

# MOODY'S INVESTORS SERVICE

Testimony of Raymond W. McDaniel  
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before the  
Financial Crisis Inquiry Commission  
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## INTRODUCTION

Good afternoon Chairman Angelides, Vice Chairman Thomas and members of the Commission, my name is Ray McDaniel, and I am Chairman and Chief Executive Officer of Moody's Corporation ("MCO"), the parent of the credit rating agency, Moody's Investors Service ("Moody's"). Moody's recognizes the importance of the work being undertaken by this Commission and on behalf of my colleagues, I welcome the opportunity to participate in this hearing today and contribute our views regarding the role of credit rating agencies ("CRAs").

Over the past several years, we have witnessed events whose magnitude many of us would have once thought unimaginable. The turmoil in the U.S. housing market that began in the subprime residential mortgage sector subsequently led to a global liquidity crisis and a loss in confidence in the U.S. and global financial system. The impact has created great hardship for many Americans. Families have lost jobs, homes, and college and retirement savings as a result of this financial crisis.

Moody's is well aware that the crisis of confidence in the market has also impacted the confidence in the credit ratings industry. Our reputation is the single most important asset that we have. Over the course of our 100-year history, Moody's employees have brought their insight and integrity to rating trillions of dollars of debt and hundreds of thousands of issuances across a broad range of sectors, asset types and regions. Their track record for providing predictive credit opinions, which Moody's disseminates publicly and at no cost to users, has earned Moody's a strong reputation among capital market participants worldwide. I am proud of our history and the work of our people.

However, the performance of our credit ratings for U.S. residential mortgage-backed securities ("RMBS") and related collateralized debt obligations ("CDOs") over the past several years has been deeply disappointing. Moody's is certainly not satisfied with the performance of these ratings. Indeed, over the past few years, there has been an intense level of self evaluation within our organization.

To this end, I and members of my management team have been open to ideas, questions and differing perspectives, from both inside and outside of the company, for two purposes:

**1) Better understanding the reasons for the poor performance in this sector.**

Subprime mortgages by their nature are more risky than prime mortgages and therefore RMBS backed by subprime pools and rated by Moody's had greater credit protection. In addition, starting in 2003, Moody's did observe a trend of loosening mortgage underwriting processes and escalating housing prices, and we repeatedly highlighted that trend in our reports and incorporated it into our analysis of the securities. However, neither we – nor most other market participants, observers or regulators – fully anticipated the severity or speed of deterioration that occurred in the U.S. housing market or the rapidity of credit tightening that followed and exacerbated the situation.

## **2) Raising the bar in assessing credit risk in a fast changing and less predictable market environment.**

As a result of our active internal dialogue and our communications with market participants as well as policy makers both in the United States and internationally, we have implemented a number of new measures, some of which I will highlight for you today, to enhance our processes. We also have been working to adapt, as needed, our policies, systems and organization to implement rules recently adopted by the Securities and Exchange Commission (“SEC”) for nationally recognized statistical rating organizations (“NRSROs”), and the European Union (“EU”), among other national and regional authorities.

Still, more can and should be done. In this regard, we are continuing our communication with market participants, public sector authorities and market commentators to better understand various concerns and recommendations. Most of the recommendations are premised on instilling greater accountability in the CRA industry, as well as among other market participants. We share this goal, and we welcome reform efforts that are likely to reinforce high quality ratings and enhance accountability without intruding into the independence of rating opinion content. We believe that many of the changes that have been suggested – such as increasing transparency in the rating process and reducing the use of credit ratings in regulation – likely will have a positive impact and promote greater accountability.

We remain concerned, however, that other proposed measures are at times contradictory in nature. This may be indicative of a broader misunderstanding about the role and function of rating agencies in the capital markets. For example, some proposals would promote the use of ratings by regulators, other proposals would eliminate it; some would promote diversity of opinions, others would discourage it; still another set of measures would increase transparency in the rating agency industry, while others could significantly reduce it.

The proper role of CRAs in the debt market is to be an unbiased commentator and to provide predictive opinions on just one characteristic of an entity or obligation – its likelihood to repay debt in a timely manner. In pursuing reforms to the industry and market, we believe it is important to understand that:

- **Credit rating agencies are not gatekeepers.**

Rating agencies are credit market commentators. They cannot stop a particular security from being issued, nor can they stop securities from being purchased. Indeed, markets can and do grow without ratings. Perhaps the most striking example of this reality is the credit default swap market, which was wholly unrated but actively traded. The capacity of individual credit rating firms to act as gatekeepers is even more attenuated. For example, Moody’s has declined to rate various market sectors because of credit concerns and our actions have not served to “gate-keep” those markets. To deem CRAs as gatekeepers who regulate the flow and characteristics of securities issued is to assign CRAs a role that they are neither intended, nor equipped, to fulfill.

- **Credit ratings are not investment advice.**

Moody's credit ratings provide probability forecasts on only one characteristic of a debt issuer's financial enterprise – the relative likelihood to repay debt in a timely manner. In considering purchasing or selling securities, investors generally look to a host of other characteristics, which can include price, volatility, liquidity and currency risk of the security. Credit risk is but one factor in making an investment decision, and sometimes not the most important factor.

- **Rating analysts do not structure or underwrite securities.**

The role of the rating agency is to provide a neutral opinion on future credit risk of debt securities and issuers. As a direct consequence, our analysts' role is "reactive" in nature. While Moody's analysts do and should have opinions about various aspects of issuances and transactions, they do not structure, advise on, create, design or otherwise decide the terms of debt securities. Rather, the role of our analysts is to understand the particular facts of the transaction as proposed by the issuer and clarify to the issuer the rating implications of our methodologies for that transaction.<sup>1</sup>

- **Investors should not rely on ratings to buy, sell or hold securities.**

Institutional investors (who are the primary purchasers of structured products) have their own obligations to their clients and therefore must perform their own analysis when purchasing, selling or holding a security. The claim that such investors rely on credit ratings when purchasing a security contradicts the responsibilities these investors have to the individuals whose money they manage. Brokers and investment professionals advising retail investors have similar responsibilities and obligations. Credit ratings are a tool in the process, not a buy, sell or hold recommendation.

- **Every business model has conflicts of interest that need to be managed.**

Issuers, investors and governments (which are also major issuers of bonds) all have economic interests in what ratings are assigned to securities. Some now argue that replacing the issuer-pays model with an investor-pays or deal-pays model will remove potential conflicts of interest and create better quality ratings. Such proposals ignore the fact that conflicts are inherent and must be properly managed for any model in which those paying rating fees are interested in the outcomes. It also ignores the fact that our ratings in other sectors, which also have operated under the issuer-pays model for over four decades, have performed well during the extremely challenging market conditions of the past several years (and have performed better during the issuer-pays period of our history than the five decades during which Moody's operated under an investor-pays model).

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<sup>1</sup> Similar discussions take place in the corporate and government debt sectors; for example, when a corporation is contemplating changes in financial structure or business strategy (e.g., the potential rating implication of a share buy-back program on a corporate issuer's senior unsecured debt obligations), or with new corporate issuers to whom Moody's has not previously assigned a rating.

- **Concerns about rating shopping do not stem from the business model.**

Many market participants have expressed concerns with the practice of rating shopping. Moody's has publicly shared such concerns for years. Rating shopping, however, is the result of insufficient disclosure of relevant information for purposes of assessing a security – whether as a credit rating agency or an investor – rather than the choice of business model. In the absence of public disclosure of information reasonably necessary to analyze debt securities, rating shopping equally hinders firms regardless of business model. In the U.S., this is perhaps the most striking difference between the markets for corporate versus structured debt.

Today, with the benefit of hindsight, many observers have suggested that the events that ultimately have come to pass were inevitable and easily predictable. As the events were unfolding, however, multiple potential outcomes were considered possible. Numerous market experts, including economists, financial institutions, prominent opinion providers in the media, and the federal government had differing and at times contradicting views regarding the ultimate performance of the U.S. housing sector and its potential knock-on effect on the broader economy. Moreover, once the sector began to experience shock, these same entities and individuals had differing views on the duration and severity of the downturn and the shape of the recovery. No one could tell with certainty whether the downturn would last a few months, or a few years. Similarly, predictions varied widely about whether the market would quickly rebound, climb in a more gradual but steady manner, or experience a “double dip.” These questions persist today, and a range of views continue to exist.

In my testimony, I will discuss briefly the prospective nature of credit ratings; the role and use of ratings in the capital markets; ratings performance; the issuer pays model; measures we have in place to mitigate the potential conflicts of interest arising from that model; and Moody's efforts to advance the quality, transparency and independence of our credit ratings.

## **I. BACKGROUND ON MOODY'S**

Credit rating agencies occupy an important but narrow niche in the information industry. Our roots are in the American tradition of the marketplace of ideas and our role is to publish opinions about the relative future creditworthiness of, among other things, bonds issued by corporations, banks and governmental entities, as well as pools of assets collected in securitized or “structured finance” obligations. By making these opinions broadly and publicly available, rating agencies help to reduce information asymmetry between borrowers (debt issuers) and lenders (debt investors). We sift through vast amounts of available information, analyze the relative credit risks associated with debt securities and debt issuers, and offer our opinion.

Moody's is the oldest bond rating agency. In 1909, American entrepreneur John Moody published a manual, *Analyses of Railroad Instruments*, which introduced a system of opinions about the creditworthiness of railroad bonds. Today, we have more than 1,000 analysts in some 20 countries around the world. Our products include our

credit rating opinions, which are publicly disseminated via press release and made available on our website at no cost, as well as research and special reports about debt issuers and their industries. Since 2007, Moody's has registered with the SEC as an NRSRO. Nine other firms are registered with the SEC as NRSROs, and the SEC has estimated that approximately another 20 CRAs will become registered as NRSROs in the future.<sup>2</sup>

The growth of the industry has been primarily spurred by three important factors.

- 1) Disintermediation of debt markets: Rather than borrowing exclusively from banks, companies began to borrow funds in the public debt markets which in turn resulted in growth of those markets. The public markets use the free flow of information and opinion. Ratings are part of that flow.
- 2) Internationalization of finance: Rather than being limited to their domestic markets, investors and issuers began to seek out one another in the cross-border markets. As the flow of capital across national borders rose, the need for a common language for credit became increasingly more important.
- 3) Growth of structured finance: Because of a number of regulatory and accounting rules, structured finance became an important means of diversifying funding sources and managing risk on balance sheets.

## **II. MOODY'S RATINGS ARE PREDICTIVE OPINIONS ABOUT FUTURE OUTCOMES**

Moody's ratings provide predictive opinions on just one characteristic of an entity – its likelihood to repay debt in a timely manner. Our ratings of corporate issuers (including financial institutions) are based primarily on analysis of financial statements, as well as assessments of management strategies, industry positions and other relevant information. Our ratings of structured finance bonds<sup>3</sup> are based primarily on analysis of the transaction's legal structure, the cash flows associated with the assets on which the transaction is based and other risks that may affect the bonds' cash flows. In both corporate and structured analysis, we also take into consideration publicly available factors that may be relevant to the credit analysis, such as market dynamics, pricing information on the securities and other prevailing or contradictory views. Our analysis necessarily depends on the quality, completeness and veracity of information available to us, whether such information is disclosed publicly or provided confidentially to Moody's analysts.

Models are tools sometimes used in the process of assigning ratings. But the credit rating process always involves much more, including the exercise of independent judgment by the rating committee. Ultimately, ratings are subjective opinions that reflect the majority view of the rating committee's members.

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<sup>2</sup> SEC, "Final Rules: Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations," Release No. 34-55857 at 33607.

<sup>3</sup> In using the term "bonds," I am referring to the various types of debt instruments issued by structured vehicles.

The heart of our service is expressing opinions on the relative credit risk of long-term, fixed-income debt instruments, expressed on a 21-category rating scale, ranging from Aaa to C.<sup>4</sup> In the most basic sense, all bonds perform in a binary manner: they either pay on time, or they default. If the future could be known with certainty, we would need only two ratings for bonds: “*Default*” or “*Won’t Default*.” However, because the future cannot be known, credit analysis necessarily resides in the realm of opinion. Therefore, rather than simple “default / won’t default” statements, our ratings are opinions about the risk of outcomes in the future with degrees of uncertainty.

Moreover, our opinions are about the relative credit risk of one Moody’s-rated bond versus other Moody’s-rated bonds. In other words, Moody’s ratings provide a perspective on the rank ordering of credit risk, with the likelihood of loss increasing with each downward step on the rating scale. The lowest expected loss is at the Aaa level, with higher expected losses at the Aa level, yet higher expected losses at the single-A level, and so on.

### III. ROLE AND USE OF RATINGS

Moody’s ratings are one means of disseminating information about a bond to the broader market. They are not the only means of disseminating information.<sup>5</sup> The most important source of information about securities is the issuer itself – from whom the original investor is purchasing the security.

As part of our responsibility to the market, we believe it is essential for investors and others to understand the role of rating agencies and what credit ratings can and cannot measure. In particular, we have made it clear that our ratings are not designed to address any risk other than credit risk and should not be used for any purpose other than as a gauge of default probability and expected credit loss. On our website, in our press releases and in a variety of publications we consistently discourage market participants from using our ratings as indicators of price, as measures of liquidity, or as recommendations to buy, sell or hold securities – all of which are regularly influenced by factors unrelated to credit. Moody’s has also continuously advocated for the elimination of regulatory use of ratings.

Our ratings are not, and should not be treated as, statements of fact about past occurrences, guarantees of future performance or investment recommendations. The likelihood that debt will be repaid is just one element, and in many cases, not the most material element, in an investor’s decision-making process for buying credit-sensitive securities. Credit ratings do not address many other factors in the investment decision process, including the price, term, likelihood of prepayment, liquidity risk or relative

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<sup>4</sup> Moody’s also assigns short-term ratings – primarily to issuers of commercial paper – on a different rating scale that ranks obligations Prime-1, Prime-2, Prime-3 or Not Prime.

<sup>5</sup> For example, in the corporate sector, debt issuers provide registered filings with the SEC, buy side and sell side analysts provide their perspective on the securities and the financial media provides their perspective on the various offerings.

valuation of particular securities.

#### **IV. RATINGS PERFORMANCE**

Moody's success depends on our reputation for issuing neutral and predictive ratings – and the strong performance of our ratings is demonstrated over many credit cycles on the hundreds of thousands of securities we have rated. As a means of self-evaluation and in the interest of market transparency, Moody's conducts and publishes annual default studies and periodic ratings performance reports, which we post on our website, [www.moodys.com](http://www.moodys.com). These default studies, which we have been publishing since the 1980s, show that both our corporate and our structured finance ratings have been reliable predictors of default over many years and across many economic cycles. There will always be unanticipated developments in the markets that affect the credit risk of securities – and we have seen this starkly over the past several years. Indeed, because of events that occur at different times in different sectors, which will never be perfectly predictable, default rates by rating category vary widely from year to year across regions and industries within the corporate sector, as well as within various structured finance sectors.

To put this concept in perspective, prior to the recent crisis, investment-grade structured finance securities had somewhat lower credit losses on average than investment-grade corporate securities. This strong overall performance of structured securities led many market participants increasingly to perceive the sector to be “safer” than the corporate sector.

#### **V. ISSUER-PAYS BUSINESS MODEL**

For the past four decades, Moody's has been paid primarily by issuers of the securities we rate. Some observers argue that an investor-pays business model would have fewer potential conflicts than an issuer-pays model. We believe this presumption ignores the sources and drivers of potential conflicts of interest in the ratings business as well as the significant public policy benefit associated with the issuer-pays model.

- *First, investors can be just as motivated as issuers to influence ratings.* In practice, the term “investor” is a short-hand description for any subscriber to a rating service and describes a variety of parties with vested interests in the credit ratings of securities, including:
  - Short Sellers (for example, hedge funds that take a significant short position on a particular company): as subscribers under an investor-pays model, they may be highly motivated to encourage a negative rating action – and the more negative and unexpected the action, the better for their financial interests.
  - Long Investors: similar to their short counterparts, long investors are understandably interested in the outcome of rating actions. Before they purchase a security they may prefer lower ratings to obtain higher yields; following a purchase (especially for those who trade actively) they are likely



to prefer to have ratings maintained or raised rather than lowered to avoid, for example, valuation mark-downs or forced sales.

- Governments: governments, often faced with competing financial market and social policy objectives, may seek to have ratings “protect” nationally, systemically or politically important issuers such as large industrial employers, banks or governments themselves. This is particularly an issue in instances where governments have stepped in to provide systemic support to such institutions, *i.e.*, when the prudential regulator also becomes an investor.
- Second, there is often no clear distinction between investors and issuers. Investors frequently are entities that also are issuers, such as banks, insurance companies and governments.
- Third, shifting “who pays” will not prevent issuers from using other financial means to try to influence ratings. Entities seeking to influence rating actions can and have attempted to do so by challenging rating agencies through commercial mechanisms unrelated to fees, such as litigation to coerce higher ratings.

Put simply, numerous parties – including investors, issuers and governments – may want ratings assigned and maintained in a manner that is most beneficial to their interests, and those interests may often conflict with the goal of the CRA to issue an independent rating.

If Moody’s provides a rating and is paid by an entity – regardless of which type of entity – that has an interest in that rating, then we must protect against influence by that entity on our rating actions. Currently, the market broadly understands the potential conflicts of interest in the issuer-pays model, and Moody’s makes plain the steps we take to manage those conflicts. Transparency itself is a protection. If the industry were to adopt an alternative business model, it would not eliminate the perceived conflict, but merely shift it.

Given that potential conflicts are embedded in all feasible business models, we believe that offsetting public policy benefits need to be considered. The issuer-pays model of the rating business serves the public policy objective of broad, contemporaneous dissemination of credit rating opinions to the public without charge. We recognize that this business model entails potential conflicts of interest that could impact the independence and neutrality of our rating process. However, we have a four decade track record of effectively managing these conflicts. We also recognize that potential conflicts of interest arising from other sources, such as securities ownership and business and personal relationships, could similarly impact the rating process.<sup>6</sup>

To maintain our independence, and to protect the integrity of our credit ratings and rating process, we have adopted wide-ranging policies and procedures. Some of our policies and procedures to manage conflicts include:

- Determining rating opinions through a “rating committee” process. Our opinions

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<sup>6</sup> For a detailed discussion of the various policies and mechanisms we have in place that manage and mitigate the potential conflicts in our business model, please see the 2006, 2007 and 2008 updates to the “Moody’s Investors Service Report on the Code of Professional Conduct,” (“Moody’s Report”), available at [www.moodys.com](http://www.moodys.com).

are not the decision of any individual analyst but are determined by a majority vote of the members of a rating committee, with the most senior members voting last so as not to influence the votes of the junior members.

- Prohibiting all analysts from holding fee discussions with or owning securities in the institutions in whose rating process they participate.<sup>7</sup> Moody's has established a new commercial unit that is solely responsible for commercial interactions with issuers, and analysts continue to be completely excluded from such conversations.
- Not evaluating or compensating analysts on the basis of the revenue associated with the entities in whose rating process they participate.
- Providing that credit ratings will not be affected by the existence of, or potential for, a business relationship between Moody's (or any of its affiliates) and the issuer (or its affiliates) or any other party, or the non-existence of such a relationship. Rather, credit ratings are to be determined solely on the basis of factors relevant to the credit assessment. Ratings committees are not to refrain from taking rating actions based on the potential effect of the action on Moody's, an issuer, an investor or any other market participant.
- Not creating investment products or providing buy / sell / hold recommendations.

The SEC is also continuing its rule-making activities with regard to NRSROs. Some of the new rules address potential conflicts of interests, and we are adopting whatever additional policies and procedures may be necessary to implement these rules as they are finalized.

## **VI. MOODY'S EFFORTS TO ADVANCE THE QUALITY, TRANSPARENCY AND INDEPENDENCE OF CREDIT RATINGS**

The economic downturn has exposed vulnerabilities in the infrastructure of the global financial system, and important lessons for market participants have emerged from the rapid and dramatic market changes of the past two years. For Moody's part, we have responded to concerns expressed by both the private and public sectors by undertaking initiatives to improve the credibility of our ratings and strengthen their quality, transparency and independence. We have taken steps to:

- Strengthen the analytical integrity of ratings;
- Enhance consistency across rating groups;
- Improve transparency of ratings and the ratings process;
- Increase resources in key areas;
- Bolster measures to avoid conflicts of interest; and
- Pursue industry and market-wide initiatives.

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<sup>7</sup> Except through holdings in diversified mutual funds.

The individual actions and initiatives that we have pursued in each of these areas are important but numerous. We catalog and discuss them in Moody's Special Comment, *Strengthening Analytical Quality and Transparency*, which was first published in August 2008 and updated subsequently. The updated Special Comments are available on Moody's website.<sup>8</sup>

One initiative that I wish to highlight is especially important to addressing issues of confidence in structured finance: our introduction of additional measures to help the market better understand the characteristics and performance attributes of securitized instruments. These added metrics, known as **V Scores** and **Parameter Sensitivities**, seek to address two distinct questions asked by investors: (i) what is the degree of uncertainty around the assumptions that underlie our structured ratings; and (ii) how sensitive are Moody's ratings to changes in our key assumptions? We believe that supplementing our traditional ratings with answers to these questions will improve market understanding, a key ingredient to confidence. Moreover, these additional metrics are intended to respond to the interests of various oversight authorities, which have asked that rating agencies more clearly distinguish the performance expectations of securitized instruments versus corporate and public finance obligations.

We believe that we have made good progress in improving the analytical quality and transparency of our ratings. We also recognize that our practices must evolve along with changes in market dynamics. We expect to continue developing and modifying our approach in step with market needs, as well as with regulatory expectations.

## 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 actions can and have been taken by Moody's and at the industry level, and policymakers at the domestic and international levels have proposed a host of 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.

Thank you. I am happy to respond to any questions.

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<sup>8</sup> "Strengthening Analytical Quality and Transparency," August 2008. Updates of the document were published in December 2008 and November 2009.