Testimony of the Honorable Alfonse M. D'Amato before US House Committee on Oversight and Government Reform

Thank you, Mr. Chairman, for giving me the opportunity to testify before your committee today on the topic of credit rating agencies and the role they played in the recent financial crisis. Their failure to adequately protect the interest of the investing public caused homeowners, small businesses, and investors in mortgage backed securities everywhere to suffer.

Credit rating agencies, SRO's, began life providing legitimate investment tools that allowed investors to evaluate securities. Once the system changed to one where issuers pay for agencies to rate their securities, the stage was set for the trouble we have today. Add the fact that a select few ratings agencies had the imprimatur of SEC recognition as *Nationally Recognized Statistical Rating Organizations* (NSRO's) with a near monopoly on their services, and the opportunity for bad results multiplied.

The debacle of the sub-prime mortgage crisis could not have taken place without the total complicity of these credit rating agencies. Until today and this hearing, we have not had a comprehensive investigation relating to how these services- Moody's, Standard & Poor's, Fitch, and others- could have given triple-A rating to securities that clearly deserved junk bond rating.

CNBC aired a magnificent expose titled "House of Cards" in which they documented the shocking abdication of responsibility by the rating agencies. It becomes quite clear after an interview with Anne Rutledge,

one of Moody's own securities raters, that rating agencies looked the other way because they were afraid to lose business from Wall Street.

Unless there is some liability attached to their actions, rating agencies will have no real incentive to clean up their act. The testimony the committee is receiving today from another brave former Moody's analyst about the apparently continuing problem of overrating dubious securities and the "moral responsibility" he accepts for this problem underscores the need for action.

Credit rating agencies have such obvious conflicts of interest and were so derelict in their responsibilities to the investing public in the past few years that their opinions should now be heavily discounted. They have lost credibility – for as the very word *credit* itself comes from the Latin *credere* "to trust or believe", their pronouncements simply are no longer believable.

Their failure to detect obvious flaws in the financial products they were evaluating was like *not* crying fire in a burning theater. And given that they were so clearly incentivized to favorably rate their clients' offerings, in effect put the firebug in charge of the fire alarm.

This will not change unless the SEC puts real teeth in its proposed new rating agency rules. Until now the SEC has been too timid and lax in its response. The recent SEC vote to consider amending Commission rules to subject rating agencies to liability when a rating is used in connection with a registered offering is a step in the right direction, but it is one that should have been taken long ago and should not take forever to implement.

The prestigious **Financial Economists Roundtable** has made several suggestions for reform in this area that should be acted upon. I have discussed their recommendations at length with Professor Edward Altman of NYU's Stern School of Business, a distinguished scholar and one of the co-authors of the FER's Statement "Reforming The role of Statistical Ratings Organizations in the Securitization Process". With your permission, I will offer their entire Statement for inclusion in the record. If I might just quote the following recommendations:

"The FER [supports]…. Credit-rating reform. [It] supports strategies designed to improve credit rating agencies' incentives by increasing the transparency of their modeling practices and holding their managements accountable for negligent ratings errors. "

"….FER challenges the wisdom of incorporating SRO ratings in securities and banking regulations issued by governmental entities." (Doing so is like relying on Bernie Madoff's accountant to ascertain if his books were in order.)

"… [it] recommends that SROs be required to state an express margin for error in their ratings for every tranche of securitized instruments."

[Finally], "Every US issuer of securitized claims could be required to provide a monthly balance sheet and income statement for each and every securitization structure it creates."

Along with these reforms I would go one step further and support the SEC's proposed prohibition against letting a rating agency act as both a rater of and a paid advisor for securities issuers, as these dual capacities unavoidably creates conflicts of interest. The analogy I would use here is that of the conflicts that undermined the credibility of accounting

firms in the past wherein they both audited and advised certain clients. It is inherently a conflict of interest to be both an advisor and auditor, *and* it is inherently a conflict of interest to be both an advisor and a rater.

The SEC should consider new models for sanctioning credit rating agencies that increases the number of approved raters. It should seek advice from an outside panel of experts to vet and approve new rating agencies that doesn't shut out more thorough approaches to credit rating*, including models that more accurately predict the probability of securities default*. It should devise a way to prevent issuers from buying good ratings by requiring them to pay rating fees into a pool that would then be drawn on independently of the issuers by the SEC to retain rating agencies and give unbiased, un-conflicted opinions.

In conclusion, the stability of our entire financial system rests on credible, objective, conflict-free analysis of securities. If we do not shore up this pillar of US economic security, the economy will continue to suffer from a lack of confidence in both our financial institutions and our government. The time to act is now.