Moody's Investors Service

Testimony of Raymond W. McDaniel, Jr.
U.S. Senate Committee on Banking, Housing and Urban Affairs
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Good morning. I am Ray McDaniel, President of Moody's Investors Service. Let me begin by thanking Chairman Shelby, Senator Sarbanes and the members of the Committee on Banking, Housing and Urban Affairs (the **"Committee"**) for inviting Moody's to participate in this hearing.

Today, I will briefly discuss Moody's background, the role and the use of our ratings in the market, our rating process and enhancements we have made to that process, the competitive landscape in which we operate, some global developments in our industry, and finally the regulatory environment in the United States.

I. Background about Moody's

Rating agencies occupy a niche in the investment information industry. Our role in that market is to disseminate information about the relative creditworthiness of, among other things, corporations, governmental entities, and pools of assets collected in securitized or "structured finance" transactions. Moody's is the oldest bond rating agency in the world. We have been rating bonds since 1909. Today, we have more than 1,000 analysts in 18 countries around the world. Our products include our familiar credit rating opinions, which are publicly disseminated via press release and made freely available on our website, as well as research and special reports about debt issuers and their industries that reach more than 3,000 institutions and 22,000 subscribers around the globe.

Moody’s integrity and performance track record have earned it the trust of capital market participants worldwide. Our ratings and analysis track more than $30 trillion of debt issued in domestic and international markets, covering approximately 10,000 corporations and financial institutions, more than 20,000 municipal debt issuers, over 12,000 structured finance transactions, and 100 sovereign issuers.

II. What Moody’s Ratings Measure

Moody’s ratings are expressed according to a simple system of letters and numbers. Ratings forecast the relative likelihood that debt obligations or issuers of debt will meet future payment obligations in a timely manner. Company ratings are formulated utilizing the traditional techniques of fundamental credit analysis and are thus based primarily on an independent assessment of a company’s published financial statements.

Moody’s bond rating system, which we have used for 96 years, has 21 categories, ranging from Aaa to C. Investment-grade ratings include ratings of Aaa, Aa, A and Baa. Ratings below Baa are considered speculative-grade. Moody’s ratings are opinions regarding relative expected loss, which reflects an assessment of both the probability that a debt instrument will default and the severity of loss in the event of default. The lowest expected credit loss is at the Aaa level, with a higher expected loss rate at the Aa level, a yet higher expected loss rate at the A level, and so on down through the rating scale. In other words, the rating system is not a “pass-fail” system; rather, it is a probabilistic system in which the forecasted probability of future loss rises as the rating level declines.

Moody’s rating system has over the years extended to other aspects of an issuer's creditworthiness, thereby disaggregating the various elements of our analysis and providing the market with our opinions on those specific characteristics. Two such examples are:

- short term ratings – which measure the likelihood that an issuer will be able to meet its short term liabilities; and,

- financial strength ratings – which measure the stand alone financial strength of an entity, excluding any implied or guaranteed third party support

III. Role and Usage of Ratings

Moody's believes that the most important function of credit ratings is to contribute to fair and efficient capital markets. Our ratings are one means of communicating relevant information about a bond to potential investors in that bond. At the same time, the broad, public distribution of ratings by Moody's helps assure that our credit opinions are freely and simultaneously available to all investors, regardless of whether they purchase products or services from Moody's.

Our ratings have three intrinsic qualities that have made them useful for a variety of purposes. First, as I have mentioned, our ratings are publicly and simultaneously available to all market participants; second, our rating opinions are independently formed; and third, and possibly most important, Moody's rating performance:

- can be tested,
- is regularly tested, and
- has been consistently shown to have predictive content.

As a result, ratings have been employed by a diverse collection of investors, issuers, financial institutions, and regulatory bodies, which have a variety of objectives in their use of ratings. For example:

- Investors use ratings when making investment decisions to help assess a bond's relative creditworthiness;
- Debt issuers use ratings to broaden the marketability of their securities and thereby to improve their access to the capital markets;
- Portfolio managers employ ratings for performance benchmarking and portfolio composition rules (commitments to specific portfolio investment strategies); and
- Regulators of banks, securities firms, and insurers use ratings to determine investment suitability, measure capital adequacy, and promote market stability.

Moody's Management of the Rating System

The market utility of a credit rating system is highest when ratings effectively distinguish riskier credits from those that are less risky, when they do so on a comparable basis across a wide range of issuers, and when the ratings are widely disseminated. Stability of ratings is also valued in the market, and Moody's manages its ratings so that they are changed only in response to changes in relative credit risk that we believe will endure, rather than in response to transitory events or shifts in market sentiment.

Having said that, our ratings should not be any more stable than our perception of fundamental creditworthiness warrants. Moreover, in an effort to provide greater transparency around possible future changes in ratings, we have developed a series of additional public signals, called "watchlists" and "outlooks," through which we communicate our opinion on possible trends in future creditworthiness and the likely direction of ratings that are under review. A rating outlook, expressed as positive, stable, negative or developing, provides an opinion as to the likely direction of any medium-term rating actions, typically based on a 12-18 month horizon. Most investment grade companies have a rating outlook assigned to them.

If changing circumstances contradict the assumptions or data supporting a current rating, we may place the rating on our watchlist. The watchlist highlights issuers (or debt obligations) whose rating is formally on review for possible change. At the conclusion of a review, typically within 90 days of placement on the watchlist, we will assess whether the issuer's credit risk is still consistent with the assigned rating. Although the watchlist is not a guarantee or commitment to change ratings over a certain time horizon, or even to change them at all, historically about 66% of all ratings have been changed in the same direction (and rarely in the opposite direction) as indicated by their watchlist status.

Through our overall management of the rating system, we believe we have achieved the balance demanded by the marketplace for a relatively stable product that also is capable of providing timely public information about possible future movements in creditworthiness.

IV. Moody's Rating Process

Let me now describe how we go about rating debt securities issued by corporations. Our ratings and research are produced by our credit professionals generally located in the region of the issuing entity. Our rating process begins when an issuer or its representative requests a rating. A managing director responsible for the issuer's industry sector will assign the analysis of the corporation to a lead analyst and back-up analyst. The lead analyst is responsible for compiling relevant information on the issuer. Moody's analysts rely heavily on publicly available information, including regulatory filings and audited financial statements. The remainder of the information comes from macroeconomic analysis, industry-specific knowledge, and the issuer’s responses to any requests for additional information from the credit analyst. Although issuers may choose to volunteer non-public information to inform our deliberations, they are not required to do so as part of the rating process. In instances where, in Moody's' view, there is insufficient information to form a rating opinion, we will either not rate the entity or withdraw an already published rating.

Once information has been gathered, the lead analyst will analyze the company, which incorporates an evaluation of, among other things: franchise value, financial statement analysis, liquidity analysis, management quality and the regulatory environment of the industry in which the company operates. Depending on the complexity of the transaction, the analyst may include the expertise of some of our specialist teams, which I will discuss in more detail later. Based on this assessment, the lead analyst will draft a rating memorandum. That memorandum is then distributed and discussed in a rating committee, which ultimately is responsible for taking a rating decision on a majority-vote basis.

The rating committee is typically comprised of the rating committee chair; the lead analyst, who has researched the company; the back-up analyst; junior support analysts; and possibly additional analysts or managing directors who have expertise relevant to the rating decision. During the committee meeting, the lead analyst presents his or her views and discusses the underlying reasoning and assumptions. The committee then challenges and debates the various points, and after vetting the various issues, it votes.[1]

When the committee concludes, the issuer is contacted and informed of Moody's rating decision. If the issuer has new information which is important and relevant, the issuer may appeal the rating. Otherwise, Moody's provides the issuer with a copy of the draft press release announcing the rating decision. The draft press release will include the rating action and our reasoning. The issuer then has an opportunity to review the draft press release prior to its dissemination,[2] for the purpose of verifying that it does not contain any inaccurate or non-public information. Once final, the rating is released to the news-wires and made available on our website. The entire rating process generally takes from four to six weeks, and sometimes longer if the credit is particularly complex.

Once a rating has been published, Moody's monitors the credit quality of that outstanding debt issuance and will alter the rating – through the same rating committee process – should our perception of the issuance's creditworthiness change.

A. Issuer Pays Model

Most of Moody's revenues are generated from issuer fees. Issuers request and pay for ratings from us because of the broad marketability of bonds that ratings facilitate. Ratings facilitate this marketability in part because many U.S. institutional investors have prudential investment guidelines that rely in part upon ratings as a measure of desired portfolio quality. While both issuers and investors rely on our ratings, issuers are more motivated to pay for ratings than investors because of two attributes of ratings:

First, there is a substantial difference between issuers and investors in their need for a rating on any single debt instrument. While ratings promote broad marketability of bonds, investors can select from a wide range of investment alternatives and are, therefore, more interested in the general existence and application of ratings than in any individual rating. If, for example, a rating is not assigned to a particular bond, in most

1 Junior support analysts typically do not vote. They are however encouraged to fully participate in the discussion as the process is an effective means of training.

2 If an issuer has no rated debt outstanding in the market, it may request that the timing of the press release coincide with its contemplated debt issuance.

cases an investor's motivation to request and pay for a rating on that bond is low. There are many other rated bonds or investment opportunities that the investor can choose among.

This relative indifference to individual ratings means that investors would only be motivated to pay fees for ratings that are delivered on an aggregate, comparative basis. Such a service, which would have to operate as a subscription service to generate fees, is impractical because of the second principle: the expectation that ratings of public debt will be made simultaneously available to all investors through public dissemination.

Because ratings are publicly disseminated, investors do not need to purchase ratings, as they are freely available. Public availability, when combined with the relative indifference of investors versus issuers toward any single rating, allows investors to benefit from ratings as a "free good" by consuming them without a compelling need to support the cost base that produces them. An issuer does not have the same tolerance as an investor for a missing rating on its bond. It does not have the same range of choices in accessing capital that an investor has in deploying capital. In order for an issuer to facilitate broad marketability of its bond, it will likely choose to have a rating on that specific bond.

B. Conflicts of Interest

The issuer-pays business model has conflicts of interest, as does the investor-subscription business model, and so we have taken important steps to effectively manage and disclose those risks. Issuer fees were introduced over three decades ago. Since that time, we believe we have successfully managed the conflicts of interest and have provided the market with objective, independent and unbiased credit opinions. To foster and demonstrate objectivity, Moody's has adopted and disclosed publicly certain Fundamental Principles of Moody's ratings management. Among them are:

- Policies and procedures which require that analysts participating in a committee be fully independent from the company they rate – for example, analysts are prohibited from owning securities in institutions which they rate (except through holdings in diversified mutual funds);

– Analyst compensation is unconnected with either the ratings of the issuers the analyst covers or fees received from those issuers;

– Rating decisions are taken by a rating committee and not by an individual rating analyst;

– Rating actions reflect judicious consideration of all circumstances believed to influence an issuer's creditworthiness;

– Moody's will not refrain from taking a rating action regardless of the potential effect of the action on Moody's or an issuer; and

– Moody's does not create investment products, or buy, sell, or recommend securities to users of our ratings and research.[3]

The integrity and objectivity of our rating process is of utmost importance to us. Our continued reputation for objective ratings, as a recent Federal Reserve[4] study indicated, is essential to our role in the marketplace.

C. Track Record of Predictive Content

Perhaps the most important litmus test, however, for whether conflicts of interest are being properly managed is the performance of our ratings. As I said earlier, ratings performance can be and is regularly tested according to measures that are subject to third party verification. This testing has repeatedly demonstrated the predictive content of our ratings over time. Moody's and independent academics have published studies on the relationship between our ratings and credit risk.[5] Our annual "default study" consistently shows that

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3 Moody's parent company, Moody's Corporation, invests excess cash in highly-rated short-term debt securities. All investment decisions are made at the parent company level.

4 Daniel M. Covits, Paul Harrison, "Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate," Federal Reserve Board, December 2003.

5 See generally, Rober W. Holthausen and Richard W. Leftwich, The Effect of Bond Rating Changes on Common Stock Prices, Journal of Financial Economics 17 (1986) 57-89; Edward I. Altman, Herbert A. Rijken, "How rating agencies achieve rating stability", Journal of Banking & Finance 28 (2004) 2679-2714; William Perraudin, Alex P. Taylor, "On the consistency of ratings and bond market yields," Journal of Banking & Finance 28 (2004) 2769-2788; Gunter Loffler, "Ratings versus market-based measures of default risk in portfolio governance," Journal of Banking & Finance, February 28 (2004), 2715-2746; Credit Ratings and Complementary Sources of Credit Quality Information, by a working group led by Arturo Estrella, Basel Committee on Banking Supervision Working Papers, No. 3, August 2000;

higher-rated bonds default at a lower rate than lower-rated bonds, and that the proportion of defaults varies with the credit cycle. Moreover, since 2003, Moody's has been publishing a quarterly "report card" of our rating quality performance utilizing a range of accuracy and stability metrics.

V. Enhancements to the Rating Process

The ultimate value of a rating agency's contribution to market fairness and efficiency depends on its ability to offer predictive opinions about the relative credit risk of rated entities. However, I caution that our ratings should not be construed as investment advice, as performance guarantees, or as a means of auditing for fraud. Further, the quality of the opinions we provide to the market is in large part a function of the quality of information to which we have access when formulating our opinions. As a result, the role rating agencies play in any market is either augmented or hindered by the quality and completeness of the financial information published by debt issuers.

As high profile corporate frauds in recent years have demonstrated, if issuers abandon the principles of transparency, truthfulness and completeness in disclosure, neither rating agencies nor any other market participants – including regulatory authorities – can properly fulfill their roles. As one of the largest consumers of issuers' financial disclosure, Moody's has supported the efforts of this Committee and the Congress to require truthful financial disclosure.

Nevertheless, while our processes are not intended to systematically detect fraud nor re-audit financial statements, we recognize that in order to fulfill our role in the market, our methodologies must evolve with the market and our analysts must stay abreast of market developments. For almost 100 years, we have been committed to providing the highest quality credit assessments available in the global markets, which means that we must continue to learn both from our successes and our mistakes. In this spirit, we have undertaken

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Default & Loss Rates of Structured Finance Securities: 1003-2003, Moody's Special comment, September 2004; Default and Recovery Rates of Corporate Bond Issuers, 1920-2004, Moody's Special Comment, January 2005; The Performance of Moody's Corporate Bond Ratings: December 2004 Quarterly Update, Moody's Special Comment, January 2005; Measuring the Performance of Corporate Bond Ratings, Moody's Special Comment, April 2003.

substantial internal initiatives to enhance the quality of our analysis and the reliability of our credit ratings. These initiatives include:

- **Analytical specialist teams:** We have added over 40 professionals specializing in accounting and financial disclosure, off-balance sheet risk, corporate governance and risk management assessment. These professionals work alongside our analytical teams and do not have direct rating responsibilities. As such, they are able to devote full attention to their areas of concentration and bring their expertise to credits that are more complex and which need greater scrutiny.
- **Analyst professional development program:** Moody's company analysts must annually complete 40 hours of course work that covers a range of substantive disciplines, including accounting, securitization and risk transfer, liquidity analysis, and ethics.
- **Greater use of market information:** Moody's has developed market-based monitoring tools to help analysts maintain close scrutiny over their portfolios.
- **Global realignment:** Moody's has re-structured organizationally along lines of business, rather than regions, to allow analysts covering the same industry to share information and expertise more easily across borders.
- **Reinforced centralized credit policy function:** The credit policy function at Moody's has been augmented to help ensure that credit policies and procedures are efficiently communicated throughout Moody's and the market, and are uniformly implemented.
- **Chief credit officers:** We have appointed chief credit officers, charged with helping to ensure rating quality, in our U.S. and European corporate finance groups and in structured finance.
- **Performance metrics:** As part of our commitment to predictive ratings, we publish a quarterly report card on the accuracy and stability of our corporate bond ratings. We publish numerous studies and measurement statistics, which have shown that overall our ratings, as forward looking opinions, effectively distinguish bonds with higher credit risk from bonds with lower credit risk.

VI. Level of Competition in the Industry

There are numerous types of credit assessment providers, which compete vigorously for the trust of the market. They include, for example, traditional credit ratings, subscription-based rating providers, statistically derived ratings that rely solely on market-based or other financial data, bond research provided by brokerage firms, credit research performed by banks and other financial firms, and trade credit reporting agencies.

The combination of the public nature of credit ratings and natural barriers to entry[6] may imply that only a limited number of traditional rating agencies will be able to operate and thrive under an issuer-pays model. It is possible that only a limited number of agencies (though potentially a shifting group) will attain an issuer's business, regardless of the aggregate number of competitors. Therefore, while there are numerous types of credit assessment providers, the number of large traditional rating agencies has always been few.

Oversight of Credit Rating Agencies – Developments in the International Community

As the Committee is aware, over the past three years much regulatory and legislative attention has been focused on the global financial services industry. Credit rating agencies have been included in this examination process.

A global cooperative effort over the past two years led by the International Organization of Securities Commissions (IOSCO) – a committee comprised of approximately 100 of the world's securities regulatory authorities, importantly including

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[6] Natural barriers to entry in the traditional credit rating agency industry where ratings are publicly and freely provided are:

- **The Costly Nature of Executive Time –** Debt issuers have a limited use for more than a few ratings because fundamental credit analysis, and therefore each agency relationship, requires the issuer's time and executive resource commitments. This includes preparing and presenting information, and maintaining that flow of information and communication on a periodic basis.
- **Network Externalities** – Investors desire consistency and comparability in credit opinions. The more widely an agency's ratings are used/accepted by market participants the greater the utility of its ratings to investors, and therefore to issuers.
- **Broad Coverage** – Investors place greater value on an agency's ratings the broader its rating coverage and the more widely its ratings are used.
- **Track Record –** Investors have more confidence in ratings that are assigned by agencies with publicly established track records of predictive ratings over a period of time. Due to the relatively small number of defaults in the public capital markets, it is difficult to establish quickly a performance track record.

the U.S. Securities and Exchange Commission (SEC) – produced and published a code of conduct (the "Code") for the credit rating agency industry. The Code addresses:

- The quality and integrity of the rating process;
- Credit rating agency independence and the avoidance of conflicts of interest; and,
- Credit rating agency responsibilities to the investing public and issuers.

Under each broad section, the Code enumerates specific provisions. While spearheaded by the SEC, the Code was drafted jointly by global regulators, who consulted with issuers, investors, intermediaries, and rating agencies in their respective jurisdictions. The Code is to be implemented through a "comply or explain" mechanism. Specifically, rating agencies are to voluntarily adopt the Code, and then publish their compliance with it or explain why they are unable to satisfy specific provisions. Moody's has announced that we intend to adopt the IOSCO Code and periodically disclose our compliance with it. Our disclosure would naturally address our ratings activity in the United States, as well as all other jurisdictions in which we operate.

In Moody's view, the Code provides a comprehensive framework for rating agency disclosure that will better equip the market to assess rating agency reliability. Moody's is committed to supporting the IOSCO process and to implementing the Code. We believe that it fosters greater market transparency and delivers accountability, while simultaneously encouraging a competitive marketplace and information flow. Such an outcome should serve market integrity and investor confidence without unduly increasing the financial or administrative cost of business for rating agencies or users of ratings.

VII. Regulatory Landscape in the United States

The Nationally Recognized Statistical Rating Organization (NRSRO) designation in the U.S. – which allows regulated entities to use ratings provided by credit rating agencies that have been so designated – is administered and overseen by the SEC. To the extent that the NRSRO designation is seen to limit competition, Moody's is on record as not opposing its discontinuance.[7] We do not believe that our business depends upon the continuance of the NRSRO system.

By way of background, the use of ratings in U.S. regulation and legislation has been an evolutionary process. In the 1930s, bank regulators began using credit ratings in bank investment guidelines. State laws and regulations soon adopted similar standards for state banks, pension funds, and insurance companies, and additional federal regulation followed. In 1975, the SEC introduced credit ratings into its net capital rule for broker-dealers.

Informally called the "haircut" rule, the net capital rule requires broker-dealers to take a larger discount on speculative-grade corporate bonds – a "haircut" – when calculating their assets for the purposes of the net capital requirements than for investment-grade bonds. This rule specified that the ratings must come from NRSROs. While the term was not defined, rating agencies which had established a presence at the time were so designated; among them was Moody's. Over time, the use of NRSRO ratings has spread into various legislative and regulatory frameworks, including those for the banking, insurance, educational and housing industries.

It is our view that the use of ratings in regulation and the subsequent necessity of recognizing or regulating rating agencies should neither alter the rating product nor increase barriers to competition. Moody's supports allowing natural economic forces to guide competition in the rating agency industry. We believe that a healthy industry structure is one in which the role of natural economic forces is conspicuous, and where competition is based on performance quality to promote the objectives of market efficiency and investor protection.

In responding to regulatory authorities globally, Moody's has consistently supported eliminating barriers to entry caused by, for example, vague or difficult to achieve recognition standards. More generally, we have supported competition in the rating agency industry. Increased competition may augment the number and diversity of

[7] Moody's Response to the US SEC Concept Release, July 28, 2003.

opinions available to the financial markets; and encourage rating agencies to improve their methodological approach and better respond to market demands.

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On behalf of my colleagues at Moody's, I greatly appreciate the Committee's invitation to participate in this important hearing. The obligation to assure that the U.S. financial market remains among the fairest and most transparent in the world is one that all market participants should share. I look forward to answering any questions the Committee has in pursuit of this important goal.