Moody's Investors Service

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Hearing on Turmoil in U.S. Credit Markets: The Role of Credit Rating Agencies

I. INTRODUCTION

Good morning Chairman Dodd and members of the Committee. I am Claire Robinson. I am a Senior Managing Director at Moody's Investors Service ("Moody's") and have responsibility for our Asset Finance and Commercial Real Estate rating groups. On behalf of my colleagues at Moody's, I would like to thank the Committee for the opportunity to participate in today's hearing and to share our views on some of the recent developments and initiatives in the credit markets, our industry and at Moody's.

Difficulties in the U.S. housing sector have had considerable consequences in global credit markets. While most market participants today recognize that there were unprecedented forces driving U.S. mortgage delinquencies (including the deterioration in mortgage underwriting processes, misrepresentations in the mortgage application process, the steep decline in home prices and sharp contraction in credit available for refinancing) there is no question that, regardless of the underlying reasons, there has been a more general loss of confidence in the credit markets, and in particular within the structured finance sector. As a direct result of this loss of confidence, over the past several months various global authorities, policy makers and market participants have coordinated their activities and worked together to recommend a number of initiatives involving various market participants, including credit rating agencies. If implemented, we believe these various initiatives will help to restore confidence to the global markets.

Moody's strongly supports this coordinated global activity and welcomes the opportunity to work with Congress, regulators and other market participants to achieve this goal. Indeed, Moody's has been working constructively with other rating agencies, regulatory authorities and trade associations to develop various measures that could: reinforce the independence of the credit rating process; improve the transparency around the assumptions used in our analysis; and more clearly articulate the attributes and limitations of credit ratings.

Throughout its history, Moody's has taken pride in our commitment to continuously improve our analytical capabilities. Consistent with this history, and in light of recent events, we have undertaken several significant initiatives to enhance the quality of our analysis, address concerns in the marketplace, and further improve the usefulness of our credit ratings to investors. These measures include steps to:

- Enhance our analytical methodologies;
- Enhance our review of the due diligence process conducted by originators and underwriters;
- Provide more clarity about the credit characteristics of structured finance ratings;
- Promote objective measurement of ratings performance;
- Continue effectively managing potential conflicts of interest; and

- Enhance investors' understanding of the attributes and limitations of our ratings.

Finally, Moody's also believes that examination of the credit rating industry – including the review currently underway by the Securities and Exchange Commission ("SEC") – is helpful to encourage best practices and support the integrity and effectiveness of the industry, and we welcome and are eager to participate in the constructive evaluations of the industry.

II. BACKGROUND ON MOODY'S INVESTORS SERVICE

Credit rating agencies serve a narrow but important role in the investment information industry. Our role is to disseminate information about the relative creditworthiness of, among other things, financial obligations of corporations, banks, governmental entities, and structured finance transactions.

Moody's is the oldest bond rating agency in the world, having introduced ratings in 1909. Today, we are one of the world's most widely used sources for credit ratings, research and risk analysis. Our ratings and analysis track debt covering more than 100 sovereign nations, 11,000 corporate issuers, 26,000 public finance issuers, and 110,000 structured finance obligations. In addition, Moody's publishes credit opinions, transaction research, and commentary serving more than 3,000 clients around the globe.

Moody's credit ratings are forward-looking opinions that address just one characteristic of fixed income securities – their creditworthiness. Ratings are not statements of fact about past occurrences or guarantees of future performance and they do not constitute a recommendation to buy, sell, or hold a security. Ratings are designed exclusively for the purpose of ranking bonds according to their relative credit risk and do not take into consideration factors such as the direction of future market prices, an investor's investment objectives, or an investor's risk parameters. Ratings are not static and we will change our rating opinions if the fundamental creditworthiness of an issuer changes.

Our long-term debt ratings are expressed according to a simple system of letters and numbers, on a scale that has 21 categories ranging from Aaa to C. Bonds with the lowest relative credit risk are rated at the Aaa level, those with a higher relative credit risk are rated at the Aa level, those with an even higher relative credit risk are rated at the A level, and so on down through the rating scale. A Moody's rating is not a "pass-fail" grade; rather, Moody's ratings are a relative ranking system.

Moody's credit ratings are widely and publicly available at no cost to investors and the general public. We publicly disseminate our credit ratings through press releases and also make them available on our website. They are made simultaneously available to all market participants regardless of whether or not they purchase products or services from Moody's. The public availability of ratings helps enhance the transparency and efficiency of financial markets, and allows the market and all users of ratings to assess independently the aggregate performance of our rating system.

Moody's has always been clear and consistent in telling the market that our ratings should not be used for any purpose other than as a gauge of default probabilities and expected credit loss. We have discouraged market participants from using our ratings as indicators of price, as measures of liquidity, or as recommendations to buy or sell securities. They are not designed to address any risk other than credit risk and should not be used for any other purpose.

The predictive content of Moody's ratings is demonstrated in our annual default studies and ratings performance reports, which are posted on our website, www.moodys.com. These reports demonstrate that both our corporate and structured finance ratings have been remarkably consistent and reliable predictors of default over many years and across many economic cycles.

There will always be unanticipated developments in some markets that impact the credit risk of securities – as we have seen over the past year. Indeed, because of shocks to different sectors, which cannot be predicted in advance, default rates by rating category have varied widely from year to year across regions and industries within the corporate sector, as well as within various structured finance sectors. (Over the past 15 years, however, investment-grade structured finance securities have had somewhat lower credit losses on average than investment-grade corporate securities.) Moody's success depends on our reputation for issuing objective and accurate ratings – and we are proud of the strong performance over time of the ratings we have issued on hundreds of thousands of securities.

III. CURRENT TURMOIL IN GLOBAL CREDIT MARKETS

The turmoil in the global credit markets has been driven, in part, by difficulties in the U.S. housing sector and the high levels of U.S. mortgage delinquencies, especially in the subprime market. Those difficulties grew out of an unprecedented confluence of factors, including the sharp deterioration in mortgage underwriting processes, misrepresentations in the mortgage application process, the steep decline in home prices and sharp contraction in credit available for refinancing.

Moody's provided early warnings on the weakness in the subprime market, and beginning in 2003 repeatedly published reports in which we pointedly commented on the deterioration in origination standards and rising housing prices. In response to the increase in the riskiness of loans made during the last few years and the changing economic environment, Moody's steadily increased its loss expectations and subsequent levels of credit protection on pools of subprime loans by approximately 30% from 2003 to 2006. As soon as we saw that deterioration in the subprime market exceeded even those levels, we took prompt and deliberate rating actions on those transactions with heightened risk.

While Moody's did see and published about the increasing riskiness in subprime lending, neither we – nor most other market participants, observers, or regulators – fully anticipated the severity or speed of deterioration in subprime mortgage lending or the rapidity of credit tightening. As the higher than expected level of delinquencies on the 2006 subprime loans became apparent, the resulting volatility in the capital markets was further exacerbated by the short positions taken by some hedge funds and the lack of transparency regarding who holds many of these structured finance products.

The rating agencies are one of many players with historically well-defined roles in the credit and structured finance markets. We believe that addressing the current challenges in the credit markets – including the general loss of confidence among many individuals and institutions – will require action on the part of all market participants, and we are eager to work with the Congress, regulators and other market participants to this end.

IV. MOODY'S SUPPORT FOR COORDINATED GLOBAL POLICY INITIATIVES

While Moody's has taken steps to adopt changes in policies and procedures that we believe can contribute to enhanced confidence in the global credit markets, we also believe that coordinated global activity by a wide range of market participants and the regulatory authorities that oversee them is required to institute all necessary reforms. Accordingly, we have been cooperating fully to support the work of various regulatory authorities around the globe who are examining these issues.

In the U.S., the Credit Rating Agency Reform Act was passed into law in September 2006. It created a voluntary registration process for any credit rating agency wishing to be designated as a nationally recognized statistical rating organization ("NRSRO"). The Reform Act provides the SEC with ongoing authority to oversee NRSROs. The SEC's final rules implementing the Reform Act came into effect in June 2007 and Moody's applied to become registered as an NRSRO in the same month. We were registered by the SEC as an NRSRO in September 2007 and are subject to the SEC's regulatory oversight.[1] The SEC has been examining NRSROs, including Moody's, that were active in rating residential mortgage backed securities ("RMBS") and collateralized debt obligations ("CDOs"). Moody's has been cooperating fully with the SEC. The examination process has been extensive and it is continuing. In addition, the President's Working Group on Financial Markets has been examining the role of various market players in the recent turmoil and has published a series of thoughtful recommendations to help restore confidence. Finally, we have been working with this and other Congressional Committees who are engaged in studying the underlying causes of the developing financial market stress.

Globally, the role of the credit rating industry in the structured finance market has been the subject of review by the Financial Stability Forum ("FSF") – a working group of authorities responsible for global financial stability. In October 2007, the FSF was directed by the G-7 Finance Ministers and central bank Governors to undertake an analysis of the current market turmoil and to make recommendations for enhancing the resilience of the markets and financial institutions. Moody's worked with and provided input to the FSF process throughout the review period. The FSF's final report was delivered to the G-7 Finance Ministers and central bank Governors at their meeting on April 11, 2008 in Washington, D.C., at which meeting the G-7 agreed to adopt the proposals and asked the FSF to report on the implementation of the various

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1 As required by the SEC's rules, Moody's has posted its initial application to become an NRSRO on Moodys.com, as well as its Annual Certification of Form NRSRO.

recommendations at the G-7's June meeting. With respect to the credit rating industry, the FSF made the following general recommendations:

- Credit rating agencies should improve the quality of the rating process and manage conflicts of interest in rating structured finance products.
- Credit rating agencies should somehow distinguish ratings on structured finance products from those on corporate ratings[2] and expand the initial and ongoing information provided on the risk characteristics of structured products.
- Credit rating agencies should enhance their review of the quality of the data input and of the due diligence performed on underlying assets by originators, arrangers and issuers involved in structured finance products.
- Investors should address their over-reliance on ratings, and investor associations should consider developing standards of due diligence and credit analysis for investing in structured products. In addition, relevant authorities should review the use of credit ratings in the regulatory and supervisory framework to ensure investors make independent judgment of risks and perform their own due diligence

Moody's supports the recommendations of this international body. We believe that implementation of these measures globally can have a positive impact in helping to address some of the current issues in the credit markets. We already have begun to adopt many of these recommendations and will continue to support these and other efforts.

V. MOODY'S INITIATIVES TO ENHANCE THE QUALITY, INDEPENDENCE AND TRANSPARENCY OF OUR CREDIT RATING PROCESSES

While we believe coordinated global action is required, we also have undertaken a series of substantial initiatives at Moody's to:

- Enhance our analytical methodologies
- Enhance our review of the due diligence process conducted by originators and underwriters
- Provide more clarity about the credit characteristics of structured finance ratings
- Promote objective measurement of ratings performance
- Continue effectively managing potential conflicts of interest
- Enhance investors' understanding of the attributes and limitations of our ratings

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[2] For purposes of this testimony, the term "corporate ratings" encompasses ratings on industrial, utility, and financial institution companies.

a) Enhance Moody's Analytical Methodologies

Over the past year, as sectors of the U.S. housing market have seen unprecedented forces driving mortgage delinquencies, Moody's has made a number of changes to the analytical methodologies used in our U.S. structured finance ratings process. These changes, which have been made incrementally over time, allow us to incorporate newly available information to better inform our view of the credit risk characteristics of a given sector. Examples of such changes for our RMBS sector are as follows.

- Increasing the average loss estimates, and therefore credit enhancement levels, for subprime RMBS that Moody's rates.
- Expanding the mortgage loan-level data we request from the issuers to include depth and breadth of a borrower's credit history, presence of escrow for taxes and insurance and presence and level of cash reserves.
- Updating our mortgage default model. The new approach will look at home prices in individual metropolitan areas, thus allowing for a more detailed geographic analysis of a given pool of mortgages. It will also allow Moody's analysts to more easily conduct "what if" scenarios by inputting values for various economic variables.
- Increasing the depth and breadth of our operations reviews of loan originators. We currently have a detailed protocol for assessing the capabilities and procedures of loan servicers. We will develop a similar approach for assessing the credit and quality control processes of loan originators.

Moody's recently issued a special report summarizing these and other modifications to our analytical approach, entitled "Updates to Moody's U.S. Structured Finance Rating Methodologies".

b) Enhance Our Review of the Due Diligence Process Conducted by Originators and Underwriters

The quality of any credit analysis necessarily relies on the quality of the underlying data, and Moody's supports efforts to improve the quality of that data. To that end, Moody's has proposed the following enhancements to improve transparency, data integrity and accountability in U.S. residential mortgage securitizations:

- Stronger representations and warranties;
- Independent third-party pre-securitization review of underlying mortgage loans;
- Standardized post-securitization forensic review;
- Expanded loan-level data reporting of initial mortgage pool and ongoing loan performance; and
- More comprehensive originator assessments.

These five enhancements are intended to work together to provide more standard and reliable information on RMBS transactions than is currently available. Moody's ability to rate a particular RMBS or assign a high or investment grade rating will depend in part upon the degree to which issuers incorporate these enhancements.

These proposals were made in a Request for Comment (RFC), "Moody's Proposed Enhancements to U.S. Residential Mortgage Securitizations: Call for Comments", published by Moody's in March 2008. Our RFC closed on April 11, and we are analyzing the responses received. We will publish the results and our next steps in the near future.

c) Provide More Clarity About the Credit Characteristics of Structured Finance Ratings

Over the past six to nine months, a debate has emerged about the appropriateness of a single rating scale for both structured and non-structured securities. In particular, some market participants, including public authorities, have asked credit rating agencies to consider:

- Distinguishing ratings assigned to structured products from those assigned to corporate and government-related issuers, and/or
- Providing information content about financial performance attributes of structured products other than credit risk.

Moody's is committed to developing the most effective possible rating scale to serve the needs of market participants. To this end, Moody's, in February 2008, issued an RFC "Should Moody's Consider Differentiating Structured Finance and Corporate Ratings?" soliciting views from market participants on whether we should assign ratings on structured securities using an alternative to the current scale and what alternative they would find most effective. Our proposal offered five alternatives for changing the rating scale, including:

- Moving to a completely new rating scale.
- Adding a modifier to ratings on the existing scale to identify them as structured finance.
- Adding a suffix to the existing rating scale to indicate rating volatility risk.
- Using the existing rating scale combined with a second scale indicating such risks.
- Making no changes, but providing additional commentary.

Our goal in laying out these various alternatives was to encourage a broad dialogue with market participants that would help ensure we considered the full range of ratings-related alternatives and perspectives, and that we adopt the most effective scale.

Over 200 market participants provided us with their views through submissions to an electronic survey; emails sent to Moody's Credit Policy Group; and comments made directly to us during meetings with market participants. We are analyzing the extensive feedback we have received and intend to publish the results in the coming month.

d) Promote Objective Measurement of Ratings Performance

Moody's has led the ratings industry in subjecting its ratings performance to objective measurement. Moody's measures a range of attributes associated with our ratings – for example: accuracy, stability, rating transitions, default rates within one year of holding an investment-grade rating, and rating-reversal rates (downgrades followed by an upgrade, or vice versa) within one year. We compile these measurements in a number of periodic ratings performance studies including:

- Annual corporate default and loss studies (which we have conducted since 1989)
- Annual structured finance rating transition studies (which we have conducted since 1995)
- Annual structured finance default and loss studies (which we have conducted since 2003)
- Quarterly corporate ratings performance studies (which we have conducted since 2003)
- Semi-annual structured finance ratings performance studies (which we have conducted since 2005)

Measurements are calculated on a periodic basis for the purposes of making ratings performance comparisons over time and, where data permit, comparisons of Moody's ratings performance against alternative credit risk indicators.

e) Continue Effectively Managing Potential Conflicts of Interest

To foster and demonstrate objectivity, Moody's has adopted and publicly disclosed important fundamental principles for managing Moody's ratings process. For example, among other steps:

- Ratings decisions are made by a rating committee, not by an individual analyst.
- Analysts participating in a committee are required to be fully independent from the companies they rate.
- Analyst compensation is unconnected to either ratings or fees of the securities they rate.
- Analysts have standards by which they are required to conduct themselves with issuers and investors.
- An independent and separate surveillance team reviews the performance of most structured finance transactions on an ongoing basis.
- Our ratings methodologies are transparent and publicly disclosed.

These and other measures protect the integrity of Moody's rating opinions and allow us to manage any potential conflicts of interest. They are described in our Code of Professional Conduct, which is available on our Regulatory Affairs home page at www.moodys.com.

While we believe these safeguards are robust and transparent, we continue to work to enhance protections against potential conflicts. We have recently implemented, or are in the process of implementing, several other measures to further demonstrate the independence of our rating process:

- Formalize the Separation of Ratings-Related Businesses: Moody's recently reorganized its operating businesses to formalize the separation of our ratings-related and non-rating activities into two different business units.
- Enhance the Credit Policy Function: The Credit Policy function at Moody's has long been independent from those parts of the rating agency with revenue-generating responsibility, and we have taken steps to further separate this function. The Chairman of Credit Policy now has a reporting responsibility directly to the Moody's Board of Directors. The performance incentives for Credit Policy personnel are based exclusively on the effectiveness of the rating process and the analytical quality of their oversight. And, the measurement of the unit's performance is wholly independent of the financial performance of the company or any business unit.
- Codify the Existing Policies About Analyst Communication With Issuers: In order to enhance market confidence in the appropriateness of communications between Moody's analysts and issuers or advisors, we are codifying our existing practice that such communications are limited to communications about credit issues.
- Implement "Look-back" Reviews to Confirm Integrity of Analysis: Moody's has adopted a new policy related to employees who leave Moody's to work for another market participant. When we learn that an issuer or a financial intermediary representing the issuer has hired a Moody's employee who has served as lead analyst for that issuer, we will now review the analyst's work related to the issuer and its securities over a six-month "look-back" period to confirm the integrity and rigor of that analyst's work.

f) Enhance Investors' Understanding of the Attributes and Limitations of our Ratings

While capital market participants are often highly sensitive to Moody's ratings and rating actions, we note that misunderstandings remain about the objectives and performance of our ratings. We have undertaken numerous steps to improve the understanding of our ratings, including frequent publications,[3] extensive distribution of

[3] For examples, see our publications: "Understanding Moody's Corporate Bond Ratings and Rating Process," May 2002; "Comments from Moody's Investors Service on the European Commission Services' New Capital Adequacy Directive: Recognition and Supervision of ECAIs," January 2003; "Measuring the Performance of Corporate Bond Ratings" April 2003; "Moody's Investors Service Response to the Director General Internal Market Services' Working Document on the Implementation of the European Parliament and Council Directive 2003/6/EC on Insider Dealing and Market Manipulation," April 2003; "Moody's Investors Service Comments on the Securities and Exchange's Concept Release on Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws," July 2003; "Are Corporate Bond Ratings Procyclical?" October 2003; "Statement of Raymond

information on these topics, and hundreds of face to face meetings with investors. We intend to continue these efforts and hope to work with other market participants to improve market understanding about what our ratings do and do not measure. We believe this can help ensure more appropriate use of our credit ratings going forward.

VI. Conclusion

Recent events show that markets can change rapidly and dramatically. Such change should teach important lessons. The opportunity to improve market practices, including credit analysis and credit-ratings processes, must be pursued vigorously and transparently if confidence in, and the healthy operation of, credit markets are to be restored.

We are firmly committed to the integrity of our rating methodologies and policies and the transparency of our performance metrics. In this regard, we look forward to continuing our dialogue with authorities and market participants to help strengthen confidence in the financial markets.

I am happy to respond to any questions.

McDaniel at the 29th Annual Meeting of the International Organization of Securities Commissions" October 2003; "Statement of John Rutherfurd at the 30th Annual Meeting of the International Organization of Securities Commissions" April 2005; "Moody's Investors Service Comments on the Securities and Exchange Commission's Rule Proposal on the Definition of Nationally Recognized Statistical Rating Organization," June 9, 2005; "Moody's Investors Service Code of Professional Conduct," June 2005; "Response of Moody's Investors Service to The Committee of European Banking Supervisors' Consultation Paper on the Recognition of External Credit Assessment Institutions," September 2005.

ANNEX I

Guide to Moody's Key Rating Methodologies, Ratings System Management Policies and Ratings Performance Studies

Moody's methodologies, policies and performance studies all appear on our website, www.moodys.com, and can be located by navigating the Credit Policy and Regulatory Affairs Web pages, both of which have direct links from Moody's homepage.

Rating Methodologies. Within the corporate and the sovereign/subsovereign sectors, individual reports are available that detail our rating approach for each major industry or sector. These reports are organized in a simple outline structure on the Web page entitled "Fundamental Rating Methodologies Index". Structured finance rating methodologies for all sectors can also be found at www.moodys.com. The easiest way to find structured finance methodologies is to search the "Index of Special Reports."

Rating System Management Policies. Moody's rating policies and procedures can be found on its Regulatory Affairs homepage. The document, entitled "Moody's Investors Service Disclosures," discusses and contains links to Moody's Codes of Professional and Business Conduct, Policy with Respect to Non-Rating Services, Core Principals for the Conduct of Rating Committees, Designating Issuers that Do Not Participate in the Ratings Process, Designating and Unsolicited Ratings. A wide variety of additional ratings policy documents are posted on the Credit Policy page of the Moody's website. For a useful overview of how Moody's manages its ratings system, see "Understanding Moody's Corporate Bond Ratings and Rating Process," Special Comment, May 2002.

Ratings Performance Studies. Moody's rating performance is measured by the Credit Policy Research Group, which reports to the Credit Policy Chair, who reports administratively to the President of Moody's Investors Service and has a periodic reporting responsibility to the Moody's Corporation Board of Directors.

Moody's outlined its general approach to measuring ratings performance in April 2003 in a Special Comment titled, "Measuring the Performance of Moody's Corporate Ratings." The paper discusses the dual objectives – accuracy and stability – of the rating system; the greater importance placed on relative ratings accuracy compared to cardinal ratings accuracy; and the tools available to measure these various aspects of performance. The key metrics include accuracy ratios, rating action (volatility) rates, and investment-grade default rates. In addition to measuring changes in performance over time, Moody's compares the performance of its ratings to "ratings" inferred from bond prices, credit default swaps spreads, equity prices, and financial accounting ratio models.

Moody's has been since 2003 updating these performance measures for its corporate ratings on a quarterly basis, with the most recent report entitled, "The Performance of Moody's Corporate Bond Ratings: December 2007 Quarterly Update." Similar metrics have also been applied to Moody's structured finance ratings on a semi-annual basis since 2005, with the most recent report entitled, "The Performance of Structured Finance Ratings: Full-Year 2006 Report."

In addition, Moody's publishes detailed annual studies of default, transition, and loss rates for corporate ratings, transition rates for structured finance ratings, and material impairment and loss rates for structured finance ratings. The most recent versions of these reports are titled:

- "Corporate Default and Recovery Rates, 1920-2007,"
- "Structured Finance Rating Transitions: 1983-2007," and
- "Default & Loss Rates of Structured Finance Securities: 1993-2006."

Lastly, the Credit Policy Research Group produces a wide variety of special research reports on ratings performance within sectors and of broad interest to market participants, regulators and academics. These reports are indexed at www.moodys.com and are listed in a Special Comment entitled, "Guide to Moody's Default Research," which is updated every few months.