TESTIMONY OF
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BEFORE THE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
OF THE SENATE COMMITTEE ON HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS
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I appreciate the opportunity to submit testimony on the topic of "Wall Street and the Financial Crisis: The Role of Credit Rating Agencies".

As a result of investigations beginning in 2007, I have sued credit rating agencies for violations of Connecticut's Unfair Trade Practices Act.

Although credit rating agencies repeatedly emphasized their independence and objectivity when rating structured finance securities, I found that Moody's and S&P knowingly failed to fulfill their representations. In particular, their ratings on structured finance securities were tainted by their desire to earn lucrative fees.

Moody's and S&P knowingly catered to the demands of investment banks and other large issuers of structured finance securities to increase their own revenues. As a result, many risky structured finance securities undeservedly received Moody's and S&P's highest ratings.

Essentially, these credit rating agencies gave the best ratings money could buy, thus serving their powerful investment banking clients, rather than objectively rating risky securities. They misled investors and others -- including individuals, banks, mutual funds, insurance companies, hedge funds, pension funds and government regulators -- into believing that their credit ratings were independent and objective. Many investors may have avoided particular investments if they knew that these instruments contained far more risk than the agencies' ratings indicated, with many ultimately proving nearly worthless.

My investigation demonstrated as well that the current business model -- where the issuer pays for the rating and there is virtually no oversight or accountability -- must be fixed. We can no longer afford band aids and quick fixes to a problem that runs much deeper and originates with the skewed incentives at the core of the system.

As guardians of America's financial markets, Moody's and S&P have an obligation to fulfill their promises of independence and objectivity. Similarly, they must end their misplaced focus on meeting the demands of their big financial firm clients at the cost of objective analysis and maximizing revenue to the detriment of ratings quality. Competition between the rating agencies cannot be a race to the bottom -- victory going to the company that most quickly and deftly weakens its methodologies to satisfy a powerful customer.

The rating agencies have been enablers of the wrongdoing that brought our nation to the brink of economic catastrophe.

This insidious dynamic was thrust into public view by the lawsuit filed last week by the Securities and Exchange Commission ("SEC") against Goldman Sachs & Company. According to the SEC's complaint, the ABACUS CDO -- a security that unknown to investors was *designed to fail* -- was given the highest rating by both Moody's and S&P, and yet was nearly worthless within months of its issuance. As described in an email contained in the SEC's complaint, "rating agencies . . . have all the incentives to keep the game going, while 'real money' investors have neither the analytical tools nor the institutional framework" to prevent such calamities.

ABACUS is just one of several significant examples of the credit rating agencies' dismal and deceptive conduct. In the absence of meaningful and systematic reform, our country will be left with more of these ticking time bombs, likely culminating in another financial crisis.

The credit rating agencies have been allowed to claim immunity for their willful misconduct for far too long. Congress needs to impose accountability. Ironically, contrary to their lawyers' strained interpretations of the law, this simple principle apparently even has support within the rating agencies. As part of a presentation in October of 2007 chronicling Moody's lapse in standards and outlining solutions, Moody's CEO advised his Board of Directors: "Bad ratings must be perceived to have (much) worse consequences than market share slippage. Accountability is key." Accountability is what I encourage the Subcommittee to foster and the lawsuits filed by my office seek to provide.[1]

Structured finance securities include, among other things, the securities composed of sub-prime loans and other assets. Some of the most common securities at issue are residential mortgage backed securities ("RMBS") and collateralized debt obligations ("CDOs"). In order to successfully market and sell these investments, issuers require a credit rating from Moody's, S&P, or other credit rating agency recognized by the SEC.

Credit rating agencies such as Moody's and S&P are gatekeepers on whom investors and other market participants rely. Moody's and S&P play a special role in the structured finance securities market because their investment grade rating is required by SEC regulations for many institutional investors to buy debt securities. Furthermore, structured finance securities are incredibly complex and opaque investments whose value and credit risk are not easily determined by even the most sophisticated institutional investors. As a result, purchasers of structured finance securities and other market participants are particularly dependent on the ratings assigned by Moody's and S&P.

Moody's and S&P are aware of investors and other market participants' reliance on their ratings of structured finance securities and encourage this reliance by making repeated public representations assuring the independence and objectivity of their analysis. Indeed, Moody's and S&P take every opportunity to proclaim that their ratings are objective, independent, and not

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[1] A more detailed recitation of Moody's and S&P's knowing misconduct and the relief requested by the State of Connecticut can be found in our complaints filed on March 10, 2010, and located at http://www.ct.gov/ag/cwp/view.asp?A=2341&Q=456804.

influenced by either their own or their clients' financial interests. These statements of independence and objectivity are simply untrue, and Moody's and S&P know it.

Specifically, as far back as 2001, Moody's and S&P knowingly catered to the demands of investment banks and other large issuers of structured finance securities in order to increase their own revenues. As a result, many risky structured finance securities undeservedly received Moody's and S&P's highest ratings.

Moreover, the users of Moody's and S&P's structured finance ratings received a product or service significantly different from what Moody's and S&P publicly represented that they were providing to the marketplace. Instead of being independent and objective, Moody's and S&P placed their own financial interests, and those of their largest clients, ahead of those they pledged to protect -- the investing public.

Issuer Pays for Ratings Business Model

Lack of independence and objectivity resulted directly from conflicts of interest inherent in the "Issuer Pays" business model, where Moody's and S&P are compensated by the issuers of the structured finance securities that they rate. The "Issuer Pays" business model remains in effect, placing the same pressures and conflicts of interest on Moody's and S&P. Moody's and S&P have demonstrated that, despite their public representations to the contrary, they are unable to manage this conflict of interest effectively.

With "Issuer Pays," Moody's and S&P -- in order to maintain their revenue, high profit margins, and win new business -- have to continually please the large issuers of structured finance securities, who are their repeat customers and collectively account for a large percentage of both companies' revenue. As my investigation and others show, Moody's and S&P decided that the best way to please issuers of structured finance securities was to weaken criteria for evaluating these investments so that a high credit rating was more readily given. Contrary to their public promises, both Moody's and S&P willfully relaxed standards in order to further their own and their clients' financial interests.

Ratings Shopping by Businesses under the Issuer Pays Business Model

"Ratings shopping" is the practice of an issuer offering structured finance security rating business to competing rating agencies and usually giving the work to the firm (or firms) willing to assign the highest rating. If the issuer is unhappy with the credit rating agency's initial analysis, the issuer attempts to influence the process by informing the agency of the rating that one of its competitors is willing to assign. Based on this information, the rating agency either compromises its core standards to meet the rating of its competitor or forgoes its fees.

Between at least 2006 and 2007, both Moody's and S&P were repeatedly pitched by issuers attempting to influence the rating assigned to a specific security. Upon learning of the rating the competition was likely to assign to a transaction, Moody's and S&P routinely relaxed their analysis and agreed to provide the higher rating. Moody's and S&P's greed clouded their judgment, as both companies chose to increase their revenue rather than lose out on business to a competitor. As Moody's CEO, Raymond McDaniel, acknowledged to his Board of Directors in

October of 2007: "Analysts and [managing directors] are continually pitched by bankers, issuers, investors . . . whose views can color 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."

Changes to Ratings Methodologies Based on a Quest for Revenue

The pressure to increase revenue and win business also ultimately influenced the methodologies that Moody's and S&P developed for rating structured finance securities. Going back to at least 2001 for S&P and 2004 for Moody's, both companies hid from the general public that their respective ratings methodologies were directly influenced by the wishes of their clients. Moody's and S&P adopted this approach specifically to please their clients (*i.e*., the issuers that paid their fees) and to enhance their revenue. Whether Moody's and S&P's ratings methodologies accounted for all the credit risk that Moody's and S&P knew existed was of secondary importance to their own bottom line. Moreover, the independence and objectivity that both companies promised to the marketplace was largely forgotten.

S&P in particular knew that its ratings methodologies were based on limited and out-of-date data about the actual performance of the new sub-prime mortgage products flooding the market. Rather than obtain that data, which was readily available to S&P, and implement the necessary changes to update its rating methodologies, S&P simply continued using the models that were already generating the high ratings that its clients desired. In the words of one S&P executive, the primary factor in S&P's decision not to update its model was that ". . . [S&P] enjoyed the largest ratings market share among the three major ratings agencies (often 92% or better), and improving the model would not add to S&P's revenues."

S&P's flagrant disregard for independent and objective credit analysis also impacted how it monitored the structured finance ratings that it already had assigned. S&P publicly represented that it conducted extensive surveillance on the structured finance securities that it rated so as to make sure that its ratings continued to correctly reflect its current assessment of credit risk. In actuality, however, prior to at least 2008, S&P deliberately subverted its surveillance team, which was woefully understaffed, saddled with outmoded monitoring resources and thus rendered incapable of keeping up with S&P's voluminous deal flow.

Specifically, S&P failed to employ its rating models or knowledge and updates its analysts garnered about how poorly sub-prime loans were performing to review ratings on earlier vintage RMBS or other structured finance securities. S&P failed to do so because it knew that if it actually carried through on its public representations of a thorough surveillance process, it would have to acknowledge that many of the structured finance securities that it had previously rated AAA were undeserving of such a high rating. This would have resulted in multiple downgrades and, ultimately, S&P making less money.

Punishment of Employees with Dissenting Views

Moody's was equally culpable. In addition to allowing its rating methodologies to be influenced by financial considerations, Moody's took significant steps to ensure that its employees adhered to its hidden objectives of revenue enhancement and pleasing the dominant

issuers of structured finance securities and punished those workers who expressed dissenting viewpoints. Specifically, employees who raised concerns about Moody's practices were given negative performance reviews, reassigned or demoted and, in some cases, were ultimately forced out of the company. The message to Moody's employees was clear: If you speak up and potentially interfere with Moody's plan to please issuers and, therefore, generate additional revenue for Moody's, you should be prepared to suffer the consequences. This incentive was directly at odds with Moody's public emphasis on maintaining independence and objectivity in its ratings and damaged the quality of Moody's ratings on structured finance securities.

Marginalization of Compliance Department

Similarly, rather than viewing its Compliance Department as a partner, Moody's senior management regarded it as an obstacle to be contained and marginalized. In 2006, senior compliance personnel were replaced by inexperienced employees from Moody's structured finance group. Additionally, Moody's compliance department was intentionally and routinely excluded from matters within its own jurisdiction. In the words of the former director of the department, "my guidance was routinely ignored if that guidance meant making less money or placing separation requirements to address conflicts of interest."

As the above examples demonstrate, rather than being the independent and objective evaluators of credit risk they claimed to be, Moody's and S&P were hopelessly conflicted and allowed this conflict to compromise the integrity of their ratings. As a result, many investors purchased structured finance securities riddled with concealed risk that ultimately proved to be nearly worthless.

Moody's and S&P's willful dereliction of their standards was particularly harmful because their ratings pervaded the entire financial system, including investors, issuers, government regulators, and private financial contracts (*i.e.*, credit default swaps). As the financial collapse has demonstrated, widespread issuance and investment in the toxic assets enabled by Moody's and S&P's biased and tainted ratings process has touched nearly every facet of our economy and has put our entire financial system at risk.

The harm caused by this catastrophic failure was not just born by the wealthy. In addition to financial institutions and hedge funds, structured finance securities are found in the portfolios and pension funds of schoolteachers, policemen, and factory workers; hardworking average Americans who count on these investments for their future.

In closing, I commend the Senate Subcommittee's work on this important issue. I want to emphasize that significant reform of the credit rating agencies' business practices is vital. In thinking of Moody's and S&P's misaligned priorities, I am reminded of a quote from the Chinese Zen Master Hsi Tang - - "Although gold dust is precious, when it gets in your eyes it obstructs your vision." That is clearly what happened to the rating agencies.