

# MOODY'S INVESTORS SERVICE

Testimony of Nicolas Weill  
Group Managing Director

before the  
Financial Crisis Inquiry Commission

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## INTRODUCTION

Good morning Chairman Angelides, Vice Chairman Thomas and members of the Commission. My name is Nicolas Weill, and I am a Group Managing Director and the Chief Credit Officer for Structured Finance at Moody's Investors Service ("**Moody's**"). My testimony today will provide you with a general description of Moody's ratings monitoring process, our monitoring activities and the actions we took in response to the challenging market of 2007, at which time I headed the surveillance team for U.S. residential mortgage-backed securities ("**RMBS**").

In early 2007, Moody's believed the RMBS we rated had sufficient credit protection to withstand a market downturn similar in depth and duration to those experienced in the recent past. Unfortunately, Moody's, like others in the market, did not anticipate the severity or speed of deterioration that occurred in the U.S. housing market during that period or the rapidity of credit tightening that followed and exacerbated the situation. With the clarity of hindsight, it now appears that the trends that Moody's observed and acted upon were exacerbated by the unprecedented confluence of circumstances that led to the unusually poor performance of subprime mortgages originated in 2006. In hindsight, it is now known that the following three factors were especially relevant:

- **The rapid and drastic decline in home prices on a national basis.** This was the most important factor in the deterioration of subprime mortgage loan performance. Both the magnitude and the speed of the decline have been unprecedented, and in turn have reduced borrowers' equity in their homes and constrained their refinancing opportunities. The borrowers most affected by the housing downturn have been those who, because of the timing of their purchases, did not benefit from the price appreciation that occurred in prior years.
- **The rapid reversal in mortgage lending standards from very loose to very restrictive.** This quickly stranded overstretched borrowers who needed to refinance but had few, if any, opportunities to do so.
- **The existence of fraud.** It appears that fraud – such as misrepresentations made by mortgage brokers, appraisers and the borrowers themselves – also played a significant role in exacerbating the problem. Numerous sources have now indicated that information such as home values and borrowers' incomes was overstated and that the intended use of the home was often misrepresented (*e.g.*, as a primary residence rather than as an investment property).

Nonetheless, at the time, as conditions in the U.S. housing market began to deteriorate beyond expectations, we took aggressive steps to increase our monitoring and to analyze the unprecedented market conditions and the behavior of various market participants. Based on these analyses and reviews, we took rating actions as soon as loan performance data warranted it.

I note at the outset that the observations and information in my testimony are largely based on data and experience related to the subprime mortgage securitizations that

Moody's rated, and not on the broader subprime mortgage market, some of which was securitized and rated by other rating agencies, some of which was securitized but not rated, and much of which was not securitized.

## **I. MOODY'S MONITORING PROCESS**

A rating is a probabilistic rank ordering of future credit risk. Ratings in aggregate are opinions about the relative creditworthiness of securities based on assumptions and market environments that can and do change over time. Consequently, once Moody's publishes a rating, we monitor the original rating on an ongoing basis and will change it as appropriate to respond to market or security-specific developments.

As part of this monitoring process, analysts may review public information as well as non-public information provided by the issuer or its agent. Analysts also use a range of tools to monitor and track rated issuers and obligations. These include comparisons of Moody's ratings with other measures of credit risk, including those derived from the market prices of corporate bonds and credit default swaps, accounting ratio-implied ratings based on default prediction and rating prediction models for corporate and sovereign issuers. We also use monitoring processes overseen by Moody's Credit Officers. For example, in our Financial Institutions group, we conduct periodic portfolio reviews to compare the quality and consistency of ratings within a peer group. In these portfolio reviews, senior analysts from inside and outside the group assess the quality of all Moody's rated issuers in an industry or industry sub-sector. A rating committee is convened if it appears that the rating of one issuer may be inconsistent with the ratings of its peers.

Moody's monitors its ratings on all securities regularly, and, as appropriate, considers the need for an upgrade or downgrade. In most of Moody's U.S. Structured Finance groups, monitoring is performed by dedicated surveillance analysts. With respect to RMBS, we generally receive updated loan performance statistics on a monthly basis for the collateral pools of the transactions we have rated. This information is assessed using quantitative models that can flag potential rating "outliers" – securities whose underlying collateral performance indicates that the outstanding rating may require review because, for example, the performance data is not in line with expected parameters. Once a specific rating is flagged, a Moody's surveillance analyst will investigate further and determine whether a rating change should be considered. If the analyst decides that the rating should be considered for change, it is brought to a rating committee, whose members together determine whether a rating change should be made.

Moody's does not take wholesale rating actions based on market speculation. Rather, our analysts carefully and deliberately consider the data that we receive on a transaction-by-transaction basis, and we conduct the monitoring process judiciously to make sure that such relevant information is appropriately considered.

## II. MOODY'S RESPONSES TO THE WEAKENING U.S. SUBPRIME HOUSING MARKET

In January 2007, we published a special report highlighting the rising defaults on the 2006 vintage subprime mortgages.<sup>1</sup> In that report we stated:

*"Mortgages backing securities issued in late 2005 and early 2006 have had sharply higher rates of foreclosure, real estate owned (REO) and loss than previously issued securities at similar, early points in their lives. These 'early default' measures have been primarily visible in the subprime universe, but are not limited to that sector. Moody's is currently assessing whether this represents an overall worsening of collateral credit quality or merely a shifting forward of eventual defaults which may not significantly impact a pool's overall expected loss."*

That report was the first in a series of publications in 2007 that discussed the deteriorating condition of the U.S. subprime and housing market. Those publications expressed concerns about expected loan deterioration while we collected performance data and other information on specific pools to validate our assessment of overall market conditions and differentiate performance among individual mortgage pools.

In our March 7, 2007 report, "Challenging Times for the US Subprime Mortgage Market," Moody's said that: *"In response to the increase in the riskiness of loans made during the last few years and the changing economic environment, Moody's has steadily increased its loss expectations on pools of subprime loans."* However, Moody's also identified a number of factors that we believed would be critical in determining the ultimate performance of these loans. In relevant part, the report said:

*"It is generally too early to predict ultimate performance for the subprime mortgage loans originated in 2006 and the bonds secured by such loans. A number of factors will determine the ultimate losses. Home price appreciation and refinancing opportunities available in the next few years are expected to have the biggest impact. Economic factors, such as interest rates and unemployment, will also play a significant role as will loss mitigation techniques employed by loan servicers."*

While we identified the factors that we believed would lead to the ultimate losses on the 2006 subprime mortgages and the bonds secured by them, we did not anticipate the magnitude or severity of these factors. Throughout 2007 we conducted intensive monitoring of all mortgage securities. In particular:

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<sup>1</sup> "Special Report: Early Defaults Rise in Mortgage Securitization," January 18, 2007.

**1) We monitored and analyzed the unprecedented market conditions and the reaction of various market participants as the crisis continued to unfold.**

Moody's aggressively monitored market conditions (*e.g.*, rising delinquencies and defaults, falling home prices) as the crisis unfolded. Importantly, these developments were impacting the behavior of the various market participants (including the borrowers, the mortgage servicers, lenders and the Federal government), whose reactions could further impact default and delinquency rates. For example:

- How would borrowers act? Given that some loans were about to experience interest rate resets, how severely would this impact default and delinquency rates?
- How would sponsors act? Would they be able and willing to repurchase the loans in a pool that had breached the representations and warranties?
- How would the lenders act? In particular, how much were they tightening their lending criteria (and therefore the availability of credit) and how long was this tightening likely to last?

By way of example, in an effort to gauge the potential impact that loan modifications might have in reducing losses on defaulted loans, especially in light of interest rate resets when monthly payments increased, Moody's conducted a survey of the modification practices of 16 subprime mortgage servicers (who together constituted roughly 80% of the total subprime servicing market). The survey results, which were published in September 2007,<sup>2</sup> suggested that, on average, subprime servicers were not focused on modifying loans, and that most servicers had modified only approximately 1% of their serviced loans that experienced a reset in the months of January, April and July 2007. Based on this data, it appeared that the number of modifications performed by subprime servicers on loans facing reset would be much lower than anticipated by many commentators, and would therefore be unlikely to meaningfully mitigate the ultimate losses in subprime pools backing rated securitizations. We published follow-up surveys in December 2007 and July 2008.<sup>3</sup>

**2) We took rating actions as soon as warranted by actual performance data.**

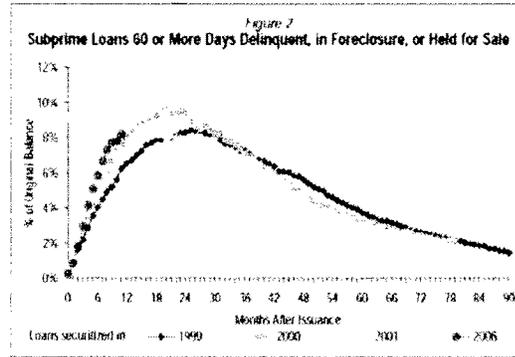
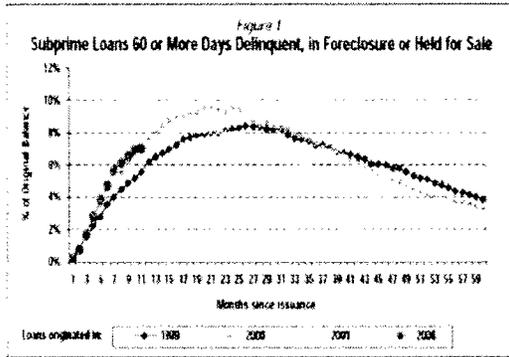
Moody's monitors the actual performance of the underlying mortgage pool for the RMBS that we rate throughout the life of the security. This was the case for the 2006 vintage and for the first several months, the loans in these securities performed in line with our expectations. In fact, the early performance of these mortgage loans resembled the performance of similar subprime loans during the 2000 and 2001 U.S. recessions. This performance in turn was consistent with the higher loss expectations that we had already anticipated for the vintage. **Figures 1 and 2** below, published respectively in our

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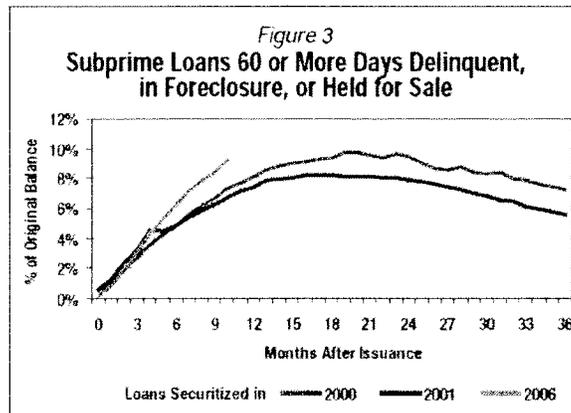
<sup>2</sup> "Special Report: Moody's Subprime Mortgage Servicer Survey on Loan Modifications," September 21, 2007.

<sup>3</sup> "Special Report: US Subprime Market Update: November 2007," December 17, 2007 and "Special Report: Moody's Subprime ARM Loan Modification Update," July 14, 2008.

March 2007 and April 2007 publications, show that the loan performance closely tracked that of the 2000 and 2001 vintages. And, as noted above, the 2006 Moody's Aaa-rated RMBS had sufficient credit protection to withstand such performance had macro-economic conditions not deteriorated in such an unprecedented and unanticipated way.



Moody's first rating actions (downgrades and reviews for downgrades) on outstanding securities backed by 2006 vintage subprime loans took place in November 2006 and further rating actions occurred in December. At that time, based on the then-available information, we did not believe that more aggressive rating actions were warranted for the entire 2006 vintage. Not until performance data from the second quarter of 2007 became available was it clear that performance of the 2006 vintage was likely to worsen and that it might deteriorate beyond that observed in the 2000 – 2001 recession. **Figure 3**, published in our July Update 2007, shows the significantly higher loan delinquencies in the 2006 vintage than that of the 2000 and 2001 vintages.



Our first comprehensive set of rating actions (on second lien mortgage transactions) took place in April 2007, with a second set of actions (on first lien mortgage transactions) in July 2007. We did not take these rating actions sooner because there was insufficient actual performance information to judge the persistence of the early trends.

Consistent with our approach to assigning and monitoring ratings, we based our actions on actual performance information and on a transaction-by-transaction review, rather than on general negative market sentiment.

## **CONCLUSION**

The unprecedented events of the last few years demonstrate how rapidly and dramatically markets can change. Moody's is not satisfied with the performance of our ratings in the RMBS sector, and we have since implemented numerous changes. With the benefit and clarity afforded by hindsight, many commentators now claim that we and other market observers who were responding to the unpredictable and erratic market conditions that existed during 2006 – 2008 should have better anticipated what course the market would take. In the face of such unprecedented volatility in the market, Moody's carefully monitored developments, commented publicly on the trends we were seeing, and took decisive rating actions on a transaction-by-transaction basis when sufficient information became available to warrant such action. As always, Moody's sought to provide the best opinions possible, with the information then available, on the future creditworthiness of the securities.

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