscalculated the interdependence among loan defaults.¹⁷ In 2007, S&P testified that: “[W]e are fully aware that, for all our reliance on our analysis of historically rooted data that sometimes went as far back as the Great Depression, some of that data has proved no longer to be as useful or reliable as it has historically been.”¹⁸ The former head of the RMBS group at S&P told the Subcommittee that he believed their model needed updating, but that the company chose not to commit the resources in order to do so.

Other emails indicated that ratings personnel acted at times with limited guidance, unclear criteria, or limited understanding of complex deals. For example, one S&P employee wrote: “[N]o body gives a straight answer about anything around here ... how about we come out with new [criteria] or a new stress and ac[tu]ally have clear cut parameters on what the hell we are supposed to do.”¹⁹ Another S&P employee wrote in May 2006, about deals that “between the three of us were all rated by the same person ... who neglected to catch other important criteria issues ... or ignored them after being told to correct them by Team Leaders.”²⁰ An analyst complaining about a rating decision in May 2005, wrote: “Chui told me that while the three of us voted ‘no’, in writing, that there were 4 other ‘yes’ votes. ... [T]his is a great example of how the criteria process is NOT supposed to work. Being out-voted is one thing (and a good thing, in my view), but being out-voted by mystery voters with no ‘logic trail’ to refer to is another. ... Again, this is exactly the kind of backroom decision-making that leads to inconsistent criteria, confused analysts, and pissed-off clients.”²¹

--Improper Influence. Former Moody’s and S&P employees told the Subcommittee that the culture at the ratings firms also changed over time, and that gaining market share and revenues and pleasing investment bankers bringing business to the firm, impacted the quality of ratings. In a 2007 email to Moody’s

¹⁷ Congressional Research Service, *Credit Rating Agencies and Their Regulation*, September 3, 2009.

¹⁸ Testimony of Vicki Tillman, S&P Executive Vice President, before U.S. House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, 9/27/07, at 1-2, S&P SEN PSI 001946.

¹⁹ Instant Message from S & P employee, 5/8/07, PSI-SP-000016.

²⁰ Email from S&P employee, 5/2/06, PSI-SP-000339.

²¹ Email from S&P employee, 5/12/05, PSI-SP-000005.

CEO Ray McDaniel, for example, Moody's Chief Credit Officer wrote that the company's analysts and managing directors were continually "pitched by bankers, issuers, investors -- all with reasonable arguments -- whose views can color our credit judgment, sometimes improving it, other times degrading it (we 'drink the kool-aid'). Coupled with strong internal emphasis on market share & margin focus, this does constitute a 'risk' to ratings quality."²²

One concrete example of how revenues could affect ratings is suggested in an email exchange in June 2007. A Moody's analyst told a Merrill Lynch investment banker that she could not finalize a CDO rating until the "fee issue" was resolved. The investment banker responded: "We are okay with the revised fee schedule for this transaction. We are agreeing to this under the assumption that this will not be a precedent for any future deals and that you will work with us further on this transaction to try to get to some middle ground with respect to the ratings."

Another example involves a CDO known as Vertical ABS CDO 2007-1, in which S&P analysts complained about lack of cooperation from the issuer, UBS, and the deal's credit risk. In an April 2007 email, one S&P analyst wrote:

Vertical is politically closely tied to B of A – and is mostly a marketing shop – helping to take risk off books of B o[f] A. Don't see why we have to tolerate lack of cooperation. Deals likely not to perform."²³

Despite the analyst's judgment that the CDO was unlikely to perform, S&P rated it. So did Moody's. Four months later, the CDO was put on credit watch. Two months later, it defaulted. One of the purchasers, a hedge fund called Pursuit Partners, sued both UBS and the CRAs over the quick default. The CRAs were dropped from the lawsuit, but the court ordered UBS to set aside \$35 million for a possible award to the investor. The investor had found internal UBS emails calling the investment-grade Vertical securities "crap."

--Failure to Retest After Model Changes. The surveillance of existing rated products was also inadequate. First, the surveillance groups lacked the resources to properly monitor the thousands of rated products, with backlogs of RMBS products requiring analysis. Secondly, the RMBS surveillance groups failed to retest existing products after ratings model changes, despite the fact that many of them contained the same assets and risks that the model was revised to evaluate. Testing the existing deals would have resulted in a significant number of downgrades that might have upset investment banks and investors. For example, in July 2006, the S&P RMBS group updated its model with improved data and determined that, to avoid an increasing risk of default, subprime RMBS securities required a credit enhancement with 40 percent larger loss protection in the equity tranches. Even though S&P had determined that credit risk had increased and altered its model accordingly, it decided not to retest existing rated subprime RMBS securities as

²² Moody's-COGR-0038027.

²³ PSI-SP-000404.

part of its surveillance effort. Moody's also did not retest existing RMBS securities. Its policy stated: "Currently, following a methodology change, Moody's does not re-evaluate every outstanding, affected rating."²⁴ Had the CRAs retested existing securities and issued appropriate downgrades in 2006, it would have sent an early signal to the market that there were problems in the subprime market and perhaps dampened the high risk lending.

Gamesmanship also took place with issuers seeking ratings for new securities to use the old model that produced higher ratings than the new model. For example, in 2007, Morgan Stanley sent an email to a Moody's analyst saying: "Thanks again for your help (and Mark's) in getting Morgan Stanley up-to-speed with your new methodology. As we discussed last Friday, please find below a list of transactions with which Morgan Stanley is significantly engaged already (assets in warehouses, some liabilities placed). We appreciate your willingness to grandfather these transactions [under] Moody's old methodology."²⁵

--Mortgage Fraud. Still another problem was that, although the CRAs were aware of increased levels of mortgage fraud and lax underwriting, they did not factor that credit risk into their models. As early as 2004, the Federal Bureau of Investigations (FBI) issued a report announcing increased mortgage fraud: "[L]oan frauds are expanding to multitransactional frauds involving groups of people from top management to industry professionals who assist in the loan application process."²⁶ In 2006, the FBI reported that the number of Suspicious Activity Reports on mortgage fraud had increased sixfold, from about 5,600 in 2002, to about 35,000 in 2006, while mortgage fraud convictions had increased 131%.²⁷ The Mortgage Asset Research Institute (MARI) also reported increasing mortgage fraud over several years, including a 30% increase in 2006 alone.²⁸

Internal emails demonstrate that CRA personnel were aware of the problem. In August 2006, for example, an S&P employee wrote: "I'm not surprised, there has been rampant appraisal and underwriting fraud in the industry for quite some time as pressure has mounted to feed the origination machine."²⁹ In September 2006, another S&P employee wrote: "I think it's telling us that underwriting fraud; appraisal fraud and the general appetite for new product among originators is resulting in loans being made that shouldn't be made." A colleague responded that the head of the S&P Surveillance Group "told me that broken down to loan level what she is seeing in losses is as bad as high 40's – low 50% I'd love to be able to

²⁴ MIS-OCIE-RMBS-0037203

²⁵ Email from Morgan Stanley to Moody's, 5/2/2007, SEC_MOODY00000345.

²⁶ FBI, Financial Institution Fraud and Failure Report, 2004, <http://www.fbi.gov/publications/financial/2004fif/fif04.pdf>

²⁷ "Financial Crimes Report to the Public Fiscal Year 2006, October 1, 2005 – September 30, 2006," Federal Bureau of Investigation

²⁸ Ninth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association, April 2007, Mortgage Asset Research Institute, LLC.

²⁹ Email from S&P employee, 8/8/06, S&P SEC-E 31894.htm.

publish a commentary with this data but maybe too much of a powder keg.”³⁰ In October 2006, still another S&P employee wrote: “Pretty grim news as we suspected – note also the ‘mailing in the keys and walking away’ epidemic has begun – I think things are going to get mighty ugly next year!” Articles about the deterioration of the subprime and housing market were circulated within the credit rating agencies throughout 2006 and 2007, yet no model adjustments to the models were made to account for fraud.

In January 2007, when S&P was asked to rate a CDO with subprime loans issued by Fremont Investment and Loan, a subprime lender known for poor quality loans, an S&P ratings analyst sent an email to his supervisors: “I have a Goldman deal with subprime Fremont collateral. Since Fremont collateral has been performing not so good, is there anything special I should be aware of?” One supervisor told him: “No, we don’t treat their collateral any differently.” The other wrote that, as long as he had current FICO scores for the borrowers, the analyst was “good to go.” In the meantime, an article was circulated stating that Fremont had stopped using 8,000 brokers due to loans with some of the highest delinquency rates in the industry. Despite Fremont’s higher credit risk, both S&P and Moody’s rated the CDO in March 2007. By the end of the year, both began downgrading the CDO. Currently, two of the five AAA tranches have been downgraded 17 notches to junk status.

In September 2007, looking back, one Moody’s managing director wrote: “[W]hy didn’t we envision that credit would tighten after being loose, and housing prices would fall after rising, after all most economic events are cyclical and bubbles inevitably burst. Combined, these errors make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue, or a little bit of both.”³¹

SEC Report. In 2007, after the mass downgrades began, the SEC initiated an examination of the credit rating agencies. In 2008, the SEC issued a report which found that despite the large increase in volume of CDO/RMBS products, the credit rating agencies did not increase their staff to rate or monitor these securities; the credit rating agencies appeared to be rating complex deals with little understanding of them; CRAs were not conducting ongoing surveillance of their rated products; and Wall Street firms were part of the CRA rating process and influenced the outcome.

Subcommittee Findings. Based upon the Subcommittee’s ongoing investigation, we make the following findings of fact regarding the role of the credit rating agencies in the 2008 financial crisis.

- 1) **Inaccurate Rating Models.** From 2004 to 2007, Moody’s and Standard & Poor’s used credit rating models with data that was inadequate to predict how high risk residential mortgages, such as subprime, interest only, and option adjustable rate mortgages, would perform.

³⁰ Email from S&P employee, 9/29/06, S&P-SEC-E 333308.

³¹ Moody’s Managing Director, Moody’s Town Hall Feedback, Sept. 2007, Moody’s 0052080 at 79.

- 2) **Competitive Pressures.** Competitive pressures, including the drive for market share and need to accommodate investment bankers bringing in business, affected the credit ratings issued by Moody's and Standard & Poor's.
- 3) **Failure to Re-evaluate.** By 2006, Moody's and Standard & Poor's knew their ratings of residential mortgage backed securities (RMBS) and collateralized debt obligations (CDOs) were inaccurate, revised their rating models to produce more accurate ratings, but then failed to use the revised model to re-evaluate existing RMBS and CDO securities, delaying thousands of rating downgrades and allowing those securities to carry inflated ratings that could mislead investors.
- 4) **Failure to Factor In Fraud, Laxity, or Housing Bubble.** From 2004 to 2007, Moody's and Standard & Poor's knew of increased credit risks due to mortgage fraud, lax underwriting standards, and unsustainable housing price appreciation, but failed adequately to incorporate those factors into their credit rating models.
- 5) **Inadequate Resources.** Despite record profits from 2004 to 2007, Moody's and Standard & Poor's failed to assign sufficient resources to adequately rate new products and test the accuracy of existing ratings.
- 6) **Mass Downgrades Shocked Market.** Mass downgrades by Moody's and Standard & Poor's, including downgrades of hundreds of subprime RMBS over a few days in July 2007, downgrades by Moody's of CDOs in October 2007, and downgrades by Standard & Poor's of over 6,300 RMBS and 1,900 CDOs on one day in January 2008, shocked the financial markets, helped cause the collapse of the subprime secondary market, triggered sales of assets that had lost investment grade status, and damaged holdings of financial firms worldwide, contributing to the financial crisis.
- 7) **Failed Ratings.** Moody's and Standard & Poor's each rated more than 10,000 RMBS securities from 2006 to 2007, downgraded a substantial number within a year, and, by 2010, had downgraded many AAA ratings to junk status.
- 8) **Statutory Bar.** The U.S. Securities and Exchange Commission is barred by statute from conducting needed oversight into the substance, procedures, and methodologies of the credit rating models.
- 9) **Legal Pressure for AAA Ratings.** Legal requirements that some regulated entities, such as banks, broker-dealers, insurance companies, pension funds, and others, hold assets with AAA or investment grade credit ratings, created pressure on credit rating agencies to issue inflated ratings making assets eligible for purchase by those entities.