FINANCIAL CRISIS INQUIRY COMMISSION

Official Transcript

Hearing on "Credibility of Credit Ratings, the Investment Decisions Made Based on Those Ratings, and the Financial Crisis"

Wednesday, June 2, 2010

The New School

55 West 13th Street, New York, New York

8:30 A.M.

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Reported by: DAVID LEVY, CSR, Hearing Reporter

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P R O C E E D I N G S

CHAIRMAN ANGELIDES: Good morning. The meeting of the Financial Crisis Inquiry Commission shall come to order. We have a quorum present. And so we will now begin our proceedings. Today's hearing will be on the credibility of credit ratings, the investment decisions made on the basis of those ratings and the financial crisis.

I want to welcome all of you to The New School, and now it is my distinct privilege and honor on behalf of the whole commission to introduce Bob Kerrey, former governor, former senator from the State of Nebraska, now president of The New School, and our host today. Senator Kerrey, thanks so much for having us here. You and your staff have been terrific. And the microphone is now yours.

PRESIDENT KERREY: Well, first of all Chairman Angelides and Vice-Chairman Thomas and members of the Financial Crisis

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Inquiry Commission, both The New School and New York City is -- are proud to welcome you here this morning, and I appreciate very much you praising the staff because they have done all the work to make this possible, and it is always quite moving to me, the effort that they make to accommodate these kinds of extremely important efforts. I don't envy your work.

This is a complicated matter. Those of us who have sufficient quantitative skills but not impressive qualitative skills find ourselves actually quite unable to comprehend exactly what was going on and what went wrong.

Trying to manage risk today has become more and more difficult, and my own view of the matter is that, for what it's worth, which is probably not terribly relevant to your work, is that America did not become a great country by trying to avoid risk. And I do not believe that we'll remain a great country if we try to

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avoid and take risk to zero.

This city as an example, benefitted enormously from a public works project called the Erie Canal. It was begun at the start of a great recession in 1817, took seven years to build. Not a single member of the New York City assembly or Senate delegation voted for the project because they considered it to be an upstate project. But the details of that story, which I have acquired, having come and been in this city for ten years, caused me to wonder whether or not the Erie Canal could be built today, because we have become very risk-averse and it's become more difficult to take on projects with almost any kind of risk attached to it.

So I very much appreciate your willingness to tackle this problem because getting our markets and regulating our markets, and many of you have had experience at both regulating and having difficulty doing what you believe is now

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clear, I'm looking at Brooksley here, was the right thing in the 1990’s, regulating those markets so those markets remain viable, remain active and trusted by the American people and the world, is an extremely important task.

So I welcome you once more to The New School, to New York City, and I congratulate and thank you for myself and, I hope, for other Americans as well, for your willingness to tackle this problem.

CHAIRMAN ANGELIDES: Thank you much, Senator. Would you like to make a comment to the senator or reserve those for your remarks?

VICE CHAIRMAN THOMAS: No, if he's leaving, I want to say it in front of him, Senator Kerrey and I served on the bipartisan Medicare Commission and what I always enjoy is visiting old friends from former battles, and I like it because you haven't changed at all.

The idea of someone who is as liberal as he is, check out his voting record,

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understanding risk, which is the other side of the coin of opportunity, and how this country manages not providing a guarantee for everything, which means risk, but succeeding because of that, has always been a theme that he presented well back when we had a chance to make a big difference. And it's exciting to see you again in these circumstances 'cause we're taking a risk getting out of Washington. You know, how cocooning Washington is, in terms of commissions and hearings. And this is our first venture out of the Washington Beltway.

So thank you for being receptive to us, and I guess we may see you back inside the Beltway.

PRESIDENT KERREY: You do have a couple of months as I go down there to try to steal money for The New School.

VICE CHAIRMAN THOMAS: Turn it over.

PRESIDENT KERREY: I guess I have demonstrated physically my lack of understanding of risk. I get down there

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actually quite often as it is on behalf of The New School, trying to --

VICE CHAIRMAN THOMAS: Yeah, but you're queuing up asking for money rather than...

PRESIDENT KERREY: Queuing up is all right.

CHAIRMAN ANGELIDES: Thank you so much and thank you for your hospitality.

Let's begin our proceedings. Again, thank you, President Kerrey. On behalf of the Financial Crisis Inquiry Commission, I want to thank everyone at The New School for their hospitality, I want to thank all of you for being here today. As always, I want to thank Vice-Chairman Thomas and I especially want to especially commend Commissioners Georgiou, Graham and Wallison for taking the lead on this hearing.

Today's hearing on credit ratings is part of our larger investigation into the cause of the financial and economic crisis that continues to bring so much hardship

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to our nation. Credit rating agencies have played a pivotal role in our financial markets. Their Good Housekeeping Seal of Approval guided decisions by individuals and institutional investors alike. Financial institutions look to ratings to make determinations about their capital requirements. And these ratings enabled the issuance of trillions of dollars worth of subprime mortgage securities.

Today, we're examining Moody's Corporation as a case study. We will have questions about why, what things went so very wrong.

I should add that this hearing is just one aspect of our investigation. Our staff has already combed through 430,000 pages of documents and interviewed dozens of witnesses on Moody's alone.

To be blunt, the picture is not pretty. From 1998 to 2007, Moody's revenues from rating complex financial instruments like mortgage securities grew

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by a whopping 523 percent. From 2000 to its peak in 2007, the company stock price climbed more than six-fold. Moody's did very well. The investors who relied on Moody's ratings did not fare so well.

From 2000 to 2007, Moody's slapped its coveted AAA rating on 42,625 residential mortgage-backed securities. Moody's was a triple-A factory. In 2006 alone, Moody's gave 9,029 mortgage-backed securities a AAA rating. That means they put the AAA label on more than 30 mortgage securities each and every working day that year.

To put that in perspective, Moody's currently bestows its AAA rating on just four American corporations. Even Berkshire Hathaway, with its more than $20 billion cash on hand, doesn't make that grade.

We all know what happened to those AAA securities. In 2006, $869 billion worth of mortgage securities were AAA-rated by Moody's. 83 percent went on

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to be downgraded. Investors from university endowments to teachers and police officers relying on pension funds suffered heavy losses.

Now, many of the witnesses we've heard from over the course of our investigation, whether it's bankers or regulators or the Chairman of the Federal Reserve, have said that there was no way they could have foreseen the steep nationwide decline in housing prices we've experienced. I suspect we may hear more of that today. But of course there were warning signs. The attempts by many states to stem the tide of deceptive and predatory mortgage practices, the 2004 FBI warnings about mortgage fraud, and most of all the fact that housing prices had shot up an unprecedented 89 percent from 2000 to 2006, leading to the obvious possibility that what goes up might come down.

Even within the Moody's Corporation, there were warnings, including a prescient

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2006 report from Moodyseconomy.com about the dangers of an overheated housing market. And it didn't take a 30-percent decline in housing prices for these ratings to come unhinged. Housing prices had only dropped four percent from their peak when Moody's began its massive downgrades in July 2007. Imagine if you had a laboratory that tested the safety of toasters. If at first a few toasters caught fire, there would be an outcry about the toaster inspectors. And yet, instead of halting the assembly line, you sped up the production of these combustible toasters. After a while, if you found that 90 percent of the toasters you rated safe had caught fire, you'd think that something was fundamentally wrong.

Why did Moody's get it so wrong? Was it because of fraud ratings models? Was it because they were paid by the bankers whose secures they rated? Did a push for profits and market share skew their risk assessment? Was it a failure of corporate

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governance and management?

Today, we'll be asking questions of the front-line personnel at Moody's and the CEO, Raymond McDaniel. We'll also have Moody's largest shareholder, Warren Buffet, here to answer our questions. We hope to learn how and if credit ratings, and the companies that were bestowed them, contributed to the financial crisis.

In closing, I would like to note that the Commission has an excellent background report on credit rating agencies on our website at fcic.gov. With that, let me turn over the microphone to Vice-Chairman Thomas.

VICE CHAIRMAN THOMAS: Thank you, Mr. Chairman. This does mark a difference from our previous hearings. We're looking at a single type of product, credit ratings, and focusing on a single firm.

Admittedly, there aren't a lot to choose from. It's one of those areas where the expertise is narrow and deep, and it's tough -- especially with

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decisions that the government has made in recent years to get into the business as a direct competitor.

We need to examine this area. I'm interested in listening to the people who tried to tackle what we now know was a near-impossible job, partially with tools that they created but with others looking over their shoulders.

I do want to say, I understand how easy it is after the fact to talk about the fact that you should have known what we now know. I also find it interesting to deal with revisionist historians who go back and look at various periods using their current conceptual frameworks to explain situations in history and, rather than adopt the conceptual framework of those who were at the moment in the history, they impose theirs and wonder why.

I don't think that produces a lot of useful answers, except, they didn't know what they didn't know. And after the

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fact, dealing with some of the witnesses that we have today, I'm hopeful that we can get an accurate look.

What struck me in reading one of the books that are now coming out, looking at that situation, Michael Lewis', I think very good, The Big Short, is how few there are that he could talk about who were on the other side. So if all of the folk were basically honest and earnest in what they were doing, you would think there would have been more names and a slightly thicker book examining those who took the other side.

There are very, very few who took the other side and what we're trying to do is understand, one, why and how they got where they were, but probably more importantly, where a majority, a vast majority of the people were, in assuming that certain things would continue to occur in certain ways.

One of the things I'm most fascinated by is, in looking at Moody's and their

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history, and the product that they rated for such a long time, and then the very short interim in which they had to shift significantly to what was a really different product, and my questions are going to focus on, did they realize how different that product was, and did they believe they had shifted enough to cover it. And now, in retrospect, what do you think?

The other witnesses I think are going to be helpful in a broader sense. I think it's going to be interesting to examine the leadership, the executive direction of Moody's at a time where bravery was not abundant and some of the drop in business was because they decided to change the way in which they evaluated if product they are paid for. And that is going to be a focus on whether or not they were part of the cause of the financial crisis, or were one of the victims.

And that, Mr. Chairman, is a point I'm interested in investigating. Thank

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you very much and thank our witnesses for being here.

CHAIRMAN ANGELIDES: Thank you, Mr. Vice-chairman. With that, I will ask the witnesses for our first session to come forward. If you would please take your seats at the table. And actually, before you take your seats at the table, why don't you stand, because I'm going to administer the oath, which is what we customarily do for everyone who does appear before us.

If you would please stand, which you are already doing and raise your right hand and I will read the oath.

E R I C K O L C H I N S K Y ,

J A Y S I E G E L ,

G A R Y W I T T ,

having been duly sworn, testified as follows:

CHAIRMAN ANGELIDES: Thank you very much. We will begin now with session 1 of today's three session hearing. Session 1 is entitled, "The Ratings Process." It is our opportunity to hear from people at Moody's who were involved in the ratings process, both for residential mortgage-backed securities and for collateralized debt obligations. And we have asked each of the witnesses who have delivered written statements if they would provide us with a five-minute opening statement, or an opening statement of no more than five minutes.

There is a timer, I see there, and I don't know if there's another one here -- yes, there is. There is a timer where the light will go to yellow when there's one minute to go, and it will go to red when your time is up. So I'd like to ask if you would each avail yourself of this opportunity to give us a, no more than five-minute opening statement.

And Mr. Kolchinski, we will start with you, and we'll go from my left to my right. Thank you so much, Mr. Kolchinsky.

MR. KOLCHINSKY: Thank you very much. I want to thank Chairman Angelides,

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Vice-Chairman Thomas and the commissioners for inviting me to speak about the role of the ratings agencies in the financial crisis. My name is Eric Kolchinsky and, during the majority of 2007, I was the managing director in charge of the business line which rated subprime-backed collateralized debt obligations at Moody's Investor Services. I spent my entire career in structured finance and began working on CDOs in 1998.

In addition to spending eight years at Moody's, I've also worked at Goldman Sachs, Merrill Lynch, Lehman Brothers and MBIA. I hope to shed some light on the fundamental question facing the Commission: What caused the ratings agencies to assign such erroneous ratings? How could renowned companies like Moody's, S&P and Fitch, with a hundred years of experience in credit analysis produce such poor products? More importantly, how can this be prevented from happening again?

The answers lie primarily in the

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structure of the market for ratings services. While the initial users of ratings may be private entities, they seek ratings to satisfy various regulatory mandates. Thus, the nature of rating agencies is quasi regulatory and is very similar to the auditing work done by accounting firms.

The failure of the rating agencies can be seen as an example of regulatory capture, a term used by economists to describe a scenario where a regulator acts in the benefit of the regulated and not in the public interest.

In this case, the quasi regulators were the rating agencies. The regulated including banks and broker/dealers, and the public interest lay in the guarantee which taxpayers provide for the financial system. This dynamic manifested itself in interplay of several factors: The mandated outsourcing of credit analysis without any associated mandated standards of highly complex and flexible structured

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finance instruments for private companies whose managers were strongly incentivized to maximize profits. In short, the rating agencies were given a blank check.

Consider the incentives created by these factors. The rating agencies could generate billions in revenue by rating instruments which few people understood. The lack of guidance from private and public users of ratings ensured that there's little concern that anyone would question the methods used to rate the products.

The only negative factors to consider were some amorphous concepts of reputational risk. In other words, the rating agencies faced the age-old and pedestrian conflict between long-term product quality and short-term profits. They chose the latter.

These asymmetric incentives caused a shift of culture at Moody's from one resembling a university academic department to one which values revenue at

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all costs. By 2007, Moody's was a major public company with revenues of over two billion, and one of the best equity performers in S&P 500. The products rated by my group had gone from financial backwater to profit leader.

In 2001 a total of 57 billion of CDOs were rated. In 2006, the number had reached 320 billion, a nearly six-fold increase. In the first half of 2007, our revenue represents 20 percent of the total rating agency revenues earned by Moody's. For senior management, concern about credit quality took a back seat to market share. While there was never any explicit directive to lower credit standards, every missed deal had to be explained and defended.

Management also went out of its way to placate bankers and issuers. For example, and contrary to the testimony of the Moody's senior managing director, banker requests to keep senior analysts off their deals were granted.

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The focus on market share led inevitably to inability to say no to transactions. It was well understood that if one rating agency said no, then the banker could easy take their business to another. During my tenure at the head of US ABS CDOs, I was able to say no to just one particularly questionable ideal. That did not stop the transaction -- the banker enlisted another rating agency and received the two AAA ratings he was looking for.

The poor performance of the structured finance ratings is primarily the result of senior management's directive to maintain and increase market share. Leverage during negotiations can only be gained if one side has the ability to walk away. Without this leverage, the power to extract meaningful concessions from bankers ceased to exist. Instead, analysts and managers rationalized their concessions since the nominal performance of the collateral was often quite exceptional.

The increased use of synthetics also changed the nature of the ABS CDO market, the ability to go short created a new class of investors whose goal was to maximize losses. The influence of these players was never anticipated by our models and assumptions.

Additionally, the ability to infinitely replicate any credit synthetically also raised concerns about correlation between any two CDOs. The property of to identical bonds in two separate portfolios was no longer limited to the outstanding size of the issue. This correlation concern was especially true with respect to the bonds in the ABX index.

The index or its components started appearing frequently in many of the CDOs we rated. A methodology detailing this concern and limiting CDO exposure to the index was ready to be published in October of 2006. However, it was not published due to market share concerns.

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Synthetics also changed the dynamics of the ratings process. While a cash transaction would have taken months to accumulate the collateral it needed to close, a synthetic transaction could ramp up in a week. This significantly shortened the window for analysts to be able to analyze their transactions. Pressure from bankers --

VICE CHAIRMAN THOMAS: Mr. Kolchinsky, don't pay attention to the light. Because frankly, the delivery in the last 30 seconds or so wasn't worth anything because I was trying to follow you. I'll yield my time for a little while so that you can finish it in the way in which we can understand the testimony. We have it written, but there are people who are interested in what you have to say.

CHAIRMAN ANGELIDES: If you could do this, just take a minute or so to wrap up, please, because we'll have lots of time for questions, Mr. Kolchinsky, and we do have your written testimony.

MR. KOLCHINSKY: Thank you --

CHAIRMAN ANGELIDES: You just do your major points in the last minute, that would be good.

MR. KOLCHINSKY: Yes. Despite the increasing number of deals and the increasing complexity, our group did not receive adequate resources. By 2007, we were barely keeping up with the deal flow and the developments in the market. Many analysts, under pressure from bankers and their high deal loads, began to do the bare minimum of work required. We did not have the time to do any meaningful research into all the emerging credit issues. My own attempts to stay on top of the increasingly troubled market were chided by my manager. She told me that I spent too much time reading research.

As the market began to falter after the collapse of the Bear, Stearns hedge funds, I was asked to post senior management on the developments in the markets. There appeared to be little concern regarding credit quality. According to my manager, the CEO, Ray McDaniel, was asking for information on our potential deal flow prospects: "Obviously, they're getting calls from analysts and investors."

What can be done to improve rating quality? One solution which has been proposed is to completely remove any references to ratings in regulations. While this proposal seems simple and just, it is also impractical. At this point, there's no organization ready to take the rating agencies' role in the credit markets. Furthermore, the perverse incentives described above will apply to any private organization charged with the same task.

The only practical solution is to add accountability to the system by mandating minimum credit standards. This would put a floor on market-share-motivated free-falls in methodologies and restrict

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competition to where it belongs -- price and service. Thank you very much.

CHAIRMAN ANGELIDES: Thank you very much, Mr. Kolchinsky. Mr. Siegel?

MR. SIEGEL: Good morning, Chairman, Vice Chairman, and members of the Commission. My name is Jay Siegel. I've worked for Moody's Investors Service for twelve years, from 2001 until 2006, April, when I departed from the company. I was one of two and then three of the managing directors of Moody's responsible for its work rating residential mortgage-backed securities or RMBS. I welcome the opportunity to explain this process today.

The role of ratings agencies in the market is to provide a public opinion that speaks to one aspect of the securitization; specifically, the relative risk of credit default associated with the particular security. As with all securities that Moody's rates, the methodology for rating RMBS incorporates qualitative and quantitative factors that are weighed and assessed by Moody's analysts.

Quantitative factors may include the degree of credit enhancement provided by the structure, the historical performance of similar assets created by the originator, and metrics relating to borrowers' credit history. Qualitative factors may include an assessment of the bankruptcy-remoteness of the issuing entity, the integrity of the legal structure, and management and servicing quality.

In the course of rating an RMBS transaction, Moody's analysts do not see individual loan files or information identifying borrowers or specific properties. Rather, credit rating agencies receive from the originator or underwriter credit characteristics for each loan on an anonymous basis. The originators of the loans also make representations and warranties to the trust for the benefit of investors in every transaction.

Moody's runs its rating process through a committee system. That is to say, rating committees, not individual analysts, decide the ratings. The committee system is at the core of everything Moody's does and is designed to protect the quality, integrity and independence of the ratings.

One common misperception is that Moody's credit ratings are derived solely from the application of a mathematical process or model. This is not the case. Models are tools sometimes used in the process of assigning ratings. But the credit rating process involves much more; most importantly, the exercise of independent judgment by members of the rating committee. Ultimately, ratings are subjective opinions that reflect the majority view of the committee's members.

Rating committee members are selected based on relevant expertise and diversity of opinion. Each member is encouraged to express dissenting or controversial views, and to discuss differences openly and frankly. Once a full discussion has taken place, the members then vote, with the most senior members voting last so as to not unduly influence the votes of junior members. Each vote carries equal weight and the majority vote decides the outcome.

Once a credit rating is published, Moody's monitors the rating on an ongoing basis and will modify it as appropriate to respond to changes in its view of the relative creditworthiness of the issuer.

As a general matter, subprime loans are expected to perform materially worse than prime loans; and therefore, higher delinquencies and defaults are anticipated and reflected in Moody's ratings.

Beginning in 2003, Moody's observed and commented on the trends of loosening mortgage underwriting processes and escalating housing prices. Moody's published on and incorporated these trends into its analysis of RMBS. As a result, Moody's steadily increased its loss expectations on pools of subprime loans and the levels of credit protection required for a given rating so that RMBS backed by subprime mortgages issued in 2006 and rated by Moody's had more credit protection than bonds issued in earlier years.

In practical terms, this meant that, for the 2006 vintage rated by Moody's, more than half the mortgages in a pool would have to default and recover less than half of the appraised value on the property before a Moody's AAA-rated bond would suffer its first dollar of loss.

In the end, even this increased credit protection proved not sufficient to maintain rating stability due to unprecedented levels of mortgage delinquencies, coupled with home price depreciation. In looking back on that period with the clarity afforded by hindsight, many commentators think that the credit rating agencies and others in

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the market did not fully appreciate the macroeconomic environment and anticipate the magnitude of the housing market downturn. Moody's, like other market participants, certainly did not foresee as imminent the severity or speed of deterioration that occurred in the U.S. housing market after that period or the rapidity of credit tightening that followed and likely exacerbated the situation.

During my tenure, however, I believe that Moody's ratings reflected the best opinion on the future creditworthiness of the debt securities based on the information available at that time.

I understand that many changes have been made to improve the performance --

CHAIRMAN ANGELIDES: Can you wrap up, pleads, Mr. Siegel?

MR. SIEGEL: -- yes, Chairman -- performance of ratings going forward and I believe that this and other forums can play a valuable role in assessing what

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additional changes may be appropriate. Thank you, I am happy to respond to any questions.

CHAIRMAN ANGELIDES: Thank you so much. Mr. Weill?

MR. WEILL: Good morning, Mr. Chairman and Mr. Vice-Chairman and members of the Commission.

My name is Nicolas Weill. I'm the Chief Credit Officer for structured finance in Moody's Investors Service. In 2007, I was managing director of U.S. RMBS surveillance. Today, I will describe Moody's rating monitoring processes and will detail our monitoring activities and the actions we took in response to the challenging environment of 2007.

As we entered 2007, Moody's believed that residential mortgage-backed securities, RMBS, had sufficient credit protection to withstand a market downturn of similar depth and duration as the previous real estate downturns. 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, nor the speed of credit tightening that followed and exacerbated the situation.

A rating is an opinion of the relative creditworthiness of a security based on certain discussions that can change over time. Once published, we monitor it on an ongoing basis and we change it as appropriate to respond to changes in our original assumptions or updates to our views of the relative creditworthiness of the issuer or obligation. With respect to RMBS, Moody's generally monitors its ratings on all securities on a monthly basis. In general terms, the surveillance analyst receives data from regular servicers or trustee reports, assesses the data and, if necessary, conducts a rating analysis.

Finally, when necessary, a rating committee convenes to debate and to vote. Any rating change is then published as soon as practically possible.

Throughout the 2007 time period, Moody's aggressively monitored market conditions, as the crisis continued to unfold, to assess the impact of how the various market participants might respond to the extremely fast-changing conditions. In January 2007, we published a special report highlighting the rising defaults on the 2006-vintage subprime mortgages. This was the first of a series of publications in 2007 in which Moody's discussed the deteriorating conditions of the U.S. subprime and housing market, as well as the market and economic factors that we believed would be critical in determining the ultimate performance of these loans.

Moody's first downgrade and reviews for downgrade on securities backed by 2006-vintage subprime loans took place in November 2006. Further rating actions occurred in December 2006 and January 2007.

Our first comprehensive set of rating

actions on second tier mortgage-backed transactions took place in April 2007. A second set of actions on first tier mortgage-backed transactions followed in July 2007. We took these rating actions as soon as there was sufficient actual performance information to judge the persistence of the early trends.

Indeed, as Moody's monitored the actual performance of the 2006 subprime RMBS, it appeared that the earliest loan delinquency data for the 2006 vintage were largely in line with the delinquency data observed during the recession of 2000-2001. This performance was consistent with the higher loss expectations that were already anticipated for the vintage.

Not until performance data from the second quarter of '07 became available was it clear that the performance of 2006 vintage was likely to worsen and that it might deteriorate beyond that observed in the 2000-'01 recession.

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In conclusion, the unprecedented events of the last few years demonstrate how dramatically markets can change. With the benefit and clarity of hindsight, many commentators now think that we and other market observers should have better anticipated what course the market would take. Given the information available to our analysts at the time and the unpredictable behavior of the market, Moody's undertook efforts to observe closely, to comment publicly and to react decisively.

We have implemented numerous changes to our methodologies that we believe will allow our ratings to perform better in the future and we welcome constructive dialogue that might improve the performance of the credit markets. Thank you, and I'm happy to answer any questions.

CHAIRMAN ANGELIDES: Thank you, Mr. Weill. Dr. Witt?

DR. WITT: Chairman Angelides,

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Vice-Chairman Thomas, members of the Commission, my name is Gary Witt. For the last two years, I have been teaching full time at Temple University in Philadelphia, and no longer have any affiliation with Moody's. I am pleased to be able to participate in today's discussion. The opinions I express are mine alone.

The Financial Stability Act that recently passed both houses of Congress expands the powers of the SEC to regulate the credit rating industry. The SEC will determine over the coming months and years how best to use these new powers to foster more accurate credit ratings. I hope they find our deliberations useful.

I was an analyst and then managing director in the U.S. derivatives group at Moody's from September 2000 until September 2005, when I was reassigned within Moody's away from CDOs. I was one of three team managing directors in the CDO group from March '04 to September '05. I was responsible for the following areas:

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Cash flow, ABS CDOs, market value CDOs, collateralized fund obligations, catastrophe bonds, and with another team MD, structured financial operating companies.

If this list of my responsibility sounds intimidating, believe me, it was a very big challenge. Some of these asset categories are extremely complex. The investment bankers structuring them were highly motivated to present them in the most favorable light. On our side, we had some very good people, but not enough of them, considering the size and complexity of the business that we were running.

The CDO market was growing and changing rapidly. Our staffing levels always lagged behind growth. The group struggled to rate new CDO issuance but we had many other responsibilities, including monitoring existing transactions, and keeping rating methods current.

The biggest problem in my opinion during that time period was the absence of any reserve staff to develop, maintain and test new rating methods. After 18 months, in September 2005, I was transferred out of the CDO group.

In addition to the details about my time in Moody's, I would like to add a little perspective to our discussion, if you don't mind.

During the crisis, during the financial crisis, many people have been very quick to assign blame to the rating agencies. This is definitely appropriate, but up to a point. We at Moody's, along with almost every major participant in the capital markets, failed to grasp the magnitude of the housing bubble before 2007. And I know you're tired of hearing that from every participant in the market, but, you know, it was the same, we were all in -- had the same lack of knowledge about what the future held. The crystal ball just didn't get passed around.

However, there is always a strong tendency to blame rating agencies far more than is justified by their previously mistaken opinions. I believe this tendency to blame rating agencies results from three reasons:

The first reason is that people expect too much from ratings. As my wife once asked me, what good is a rating if it can't predict the future? Well, the answer is that ratings are tools to help investors manage risk. A bond rating is meant to boil down the received wisdom of the market to a single symbol. Especially for managers of large portfolios, ratings are an easy organization tool for a complex risk environment. They are useful and publicly available to all investors at no charge. But investment decisions should always be based on much more than just a rating.

Second, rating downgrades are bad news. It's bad news for the issuer, bad news for investors. By definition, it's the rating agency that is the bearer of this particular bad news and they are the messenger that is so often shot.

The last reason that large rating agencies like Moody's are too popular as scapegoats is the glaring conflict of interest at the heart of their business model. They are paid by the issuers they rate. Managing this conflict requires that Moody's balance competing interests of two groups, the investors in Moody's shares, and the investors in the debt that Moody's rates.

During my time at Moody's, management did focus on market share and profit margin. So a question that I often asked myself is this: Did the competition among rating agencies in the securitization markets lead Moody's management to overemphasize the short-term interests of shareholders? I don't know.

I can say that it is difficult to know where the line should be drawn between these two competing interests. While short-term profits are easy to measure, bondholders' interests are served by the zealous pursuit of an elusive but distant goal, the right rating.

In my opinion, addressing the conflict between these two asymmetric goals is the most important task the SEC faces in its regulation of the credit rating industry. I've described my ideas in addressing this issue in a published article that I included with my testimony. Thank you.

CHAIRMAN ANGELIDES: Thank you very much, Dr. Witt. We will now begin with questioning of the witnesses. I will begin the questioning today, as is custom, and followed by Vice-Chair Thomas, and then the members of our Commission who led this investigation.

So I'd like to start with some questions that go to really what a couple of you have talked about as a flawed business model. The very model under which the issuer pays while in a sense the supposed beneficiary of the rating should be the long-term bondholder, the duopoly

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in this industry, or certainly oligopoly, that limits competition, the fact that there are extraordinary legal protections for credit rating agencies, and finally that there is this tremendous tension between short-term profits and quality of ratings over time. So I'd like to just ask a couple of you to start the following.

I think, Mr. Kolchinsky, you've spoken on this, and I'm going to ask a couple of the other folks. In August of 2007, the SEC did a report on Moody's. It was part of a larger report which they did on all rating agencies. And I'd like to actually enter that SEC report on Moody's into the record. It's, I believe, tab 1. So if the staff would please note.

But in that report, the SEC noted a number of items, and they said that the ratings had suffered due to the increase in the number and complexity of deals, just the sheer volume; they said that, as a corollary of that, that staffing had not

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kept up with revenues and the number of deals, in a sense there had been almost a conveyer belt moving faster and faster, as no revenues -- and this is not the SEC but this is my notation -- revenues at Moody's went from 600 million in 2003 to over 2.2 billion in '07, profit margins grew from 26 percent to 37 percent by 2007.

But the SEC found staffing shortages. They said deals were pushed out the door and that investment analysts were also involved in fee negotiations and that ratings had affected business interests. I'm going to ask you very quickly, Mr. Kolchinsky, do you think those are fair characterizations of what you saw there?

MR. KOLCHINSKY: I think that's right. I think the fee negotiations in many cases were limited because we had a standard contract that we signed off to bankers. But in terms of lack of adequate resources, in terms of the factory mentality, I think that's a very fair characterization, yes.

CHAIRMAN ANGELIDES: Dr. Witt, do you think that's a fair characterization of the SEC's report?

DR. WITT: Yes. As my opening comments reflected, you know, I definitely thought that we were under-resourced, you know, we were always playing catch-up. We didn't have an independent research group. Of course, I'm talking about the period up until September '05, when I left the CDO group.

But on the other hand, you know, at the time, the reason that we would hear from management above us why we were under-resourced was because the growth was just so fast and because each year, they would predict that, you know, the residential mortgage-backed market and the CDO market was going to flatten out, and we, our hiring would be based on those predictions. But we just never seemed to catch up. So we were definitely under-resourced.

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CHAIRMAN ANGELIDES: Didn't you express some concern in your interview with our staff that there were some people you wanted to bring on and you couldn't get the approval for their salary levels and the talent you needed?

DR. WITT: Yes. That was -- I mean, I thought -- you know, my remarks reflected, you know, I'm kind of in the middle here. I don't work at Moody's anymore. I certainly don't have any axe to grind.

But one of the things I did feel strongly about at the time, and I still do now, is that, you know, we just didn't -- the profit margins were so wide, and especially in the CDO group, and yet management really stinted on hiring staff, and I just couldn't understand it then and I still don't now.

CHAIRMAN ANGELIDES: Okay, thank you. Let me go to business practices here for a minute, Mr. Siegel and Mr. Weill. So let me just ask you, first of all, to your

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knowledge, let me ask, do either of you have any background in housing, housing finance, mortgages, housing business, ever been in the business itself?

MR. SIEGEL: Mr. Chairman, my experience in the industry was based on my twelve years at Moody's. I helped develop models and did research that way but --

CHAIRMAN ANGELIDES: But not on the ground. You, Mr. Weill?

MR. WEILL: No.

CHAIRMAN ANGELIDES: How many folks in the business rating RMBS and CDOs mortgage securities in your shops actually had been in the business in any real way? In other words, touching, feeling the actual business? Mortgages, lending, housing?

MR. SIEGEL: I would estimate about ten percent at any time, but staffing, there's always turnover.

CHAIRMAN ANGELIDES: Now, my understanding is that you did do visits to originators in the RMBS group, but my understanding is, you would look at originators but, beyond going to originators, because I understand there were some adjustments made for different originators, did Moody's ever do any actual due diligence on loans, borrowers, go to places like Inland Empire, Bakersfield, Sacramento, Las Vegas, and actually do on the ground assessments of the housing market, places where, you know, there was a national housing price increase of 89 percent from 2002-2006? And in many of these markets, from which many of us hail, there was extraordinary price escalation. Were there any teams sent on to the ground to assess the market to your knowledge?

MR. SIEGEL: Our analysis of housing market trends was based on published and available research and discussions with issuers, and observations they were able to make from being on the ground.

MR. WEILL: Mr. Chairman, we also have a lot of dialogue within Moody's with

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various teams of economists. You mentioned Moodyseconomy.com earlier. So this ongoing dialogue allows us to be informed of market developments, regional market developments.

CHAIRMAN ANGELIDES: Any efforts, systematic efforts, after the FBI and others warned about mortgage fraud, to detect mortgage fraud within the securities you were rating?

MR. SIEGEL: Mr. Chairman, we're prohibited by law from looking at personally-identifiable information. So in terms of that sort of fraud, the Social Security number appears on three loans, there must be something wrong. We would not be able to get that information.

But part of the originator review would include an assessment of their checks for fraud. I don't recall specifically that FBI report, but I do recall substantial industry discussion about the increased sophistication of fraud availability over the internet of fake W-2s --

CHAIRMAN ANGELIDES: Let me ask this question, and then the Vice-Chair does have a question which he wants to do as a follow-up. Any specific adjustments to models to account for changing risk profile in terms of fraud?

MR. SIEGEL: If you're referring more broadly to our overall methodology --

CHAIRMAN ANGELIDES: With respect to that specifically.

MR. SIEGEL: -- our overall methodology, we look to the reps and warranties and strengthen our analysis of examining the companies providing the reps and warranties, which would include loans that turn out not to be representative --

CHAIRMAN ANGELIDES: If you would get for us or provide exactly what Moody's did in terms of altering its methodology to account for perhaps increased fraud. Mr. Vice-Chairman?

VICE-CHAIRMAN THOMAS: Just directly and specifically on your response to the

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Chairman, in terms of actually getting firsthand or primarily knowledge, you indicated in the residential, in the mortgage area, that you relied on published sources, so it was secondary.

Did Moody's rely on secondary sources in all of its rating activities or were you involved in some primary pursuits in terms of examining particular areas? Were you a catcher all the time in terms of data that was already out there, or did you generate or pitch some of the time in terms of the way you came to your conclusions?

MR. SIEGEL: If I understand the question, in some cases, Moody's was actually a good source of data because, for deals we rated, we received monitoring information. So if you count that as being primary, the service would report, "Here, how many borrowers are delinquent on this particular pool," "Here, how many are in foreclosure." If you count that as primary, we used that information to

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inform --

VICE-CHAIRMAN THOMAS: Did you yourself sample it or was this others providing material to you?

MR. SIEGEL: The -- we didn't open the check and -- the envelope and see if the borrower was making the full payment or not, but the servicer would report on this pool of loans, that ten borrowers are delinquent and Moody's would use that information.

VICE-CHAIRMAN THOMAS: Last aspect of the question. Do you do sampling now based upon your recent experience?

MR. SIEGEL: I'm sorry, I left Moody's in --

VICE-CHAIRMAN THOMAS: Ah, Mr. Weill, you're the one who is still there.

MR. WEILL: Yes, Mr. Vice-Chairman.

VICE-CHAIRMAN THOMAS: I don't mean to finger you or point you out. It's just, the answer customarily is, "I wasn't there." So you're a live one, and I can ask you directly. What do you do?

MR. WEILL: Appreciate the privilege.

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We have published recently a lot on our improved methodologies. I think there are two fronts that are covering your question. One of them is the fact that there is a need to enhance how representation and warranties are implemented and enforced through securitization. And we can discuss it as part of the monitoring effort.

The other part is, Moody's believes that it's useful, as we don't have access to loans, to have third parties sample large sections, large proportion of the loans to indeed check that the various representations in the warranties on appraisals, on occupancy or income are indeed correct.

VICE-CHAIRMAN THOMAS: When did that start?

MR. WEILL: The process on representation and warranties, as stated earlier, has started a long time ago. We have indeed published recently in 2008, I think, various reports suggesting various enhancements for the RMBS markets.

VICE-CHAIRMAN THOMAS: The sampling of specific factors involving loan delinquencies and so on, is that what you're referencing, or is that a secondary, and an additional sampling model?

MR. WEILL: I'm referring to recent 2008 publications where we have discussed sampling and --

VICE-CHAIRMAN THOMAS: Okay. "Recent" and 2008 to me don't connect, given the fact that this is 2010. So if that's the most recent, okay. Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you. Let's see, picking back up on this, so, let me ask you a question. Was there any discussion ever in Moody's as housing prices began to escalate at an extraordinary rate -- here is, by the way, a graph of the Case-Shiller index, if you can all see that. You'll see that about 2000, there is an historic and

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unprecedented rise in housing prices, it says 89 percent, in the last, from 2000-2007.

Was there any discussion internally about fundamentally, not just incrementally, but fundamentally changing the models and/or sending assessment teams out into the field? Was there any fundamental rethinking of the models? I know there were calibrations done. But was there ever a "whoa" moment for the team, Mr. Kolchinsky, you can remember?

MR. KOLCHINSKY: Well, I didn't work for the RMBS --

CHAIRMAN ANGELIDES: Or CDOs also.

MR. KOLCHINSKY: Not for CDOs.

CHAIRMAN ANGELIDES: Was there ever just, "Let's stop this for a minute, we're rating nine thousand securities a year, there's four AAA corporations, something's out of whack here?" Any kind of just a step back?

MR. SIEGEL: No. There were discussions with Moody's economist as to what he -- his views were on national real estate prices.

CHAIRMAN ANGELIDES: Well, when Moody's.com came out with a report in October 2006, saying there was going to be a crash, that's the word they used, in twenty metropolitan areas, did the group say, "Whoa, let's stop this"?

MR. SIEGEL: I'm sorry, Mr. Chairman, I left in April of 2006.

CHAIRMAN ANGELIDES: Was there any, in October of 2006, when Mark Zandi and his crew said there was going to be a crash, "Let's stop this, let's put this on hold"?

MR. WEILL: I was part, as I said in my testimony, on the surveillance team, so we had a lot of dialogue with Moodyseconomy.com among others, and at the time my recollection is, for 2007, the prediction were more for a soft landing at the end of 2007, maybe for a ten percent national price decline, worst case maybe 15. And the level of protection that the

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securities had would easily take into account a ten --

CHAIRMAN ANGELIDES: Well, let me query you on that. Then why is it when prices dropped by four percent in July 2007, you're already downgrading? Your models haven't withstood a ten or 15 percent decline. You're in downgrade mode by July when prices have just come four percent off their peak. Why is that happening?

MR. WEILL: Our weighting situation is level of certainty associated with repayment. In other words, you have a 21 rating scale from AAA all the way to C. And each of them reflects the probability of an obligation to be repaid. A downgrade reflects more a shift in this probability, and as we saw delinquencies ramping up in an environment that would be less favorable in terms of home price decline, downgrades were actually reflective of changing views on the probability of repayment. In other words, the --

CHAIRMAN ANGELIDES: Well, the expected loss, correct?

MR. WEILL: That's correct.

CHAIRMAN ANGELIDES: So by four percent, you're already recalibrating expected loss, not at ten percent. That's a fact, right?

MR. WEILL: Mr. Chairman, the rating actions are not based on the macro view. The rating actions that we took in July '07 and that we always take are based on an analysis of security by security. So what is driving the downgrade is a lot more the performance, the level of delinquencies, the servicer reports showing the severity of loss upon liquidation not--

CHAIRMAN ANGELIDES: But Mr. Weill, let me just point out again, the downgrades begin at four percent not when -- everyone is fond of saying that we couldn't have predicted 30 percent diminution in home prices, but the downgrades start well before that time period.

Let me move right now to some market practices. I referred to them in the SEC report. But we've heard in a lot of our interviews, staff interviews, that there was a lot of constant pressure for market share. Some of you have spoken about that today. And it's our understanding that people leading the ratings team would regularly get market share reports.

In fact, I want to enter as examples, routine examples, tab 26, tab 36, tab 37. Those are e-mails from Michael Zoccoli, Sunil Surana. A number of comments have been made. Jay Eisbruck, who is one of the analysts, said, "If business was missed, you would have to answer to Brian.” That's Mr. Clarkson, Mr. Witt. You once said that, you know, market share was critically important, “that is why Brian Clarkson's rise was so meteoric, was because he was the enforcer who could change the culture to have more focus on market share.” Jerome Fons, who worked at Moody's said “they willingly

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looked the other way, traded the firm's reputation for short-term profits."

I guess, Dr. Witt, what would happen if you didn't rate a deal?

DR. WITT: Well, you know, like you were talking about Sunil's reports, Sunil was on Brian's staff, and we would get a report that said the deals that you didn't rate, and you would be typically asked to explain why you didn't rate them. You were supposed to look into it and give an explanation.

CHAIRMAN ANGELIDES: And? But every deal you didn't rate you would have to do that?

DR. WITT: Well, no, not necessarily every deal. But if, you know, the percentage were changing a lot, or they may have some interest in a particular deal, but you got a report that detailed each transaction.

CHAIRMAN ANGELIDES: By the way, just for the record, those items I mentioned, I'd like to enter into the record.

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It's my understanding that performance evaluations were based on five items: market coverage, revenue, market outreach, such as speeches, presentations, ratings quality and development of tools.

Now, three of the five items seemed to be on the profits metric, not on the ratings quality metric. And of course the rating quality wouldn't show up for quite some time.

I did see an e-mail from Mr. Clarkson to managers saying, it's document -- that's tab 15 -- essentially saying, "Here's the last market share, here's a market share report, you ought to be using this in your personal evaluations."

To what extent were personnel evaluations based on the quality of the rating versus your ability to move the business, Mr. Kolchinsky? And then I'll ask Mr. Siegel.

MR. KOLCHINSKY: I actually never received a formal evaluation as a managing director. But it was very clear to me that my future at the firm and my compensation would be based on the market share that was brought in. And that was reinforced in many ways, especially with these e-mails that were sent out, at least quarterly, and occasionally monthly. I recall one e-mail that was sent out, I believe in October of '07. This was right around the same time that three thousand tranches were downgraded by Mr. Weill's team.

There was a question that our market share dropped from 98 percent to 94 percent, and please explain why. And that's sort of the mentality. It was very clear that, whether explicit or implicit, that the performance and the future of a managing director in structured finance really depended on keeping and maintaining market share.

CHAIRMAN ANGELIDES: Mr. Siegel?

MR. SIEGEL: Mr. Chairman, I never found that to be the case during my tenure at RMBS. First of all, the performance evaluation metrics you described sound like they are for managing directors and above. The analysts were never evaluated based on market coverage. That was a component of the managing directors' evaluation.

It was always understood that market share was to be explained, not to be held as a hard-and-fast number. So losing a deal because the issuer found someone else who offered higher ratings or weaker standards, that was perfectly acceptable. If we lost a deal because an analyst wanted to leave at 3 o'clock and the issuer had wanted feedback at the end of the day, that would be an issue.

CHAIRMAN ANGELIDES: Okay. I just want to point out this memo from Mr. Clarkson went to Ed Bankole, Pramila Gupta, Michael Kanef, Andrew Kriegler. What level would they have been?

MR. SIEGEL: They would have been team managing directors, the same as my level --

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CHAIRMAN ANGELIDES: All right, well, it says, "You should be using this in PEs and to give people a heads-up on where they stand relative to their peers."

So he's telling his managers, use this down the chain.

MR. SIEGEL: But again, Mr. Chairman, that's not the number. That's the explanation that's part of that file and if people are losing deals because of customer service, they left at 3 o'clock --

CHAIRMAN ANGELIDES: But that's not what it says. It says you should tell -- you should give them a heads-up about where they stand with their peers. All right.

Let me -- last question here, before I move on to the Vice-Chair, we looked at a couple of specific deals that struck me. Just to see how this worked, we looked at a 2006 RMBS sponsored by Citigroup. It was a bunch of New Century loans, $948 million; 75 percent were adjustable rate, 33 percent were 228 loans, balloon payment. It was issued in '06. Within a year, 13 percent of the mortgaged properties had been foreclosed upon. By June 2009, 31 percent.

Over fifty percent of the loans are now 60 days-plus delinquent and all the bonds have been downgraded to junk.

The other deal we looked at was a Merrill Lynch deal. It's tab 70, and by the way, the New Century deals is the ratings memos, tab 22. I'd like to enter those both in the record.

But Mr. Kolchinsky, I think you may have worked on this Merrill Lynch deal. It was a 2006 deal, 488 million. Downgrades started in October '07. It's now been all downgraded to junk. And the value of the collateral originally 488 million, is now at 67 million, down 87 percent from its peak.

You know, I look at that and I think when you go into a store and you get, you see grade A eggs, you assume maybe one of those eggs will be cracked. Turns out all twelve are cracked and it was originally rated AAA.

I guess my question for you, because you were on this deal, and by the way, you sent an e-mail about this deal, which I'd like to enter into the record, to Yvonne Fu and Yuri Yoshizawa, talking about how this deal was, you sent the e-mail because you said it was important to have, "A record of transactions which have grievously pushed our time limits and analysts."

Tell me a little bit about this deal and why it went wrong.

MR. KOLCHINSKY: Sure. On this deem, I wouldn't even consider this one of the worst performers and it's a standard hybrid ABS CDO backed by mezzanine loans. It was underwritten by Merrill Lynch. The manager was GSC, which is the old Greenwich Street Capital Partners. It went wrong just like most others.

The severe downgrades in the subprime

area, and there's concentrated heavily in subprime, drove the ratings down. Eventually this deal suffered an event of default, and none of the ratings there actually -- the notes are at this point not making any payments.

As far as the structure or the concern, this was -- this deal was fairly ordinary. It was backed by primarily BAA2 and BAA3 collateral, primarily subprime and midprime.

What the trouble on this deal was, and this is crucial about the market share, was that the banker gave us hardly any notice and any documents and any time to analyze this deal. That was part of the problem with not being able to say no. If I could say no, and the documents came outside the window, which we would have appreciated, I would have said, "Look, I'm sorry, I can't give you an opinion. I need at least three or four weeks to analyze this deal more fully."

But because bankers knew that we

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could not say no to a deal, could not walk away from the deal because of a market share, they took advantage of that. And this deal particularly, the banker sent us various documents, either a few days before closing or sometimes after closing. In this case, I believe in this transaction, we didn't even know the deal was priced. We found that out from the collateral manager when we visited the collateral manager and they mentioned, "Oh, by the way, we priced the deal." And that was something in the ordinary course of events we would like to know.

In the old days, we had about a month-and-a-half, two months to actually rate a deal. It took a lot of time. We got the documents. They were sold back and forth. At this point, the bankers took advantage of the fact that we wouldn't walk away from the deal and started sending us documents whenever they wanted to.

CHAIRMAN ANGELIDES: Am I reading

this right to say some of the documents you got the day before the closing, some about three or four days?

MR. KOLCHINSKY: I believe that's correct, yes.

CHAIRMAN ANGELIDES: Did you ever see "I Love Lucy?" Have you ever seen that famous episode where she's working in the chocolate factory, and the conveyor belt goes faster and faster? Did you ever feel like Lucy?

MR. KOLCHINSKY: Oh, yes, all the time. All the time. We certainly had a conveyer belt and we definitely felt that way.

CHAIRMAN ANGELIDES: All right. I'll reserve the balance of the time. Thank you very much. Mr. Vice-Chairman.

VICE-CHAIRMAN THOMAS: Thank you, Mr. Chairman. I want to pursue a similar line, but in a slightly different way. You're interesting and useful to me because at least in my mind, and any time I make a statement that you don't feel is, you know, accurate depicting the general scene as you looked at it, let me know. Because I see you as a choke point, not in a negative sense, but it's a very limited number of people doing what you do. And I guess, given the volume and the history, you're probably as good as any of them doing it. So someone would want to get your label, and that's one of the reasons they came to you.

So as a choke point, especially since you were there in this transition of rating what, for want of a better term, I guess it's been called plain vanilla, the old corporate bonds, in a time frame that seemed luxurious, looking back at it, and then the transition to a much more complex structured product in a far more voluminous way in a time frame that gets shortened from weeks or months to literally days, and when it's the output that's focused on and not necessarily the quality of the output, it clearly creates a dynamic.

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And so I want to talk a little bit about how you felt or what was the mental set. Because in looking at what you do, I'm very much struck by the comparisons that you might make. Anybody looking at Wall Street or looking at investment banks, it just always has, to me, a kind of an auction atmosphere. It's very hectic. There's pressure, time lines, bidding and so on.

In looking, especially in reading about what you folks do, it just seemed to be much more of an academic atmosphere, at least earlier, about, even coming together as committees to discuss how we do and what does it look like and suggesting changes that might be made. I'll come back to that in a minute.

So when you say that you're compensated, what did that mean? Was any of it truly, in your mind, as the Chairman referenced, rated to the volume of what you were doing, quality versus quantity? How did you think you were judged in terms

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of compensation?

First of all, and it's just open to everybody depending on when you were there, because I don't want an answer, "I'm sorry, but I wasn't there." That's almost all we've gotten from people higher up in the structure, and that's one of the reasons I like this panel because you were actually doing it, and we've got people who are there today, and back at that particular period.

So how did you think you got paid? Anybody? What did you get paid on?

DR. WITT: Well, one thing I want to point out is --

CHAIRMAN ANGELIDES: One mike on at a time, just because -- Dr. Witt, you go ahead.

VICE-CHAIRMAN THOMAS: You can referee. Go ahead.

DR. WITT: We got a salary and a bonus which sounds like, you know, just like the rest of Wall Street. But the bonus that we got was a fraction of our salary, not multiples of it like it was on Wall Street. So the variable compensation component was not nearly as large as it was for investment bankers. But it did vary --

VICE-CHAIRMAN THOMAS: Well, it was an incentive.

DR. WITT: It was an incentive.

VICE-CHAIRMAN THOMAS: A realistic incentive.

DR. WITT: And I definitely thought that, you know, making sure that we kept market share as high as we could subject to getting the ratings right. I thought that was definitely something that was important, and that my manager looked at and he thought about a lot, and talked about. Yeah.

VICE-CHAIRMAN THOMAS: Let me not get ahead of myself, because one of the things we found is that there's never enough time and we can't ask all the questions and frankly, as we go forward, we know more than we did when we asked you the questions in the first place.

So would all of you be willing, and I would like a response to the question, be willing to answer questions of you submitted in writing as we go forward? Would that be something each of you would be willing to do?

MR. KOLCHINSKY: Yes, certainly.

VICE-CHAIRMAN THOMAS: He has a hard time reporting nodding of heads.

MR. SIEGEL: Yes, after my tenure there.

DR. WITT: Sure.

VICE-CHAIRMAN THOMAS: Back to this catchers-and-pitchers thing. Did you basically feel that you were there and you weren't active unless someone came to you, or did you go out and actively seek folk making pitches to them to use you for the purpose of rating? To what extent were you catchers, pitchers or you did both? In the company. Does that make sense to you?

You're a rating company. People want

you to rate their product. Did you wait for them to come to you? Were you purely a catcher of people who came to you with product?

MR. SIEGEL: Moody's does not structure deals, so we would not go to someone who had originated subprime mortgages and say, "Oh, you could do a securitization and we could be your rating agency." So in that respect the deals would come to us. Someone who owned the collateral would be driving the structure.

VICE-CHAIRMAN THOMAS: And it never, ever was a discussion about going out and making pitches because you're seeing things crossing your choke point that others might not.

MR. SIEGEL: We did want the market to appreciate the quality of the Moody's ratings. So we would speak to investors, we would publish on trends in the market, we would publish on rating methodologies, we would publish on risk. We would also meet with issuers so, if an issuer did a hundred deals and we were on 90, we would inquire as to why we weren't on the others. And if it was, again, customer service, of course we would pursue, "Oh, you want us to have an analyst available on Saturdays? Let me try to arrange that."

VICE-CHAIRMAN THOMAS: Sure, just convenience. I was also struck by the level of dollar amounts. By that I mean, they were real. In discussing investment banks and what people were paid and the amount of millions they would receive and their answer was, "That was above my pay grade?" It's been very difficult to deal with that. So I was especially struck with Dr. Witt's testimony about the failure to retain someone for $20,000 a year. There aren't enough zeros there to impress folk in other areas.

So I'm sure that you had people who had been on the team for a long time and that, having someone who had been in the service of Moody's or another rating

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agency would probably be a fairly attractive hire for the people who were going to be coming to you in the future to ask for ratings; i.e., "I now have someone at an investment bank under my employment who knows the setup and key people and the rest."

Did you see a frequency of people moving from Moody's or others that you were aware of to Wall Street?

MR. SIEGEL: The plurality of people who left Moody's for another job would have ended up on Wall Street.

VICE-CHAIRMAN THOMAS: And did they remember you? Did they call you? Did they talk to you?

MR. SIEGEL: Most of them knew that that was not appropriate behavior; that they could bring expertise on the product type, but I would not look favorably on someone calling and saying, "Can you do something different or special for me." That would not have gone over well at all.

VICE-CHAIRMAN THOMAS: Okay. We're

going to accept that as the statement. Does anyone want to say that that sounds good but it wasn't always that way? Mr. Weill?

MR. WEILL: I would just add that on my side, which was the surveillance side, just because someone would have left to an investment firm or another firm would not create any kind of specific relationship to be informed of any rating actions.

VICE-CHAIRMAN THOMAS: It wouldn't be a specific rating relationship but you knew each other.

All right, back to this business of going from plain vanilla, rating corporate bonds, and would it be fair to describe a relatively rapid change of what you did as a business in terms of the products you were rating? Moving to structured, complex structured financial documents?

Did it hit you as a company in terms of what you were offering over the years, versus what you were now asked to offer?

MR. SIEGEL: This goes back, I

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started at Moody's around 1994. And even before that, Moody's had developed the methodology. They pulled some of the more quantitative analysts and developed entirely separate teams to rate structured finance, separate people from the people who were rating what you described as a plain vanilla corporate bonds.

VICE-CHAIRMAN THOMAS: Okay. But then it also sped up even faster than you thought it was going to, based upon your statements that it was going -- you thought it was going to level off. I think, Mr. Weill, you made that statement.

So what I'm looking at -- or Mr. Witt did -- what I'm looking at are these teams, the committees in making decisions, as the process sped up, and obviously people understood that if you're simply going for the letters, if they shortened the time in which you had to consider what it was, notwithstanding they have made significant changes in the product, if they could indicate to you, or structure it in a way that it looked like similar products, you would have a tendency to give it the same rating, notwithstanding the fact the internal structure wasn't the same? Did you have that feeling as you were looking at products over this timeline?

MR. KOLCHINSKY: I think that's exactly what occurred with the products. You had a sort of, an exterior that looked sort of -- and this is -- I'm talking -- I wasn't there, I never worked in corporate -- even on the pure structured products, the exterior looked like it would match our models. But all the underlying mechanisms were changing and the credit was deteriorating underneath that.

And the problem with the ratings process was, if you had a hunch that something was wrong or it was a qualitative feeling things were wrong, you couldn't really do anything, because you couldn't say no to a deal. And therefore

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they just got passed through because quantitatively, the numbers, the headline numbers were great. Underneath, and this goes to explain some of the factors in RMBS, the quantitative numbers, the performance numbers looked great. Underneath that, what the originators, the bankers did, they undermined credit quality by changing things, creating different structures, new products that looked like the old products but were in fact different.

So the problems with the rating agencies and what they did or didn't do are omissions and sort of taking at face value some of the things that came to us because they looked good in the old perspective while the bankers were changing things around --

VICE-CHAIRMAN THOMAS: Okay, going to the Lucille Ball, "I Love Lucy" chocolate conveyer belt, if you started out with caramels, you could handle them pretty quickly because they are solid, but if you get into the creams, you've got to be fairly careful as to what you do with them, and as I recall, she just started mashing them all.

Did you have a gut feeling that they looked the same, but weren't?

MR. KOLCHINSKY: They were definitely gut feelings but, you know, the better analogy is that you had a solid chocolate versus something that was empty on the inside. So they kind of looked the same going down the conveyor belt, and with time and time they became more empty on the inside and had less cocoa content --

VICE-CHAIRMAN THOMAS: So part of the problem was, you are analyzing this, you were coming up with new models. So you met as committees. Probably, Mr. Weill more than anyone else, did you ever have a session with a committee where you kind of looked at each other and said, "This thing is changing rapidly, it's different than what we thought it was, let's go get some reserve and reconvene as a committee a little bit later to examine what in fact we have this gut feeling that it's slightly different than what it was"? Did that occur?

MR. WEILL: That's exactly what we did in the first couple of months of 2007. Where we published at the beginning of 2007 a special report on early payment defaults. We saw that there was a changing in borrower behavior, in homeowners' behavior, and we had a lot more early payment defaults. And what we did is, we paused and we convened a larger group of people to think about what was happening there, whether there was a change, a departure from annual existing trend to a new trend, whether the -- whether this was a macroeconomic trend, whether this was a refinancing trend, whether it was a homeowner behaviors trend, an originator trend, certain behavior on reps and warranties, on appraisals, on servicing and loan modifications. We put a lot of effort and people together to try to think through those issues. That's exactly, I think, what you are describing here.

VICE-CHAIRMAN THOMAS: So, and this is an attitude that I'm asking you in your opinion. As these products multiplied in terms of number, clearly, just the sheer volume you were facing, they were also changing in terms of structure.

Was there any discussion or belief on your part that these products were changing in structure, clearly done so by those who were structuring them for the purpose of getting a rating, notwithstanding the fact it was harder to produce those same solid chocolates that they did before?

MR. SIEGEL: Mr. Vice-Chairman, on my team, the staffing levels did grow substantially during this time period to keep up with the increasing complexity in the market. We did walk away from deals where we had a more conservative approach. So there were -- there were many cases where the analysts would look at the deal and they would be able to present an analysis to committee as the structures were changing. In some cases, we'd feel it was in response to risks that we may have identified. So if we identified a risk of increasing interest rates, we might see a deal come back with a swap. So the investment bank would say, "We'll put a swap and we'll take out that risk. Now what do you think about the deal?"

VICE-CHAIRMAN THOMAS: Did you ever think that, based upon that kind of a discussion, the next time a product came down the conveyor belt, that they got a little more clever in terms of the way they did it, to confuse, confound or in fact cover up what it was that they were doing? Was it a learning curve on their part to outsmart you? Did you ever have that feeling as you were looking at the products?

MR. SIEGEL: I think it’s very important that we distinguish our

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methodology from our models. We always, when we would make available a model, we would indicate that the rating still has to go through committee. There were times where a model would come out like the interest rate example. We'd say our stress case might be a rise of five percent, and the swap might be so highly engineered that it only protected against that five percent case, not a case right up to or right past it. So then we would just change the way we analyzed the deal during the committee process.

VICE-CHAIRMAN THOMAS: Mr. Chairman has a question?

CHAIRMAN ANGELIDES: No, I'm fine right now.

MR. KOLCHINSKY: One example of that occurred in about second quarter of '07. We, in the CDO group, actually had a methodology that prevented deals from getting full credit for bonds that were being priced at a discount. A discount pricing rule. It worked very well with cash instruments but because synthetics were to flexible, you could change the price, you could change the spread, it was very hard to nail down what the actual discount was. And as the prices in the market started deteriorating as evidenced by the ABX index, the subprime index, we always enforced this rule.

But the bankers started getting more and more clever with the ways that they would try to counter that rule. And it became almost like a chess game. We would make a move, they would make two moves. And it became very difficult. And this is where my view about saying no, at that point, we should have been able to say, "No. You know what? We see what you're doing."

And I saw some portfolios that were clearly meant to game that rule. We should have said, "No, you're not trustworthy. We don't want to do this with you."

But we couldn't do that, so we had to

play the chess game, which we kept losing. So -- but that certainly occurred.

VICE-CHAIRMAN THOMAS: Mr. Chairman, I'm going to reserve my time because some want to use it, others; but I'm going to ask you a series of written questions around a concern that I have and I know a number of others have.

You, as the people who created the ratings, have, in your mind, what you believe the AAA means. The customers who ask for those ratings I think had in mind what they thought a AAA rating meant, and especially those people who were out there purchasing the products had, in their mind, what a AAA rating meant.

And I know only one of you is an attorney, Mr. Kolchinsky, so when I ask the question, I would prefer not to have an attorney's answer.

But this is a source of confusion among a number of people because AAA meant something to you who delivered it, it meant something to the people who were seeking it, obviously, with the game-playing, and it meant something to those who purchased it. And it turns out in the end, the people who purchased it didn't have any conception, often, what it was and what it meant. And that we need to focus on more. But we can't do it with the time we have.

Thank you, Mr. Chairman, I'll reserve the balance of my time.

CHAIRMAN ANGELIDES: Yes, very quickly as a follow-up, it seems to me listening this morning so far, there's kind of two big issues. One is, why the heck were the ratings so wrong? And they were. I just want to put in perspective. They weren't off by small measure. You know, 83 percent of the AAA in 2006 was downgraded. In 2007, 89 percent of the investment-grade products were reduced to junk. I mean, this was way off. And without using the legal term, without casting aspersions, to the extent you're providing a product, this comes as close as you can to the very product being fraudulent or of no use to the marketplace in reality. So one is the quality of ratings. But I'm more struck or equally struck but, I think what you referred to, Dr. Witt, is just the structural problem here. The very system that didn't allow you really to say no to 30 to 40 percent of the deals. You might miss a deal or two, but you really couldn't say no to a whole market slice because you're paid by issuers, and your profit, and that was, it seemed to me always predominant, versus quality of rating.

So in 2007, you know, you talked about how things were recalibrated but I want to point out in 2007, when housing prices are heading south fast, Moody's rated more than $500 billion in residential mortgage-backed securities.

After July, when you really start your massive downgrades, $119 billion get rated as the market's in free fall. And these go very bad very quickly.

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I guess, I want to ask you, Dr. Witt, was the model so flawed, issuer-paid, profit, tension, you are an operating business, that it was very hard to make the fundamental shift to say, "We're not going to rate these flawed products anymore?"

DR. WITT: You know, fortunately, I wasn't in the CDO group in 2007, so I didn't have to make that difficult judgment, you know, the -- you know, Eric was. But, you know, I would think, if I had been a manager in that group, yeah, it would have been -- it would have been a hard decision to say, "You know, we're just going to stop rating this stuff and we're going to, you know, however many tens of millions of dollars of revenue the other rating agency is going to pick up, we're just going to leave it on the table." I think that would have been difficult.

CHAIRMAN ANGELIDES: Okay. Because I'm asking, could you have made that decision? Mr. Weill, could you have gone to your superiors and say -- look, I mean, if you think of United Labs for a minute, they are not going to keep rating defective electronic equipment if in fact they don't believe that it should make it. Consumer Reports has a very different model, you know, no payments by products being rated.

Is the model such that you just couldn't do that, could you say, Mr. Weill, could you go to your bosses and could you say, "Twenty to thirty percent of this stuff we ain't going to rate." Could you do it?

MR. WEILL: Mr. Chairman, I would offer you a surveillance perspective to this. When we were surveilling 2007 transactions, and we were seeing an increase in delinquencies or potential for defaults on the mortgages, we were constantly closing a feedback loop with the various teams. And I think this was part of a great interest from senior management to know how the pools were performing in order to know what to do with new ratings, potentially.

CHAIRMAN ANGELIDES: But you kept rating. I mean, he didn't turn down -- did the decline rate on new ratings shoot up? In other words, the did you start, instead of not rating two percent, start not rating 20 to 30 percent, or again, did the business model make that an impossibility?

MR. KOLCHINSKY: It did. I said no to one deal, and it was a difficult undertaking. It was a particularly questionable deal, and I had appeals from my managers. I had to go through a lot of takes to make sure that I convinced people that this deal should not be rated. So it was a very difficult -- it was harder to say no than to say yes.

CHAIRMAN ANGELIDES: Thank you.

VICE-CHAIRMAN THOMAS: Just very briefly, along those same lines to a certain extent, and I guess primarily

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Mr. Weill, because he's the one who was there in June of '07, in the application to the Securities and Exchange Commission by Moody's, under the heading, "Interacting with the Management of an Issuer," Moody's said to the SEC, "Most issuers operate in good faith and provide reliable information to the securities markets and to MIS. And we rely on issuers and their agents to do so," da, da, da. "Nevertheless, our analysts seek to exercise skepticism with respect to an issuer's claims. If we believe we have inadequate information to provide an informed credit rating to the market, we will exercise our editorial discretion and will either refrain from publishing the opinion or withdraw an outstanding credit rating."

What I'm going to be asking for in writing from all of you from memory, but especially the more recent situations, what skepticism did you exercise? Do you have specific examples of exercising skepticism based upon it? And when you were in the situation of having to produce volume versus exercising the professional skepticism that you told the SEC you were going to exercise, I just want to see some examples of that skepticism being exercised. So I'll get it to you in writing and you can give me some examples.

Thank you very much, Mr. Chairman.

CHAIRMAN ANGELIDES: Terrific. We will now move to Mr. Georgiou.

COMMISSIONER GEORGIOU: I suddenly became more senior on the committee, which is a great honor.

I wanted to inquire really of all of you. I think I'm finally getting to the point where I'm understanding how the money is made in this business, and one of the things we've learned in prior hearings is that a significant element of fraud occurred when we double-incentivized mortgage brokers in the origination of mortgages by paying them a higher percentage of the mortgage if they put a person into a mortgage that paid a higher rate of interest, and was more valuable to the lender.

And in many instances, we found that the rates that they were paid were, for example, if one percent on putting people into a standard 80/20 mortgage that paid a lower rate of interest, and two percent of the origination fee if they put them into a more expensive mortgage, which we believe in certain instances led mortgage brokers, because they would make twice as much money, led mortgage brokers to leading borrowers to loans that were more expensive to them when they might have qualified for a more reasonable loan.

Now, I learned from our staff's investigation report, and I want to clarify this, I want to make sure it's true, that, for many years, Moody's, in charging issuers on RMBS analysis, you charged a certain rate, in this instance 4.75 basis points for the dollars that were in the senior tranches, and 3.75

basis points for the dollars that were put in subordinate tranches, which strikes me as an incentive, creating a financial incentive for Moody's to put a greater percentage of the dollars in the senior, superior tranches as opposed to subordinate tranches, which may help to explain why it is that, in these RMBS structures, often some, as much as 90 percent of the issue of the tranches are rated at the very, very high end.

Can anybody speak to this? Is anybody aware of that or understand the financial incentives?

MR. SIEGEL: Commissioner, I don't recall the exact fee schedule. The initial analysis of a deal would have almost a fixed component, analyzing the collateral, and then the tranching, where you would get these senior classes, and subordinate classes would come later. But in no case was there any distinction in my mind, as the manager who knew about the fees, that there should be a shift based on the potential fee income to Moody's. And the analysts who constituted the majority of committee would not even have known about that differential.

COMMISSIONER GEORGIOU: But then why was it structured in that way? In other words, if you have got a $250 million RMBS that you're analyzing, why would you ask the issuers to pay you a higher fee per dollar on the senior tranches than you would on the subordinate tranches? Dr. Witt, do you have any views on that?

DR. WITT: There was no practice analogous to that in CDOs that I know of. It was just a straight fee per rated dollar in --

COMMISSIONER GEORGIOU: Right, that's correct. Now, CDO, of course, you got paid nine basis points per dollar rated.

DR. WITT: It depended on the type but yes, there were some that you did, yes.

COMMISSIONER GEORGIOU: Which was more than double the highest rate that you got for rating RMBS, which may also speak to why people were incentivized to rate CDOs significantly, because --

DR. WITT: Well, I mean, we were paid both times. We were paid for the RMBS and then they put it in the CDOs.

COMMISSIONER GEORGIOU: Right, and paid at twice the rate.

Mr. Kolchinsky, did you ever note this disparity or did anybody that you're aware of note it?

MR. KOLCHINSKY: No, Commissioner. Like Dr. Witt, in CDO we had a flat fee with a cap. We did not --

COMMISSIONER GEORGIOU: So who was in RMBS, Mr. Weill?

MR. WEILL: Commissioner, I would -- I wasn't aware of the fees. I wasn't a manager on the ratings team that was rating deals. The thing I would emphasize, I think, which is important to provide some color here, is that if you have a rating committee, you may have three, five, ten people in the committee

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and none of us, when I was an analyst in surveillance or an analyst in ABS rating autos or aircraft or other deals, was aware of the rating fees.

In other words, you have a debate and everybody has one vote. The most senior person, the managing director or the most senior person votes last. Cannot influence the process of the decision.

COMMISSIONER GEORGIOU: Do you know who developed that fee charging structure? Does anybody know?

MR. SIEGEL: I don't.

COMMISSIONER GEORGIOU: Maybe that's a question that I'll have to ask Mr. McDaniel here in the next panel. But Mr. Siegel, are you aware of who constructed the charging --

MR. SIEGEL: Again, I don't -- I don't actually specifically remember there being that distinction between the seniors and subordinates. But assuming you have that -- that is the case, at some point the managers would have been involved in a

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fee discussion and come up with a schedule. And there were different RMBS schedules, depending on whether it's prime, subprime, second lien, et cetera.

But again, there might have been some thinking that we have this fixed component, so the senior bond determines if you're on the deal or not, that you'd want to charge to cover your collateral analysis. And then if you happen to tranche it up, it isn't as expensive, as time-consuming to figure out the ratings on the junior tranches within the deal.

COMMISSIONER GEORGIOU: Right. Mr. Chairman, with your permission, I'd like to have the staff direct a written question to Mr. Weill and to Mr. McDaniel to ascertain if we can find out how it developed, what the etiology of this --

CHAIRMAN ANGELIDES: So done.

COMMISSIONER GEORGIOU: -- and also, it says in here in our investigative report that all fees were due and payable at the time the rating was issued. But you were never paid until the actual issue was sold, were you?

MR. KOLCHINSKY: We were generally, on the CDO side, paid out of the closing day waterfall. Meaning that's when the securities were sold, we were paid along with other supporting, the auditors, the attorneys, the bankers themselves.

COMMISSIONER GEORGIOU: Correct.

MR. KOLCHINSKY: There was also an annual monitoring fee, but that was usually a fraction of the up-front fees.

COMMISSIONER GEORGIOU: Correct. But the up-front fee, like if you rated an issue and they didn't sell it for two months, you didn't get your pay -- the company wasn't paid when the rating was issued, right? The company was paid when the issue was actually sold from the proceeds.

MR. KOLCHINSKY: That is correct. There was, in our contracts in CDO, there was a breakup fee but that was almost never enforced. It was difficult -- it was a fraction of the number. It was very difficult to actually get that fee. In my experience, I don't believe we've ever actually charged that breakup fee.

COMMISSIONER GEORGIOU: So doesn't that create yet another perverse incentive to be sure that the ratings will support the sale of the security, that you're actually not paid until the security itself is sold?

MR. KOLCHINSKY: I think more so that -- I would, in my mind, it was the fact that you couldn't say no in any case. That created the worst incentives to the deal. And after that, you know, it kind of went down from there.

COMMISSIONER GEORGIOU: Right. Dr. Witt, do you have a thought on that?

DR. WITT: Well, I don't know that that had a big component to, you know, people's incentives. But I did, I just noticed there was an article in The Times, I think yesterday or today, and they were talking about the timing of when the rating is issued. The rating was normally issued, if you look at the prospectus, it will say it's a condition of issuance that the ratings be certain levels. So the rating came out like coincident with the deal. And that fact meant that there had to be this interchange between the rating agencies and the structuring, the investment bank.

And what this article said was that they suggested that maybe there should be some waiting period, that ratings should be issued after the deal. And I personally think that that's a really good thing that should be considered.

COMMISSIONER GEORGIOU: Right. That was Andrew Ross Sorkin's, one of his suggested questions to us, was that William Ackman, who is a hedge fund manager, suggested that the ratings agency adopt a wait-to-rate policy for 60 days after the preliminary purchasers had already purchased the bonds, so that they would be obligated then to do their own

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diligence, and the ratings wouldn't be their primary factor. Do you think that would be advisable?

DR. WITT: I think it would. You know, investors wouldn't like it because it introduces more risk to them. But somebody's got to buy those bonds without a rating. So they had a sort of additional ratings risk. But it forces investors to, you know, to take that risk, to look at the deal more, not rely on ratings so much as a crutch and not just buy the rating but buy the issue.

And then the ratings themselves could be more of a, you know, an objective analysis and you wouldn't have the close -- you wouldn't have the need for the close interaction between the rating analyst and the investment bank. You could have more of a distance, hands-off relationship.

COMMISSIONER GEORGIOU: Mr. Kolchinsky, in one of your prior testimonies, or perhaps it was here today, you suggest

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that in many ways, the incentives for rating agencies have become worse since the credit crisis. That there are now more rating agencies and they are all chasing significantly fewer transaction dollars. And the new controls put in place by regulators are too weak to significantly alter this dynamic. Can you elaborate on that, please?

MR. KOLCHINSKY: The changes in incentives were, before you had, I think, three major, four major rating agencies. At this point, I think ten or eleven are regulated as NSROs. There are much fewer transactions that are going around just because, frankly, the market has died out.

The rating agencies, any large rating agency that wants to run a structured finance business has a lot of fixed costs, very high fixed costs. So at some point, as a private business, you have to justify those fixed costs, and you have ten people you're competing with.

So the incentives to play around with

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your methodology are much greater. If you want to maintain your business, you want to maintain your title, you want to maintain your position in the company, you have to compete a lot more. You have a lot less business you're competing for. And frankly, the structural, up to that point, and probably true going forward, so far, that have been put in place, have been fairly weak on that, in terms of maintaining, improving ratings quality. So again, you have a lot more rating issuers competing for a smaller pie.

COMMISSIONER GEORGIOU: Let me, I want to read into the record one portion of a letter we just received yesterday from the executive director of the Montana Board of Investments, which was a major purchaser of bonds, in reliance to some significant extent on ratings. And it said here:

"As more complex exotic investments have been created and sold to investors, the rating agencies 'got it wrong,' either because their vetting was superficial or they were unduly influenced by the creators of the investment and needed to get the deal done. When the rating agencies chose to rate complex and market-sensitive instruments such as structured investment vehicles as risk-free as U.S. Government bonds, they failed the investors who were depending upon their independent, thorough analysis. This board and other public investors are still living with the impacts of that failure."

If I could ask, Mr. Weill, just one question real quick, just as a final, how much, how present in your mind as you did your analysis was the fact that many, many public and private pension funds and other investors responsible for funding the retirement benefits of beneficiaries, how present was that consideration in your mind as you did your ratings?

MR. WEILL: I would say that every rating committee feels significant

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responsibility when they assign a rating, whether they downgrade or upgrade a rating, and they have in mind all the users of the ratings in a very significant way.

COMMISSIONER GEORGIOU: All right. Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you, Mr. Georgiou. Mr. Wallison?

COMMISSIONER WALLISON: Thank you, Mr. Chairman. I want to just be sure we all are talking about the same thing. And we're talking here about subprime and Alt-A loans securitization. We're not talking about prime securitizations. Does any of you know what the record of Moody's was for prime securitizations? That is to say, did you have many downgrades of prime securitizations?

MR. WEILL: Commissioner, are you referring to the recent period or are you referring to --

COMMISSIONER WALLISON: We'll talk about the same period that we've been talking about here from 2005 to 2007.

MR. WEILL: We have indeed have had significant ratings transition downgrades on the prime mortgage-backed securities. We have a team that publishes on a frequent basis, I think twice a year in a very transparent way, the performance of our rated bonds. I don't have the exact numbers with me. That's something we can provide the Commission with.

COMMISSIONER WALLISON: I think we'd like that information.

MR. WEILL: Absolutely.

COMMISSIONER WALLISON: Let me just say this, that I'm listening to all of you and I think you're all well-intentioned people. We've had what anyone would regard as a terrible failure here. And so my inclination always is to wonder whether there was not an information problem more than anything else. And so my questions are going to be about the information that was available to you and the extent to which this information was or was not sufficient for you to make the kinds of judgments that you were making.

So the first question I would like to ask here is, and I think this is obvious, the ratings depend, do they not, on assumptions about housing prices? Mr. Siegel?

MR. SIEGEL: Yes. Ratings depend, the performance of mortgages depends very much on home price movements and at different rating levels, you would be looking at different stresses to possible future home price movements.

COMMISSIONER WALLISON: Does anyone disagree with that? Mr. Weill?

MR. WEILL: Home price movements are one input. You have other inputs like --

COMMISSIONER WALLISON: But that is one of the significant issues, what you expect home prices to be, is that -- that's correct?

MR. SIEGEL: It's what you expect, like the expected best guess, and it's what you might expect as a range of stress

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off of that best guess.

CHAIRMAN ANGELIDES: Mr. Witt?

DR. WITT: You know, I was in the CDO group. We used the ratings from the RMBS group as an input. But we did establish correlations and, you know, if we had, you know, if we had a crystal ball and we'd foreseen a really large decline in house prices, we would have raised correlations as a result.

COMMISSIONER WALLISON: Okay. I'm going to get to the correlations question, I hope, if I have time.

Okay, so housing prices depend on an assumed number of delinquencies, you’re believing that there will be an assumed number of delinquencies. And it turned out, if I understand what you've said up to now, it turned out that your estimate of the number of delinquencies was wrong. There were actually many, many more than you expected. Is that true, Mr. Siegel?

MR. SIEGEL: Yes. Nicolas would have more of the performance information after

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the deals close. But the delinquencies were far above the most likely path of delinquencies.

COMMISSIONER WALLISON: Mr. Weill?

MR. WEILL: Commissioner, the way I would phrase the question, I would divide it, there are two components to it. And one of them is how the macro trends of home price, whether they increase or decrease, and then you have the borrower's behavior. And delinquencies is definitely more a borrower's behavior than a macro trend. At some point, they do connect.

And I think you need the third component to really connect them together which is, as home prices decline and refinancing opportunities dry up, then it does magnify the delinquency issues.

In other words, if borrowers are feeling that they are underwater on their mortgage because they see home price declining, their first reaction would be, try to get out of this financial obligation in a way that would be ideal, i.e., selling the properties and avoiding foreclosure and a default.

As refinancing opportunities dry up, and home prices suddenly decline, it does magnify the delinquency trends.

COMMISSIONER WALLISON: And this would be especially true, I would presume, for subprime and Alt-A loans.

MR. WEILL: They are more sensitive to the various accounting factors and the refinancing opportunities.

COMMISSIONER WALLISON: Mr. Siegel, the same?

MR. SIEGEL: Yes, I agree. That's how prime borrowers are statistically more sensitive to these trends.

COMMISSIONER WALLISON: Now, when you are constructing your evaluation of a particular securitization of a pool, do you take into account the number of subprime and Alt-A loans that are actually outstanding in the market as a whole? Not just in this portfolio or pool or securitizations, but rather, the market as

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a whole throughout the country?
Mr. Siegel?

MR. SIEGEL: Sorry, Commissioner, I'm not sure I understand the question.

COMMISSIONER WALLISON: If you are assigning a rating to a pool, the pool is in front of you, it has a certain number of subprime and Alt-A loans in it, in fact that's what we're talking about --

MR. SIEGEL: Right.

COMMISSIONER WALLISON: -- now, is it important to you to know not just about the loans in the pool but, rather, if loans that are subprime and Alt-A throughout the country, so that you are placing this pool in effect in a context of all mortgages that are subprime or Alt-A throughout the country?

MR. SIEGEL: Well, when we would analyze the collateral performance on expectation, performance expectations on a particular pool, we would compare it to other pools that we had committed and historical data, and then indirectly,

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there might be an effect in saying, "Well, here are general market shifts. Is this going to have an impact on future performance" --

COMMISSIONER WALLISON: Indirectly. Did you have information about where the market was in terms of the number of subprime or Alt-A loans that were outstanding?

MR. SIEGEL: Moody's published on the number of Alt-A and subprime loans that had been securitized. So we -- and we saw the -- we saw an increasing -- substantially increasing number of subprime mortgages that were included in securitizations leading up to 2006.

COMMISSIONER WALLISON: Only the ones that had been securitized by Moody's or those that had been securitized by all -- not securitized by Moody's, but rated by Moody's --

MR. SIEGEL: We published based on rated by Moody's. That was information that we had factual and to the dollar.

But there's also a sense of securitizations that we did not rate. So we had a feel for that number, too.

But in terms of spending a lot of time looking at whether FHA and Ginnie Mae deals included subprime, that was --

COMMISSIONER WALLISON: What about Fannie Mae and Freddie Mac, did you include those?

MR. SIEGEL: Fannie Mae and Freddie Mac do not originate loans, right? They buy loans --

COMMISSIONER WALLISON: They certainly do not originate, that's right. But they do securitize. Actually about four trillion dollars in subprime and Alt-A loans were securitized by Fannie Mae and Freddie Mac at the time you were looking at these things in 2007.

So did you take into account the fact that there were this number, it turns out to be about twelve million of Fannie Mae and Freddie Mac, were in fact outstanding at that time?

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MR. SIEGEL: I don't recall that being a factor that came up in any particular deals committee as material.

COMMISSIONER WALLISON: Mr. Weill?

MR. WEILL: Well Commissioner, on the monitoring side, I don't recall who would use this information.

COMMISSIONER WALLISON: I'm sorry?

MR. WEILL: On the monitoring side, on the surveillance side of the RMBS securities, I don't recall that we would use this information.

COMMISSIONER WALLISON: And what about the rating side? I take it the monitoring side occurs afterward. But what about the rating side, did you have this information at the time that you made the ratings? No, is the answer --

MR. SIEGEL: Commissioner, I answered as to the ratings side, and --

COMMISSIONER WALLISON: I understand. I understand. And this basically is my question. How can you make a rating on a subprime or Alt-A pool when you actually don't know the effect that the total number of outstanding subprime and Alt-A loans might have on that particular pool?

Actually, let me give you some background because it's, maybe I haven't -- I've left out perhaps a logical step. And the logical step is the correlations among mortgages. Correlation is exceedingly important in the rating process, as I understand it.

If a mortgage fails in an area, if a house has to be foreclosed, it drives down the prices in that area, at least in that neighborhood and in that area. True?

MR. SIEGEL: Yes. It depends on the number. I wouldn't say, you know, one out of a thousand, but yes.

COMMISSIONER WALLISON: Exactly. And so when you have a large number of subprime or Alt-A loans, there are likely, especially as you've pointed out, when a bubble begins to top out and people can't refinance, then you're going to have many, many more failures of subprime and Alt-A loans, will you not?

MR. SIEGEL: It would follow, yes.

COMMISSIONER WALLISON: And if you have many such failures of subprime and Alt-A loans, that would affect the loans that are in the pool that you're rating, true?

MR. SIEGEL: Yes, that would follow as well.

COMMISSIONER WALLISON: So this is the question:

Since there was tremendous correlation among mortgages in the sense that a mortgage fails, it has an effect on the housing prices in the area, many mortgage failures produce sharp declines in housing prices in the area, and as those failures multiply, housing prices dive and actually, we've seen that.

MR. SIEGEL: Yes.

COMMISSIONER WALLISON: So my question then is, how could you possibly have rated a pool without knowing the number of subprime and Alt-A mortgages that were outstanding in the market at large, not just in that pool?

MR. SIEGEL: Commissioner, we had commented on the fact that some of the riskier loan types were having, could have been having an impact on home prices. But that magnitude and the severity of decline in the real estate market after 2006 was not anticipated.

COMMISSIONER WALLISON: So you didn't have the data, if I understand correctly, about the total number of subprime and Alt-A mortgages in the market at the time you were doing these ratings. Yet, it is true that there is correlation in the sense that large number of mortgage failures do in fact produce declines in housing prices. And so I'm not sure that I fully understand how you were actually doing these ratings.

How did you make these judgments without the information from, say, Fannie Mae and Freddie Mac, or FHA through Ginnie Mae, how could you possibly do that, then?

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MR. SIEGEL: That was -- it was not viewed by us as imminently going to drive a never-before-seen housing price decline.

COMMISSIONER WALLISON: Okay. Then we've heard all of you say at one point or another, as we've heard in every one of these hearings, "We couldn't possibly have foreseen what happened. This was completely unprecedented," is the way many people have expressed it, and we accept that. It was unprecedented. We've never seen housing declines like this.

But what is also unprecedented, I think, is the number of subprime and Alt-A loans that were outstanding at the time, of which, as I understand it, you were unaware, and the number, as at least the Commission has received information that the number is approximately one half of all mortgages outstanding in 2007 and 2008 were subprime and Alt-A.

Wouldn't it then suggest that the enormous number of failures that would come out of this nationwide context would

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affect substantially the way your particular pools perform?

MR. SIEGEL: Commissioner --

VICE-CHAIRMAN THOMAS: We're going to yield the Commissioner an additional two minutes.

MR. SIEGEL: Commissioner, I believe that the specific data we had on the securitized subprime market was a good proxy for trends in the overall market. It reflects the percentage increase of subprimes. So we did not have the exact number, but we certainly saw that the proportion compared to the Moody's securitized prime product and Moody's securitized subprime product, had -- we had that information available and that sounds like a proxy for the topic you're discussing.

COMMISSIONER WALLISON: You had a proxy for half of all mortgages outstanding in the country at that time?

MR. SIEGEL: I would have to check the figures, but subprime grew, subprime and Alt-A grew to exceed the prime securitized markets of Moody's rated deals, so half sounds about right.

COMMISSIONER WALLISON: I really would like to see the data that you had available at the time and how you analyzed it from that point of view. Thanks very much.

MR. SIEGEL: Sure.

VICE-CHAIRMAN THOMAS: Dr. Witt?

DR. WITT: If I could, I think this speaks to a larger problem. I talked about the absence of independent research staff. That's just like one of those, like, really bigger issues. I don't want to put words in Jay's mouth, but I believe that he was, you know, managing director in charge of rating new deals at the same time he was sort of the lead guy on, you know, methodology and trying to think about those bigger issues, like you said.

It's very difficult to wear both those hats in a market where you're just so busy, you're rating so many deals. You

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need an independent research function that is, you know, thinking about those kinds of issues.

COMMISSIONER WALLISON: Well, you know, I understand your point, perfectly reasonable point. If someone had thought that the issue was significant, you could have as many people on the staff doing research on the market. You have to have the people who are doing the ratings believing that that information is important.

I don't think it's the fact that you didn't have enough people looking for that information. That information could have been obtained by one person who thought it was important. And I gather that it was just not thought to be important.

DR. WITT: You know, I agree with that. But when you have somebody whose job it is to be thinking about bigger issues all the time, to be reading about them and thinking about them, I think you're a lot more likely to come to the

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conclusion that it's an important issue.

CHAIRMAN ANGELIDES: All right, thank you. Senator Graham?

COMMISSIONER GRAHAM: Thank you, Mr. Chairman and thanks to each of you for your very illuminating testimony. I'm going back to a comment that was made by President Kerrey in his generous introductory comments in which he said that America could not turn away from risk and continue to be a great nation. I agree with that, but with a couple of caveats.

One is, risk to whom? What seems to have been happening is that those who were creating the increasing risk were also finding ways to hand that risk off to other entities. Those other entities might be the Montana Pension Board, they might be the United States Government, and they have turned out to be the people of America, in terms of lost homes, lost jobs and lost hope.

The second caveat is that risk is a

different concept than recklessness. One of the things that, and I'm going to probe, is the recurring pattern in American society where we see bright warning lights going off which are ignored until they mature into a catastrophe. We have one of those happening today in the Gulf of Mexico where there were warning signals that that type of extraction had dangers that were not being adequately mitigated or prepared for, and we see it in the subject that we are dealing with today.

I think there were significant warning signals that appear to have been ignored.

I would start with the fact that, beginning as far back as the early 1990s, there was a significant change in what constituted a mortgage. There was an increase in loan-to-value ratios, an increase in mortgages to borrowers with poor credit history, an increase in mortgages for purchases of investor rather

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than resident-owned properties; and increase in the number of cash-out refinancing loans that lowered the borrower's home equity. All of those changes were significantly altering what the word "mortgage" meant in America.

Then, beginning in 2000, and the Chairman has already shown the chart of the increase in housing prices that began in the year 2000, running up to the year 2005.

Could we have our chart? I can't -- is there a chart?

CHAIRMAN ANGELIDES: A big chart.

COMMISSIONER GRAHAM: Oh, here comes the chart. I'm not going to be able to see the big chart, but I'm going to be referring to a smaller version. Can you put -- okay, we're going to put the chart --

CHAIRMAN ANGELIDES: You can put it in front of me.

VICE-CHAIRMAN THOMAS: I have a smaller version.

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COMMISSIONER GRAHAM: While the chart is being mounted, the chart shows basically three things:

First is the dollars expressed in billions of dollars issued --

CHAIRMAN ANGELIDES: All right, can we do this? Ms. Born objects. Can we move this over just a little so that we can -- let's stop the clock here for a minute. Move it over to --

VICE-CHAIRMAN THOMAS: Can you put it at an angle in front of the lights?

COMMISSIONER BORN: My position is that the commissioners should be able to see the witnesses as they are testifying. Thank you.

CHAIRMAN ANGELIDES: Let's do this: And we'll just move those chairs out of the way. It's a big chart.

VICE-CHAIRMAN THOMAS: I want people to know this is a totally spontaneous and unrehearsed program.

COMMISSIONER GRAHAM: The chart demonstrates three –

VICE CHAIRMAN THOMAS: Excuse me. Angle it slightly so the cameras can look at it. It makes no sense to have that big a chart if people at home can't see it.

CHAIRMAN ANGELIDES: Let's move it over, and pull it over a little so you don't obscure Ms. Born, please.

COMMISSIONER BORN: I'm fine. I can see all the witnesses.

CHAIRMAN ANGELIDES: All right, good. We're all happy, now let's get back to substance. You play start the clock again.

COMMISSIONER GRAHAM: First, the blue mountain reflects in billions of dollars of issuance of RMBS; the red mountain, billions of dollars of issued CDOs; and then the yellow boxes, historic events, starting with an event in October of 2006, when the Moody's research unit issued a study called, "Housing at the Tipping Point," the introductory paragraph in the executive summary reading, "The U.S. housing market downturn is in full swing. New and existing home sales and single family housing construction are sliding. Inventories of unsold homes are surging to new record highs and house prices are falling in an increasing number of areas."

That was in October of 2006. And you'll note that immediately thereafter, the red line goes into ascent with the number of CDOs jumping in a period of less than 90 days from $20 billion to over $40 billion.

Then, in January of 2007, Moody's issued a special report detailing abnormally high rates of early default in mortgage securitizations issued in late 2005 and early 2006. Almost immediately after that, another sharp incline in both the RMBSs and the CDOs; in the case of the CDOs, going from less than ten billion to approximately 55 billion in 60 days.

Then in March of 2007, Moody's issues a special comment noting that CDOs containing large concentrations of RMBSs as collateral were likely to experience steep downgrades in the event that the subprime collateral defaults.

After a short downturn, both the RMBS and the CDO line again goes upward. Then in April of 2007, Moody's releases a report projecting cumulative losses of six to eight percent for loans backed in 2006 subprime RMBSs. And again, both the blue and the red line go up.

Finally, in July of 2007, Moody's and S&P downgrade hundreds of RMBSs totaling 5.3 billion in value, and place CDOs backed by RMBSs on watch for possible downgrades.

My question is, and Mr. Witt, you said you needed research, more research to better understand the environment in which the ratings were being offered, it seems to me as if your own organization was issuing sharp warning signals.

Why was this research inadequate and why was it not, apparently, taken into account?

DR. WITT: I was wondering the same thing, you know. I was out of the CDO group. I left in September '05, a year before this graph starts. So...

COMMISSIONER GRAHAM: So that explains your -- what about those who were here? What did those of you, Mr. Weill, Mr. Siegel, what did you do with this information?

MR. WEILL: Should I take the question, Commissioner?

COMMISSIONER GRAHAM: Yes.

MR. WEILL: Over the course of 2007, we had a lot of dialogue with a lot of economists, including Moodyseconomy.com, and the discussion at the time was not on a crash but was more primarily on a soft landing. The actual predictions of --

CHAIRMAN ANGELIDES: Can I just --

COMMISSIONER GRAHAM: Did you read your own report? This was issued in October of 2006. "The U.S. housing market downturn is in full swing. New and existing home sales and single family housing construction are sliding. Inventories of unsold homes are surging to

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new record highs and house prices are falling in increasing numbers of areas."

Did that information not get to those responsible for ratings?

CHAIRMAN ANGELIDES: Can I add on my time one item, since you used the word "crash?" Here's what it said: Nearly 20 of the nations metro will experience a crash in housing prices." So I just -- since you mentioned "crash," I thought I'd put that on the record.

MR. WEILL: My team and myself, we read the research we get, including the research from Moodyseconomy.com. We get more detailed reports with actual numbers on the home price declines, and we need to get the actual numbers, and then when we look at the numbers that were produced in 2007, most economic forecasters were predicting a national decline of about five percent. Soft landing first, then five percent, then maybe ten.

There were some. I must say, some pockets within the country where maybe more significant price declines were envisioned. But over the course of 2007, if you look back at the research that was produced, most economists were talking about a soft landing and maybe five or ten percent.

COMMISSIONER GRAHAM: Well, that's not what your own economists were calling for.

MR. WEILL: Well, I mean, I think there were multiple reports and I think there were a number of reports by our own Moodyseconomy.com focused on this as well.

COMMISSIONER GRAHAM: How do you explain what seems to be counterintuitive, that you get very bad news and the number of CDOs jumps by a factor of 60 or 70 percent in 90 days?

MR. WEILL: I mean, this is, I think, two different items. What I'm --

COMMISSIONER GRAHAM: I mean, one is the warning and the other is the action taken on the warning. They seem to be running in contrary directions.

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MR. WEILL: I think what is running in a similar direction, Commissioner, is, if we are warning the market -- if some economists start to speak about potential severe home price declines, it is very much linked to what we're seeing, that we are seeing early payment defaults.

So I think when we signal to the market in early 2007 that we're seeing early payment defaults, I think it does match quite well with the announcement that it could be severe pressure on the home prices. And if you put it in perspective, just maybe to put a number here, when we discussed early payment defaults in early '07 for the entire subprime mortgage industry six months or so after seasoning, it was about two percent delinquencies, 2.5 if my memory serves me well.

So if you put things in perspective, as long as -- it does sort of correlate quite well that there is a view out there in the market, or more views that prices are declining and early payment defaults are increasing.

COMMISSIONER GRAHAM: Mr. Kolchinsky, how would you explain the fact that you get such a hair-raising report in October, and immediately thereafter, the number of CDOs issued by Moody's rockets up?

MR. KOLCHINSKY: It's actually, what you mention, it's actually an interesting dynamic. By this time, and this is sort of 20-20 hindsight, there were very few, what you would call real money investors in CDOs. The bankers themselves were taking down the super-senior structures from these deals. The mezzanine pieces were going into the warehouses of these same banks, into other CDOs. So the bulk of it was being sold to other structured vehicles that were being, the economic risk of which was taken by the banks.

From the bankers' perspective, and this is where you get the bad incentives, there were some price declines in the ABX at this point. No ratings declines, but

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price declines. From the bankers' perspective, as opposed to the taxpayer who provides the guarantee for the bank, these were arbitrage opportunities. They made the economics better. So that's something we saw in the first quarter of '07, second quarter of '07. People stepped on the gas and they issued as many deals as they could.

From our perspective in the CDO group, we used ratings, just plain old ratings as determinants of the default probability of the underlying securities. We did have this discount purchase rule to sort of look at scenarios where prices were really showing something very different than ratings; but as I said before, the bankers had a lot of ways to get around that rule and they did.

But this shows -- the incentives were very perverted in this case. The bankers were trying to do more deals.

COMMISSIONER GRAHAM: Did the rating agencies, were you aware of this perverse incentive and actions by the bankers?

MR. KOLCHINSKY: I mean, I mean we -- I understood but I didn't know the extent of the fact, how much of the collateral was being put on the banks' balance sheet, how much was going to other warehouses. That's one area that the bankers would not tell us, is where they were sold into.

COMMISSIONER GRAHAM: Are you not able -- are you not able to command that kind of information?

MR. KOLCHINSKY: Oh, absolutely not, no. That was --

COMMISSIONER GRAHAM: Why not?

MR. KOLCHINSKY: That bankers viewed it as proprietary information where they sold these bonds.

COMMISSIONER GRAHAM: Does this go back to the fact that you couldn't walk away from a deal because you were so concerned with market share?

MR. KOLCHINSKY: Some it does. I think in some ways that is a legitimate position for bankers to take, that --

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COMMISSIONER GRAHAM: You're putting your reputation on the line --

MR. KOLCHINSKY: That's correct.

COMMISSIONER GRAHAM: -- that these securities are going to perform against the rating that you're going to give them.

Isn't that an important factor?

MR. KOLCHINSKY: In general, I would say. But in some cases, I have had cases where bankers, what I believe, lied to me about where these were being placed and there was nothing I could do about it. You know, there's no penalty for lying to a rating agency analyst. So I couldn't, since I couldn't say no, I kind of had to take my lumps, but absolutely.

COMMISSIONER GRAHAM: Could I take another minute?

CHAIRMAN ANGELIDES: Yes, just one minute.

COMMISSIONER GRAHAM: The Chairman asked in his opening comments some questions relative to, did you have anybody on your committees that were making the judgment who had actually had experience in housing, and the answer was no.

Did you have anybody on your committee who had actually had some experience working in one of these banks or investment houses that were putting these deals together so that you would be alert to efforts that might be designed to deceive you?

MR. KOLCHINSKY: I actually, myself, I worked at banks but I was one of the few people who had worked for an investment bank and, to be honest with you, the nature of the market from the time that I worked at a bank had changed by '06-'07. In the beginning of the market, there were placements to investors, to actual real-money investors.

But the nature of this market changed. As more and more structured vehicles, you know, the RMBS collateral, a lot of it went into CDOs or into SIVs. The CDOs themselves were repackaged and sold into other CDOs or into SIVs, and the super seniors were held on the balance sheet. So that factory structure really changed the nature of banking from even the time I was there.

COMMISSIONER GRAHAM: And you're saying that even though you'd had some background, you would not have picked up on that?

MR. KOLCHINSKY: No.

COMMISSIONER GRAHAM: And that you were an exception in that you'd had some experience in the industry.

MR. KOLCHINSKY: That is correct. And I could not have imagined that actually, the risk management was so poor at banks that this was allowed to go on. So I, if I was at part of, at least the early market where the bankers actually -- you actually had to sell the deal. Real live investors with real money to actually buy the deal. Otherwise, the deal didn't work. That changed by '06-'07, where this just went into a perpetual factory and

packaged it into other securities.
CHAIRMAN ANGELIDES: Thank you very much. Ms. Born?
COMMISSIONER BORN: Thank you very much. And thank you all for appearing. Let me just follow up, Mr. Kolchinsky, with something that you just said.
You said that there was no penalty if an issuer or an investment bank who was working with you lied about aspects of the deal. Is that correct?
MR. KOLCHINSKY: That is correct. For practical purposes, we would not walk away from a deal. We couldn't say no, so that would be the most obvious penalty, that you do in any normal business, if you find that your trading partner is not being truthful to you, you say, "I'm not going to do any business with you."
So once that avenue is closed off because you want to increase market share, there's no penalty. We were in the position of being a quasi regulator, which means we had no power to compel people to

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give us information. We had no power to check the veracity of their statements.

So that, without the -- without the ability to say no to a deal, without the ability to compel, you just were left in this sort of limbo where you tried very hard, and many people tried very hard to force the information out. But at the end of the day, with push comes to shove, people could lie to you without a penalty.

COMMISSIONER BORN: And there would be no repercussions with, under the securities laws, for example? I mean, that means an issuer can go to a rating agency, provide false information resulting in a false AAA rating, for example, and there would -- you would not -- if you found out that that information was false, would you consider going to the SEC with information about, you know, these misrepresentations that misled investors?

MR. KOLCHINSKY: I had never considered that, but I think it would be -- it would take a chain of events to -- which were of very low probability. We would have had to find out, which could be difficult. It would have to be material; and, to be perfectly honest with you, you would have to get the management to agree to take action against large fee providers, which probably is the most difficult. So that probably would not occur.

Even if -- even if we did have evidence, direct evidence, it would probably be handled on some higher level between the two parties instead of taking it to a regulator.

COMMISSIONER BORN: Mr. Siegel, do you disagree?

MR. SIEGEL: I've been operating, when I was at Moody's, and not having done the legal research in particular, I was operating under the impression that it was a violation of securities law to lie to the rating agencies that had been published in the general media.

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When Moody's got information from colleges and if -- it turned out to be -- who needed a rating -- turned out to be more truthful than information they provided to Newsweek when they were trying to tout how strong their schools were, and there was commentary that they couldn't lie to the rating agencies. So we operated under that assumption.

If I had found someone intentionally misleading, my belief is, I would have taken action. I rarely would say a senior person at an institutional level at a bank said, "Our policy is to lie to the rating agencies, do anything you can."

But if it were an individual banker who sent information that was wrong a couple of times, we'd call a more senior person and tell them, "You know, we want the information to come, you know, some other way," or, to "make sure you get the right person checking this data before we get it," on the RMBS team.

COMMISSIONER BORN: Thank you.

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Mr. Kolchinsky, I take it from your testimony, from your written testimony, that you feel that Moody's quest for market share, market coverage and revenues tended to undermine the quality of the credit ratings, at least in the structured finance area, is that correct?

MR. KOLCHINSKY: That is correct.

COMMISSIONER BORN: So a profit motive corrupted the --

MR. KOLCHINSKY: Short-term profits versus long-term product quality. It's very pedestrian, very -- nothing unusual about this conflict. It occurs probably in every industry. It's very standard.

COMMISSIONER BORN: Certainly, we're finding it occurring in the financial services industry. Mr. Witt, in your view, was the credit, the quality of the credit ratings undermined in any respect by the search for market coverage and market share?

DR. WITT: I don't know of any, like, cases where there was a really bright line that anybody crossed that I knew of where it was really obvious that somebody was changing standards or inventing standards to get a deal or to get market share.

COMMISSIONER BORN: Was there a gradual erosion?

DR. WITT: I wouldn't -- if somebody said that, I wouldn't doubt their veracity. I probably wouldn't say that myself, but...

COMMISSIONER BORN: Mr. Kolchinsky, let me ask you, you testified in your written testimony, but not in your oral testimony, you talked about your ratings of CDOs, collateralized debt obligations, when they began to contain credit default swaps, as at least a portion of the underlying assets.

MR. KOLCHINSKY: Yes.

COMMISSIONER BORN: And as I understand it, the credit default swaps began to replace some of the residential mortgage-backed securities.

MR. KOLCHINSKY: That is correct. By

'07, most of the deals, instead of having cash assets, had credit default swaps that referenced the subprime and Alt-A collateral, yes.

COMMISSIONER BORN: And did you experience particular issues or difficulties in rating the synthetic or hybrid CDOs?

MR. KOLCHINSKY: They were much more difficult to rate. They introduced a number of new factors, a number of new risks including counterparty risk, collateral risk because it all had to be funded. The number of waterfalls and the mechanics in the deal were essentially doubled.

On top of that, even credit default swaps would be customized. And by that I mean, like the things that I mentioned with the discount purchase option, the only thing that made it possible to do that for a banker is the fact that the credit default swap was so flexible. You could adjust certain things in it. The

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degrees of freedom in a credit default swap were much higher than the degrees of freedom in a normal cash bond where you only had price. So you could hide certain risks. You could create a different credit default. So that in itself changed items.

I think I mentioned that the ability to short created a new -- new type of investor who wanted to see the market deteriorate.

COMMISSIONER BORN: They wanted to see these bonds fail.

MR. KOLCHINSKY: Fail. And the point from the rating agency perspective, we did not anticipate that sort of investor in our deals, in our modeling, in our approaches, so that was something new.

And finally, it really changed the dynamic of the rating timeline. When I started, we probably had one-and-a-half to two months to look at a deal. Go back and forth with a banker while they actually had to -- actually gather that collateral, either in the primary or secondary, which took some time. When you had synthetics, that could be done in a week.

So we had the time pressure, we had this deal. The bankers don't want to hold the warehouse risk, especially when the market was going down. They wanted to get it off or get it into a different form, but still keep it on -- so the time pressures and the pressure on the banker increased tremendously.

So those were all changes as a result of the deals becoming much more synthetic.

COMMISSIONER BORN: I also think -- may I have two more minutes?

CHAIRMAN ANGELIDES: Just because we're running, sure, just if you could ask one --

COMMISSIONER BORN: Well, if I am limited to one question, how did the ratings on the synthetic CDOs perform? Do you agree with Mark Froeba, who has testified in his written testimony that they were the worst ratings in all of

Moody's once-distinguished history?

MR. KOLCHINSKY: I, without the data, I would say, my guess is yes. I mean, all these deals performed poorly. But because many of the synthetic deals were, as we know now, we didn't know then, were actually done in the portfolios selected by parties who wanted to see the deals -- maximize the losses, they would have probably performed worse. So I don't have any data, but I wouldn't --

COMMISSIONER BORN: Since they were designed to fail, they did fail.

MR. KOLCHINSKY: Yes.

COMMISSIONER BORN: Thank you.

CHAIRMAN ANGELIDES: Thank you, Ms. Born, Mr. Holtz-Eakin?

COMMISSIONER HOLTZ-EAKIN: Thank you, Mr. Chairman. Thank you, gentlemen, for taking the time to be with us today.

I want to reiterate what I think were some information requests by Commissioner Wallison and hope that we can come back to you. I am particularly interested in not

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just the absolute level of performance of your ratings in these structured products running mortgages, which I think the record has indicated is not outstanding, but how they performed versus other ratings done by Moody's, in structured finance, not mortgage-related. So was this a problem endemic to structured finance or was it a mortgage-related problem?

I'm also interested in any comparative information you might have on your performance relative to market competitors, whether it be S&P, Fitch, whoever. I think to frame this more carefully, I think it would be useful to the Commission and I look forward to your help in doing that.

It seems to me that there are three levels of questions involved. One is, what exactly is it that you did in rating these various securities; the second is the nature of the business model in which your activities were embedded and the degree to which that shaped your actions; and the third is the role the ratings themselves played in market dynamics and what was ultimately an enormous financial crisis.

A better questioner would be able to distinguish among them and lead you through it. That's not me. So you're going to get questions on each of those, as we go through. But I did want to start with the bottom of this, which is residential mortgage-backed securities, and ask you, Mr. Siegel, in particular, some questions about that process and how it worked.

And so first and foremost, what were you trying to do when you rated an RMBS?

MR. SIEGEL: Commissioner, when we rated an RMBS, there were two primary components to it. One is evaluating the collateral, so a subprime mortgage pool would be substantially riskier than a prime mortgage pool; floating rate loans, riskier than fixed rate loans, et cetera.

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And after evaluating the expected performance of the pool and the performance at different stress levels, we would lay that against a proposed structure of the deal. The reason structured finance securities in general, and prime versus RMBS in particular, to get ratings at different levels is that, within the deal, investors allocated risks among themselves.

The company, the originator might agree to take like an equity position and they would be the first to lose if the loan performed poorly. Then you might have investors at the cusp of investment grade, like hedge funds might buy the near-investment-grade classes. And they know that if losses exceeded protection from the company, they would take the loss.

In turn, the most senior investor would be protected by about 20 percent of subordination below them. So it was assessing whether the collateral dynamics projected forward compared to the protection provided within the structure, what level of risk that resulted in to buyers of the security.

COMMISSIONER HOLTZ-EAKIN: So your goal was to look at alternative futures and look at the cash flows that the underlying subprimes would generate, allocate them to the different investor tranches and look at the expected returns they might get and the degree to which they fell short, and then assign rating accordingly, that's the basic process?

MR. SIEGEL: Yes, that's a good summary.

COMMISSIONER HOLTZ-EAKIN: What would I get, would I get your rating or a full analysis, what would be available to someone using your product?

MR. SIEGEL: For each RMBS deal we strove to publish what we called a New Issue Report, which would give our ratings, along with a summary of the pool statistics, so investors could see

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what the collateral was, a summary of the structure and our rating rationale.

It would give an explanation, again, not each individual person's, but the committee would come up with a rational, why do we think 20 percent protection is enough for a AA II rating on this tranche.

COMMISSIONER HOLTZ-EAKIN: So into that process went some quantitative analysis, some modeling, as well as the other inputs from members of the committee on a more qualitative basis?

MR. SIEGEL: Exactly, our ratings were --

COMMISSIONER HOLTZ-EAKIN: So let me ask you a couple of questions about each. How did you build the quantitative analysis? What was the historical house price data? What was the information that was used to determine the performance of the subprime loans, the prepayments, the delinquencies, defaults, the entire range of behaviors you had to model?

MR. SIEGEL: Well, the models were

shifting over time, so I'll speak as to --

COMMISSIONER HOLTZ-EAKIN: How often were they updated?

MR. SIEGEL: Well, I just want to be clear on that question. How often would we do an entire revamp with new data, like a million loans of data, and look at that? That tended to be about every five years, but --

COMMISSIONER HOLTZ-EAKIN: So in particular, as you got more information about house prices declining, mortgages performing poorly, which we've heard a lot about today, there was not an effort to re-estimate the basic modeling underneath the ratings?

MR. SIEGEL: Again, it would not be the major revamp. But as any information came in, there were new loan types, and Moody's then just say, "Oh, sorry, we didn't have that in our dataset, we can't assign a rating."

Rather, we would analyze the additional risk. So an interest-only loan we didn't have historical performance on interest-only loans but everyone can imagine that if the borrower is not amortizing their loan, if they're simply paying interest over time, it's going to be risk.

So we actually had some indirect data on what would happen when payment goes up, what happens when equity doesn't go down. So we applied that to the I-O loans, not waiting five fears to get data on the actual performance on interest-only, but analytically projecting out increased risk as data came in, such as an interest-only loan.

COMMISSIONER HOLTZ-EAKIN: So I'm interested in two pieces of what I understand to be the quantitative process. One was reports we received that there was an effort to lower the sensitivity to house price increases because in fact, the models were not performing well in predicting losses. Losses were predicted to be too small. Is that a fair characterization of what went on?

MR. SIEGEL: Do you have the time frame for that? I don't --

COMMISSIONER HOLTZ-EAKIN: -- the development of your basic subprime RMBS model --

MR. SIEGEL: Let's—it’s going back to the 1996, thereabouts, model?

COMMISSIONER HOLTZ-EAKIN: I'll follow up with a -- I mean, this was, as I understand it something that happened in the 2000s leading into the development of a new model for assessing subprime RMBS. The M3.

MR. SIEGEL: M3 in around 2001 was a model being built for prime, so is that what you're referring to?

COMMISSIONER HOLTZ-EAKIN: And the subsequent for subprime, M3 subprime?

MR. SIEGEL: That was later on. I was not as directly involved with that. In fact, it was rolled out after I left the company. So I can't -- I had trouble being able to answer your question. Now I

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understand why. It probably relates to something after I left.

COMMISSIONER HOLTZ-EAKIN: I'll come back in writing to try to understand it a little better; because if you make it less sensitive going up, my guess is, you would make it less sensitive going down. And the history is pretty clear on that.

My second question has to do with picking the worst outcome in a series of, you know, 1,250 stochastic runs, doubling that to assess tail risk. How is that judgment made, and how did the issuer respond to your information about that?

MR. SIEGEL: Again, if that was what was done in the subprime, I'll take it from the question, but I don't know that's what happened in the subprime arena. A committee, when we did the economics for the model that I worked on, which sounds a similar case, we had historical home price data and were able to project out, not just the expected case, but the stress cases and a correlation across states, which is critical. All that based on observations available to us through that date.

COMMISSIONER HOLTZ-EAKIN: So I want to come back to that. So my understanding is, when this happened, often there would be an exposure in the stress test to downside risk, and issuers would purchase credit enhancements in order to get a rating.

How was the credit enhancement analyzed? You've got cash flows on the underlying collateral. What was done to assess the quality of the credit enhancements and the correlation of that with the performance of the RMBS itself?

CHAIRMAN ANGELIDES: By the way, the Vice-Chair in absentia yields his remaining two minutes to you.

COMMISSIONER HOLTZ-EAKIN: I thank the Vice-Chair. His generosity is legendary.

MR. SIEGEL: For the most part, it's two separate pieces of analysis. It is

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looking at the collateral performance through each of these different scenarios. And in the prime, there are 1250 different scenarios, and then comparing that to credit support. Credit support takes many forms. Some of that is certain, it's cash put aside in the deal, or it's over-collateralization. Where you have a hundred of loans, 90 of certificates, a ten-dollar collateral loss won't affect the security holders who have 90, to pay off the 90. In some cases, it was the agreed-upon subordination of certain investors, as I described earlier, the hedge fund agreeing that they will take losses first.

So the analysis of the type of credit support was tied to, but separate from, the collateral analysis.

COMMISSIONER HOLTZ-EAKIN: I'm going to run out of time and we won't get to have the long dialogue on correlations I desire, but that's life. Let me ask just two quick questions, one from Mr. Weill,

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and one from the CDO perspective.

It's clear you're analyzing the cash flows and then going forward. When you do surveillance, what the is nature of surveillance and how does it inform back from the basic ratings at the issuance?

And then for Mr. Witt and Mr. Kolchinsky, how is it, when you're building a CDO based on the very same RMBS, how do you capture that cash flow information, particularly what turned out after the fact to be dramatic correlation in the performance of these, what was if effort to identify that?

MR. WEILL: Commissioner, so if I summarize, you're asking me two questions. One of them is the process on how we do that within surveillance, and how do we communicate back to the --

COMMISSIONER HOLTZ-EAKIN: Yes.

CHAIRMAN ANGELIDES: Brisk answers, please.

COMMISSIONER HOLTZ-EAKIN: Imagine you’re the Vice-Chairman. Go ahead.

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MR. WEILL: On the first one, the process is divided into two components. Unlike the initial ratings side, where we get a lot of information on the pre-closing, like FICOs and other items like that like that, the surveillance side is a lot more focused on performance.

So what we care about primarily is for example, to get how much is 30-day plus 60-day, foreclosure, real estate owned. We also care about getting information on liquidation proceeds to see how much is lost.

COMMISSIONER HOLTZ-EAKIN: Recovered?

MR. WEILL: Recoveries. How much is lost when a mortgage is actually foreclosed upon. And this is giving us a lot of information on deterioration of the market or whether appraisals were too high or other items.

All the information we get on the delinquent portion informs what our thoughts are on the non-delinquent portion. In other words, if we see a significant trend of delinquencies, we do increase our views on the non-delinquent portion of the pools on the surveillance side.

Beyond that -- I don't know how brisk I'm supposed to be -- but beyond that, I would just say that we run cash flows. To the extent there are complex waterfalls, we need to have information about how cash would flow, depending on the timing of defaults and the timing of prepayments.

So that's sort of a big picture. I know we can spend a lot more time on this.

COMMISSIONER HOLTZ-EAKIN: I'll come back to you at a later time. If I could just briefly get you, Mr. Witt and Mr. Kolchinsky, to talk about the role that cash flows played and the analysis of those cash flows in the CDOs themselves.

DR. WITT: CDOs definitely had cash flow modeling. You know, you had --

COMMISSIONER HOLTZ-EAKIN: Were you to look through also the underlying subprime mortgages?

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DR. WITT: No, we definitely did not look through the underlying subprime mortgages --

COMMISSIONER HOLTZ-EAKIN: What did you look at?

DR. WITT: Okay. Well, first of all, like in a CDO, let's say you've got a hundred BBB RMBS tranches. In each RMBS tranche you've got maybe a thousand mortgages. So doing a look-through analysis would mean going through those underlying one hundred thousand mortgages and making some specific assumptions about all those.

We definitely did not do that on a -- you know, deal -- for each deal. What we did was, we took the rating that had already been assigned by the RMBS group --

COMMISSIONER HOLTZ-EAKIN: Did it have to be your own rating?

DR. WITT: It didn't have to be but if it was a rating from another rating agency, we decremented it, because we assumed that our ratings, you know, we believed our ratings. We weren't sure about other people's. It's called notching.

So we, so that's what we did. We didn't do the look-through analysis although, you know, when I was CDO manager and managing director, I really wanted to do a look-through analysis as a study, as a research tool, just to see -- really what I was interested in was the correlations that were being assumed in the RMBS at the mortgage level. If you allowed those to flow through to a CDO, would you get -- would a AAA CDO be based on similar correlations as a AAA RMBS? That was the question.

COMMISSIONER HOLTZ-EAKIN: I think we now know the answer.

DR. WITT: Well, I mean, both of them were, you know, inadequate. The correlation levels for both were far lower than they should have been.

COMMISSIONER HOLTZ-EAKIN: Mr. Kolchinsky, I'm going to come back to you in writing. I apologize

CHAIRMAN ANGELIDES: No, these are good lines of questioning. But if we could follow up in writing on this issue, it is central, and I will say that there's a lot in our research report on this. But this is an area in which we're particularly interested. All right, let's go to Mr. Thompson.

COMMISSIONER THOMPSON: Thank you, Mr. Chairman, and good morning, gentlemen. Thank you for joining us.

I'm personally struck by the cultural shifts that may very well have occurred within Moody's as time progressed. While many little anecdotes have been spoken to this morning, the fact that we could make silk purses out of sows' ears in that factory that you had is somewhat striking to me. And the fact that the models were influenced by human knowledge seems to make sense to me. I don't know why any mathematical model could ever take into effect, or in effect, all of the variables

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that may be going on in the marketplace.

But the one big variable is in fact the quest for market coverage or market shift. I'm struck, Mr. Weill, by your role as surveillance officer. So can you opine for a minute on your surveillance observations about the cultural shifts that occurred in Moody's post-IPO?

MR. WEILL: My true goals as surveillance managing director were to get the ratings right, and to communicate effectively on any rating actions. Those were very demanding objectives, and I think those were the absolute, sole priorities that were set for my team in surveillance.

COMMISSIONER THOMPSON: Did you sense pressure on the team within Moody's to drive market share rather than get the ratings right?

MR. WEILL: I never felt this. I was in charge of surveillance. No one was forcing any objectives on me other than getting the ratings right and communicating effectively.

COMMISSIONER THOMPSON: So as the surveillance officer, when much has been found by our staff in e-mails and threats about the quest for market share and market coverage, you knew nothing about that? Your team was completely oblivious to that?

MR. WEILL: My team was not focused on market share. So --

COMMISSIONER THOMPSON: No, I didn't ask that. I asked, was your team surveying what was going on within the company and recognizing the quest for market share and how that might effect ratings?

MR. WEILL: No. I'm not sure exactly I understand what you mean by that. I think the only -- there is no quest for market share in surveillance. Obviously and the sole objective is moving ratings when they deserve to be moved. We were not part of any other objectives.

COMMISSIONER THOMPSON: Dr. Witt, in

the business I come from, when someone gets reassigned, sometimes that's a euphemism for something else. What does that mean in your language?

DR. WITT: I believe that I was reassigned out of CDO group because I had -- I was looking for another job. I got an offer from a university in Texas and I told my superiors about it. And I ended up not taking the job because the details didn't turn out to be what I was expecting. And, you know, so I stayed on.

But about two months later, I was asked to leave the CDO group. I think that was the main reason. But the reason I was looking for another job was the types of things I was talking about in my opening remarks about, I felt like we were being asked, and specifically I was being asked, to be in charge of something that was incredibly complicated, and very difficult to achieve, and I did not have the resources to do it adequately.

It wasn't that I thought that we were

getting the ratings wrong or that I was being pressured to get the ratings wrong. It was that I thought that I didn't have the resources to make sure that I was getting the ratings right.

COMMISSIONER THOMPSON: So is that to suggest that the pace of innovation just overwhelmed your team or the whole company?

DR. WITT: For my team, that was definitely a big issue, yes.

COMMISSIONER THOMPSON: Mr. Kolchinsky, you have suggested in your comments or observations that the quest for market share was paramount. And can you comment on the cultural shift that may have occurred within Moody's around the IPO, or post-IPO?

MR. KOLCHINSKY: It was a slow shift, but certainly, two stories:

When I first joined Moody's I was asked to opine on a new deal that was being brought to us by a banker that contained primarily telecommunications loans, and they wanted to convince us that it was just as good as any other CMO, and I was asked to look into it. I was brand-new. I said, "No, we can't really justify this. We can't rate this deal." And that was okay, "Great, thank you very much."

By the time I became MD, not rating a deal became a very important factor, and you had these e-mails, and you had market share drops from 98 to 94 percent at a time of credit turmoil were considered great events. So it was clear to me that rating every single deal or as many deals as I could was critical to my job performance.

I think it's true that no one said, "Here, you have to lower standards." But that was one area where it was easy, both to rationalize, because prior to '07, the performance of assets was so -- so good. I mean, if you look at the subprime performance up to that point, delinquencies were extremely low, and I'm

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sure Nicholas can tell you about that as well. So it was easy to rationalize concessions. And that's how people effectively gained and maintained market share.

COMMISSIONER THOMPSON: Can I go back to Mr. Weill for a moment.

I would liken surveillance in your environment to internal audit. Is that not true? I see some guys behind you, your attorneys, apparently shaking their head.

MR. WEILL: I don't view my role as internal audit.

COMMISSIONER THOMPSON: Is it similar, though?

MR. WEILL: I don't think so. What we do is, some call monitoring like rerating. And I think the way, when Moody's assigns a rating, there are two commitments to the market. I mean, there's a commitment to the market to inform the market over time on the rating, and adjust a rating if there's any reasons to do so.

So I think, I view my team as a team of rating analysts that, instead of rating, assigning initial rating, are simply rating seasoned deals.

In other words, rating deals that are enriched by the information of performance and assigning new ratings. It's a euphemism. We're not assigning a new rating every day but we are getting information every month, and based on information we get every month, we are reassessing those ratings. So it's not an -- internal audit. It's more like a different ratings team.

COMMISSIONER THOMPSON: Thank you very much.

CHAIRMAN ANGELIDES: Very quickly, Ms. Murren, before you go on, I want to enter a couple of things in this record before I forget.

With respect to Mr. Holtz-Eakin's questions, I'd like to enter into the record an excerpt from a testimony from Mr. Roger Stein about the ratings process and the extent to which it was a matter of human involvement, recalibrating the assumptions, some of the things you talked about. I think it's an interesting part of that excerpt.

Secondly, I just want to make sure I enter tab 15, and finally, the e-mail from Mr. Kolchinsky to Ms. Fu and Ms. Yoshizawa about the record of transactions which have egregiously pushed our time limits. I don't know if I did that. Ms. Murren?

COMMISSIONER MURREN: Thank you, thanks to all of you for being here today. I have a couple of questions. The first for Dr. Witt:

You had mentioned earlier in your commentary that your job was to get the ratings right. And I'm curious, from your standpoint, does getting the ratings right mean that they conform to your internal modeling and that they've gone through the appropriate processes through your committee, or does it mean that, down the road in the future, that the ratings that you've assigned appear to be the ones that are accurate?

DR. WITT: The latter. You know, when I say "get the ratings right," I'm just trying to, it's a shorthand for, you know, accurately predict, you know, what percentage -- AAA should only have on average losses of about a basis point, for instance.

COMMISSIONER MURREN: And to your knowledge, at Moody's, was there any evaluation of performance by either the analysts, the committee itself or people in managerial positions that were backward-looking, that would say that your performance was being evaluated based on what you just described, which is making sure the ratings were right?

DR. WITT: There's definitely a group that measures the performance ratings, you know, by category, and they would put out a report every year that would tell how ratings did.

But did that affect people's pay, people's compensation? I would say in my

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experience, no.

COMMISSIONER MURREN: Okay. So it was important to you, but not because it was something that was rewarded necessarily at the firm.

DR. WITT: Yes. I mean, people took a lot of pride in trying to get the ratings right. I mean, you know, down at my level, at the analyst level and manager level, it definitely did.

COMMISSIONER MURREN: Thank you. Did all of you have contact with the issuers or those that were the ones coming to you for the ratings for these securities? It's just a yes or no question. Did you all have meetings, conversations, did you have contact with them?

MR. SIEGEL: Yes.

COMMISSIONER MURREN: On a pretty regular basis?

MR. WEILL: My contacts were, after issuance of ratings on an on-going basis to have monitor information.

COMMISSIONER MURREN: But it's again

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with the issuers themselves.

MR. WEILL: Issuers or their agents.

COMMISSIONER MURREN: And yet, Mr. Weill, you had said that when you were in the conversations in your committee deliberations, that first and foremost, or at least very prominently figured in the hierarchy of what was important to you, was the end user of the ratings, meaning the pension funds and the mutual funds that ultimately would rely on these ratings for their investment decisions.

How often did you have contact with them?

MR. WEILL: We had a lot of contacts with investors. Some investors were participating through teleconferences. We had teleconferences after significant Dow reactions. I would say in the July 2007 action we discussed today, we had a major teleconference where we presented our slides. We had a Q&A with hundreds of investors.

We also were participating to

investor briefing where investors would either come to Moody's or come to a different place where we would present our methodologies and take questions from investors. We were speaking to conferences to investors. So investors were really a key contact for us in monitoring.

COMMISSIONER MURREN: During the course of the time period that we're examining, did those investors ever convey to you that your ratings were overly optimistic or that they felt that the underlying assumptions may need to change or offer up any concerns about the housing market?

MR. WEILL: I would say two things to this, to that effect, Commissioner. The first one is, when you get a phone call from an investor, you don't necessarily know whether this investor is short or long the securities; i.e., whether they are happy with, let's say, the downgrade or unhappy if there is a downgrade.

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The second point I would say is that we have an ongoing dialogue with investors. They have views, they have models. Ratings is only one source of information for them. And major investors do actually run their own models and cash flows and they express their views. And it's a very fruitful exercise for me and for my team to get information from them.

COMMISSIONER MURREN: So now we've heard that your own internal economic forecasting is something that you may not always rely on for your information. It's one of many different factors. And the conversations that you have with investors, I guess are yet another of many different factors that you consider.

But what is the factor then that would throw up a red flag where you would react? I mean, does it actually have to be that something is in the process of needing to be downgraded or are there ever, sort of, forward-looking types of warning signals that you would heed?

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MR. WEILL: The -- we look at -- we'd look at warning signs. Like if you look, for example, at early payment defaults, and you see a small, even a small percentage of early payment defaulters, there would be a flag that we need to engage in more research. At the time where we would, for example, speak to services, get information from them on what they see in terms of revised appraisals, updated appraisals, what they see in terms of liquidations and recoveries.

So we get a few data points from the servicer reports and trustee reports. And this is -- this allows us to graph and analyze trends and forces us into a lot more research.

COMMISSIONER MURREN: And then that research, at what point do you take action, after the data in the model changes?

MR. WEILL: There is a significant tradeoff between, on when to take a rating

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action, and I think this is a very difficult question. If I take, for example, the early payment defaulters, you see a group of homeowners that are starting to be delinquent on their payments. And there could be a lot of different ways to analyze it.

One way to analyze it would be to have, to see that you have a group of speculators, people who were just hoping to make a quick profit, never intended to live in the property, just buying a house to sell it within three months, or are they actually --

COMMISSIONER MURREN: So it's somewhat subjective.

MR. WEILL: There is --

COMMISSIONER MURREN: I have two minutes left. That's why I'm rushing, I apologize.

MR. WEILL: There is a qualitative component to it.

COMMISSIONER MURREN: Thanks. Dr. Witt, if I could return to you, you

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had mentioned that there was some pressure from bankers that related to what ratings you assigned within your group.

Could you talk a little bit about that? And secondarily, you had also mentioned that you could go in and say that you didn't want to rate something, and I'm curious as to what happened to those deals. I mean, how many did you not rate, and did they go to another rating agency or did they come to market? What happened to them?

DR. WITT: Well, the first question about the bankers, you know, they always wanted higher ratings or, you know, the largest -- the bigger AAA tranches, and they would, you know, work hard to achieve that and could be very creative in the ways they would try to explain things or the types of evidence they would use.

You know, they definitely -- they would just use, pull any lever, basically, that they could. And, you know, pressure might mean, you know, calling one of our superiors and, you know, describing some situation in terms that wasn't really, you know, accurate, to try and, you know, kind of, you know, put me on the defensive.

You know, they -- that was just a part of the job.

COMMISSIONER MURREN: What happened to deals that you decided -- how many were there that you decided not to rate and what happened to them?

DR. WITT: I'm not sure, when did I say that we decided not to rate transactions?

COMMISSIONER MURREN: Perhaps it wasn't you. It might have been someone else. But there was -- someone said that it was possible to go in and say that you didn't want to rate something. You referenced one instance.

MR. KOLCHINSKY: In my case, there was only one I was able to say no to and it went to another rating agency. But it wasn't -- it was theoretically possible, but not advisable for your career prospects and practically, very difficult to say no.

COMMISSIONER MURREN: So did you ever say no?

DR. WITT: Well, you know, there definitely could be a transaction, where you would be talking to the arranger, investment banker, and they would end up with not getting a rating because they weren’t happy with the rating they were going to get.

But I don't ever remember ever saying, "We're just not going to rate this deal." It would be more like, "Okay, this is the rating we give," or, "We would give." And they would say, "Well, we don't like that," and they would go away. But I don't remember just saying, "We can't rate this."

COMMISSIONER MURREN: Of course. But how many times did people walk away because you would say, "We will not give you the rating you want?"

DR. WITT: Oh, you know, I'm sure

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there were many occasions, you know, over the year-and-a-half.

COMMISSIONER MURREN: And typically, those would go to another rating agency and they would get the rating they wanted?

DR. WITT: Often, yes.

COMMISSIONER MURREN: Thank you.

CHAIRMAN ANGELIDES: All right, thank you. At the request of Senator Graham, we'll ask this of Moody's Corporation, but we would like, Senator Graham would like some information about the backgrounds of the people who sat on the ratings committee, I think with an eye to seeing what their expertise, knowledge, diversity of background was that allowed them to make assessments of the mortgage market; correct, Senator Graham?

So we will make that request of Moody's and direct it to the appropriate person. Mr. Vice Chair, you wanted to make a comment before we close up here?

VICE-CHAIRMAN THOMAS: Well, actually, I have a couple of quick questions as well.

CHAIRMAN ANGELIDES: I would not defy you.

VICE-CHAIRMAN THOMAS: Well, after 32 years in elected office, I learned never to ask for the last question. What you do is wait until you get a good one and say that was the last question. So I'm having fun in this position.

Dr. Witt, in reading what you wrote, and listening to what you said, I know you'll give me what you believe to be the honest answer to the question in terms of your feelings not being comfortable, which finally drove you back to academia.

If you had double your pay, would you have had the same feelings?

DR. WITT: Absolutely.

VICE-CHAIRMAN THOMAS: If you had triple the pay, would you have had the same feelings?

DR. WITT: I'm telling you the truth, I would have, yes.

VICE-CHAIRMAN THOMAS: Okay. And

then finally, the plea that the ratings agencies weren't the cause of the financial crisis, I'll accept that if you'll answer this question:

We'll start with you, Mr. Kolchinsky and go down the line very quickly, preferably one word, two if you need to.

What was the major cause of the economic crisis?

MR. KOLCHINSKY: Actually, it's --

VICE-CHAIRMAN THOMAS: No, just one or two words.

MR. KOLCHINSKY: Everybody. Everybody in the chain.

VICE-CHAIRMAN THOMAS: Oh, he's an attorney, I forgot. You're an attorney.

MR. KOLCHINSKY: Not a practicing one.

VICE-CHAIRMAN THOMAS: Mr. Siegel?

MR. SIEGEL: The housing market decline.

VICE-CHAIRMAN THOMAS: If that's your answer. I mean, you guys are good at what you do, so if that's your answer.

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Mr. Weill?

MR. WEILL: Housing market decline combined with hard refinancing opportunities.

DR. WITT: The housing market decline, you could talk about --

VICE-CHAIRMAN THOMAS: Well, the question is, what was the cause of the housing market decline, was it AAA ratings on stuff that weren't?

DR. WITT: A lot of inappropriate financing, and definitely to some extent --

VICE-CHAIRMAN THOMAS: And inappropriate rating?

DR. WITT: -- and to some extent, inappropriate rating contributed to that. Yes.

VICE-CHAIRMAN THOMAS: All right. That is all --

CHAIRMAN ANGELIDES: The only thing I wanted to note is in response to Ms. Murren's question, I thought you were very delicate. Just for the record, in your interview with our staff, Dr. Witt, when asked about pressure from bankers, you said, "Oh God, are you kidding? All the time. I mean, that's routine. I mean, they would threaten you all the time."

I just wanted to note that. But I appreciate your delicacy and nuance of words today.

VICE-CHAIRMAN THOMAS: Now I understand why he wouldn't do it for triple the amount.

CHAIRMAN ANGELIDES: All right. I want to thank the panel for your time, for the answers to your questions. Appreciate it very much.

We are going to take a ten-minute break, a brief ten-minute break. We will reconvene at 11:45 for session two. So members, we're shortened up a little here.

(Recess taken.)

CHAIRMAN ANGELIDES: We will now come back into session. We are going to begin the second session of today's hearing on the credibility of credit ratings, the investment decisions made based on those ratings and the financial crisis. The second session is, "Credit Ratings and the Financial Crisis."

We are joined today at the witness table by Mr. Warren Buffet, the Chairman and CEO of Berkshire Hathaway, and Mr. Raymond McDaniel, the Chairman and CEO of Moody's Corporation.

Gentlemen, I'd like to start, thank you for being here, I'd like to start by doing to what is customary for all witnesses in all proceedings. I'd like to ask you both to stand and be sworn. Please raise your right hand.

W A R R E N   B U F F E T T ,

R A Y M O N D   M c D A N I E L ,

Having been duly sworn, testified as follows:

CHAIRMAN ANGELIDES: Thank you very much. We will begin by offering both of you the opportunity to make an opening statement of no more than five minutes. I don't know if I -- I know that Mr. McDaniel has prepared a statement, I don't know, Mr. Buffett, if you want to avail yourself of that opportunity.

MR. BUFFETT: I have no statement.

CHAIRMAN ANGELIDES: Good. That will cut five minutes off the agenda. And what we'll do, Mr. McDaniel, we'll take your opening statement and we'll go right to Commission questioning.

MR. McDANIEL: Thank you. Good morning, Mr. Chairman, Mr. Vice-Chairman and members of the Commission. My name the Ray McDaniel, I'm the Chairman and CEO of Moody's Corporation, the parent of credit rating agency Moody's Investor Services.

Moody's appreciates the important work this Commission is undertaking and on behalf of my colleagues, I welcome the opportunity to contribute our views regarding the role of credit rating agencies.

Over the past several years, we've

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witnessed events who magnitude many of us would have thought highly unlikely. The turmoil in the U.S. housing market is that began in the subprime residential mortgage sector led to a global liquidity crisis and a loss of confidence in the U.S. and global financial system. The impact has created a great hardship for many Americans. American 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.

At Moody's, our reputation is our single most important asset. For one hundred years, Moody's employees have brought their insight and integrity to rating trillions of dollars of debt and hundreds of thousands of obligations across a broad range of sectors, asset types and regions. The record for

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providing predictive credit opinions has earned Moody's a strong reputation among capital market participants worldwide.

However, Moody's is certainly not satisfied with the performance of our credit ratings for the U.S. residential mortgage-backed securities and related collateralized debt obligations over the past several years. Indeed, it has been deeply disappointing.

Starting in 2003, Moody's did observe a trend of loosening mortgage underwriting standards and escalating housing prices. We repeatedly highlighted those trends in our research and we incorporated them into our analysis of the securities. By 2006, we were requiring an unprecedented level of credit protection. However, neither we nor most other market participants, observers or regulators, 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.

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And even our enhanced credit protection requirements were insufficient to ensure ratings stability.

Today with the benefit of hindsight, many observers have suggested that the events that ultimately came to pass were inevitable and easily predictable. As they were occurring, however, various outcomes were considered possible. Market experts in both the public and private sector had differing views about the ultimate performance of the U.S. housing sector and its potential effect on the rest of the economy. These questions persist today.

The economic downturn exposed serious vulnerabilities across the infrastructure of the global financial system. For Moody's part, there has been an intense level of self-evaluation over the past few years.

Members of my management team and I have solicited ideas and perspectives from both inside and outside the company.

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We've sought to better understand what caused the poor performance of our ratings in this sector and we've sought to improve the assessment of credit risk in a fast-changing and unpredictable market environment. We've undertaken numerous initiatives to improve the credibility of our ratings and strengthen their quality transparency and independence. These actions are extensive and have occurred in six principal areas:

We have strengthened the analytical integrity of our ratings, and hence, consistency across rating groups, improved the transparency of rating and the rating process, increased resources in key areas, bolstered measures to avoid conflicts of interest, and we continue to pursue industry and market-wide initiatives.

In each area, we've made good progress. Still, I believe more can and should be done. We wholeheartedly support legislative and regulatory reform efforts that will reinforce high quality ratings and enhance accountability without intruding into the objectivity and independence of rating opinion content.

At Moody's, 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 ratings performance metrics.

Thank you. I'm happy to respond to any questions.

CHAIRMAN ANGELIDES: Thank you very much. All right. We'll begin with the questioning. So, and I will, as custom, start and move to the Vice-Chair and then the members who led this research and investigation effort into credit rating agencies.

Let me start by saying the two issues I'd like to probe with you gentlemen today are really the following:

First of all, business and management practices, corporate responsibility, management accountability, for starters.

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Second issue I'd like to look at and talk with you about is the model for credit rating agencies in the financial market. So, Mr. McDaniel, let me start with you today, and let me ask you very directly.

And by the way, the reason I want to say that these issues of corporate governance, leadership accountability are important is, in trying to assess how we had this run-up to the financial crisis, we have found over the course of months that there's very little -- there's a lot of finger-pointing away, very little self-examination. So let me start with you.

Under your leadership, there were, in the end, for whatever reasons, very significant failures of Moody's. The product that your company offered, which are ratings for the benefit of investors, proved to be highly defective, and not just by small measure but by a large amount. 83 percent of your AAA-rated securities in the RMBS area in 2006 were downgraded. In 2007, 89 percent of those which were investment-grade rated were downgraded to junk. And massive downgrades, I ought to note, started in July '07, when housing prices had declined just four percent from the peak.

Some have said that the very enterprise was fraudulent, if not in a legal sense, but in a practical sense, because the products did not closely approximate what they were represented to be. If we'd flipped a coin with respect to your 2007 ratings, it would have been five times more accurate in terms of the result.

Your shareholders have lost 73 percent of the value in the stock from the peak to today. The ratings enabled the issuance of trillions of dollars of mortgage securities which we now know were rife with significant problems from fraud to misrepresentation that may have well fueled the housing bubbles. Investors who relied on the ratings suffered enormous losses and your company's reputation, something that I know that Mr. Buffett has held important, reputation within business, is certainly under significant criticism.

My question for you is really, who should be held accountable? We have a system of capitalism in this country where we have regulatory mechanisms; we have owners, boards, and management. Who should be accountable if not you?

MR. McDANIEL: The performance of the housing sector and as a result of ratings that are associated with housing assets clearly have exhibited very poor performance in recent years. There was decades of strong performance leading up to the current crisis. We believed that our ratings were our best opinion at the time that we assigned them. As we obtained new information and were able to update our judgments based on the new information and the trends we were seeing in the housing market, we made what I think are appropriate changes to our ratings.

So I am deeply disappointed, as I said in my opening remarks, with the performance of ratings associated with the housing sector. And that is injurious to the reputation of the firm and to the long-term value of the firm. And so the regret is genuine and deep with respect to our ratings in the housing sector.

CHAIRMAN ANGELIDES: But let me probe this a little further. Just as -- and look, I've been certainly wrong as much as I'm right. I know it's hard to predict peaks and valleys. Let me just say, there's almost a common-sense test here.

Your firm rated 42,000 tranches of RMBS AAA from about 2000-2007 in a context where there's four corporations in the country -- used to be a few more -- that were rated AAA. In that context you were rating about 90 percent of these securities as AAA when, in terms of the corporate debt world, where you actually have more transparency, you can get in, look at all the public filings, understand the corporate debt, only about 1.4 percent of that was rated AAA. You led an enterprise for which you were compensated pretty handsomely, $39 million over this period.

I guess what I'm getting to, is, if American capitalism is about risk and reward, rewarding success, rewarding failure, should there have been a management change at Moody's? Don't we need to have a culture in which success and failure are essentially accounted for in our capitalist system?

MR. McDANIEL: As I remarked a moment ago, we certainly believed that our ratings were appropriate when they were assigned. And I recognize that those ratings have not performed well in the housing-related sector. And as a result, we did make management changes. If you are --

CHAIRMAN ANGELIDES: But not at the top. No board or CEO changes or --

MR. McDANIEL: If you're asking with respect to me, which I can see you are, it's a fair question. And if we reach a point where either our shareholders or our board of directors or I don't believe I am best positioned to lead the firm through this period and into the future, then I will not be in my job.

CHAIRMAN ANGELIDES: Okay. Mr. Buffett, any observations on the responses by Mr. McDaniel?

MR. BUFFETT: Well, I probably have been more draconian than you have in my view about the CEO’s responsibility and--

CHAIRMAN ANGELIDES: I just haven't been as widely quoted.

MR. BUFFETT: Well, in terms of financial institutions that have failed and required assistance by the federal government, I think that when society has to step in to save institutions for

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societal reasons, that the CEO should basically go away broke, and I think his spouse should go away broke. I think there should be a real downside, and I think incentives are an important aspect in behavior.

In the end, I don't know who, except for maybe John Paulsen or Michael Murray, would have been running Moody's and coming up with different kinds of ratings. This was the greatest bubble I've ever seen in my life, and I've read about bubbles all the way back to the tulip bubble. The entire American public eventually, was caught up in a belief that housing prices could not fall dramatically. And Freddie Mac believed it, Fannie Mae believed it, Congress believed it, the media believed it, I believed it.

If I'd seen what was coming, would I have held my Moody's stock in the 60s or something of the sort? Very, very few people could appreciate the bubble, and that's the nature of bubbles, they become mass delusions of sorts.

So I am much more inclined to come down hard on the CEOs of institutions that cause the United States’ government to come in and necessarily bolster them than I am on somebody's that made a mistake that three hundred other Americans made.

CHAIRMAN ANGELIDES: Well, let me probe that a little. Because, you know, I just want to say for the record, I do think around the country, there were people who thought the bubble was unsustainable. I don't think there was a secret here. There were a number of experts, whether it was Robert Schiller or Mr. Rubini or Mr. Baker, Dean Baker, there were a number of people who saw this bubble. We had this unprecedented rise, 89 percent in home price appreciation in seven years, something we had never seen historically.

But moving beyond that for a minute, the rating agencies did play a fundamental role in accelerating essentially the securitization, therefore, some would argue, the origination of products that tended to be highly deficient. We're talking about low teaser rates, negative amortization.

There was a warning in 2004 from the FBI that mortgage fraud had become so epidemic that, if unchecked, it would result in a crisis as big as the S&L crisis.

I mean, there were many red and yellow flashing lights along the way. There is a country song by Don McLean where he says, "When the gates are all down and the signals are flashing and the whistles are screaming in vain, and you stay on the tracks, avoiding the facts, you can't blame the wreck on the train."

Wasn't the role of the rating agencies, though, to be referees in a game that got out of control? You told our staff that, well, gee, if they had not done the ratings, they would have been howled at by Congress. But don't we expect referees to make the call even if

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they are going to get booed?

MR. BUFFETT: Yes, and they made the wrong call. They basically believed, as most of the American public did, and you couldn't have had this size bubble without over overwhelming -- and the Cassandras were there, but who was goes to listen to John Paulsen in 2005 or 2006, or Michael Murray? I mean, they -- it didn't mean anything.

And look at me. I mean, I was wrong on it, too. I recognized that something pretty dramatic was going on in housing but I actually called it in the annual meeting, when I got a question on it, a "bubblette." Well, that was a terrible term, because it was a four-star bubble. And the rating agencies missed it, and, you know, as I say, you could look at the March 30th, 2007 report to Congress by OFHEO, which had two hundred people overseeing Freddie and Fannie, and they basically gave them a green light on asset quality.

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CHAIRMAN ANGELIDES: Well, I actually think, I take a different few, if you look at OFHEO's reports, which we've had access to, they raised a number of issues.

But moving on from that, you said the ratings business was a wonderful business. You said that, as a matter of fact, because it's a duopoly, little capital required, enormous pricing power, turned out to be good for a short time, not necessarily, I think, the model that works best for the marketplace.

But I want to return to this matter of corporate governance and accountability.

You are the largest shareholder, and I realize by all accounts, you were not a particular -- in fact, you described it as, "not particularly active would probably be too aggressive." You had very infrequent contact, I think only twice with Mr. McDaniel, and maybe a little with Mr. Rutherford during the years he would come to visit you.

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But I want to probe the responsibility of shareholders. This was a company where 50.5 percent of the shares I think are held by five large owners. You had this tremendous spike in revenues coming from structured products. We've heard today from, and in the course of our interviews, a lot of concerns about the change in culture at Moody's, the pressure for profits, sacrificing ratings quality.

I guess I would ask, what do you think are the appropriate roles of shareholders and boards of directors in monitoring companies? What responsibility to kind of look into the culture problems that are arising, and did the board and the shareholders do what they should have done in this respect?

MR. BUFFETT: Yes, I -- in 2006, I was not sitting there thinking that the housing bubble was going to get as large as it did, or as it was, actually, and that it was going to burst. And like I say, if I had, I probably would have sold my stock.

CHAIRMAN ANGELIDES: So I want to keep at this a little. I mean, given the dramatic consequences that have happened here, and I do think there has been reputational damage. I think you once famously said, "It takes twenty years to build a reputation, five minutes to ruin it. If you actually think about that," something like, "You'll do things differently."

I guess the question is, in the end here, the ratings were wrong. There are reputational issues. There's been a massive loss of shareholder value and the whole business model has come apart. I mean, should there be a new board, should there be new management after this kind of change?

MR. BUFFETT: I would say that in this particular case, I think they made a mistake that virtually everybody in the country made. And going back to that OFHEO report, March 30th of 2007, it was reported the enterprise's overall asset quality is strong. That was March of 2007, and all they owned was mortgages.

CHAIRMAN ANGELIDES: Well, I will just say, arguing with you about what the markets were saying, I mean, this was not a big secret. This is The Economist after the fall shows housing prices falling like a brick. There were a lot of warnings. Even Moodys.com, Mr. Zandi is a very capable man.

So I guess you're saying the magnitude of the mistakes doesn't in the end warrant change the management, relook at the culture of the corporations?

MR. BUFFETT: It's not necessary, and incidentally, I don't think The Economist wrote an article called "Before the Fall."

CHAIRMAN ANGELIDES: This was 2005. All right. Let me move on and ask this one last question of you, Mr. Buffett, and then back to both of you very quickly.

We interviewed a member of the Moody's board, Nancy Newcomb, who indicated the board wasn't particularly involved, and didn't discuss significant issues like the ratings process. There was a recent press account, I think in the McClatchy newspapers, about the disengaged nature of the board, but also said that two senior executives approached you with significant problems at the company?

MR. BUFFETT: No.

CHAIRMAN ANGELIDES: No?

MR. BUFFETT: No.

CHAIRMAN ANGELIDES: Okay, so not accurate.

MR. BUFFETT: No.

CHAIRMAN ANGELIDES: Okay, thank you. I want to talk to both of you about the model for credit rating agencies in the context of this marketplace. It seems to me there are, you know, the worst of many worlds here. You have an issuer-pay model by its nature that creates pressure to produce credit ratings that serve the interest of the issuer, not the beneficiary of those. In fact, Charlie Munger has said, I think, as you know, "Whose bread I eat, his song I sing." I've seen him say that a number of times.

You have a duopoly with enormous pricing power. And in the end, you have also, business has had a whole set of legal protections, including First Amendment protections.

It seems to me like a pretty toxic brew of corporate non-responsibility here. Do you think radical surgery is necessary? For example, Mr. Buffett, do you think we ought to outlaw the issuer-pay model, do you think we ought to adopt the Franken positions in the Senate bill that would say that rather than issuers selecting rating agencies, they should be selected by the SEC?

What kind of radical surgery might have, had it been performed early enough, might have helped in the sense that these rating agencies would not have enabled this flood of toxic mortgage securities?

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MR. BUFFETT: Well, as Chairman of Berkshire, I hate issuer pay. I mean, we pay a lot of money and we have no negotiating power.

CHAIRMAN ANGELIDES: As treasurer of the State of California, I deeply resented the model myself.

MR. BUFFETT: It makes for a wonderful economic model for the business but, as a practical matter, I have no negotiating power. I need a Moody's rating, I need a Standard & Poor’s rating. I need both of them. It's required in many cases by the rules under which our life insurance company operates or our property/casualty companies.

So if they say to me, "My bill is a billion dollars," and I say, "Gee, you know, I'd like it to be nine hundred thousand or I'll go down the street," essentially there is no "down the street." Now, that's the nature of it.

Now, if you go to something other than user pay, it gets very tricky because

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who am I, you know, if my daughter is going to buy a ten thousand dollar municipal bond, is she going to pay for a rating for somebody? No, she'll hear the rating someplace, or it will be published in some book and --

CHAIRMAN ANGELIDES: But UL does it. United Labs. That's a nonprofit model. So you don't have the profit pressure. Consumer Reports does it. Is this a broken model?

MR. BUFFETT: Well, if Consumer Reports would want to rate bonds and people would accept those ratings, I suppose it could happen. But it would require a pretty fair expenditure of money to rate thousands of municipalities and thousands of corporations, so I'm not arguing that this is the perfect model. I'm just saying it's very difficult to think of an alternative where the user pays. I'm not going to pay.

CHAIRMAN ANGELIDES: What about selection of raters by other than the

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issuers, for example, by a panel?

MR. BUFFETT: Well, in effect, you've got selection now by directive. And in effect, I am told by the Nebraska Insurance Department, you know, which raters I have to use in terms of establishing --

CHAIRMAN ANGELIDES: Well, what about that is a change? Might that have obviated some problems? Should it be done and might it have obviated some problems?

MR. BUFFETT: I don't know the answer to that. The wisdom of somebody picking out raters, you know, is that going to be perfect? I don't know.

MR. McDANIEL: Well, there are several alternative business models that rating agencies operate under. The largest rating agencies you were under an issuer-pays model, and I think it's important for us to acknowledge and recognize that any business model in which the fee payer has an interest in the outcome is a model that has potential conflicts of interest and that those conflicts must be managed transparently and properly.

CHAIRMAN ANGELIDES: But can they really -- you know, if Fannie Mae and Freddie Mac, since you raise OFHEO, here are institutions that had this push-pull. They had, you know, the mission but also the profit motive. The profit motive is pretty powerful, both on the issuer side and in terms of your business model. Can it really be overcome? I mean, it's nice to say -- it's like transparency. Everybody loves transparency. And then they also say, "We can handle our conflicts." Is it really resolvable? Because it doesn't appear to have been, based on this latest period.

MR. McDANIEL: Well, the poor performance of ratings from the 2006-2007 period in residential mortgage-backed securities and other related securities, housing-related securities, has not at all been replicated elsewhere in the business.

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So to the extent that there is a concern that we cannot have superior ratings quality, even in the midst of a severe economic downturn, I think is a misunderstanding. And as I said, because the parties that are willing to pay fees for ratings, whether it be issuers or investors or governments, have an interest in the outcome of those ratings, I don't see how to avoid potential conflicts of interest.

And we also, under the issuer-pays model, have an important public good that is produced, which is the ratings are made available to the general public for free.

There is no selective disclosure of the ratings. Large institutions do not have an advantage over smaller institutions or individuals in terms of the access to the ratings. And I think that's an important public benefit.

CHAIRMAN ANGELIDES: But I want to probe this because this goes to management. This structured products

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division was a cash cow. I mean, this is a classic case of, if it's growing like a weed, maybe it's a weed. You went from about a hundred some million dollars in revenue this section to 700 million, and there are questions about whether you staffed up enough to do it. It became 53 percent of your revenues. I mean, it became a huge part of your business, so to say, "We did fine, we just missed here," I mean, the miss was huge. I mean, 90 percent downgrade. I mean, even the dumbest kid in the class gets ten percent on the exam. It seems to me that the resources were not applied to understand these products.

I happen to come from the real estate business. I asked your folks earlier today, did you actually have due diligence teams that went to the ground to places like Riverside or Bakersfield or Sacramento where I'm from, and take a look at the borrowers, the nature of the home markets. It doesn't seem to me you built in the capacity from a management

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standpoint to really do structured products well.

I mean, this was a huge new industry that yes, brought in revenue but it doesn't seem to me from a pure management perspective -- and you miss my point, Mr. Buffett, it wasn't just a mistake -- that the resources to understand this were put in place.

We've spent countless hours here trying to understand the modeling and the truth is, if you look at the modeling, data was put in that was relatively, frankly, incomplete, inadequate. There was a lot of human judgments but there wasn't a lot of ground-level due diligence; in fact, none other than visits to originators.

So isn't that a significant management failure, to not have built in the capacity? Might you have missed this less had you been truly on top of this in terms of understanding the products?

MR. McDANIEL: I think that we

certainly believed we were on top of this and we believed that the information that was being made available was adequate. There are other parties in the marketplace who have other roles and responsibilities with respect to valuation of properties and review of mortgage applications. So we are analysts. We consume that information.

We believe our role is to look at the information and look at the data and process that as part of our rating committee analytical process, not to replicate or duplicate roles that others in the market --

CHAIRMAN ANGELIDES: Which they didn't do.

MR. McDANIEL: It would appear that in some cases they did not.

CHAIRMAN ANGELIDES: They didn't, they didn't have fraud protection. Underwriting standards went to hell in hand basket.

Mr. Buffett, any observations on

whether this was just a pure modeling mistake or whether in fact it was also a lack of attention in terms of the depth of due diligence? I mean -- can I say something? You're a big advocate, let me just -- you're a big advocate, "Do your own due diligence."

MR. BUFFETT: Absolutely.

CHAIRMAN ANGELIDES: So here you have an entity that's a surrogate due diligence provider in a sense, and, you know, even whether people fully rely, having looked at real estate investments, you can ask a third party. But if you're going to outsource due diligence, you would hope your due diligence entity would be doing due diligence. Shouldn't rating agencies, shouldn't they have done actual ground-level due diligence, sipping those blizzards at a Dairy Queen, rather than just looking at the revenues?

MR. BUFFETT: Looking back, they should have recognized. But like I say, I didn't recognize it, and most everybody I

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know didn't recognize it. They should have recognized that this was a huge bubble. And as I understand it, they had something in the model, and I may be wrong on this, that there wouldn't be a correlation throughout the country of the same experience. And it's true that in the past, you'd have housing booms someplace that have been sort of localized; but this was a nationwide bubble, and diversification among states didn't really make that much difference. It was worse to be Nevada and Arizona and Florida, but it happened everyplace.

CHAIRMAN ANGELIDES: '91 to '93, we had actual national two percent decline in house prices because of the big drops in places, and you know there is that old line, you know, one rotten apple can spoil the bunch. And this was an instance where half the apples may have been rotten. I mean, the correlation assumptions I think were not very well defined or thought out.

All right, I've asked you plenty for

right now. Let's move on to the Vice-Chairman. Thank you very much.

VICE-CHAIRMAN THOMAS: Thank you, Mr. Chairman. Now, Mr. Buffett, notwithstanding the subpoena, I want to thank you for coming.

MR. BUFFETT: I want to thank you for the subpoena.

CHAIRMAN ANGELIDES: I wanted you to have a framed copy for your wall.

MR. BUFFETT: It's already up.

VICE-CHAIRMAN THOMAS: I think it was good cover, because then you can tell others that you don't want to go to, "If you've got the power, use it."

MR. BUFFETT: I admire that sort of instruction.

VICE-CHAIRMAN THOMAS: I also don't have anything for you to sign. But when I was younger, when Monday Night Football began, Don Meredith and Howard Cosell were the team and Don Meredith would launch in at least once a game with the, "If 'ifs' and 'buts' were candy and nuts, we would all have a merry Christmas." And at this point, I'm not interested in going after the 'ifs' and 'buts' because there were plenty to go around. I am a very strong supporter and have tried to maintain the argument that behavior has consequences.

You can do it when your ability to threaten someone with something, either as an incentive or as a negative, can influence that behavior. But I am very concerned about the amounts of money that were generated in a structure that provided those short-term opportunities, and no long-term downside, and apparently no moral angst over having done it. And there is to a degree, I think, an argument that this is basically, you know, somebody's idea of unfettered capitalism to a very great extent.

You've made comments in that regard. How concerned are you that we're able to get this genie back in the bottle to the point that if behavior has consequences, you want to claw back monies that they have? I don't see anybody being able to put that structure in place. How do you feel?

MR. BUFFETT: I think it can be put in place but it requires a whole new level of thinking. But I think you're absolutely right. That incentives affect behavior and when you run a huge financial institution whose stability or instability can affect the entire society, I think there ought to be a tremendous downside. It's fine if there's a tremendous upside, too. I don't have a problem with that.

But I think that for somebody's -- if somebody's personal equation as CEO of some large financial institution is that if they ruin the place, they walk away with a hundred million instead of five hundred million, and if they succeed, maybe they get a billion, I think that is a crazy structure. And I think that boards of directors should not sign on to such a structure, and I think that the boards themselves should bear heavy penalties when an institution has to go to the federal government, and I think that that should not be insurable.

So it wouldn't be as Draconian as I have with the CEO, but I would want to focus the attention of somebody running a huge financial institution on the fact that their mistakes could cause big problems for the society.

VICE-CHAIRMAN THOMAS: Thank you. I thought I got out of the business. I did 32 years and I didn't think I was going to be back on this side of the desk asking questions of witnesses again. But I said yes to this because of the way this Commission has been structured. It's basically my belief that it's just pure public service. I thought it was wise of the Congress to structure us not to look for answers to those 'ifs' and 'buts' in terms of projecting forward what we ought to do, because frankly, Congress is trying to address those, and I'll have a question on that in a moment. But our job is just basically to try to explain the financial crisis and do it as accurately as we're able with the resources that we have.

So one of the reasons I was pleased to have, notwithstanding the subpoena, the coincidence of you being in New York and our desire to be in New York to have you in front of us, so that I would hope that the answer that you would give me to your question isn't the one that virtually everyone else has given, because it's not unlike the behavior and the consequences. The answer is, "somebody else."

And given your reputation, but frankly, reputations are only as good as your balance sheet, you've got a really good reputation in terms --

MR. BUFFETT: I'll settle for that definition.

VICE-CHAIRMAN THOMAS: -- in terms of understanding how things work. In your estimation, I don't want to drag us through this business of woulda, coulda, shoulda, ifs and buts. We have

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legislation moving through the House and Senate that hasn't gone to conference yet and isn't locked up, and I have kind of preached to anyone who wants to hear that committees have such narrow jurisdiction that you're not going to be able to solve the fundamental problems, whatever they are, as we examine them, with a single bill that's principally gone through two committees that have roughly the same jurisdiction. You're just not going to hit it.

So what I would like you to do, and I would ask both of you that if the Commission provides you questions in writing, would you be willing to answer them, because we do not have the ability in the time we have to get to what we need to do. Mr. Buffett, would you be willing to do that?

MR. BUFFETT: Sure, I would be willing to do that. And incidentally, I did have a very good session with your staff that was recorded for two hours and --

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VICE-CHAIRMAN THOMAS: And we have that and we read it.

MR. BUFFETT: I really think they did a good job of asking both good questions and good follow-up questions. So I would hope some of the material might be in that record.

VICE-CHAIRMAN THOMAS: And we're reviewing it to make sure it is.

MR. McDANIEL: Yes, we would do so also.

VICE-CHAIRMAN THOMAS: What do you think the House and the Senate has gotten mostly right in the legislation that's moving through Congress, and where, if there are obvious misses? I don't think we need to deal with subtleties now. It might be in some follow-up written questions.

MR. BUFFETT: I haven't read the 1,500-page bill --

VICE-CHAIRMAN THOMAS: No one has, including some of the cosponsors of that. That's a denial that's okay.

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MR. BUFFETT: Okay. But I've got two thoughts basically. I think I would address if I were -- one is this question of incentives. I mean, I think it is very important -- I think it's -- I think no one has any business running a huge financial institution unless they regard themselves as the chief risk officer. They are responsible for the ship. And if they aren't, they should be willing to take that on or somebody else should be in that position. So I think there has to be huge downside for the CEO and significant downside for the board if government help is required.

The second thing I think is that part of any huge bubble is excessive leverage. And it's very hard to define leverage, because you're going to have some institution that's ten for one and their assets are all treasury bills and it doesn't make any difference, and you can have somebody that's three for one and it can be all second mortgages and you've got lots of trouble, so it's not easy to define.

But the size of the pop of the bubble was accentuated in an enormous way because of the leverage that existed in the system and some of it was hidden, you know, off-balance-sheet type things. And -- but I would -- those would be two points I would try very hard to address intelligently.

VICE-CHAIRMAN THOMAS: Thank you. Mr. Chairman, did you want to ask a question?

CHAIRMAN ANGELIDES: Yes, just one on the kind of incentives, upside and downside, and I do want to just return, because you've talked about financial institutions.

But the very structure, again, of credit rating agencies, it does seem in the end, there's lots of upside, you know, as a structured product business group, very little downside. Legal protections -- and by the way, I think there's a fine distinction between financial institutions that receive federal money --

MR. BUFFETT: I do, too.

CHAIRMAN ANGELIDES: -- and, I might add, a credit rating agency that's a full participant in the system that got us there.

So wasn't this system tilted in terms of lots of upside and no downside?

MR. BUFFETT: I think much of corporate America is tilted that way.

CHAIRMAN ANGELIDES: But you'd say that applies to credit rating agencies -- I know you're an owner, but come on.

MR. BUFFETT: We've seen significant downside. I mean, there's no question that the mistakes that were made at Moody's and Standard & Poor’s are have affected both Moody's stock and McGraw-Hill stock in a big way.

VICE-CHAIRMAN THOMAS: I have no right to ask you this, but just as the rating agencies produced whatever a

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AAA was, and then investment banks and others were able to take the leftovers, restructure them and turn them into more AAAs rated by an agency, you really need to speak out even more than you have about fundamentals. There are aren't very many people who can command the respect, and I know you were really busy out there on a chair in front of a number of different channels. But you've got to do more of this. This may be your real legacy.

MR. BUFFETT: Well, I've spoken out on some things, but I don't disagree with you that perhaps no one spoke out enough, you know, in the past years, during the bubble. But certainly, I could have done more. My partner, Charlie Mungers, makes up for me. He speaks very loudly. But I agree with you, Mr. Thomas.

VICE-CHAIRMAN THOMAS: Because once Congress acts, the ability, as you well know, to act again, to move into areas they weren't able to initially, political becomes virtually impossible. You only try to clean up the area that you moved with first.

This isn't nearly as comprehensive as it needs to be. It may even need to move to tort and other areas. So I'm going to turn my time over to others who might want to quiz you from a very particular point of view. Mine is simple.

Capitalism has changed in your lifetime. And my concern is that in those who are watching, it gets better. Which means responsibility, moral obligation, and behavior has consequences. Thank you.

MR. BUFFETT: Thank you.

CHAIRMAN ANGELIDES: All right, thank you very much, Mr. Thomas. We're now going to move to Senator Graham and yes, wheel the chart.

COMMISSIONER GRAHAM: Thank you very much, Mr. Chairman.

CHAIRMAN ANGELIDES: Microphone?

COMMISSIONER GRAHAM: Thank you very much, Mr. Buffett and Mr. McDaniel for your insightful comments.

Mr. McDaniel, you said that Moody's

had incorporated the research into its rating process.

The chart that's about to be placed --

CHAIRMAN ANGELIDES: Can we please place it where we placed it before, Karen, so we do not obscure Commissioners? And if you have to move the chairs, move the chairs. Stop the clock. Even though we should charge the Senator for this.

(A pause in the proceedings.)

CHAIRMAN ANGELIDES: All right, move on.

COMMISSIONER GRAHAM: This chart indicates the mountain of RMBS securities that were rated by Moody's as the blue, and the red are the CDOs and then in yellow boxes are some important events.

The first of the yellow boxes is in October of 2006 when, for instance, on the CDO line, it was something south of ten billion dollars issued. When Moody's Research Service issued a report, the first paragraph, the executive summary saying, "The U.S. housing market downturn is in full swing; new and existing home sales and single-family housing construction are sliding, inventories of unsold homes are surging to new record highs, house prices are falling in an increasing number of areas," and the word "crash" is used to describe the situation, in areas of the country which represented about half of the outstanding mortgages.

How was that information incorporated into the subsequent rating processes of Moody's?

MR. McDANIEL: The Moody's analysts and Moody's rating committees have information from other parts of Moody's as well as information from other firms, and governmental services available to include in their rating committee deliberations and their analysis. So, and they do use multiple sources of information, including a source from Moodyseconomy.com.

COMMISSIONER GRAHAM: Recognizing

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that this internal document, as well as external information is available, the question is how, in October of 2006, was this incorporated into the rating process?

MR. McDANIEL: I don't know exactly how it was used in the rating committees.

COMMISSIONER GRAHAM: The concern is that, immediately after that dire prediction was issued, the number of CDOs went from $10 billion a month to over $40 billion a month in less than ninety days. It doesn't seem as if the announcement of severe problems correlated with the actions that were taken.

MR. McDANIEL: I believe that the rating committees would include any information that they believe relevant in their deliberations.

COMMISSIONER GRAHAM: Could you, as a follow-up, give us some more specific information as to what did in fact happen in terms of incorporating this research into the rating process in October of 2006?

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MR. McDANIEL: Yes.

CHAIRMAN ANGELIDES: On my time, could I just amplify that? Because this came from obviously, Moody's.com, Mr. Zandi and his team, very well respected.

Could you, as part of that, actually do a chronology of what management did very specifically, how folks reacted to that report, because it's pretty dramatic. It uses the words, "The market is going to crash in 20 metropolitan areas."

So if you could give a very specific timeline about who did what when, from the top levels on down.

MR. McDANIEL: I will do that, and I should just add that I believe at this time, even with the analysis that Moodyseconomy.com was producing, their expectations were far more moderate in terms of what was going to happen in the housing market than what in fact has eventuated. So I just want to make sure that there's no misunderstanding in the degree of downturn that they were expecting at that time compared to what we've seen.

COMMISSIONER GRAHAM: One of my concerns which is not peculiar to the financial industry or to rating agencies but seems to be endemic across our culture, is the avoidance of warning signs until the situation degenerates into a catastrophe; whether it's the failure to see the consequences of new technologies in deep water petroleum extraction but not changing safety and response capabilities, or some of the signs that have led to the, now, the financial collapse.

The first panel made up of people who all had experience at Moody's gave a number of reasons why these warning signals were not acted upon. Those included the desire to increase market share, the lack of ability to walk away from a deal, the lack of human resources to keep pace with the rapid increase in the number of CDOs that were being

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evaluated, the lack of adequate independent research capabilities, the fact that the banks were misleading the rating agencies, manipulating the process. Those were some of the items that were listed.

Do you concur with that list and are there other items that you would add to the list of why were the warning signs missed?

MR. McDANIEL: There were some things that I would concur with, and other things that I would not. And to highlight two that I think are important, first of all, we agree that having a robust, independent research and credit policy function is important, and we have made changes in both the number of individuals and the independence of the credit policy function over the past three years.

COMMISSIONER GRAHAM: Excuse me, could I ask, one other issue was the fact that the committees that were doing the rating seemed to be devoid of people either from the real estate industry or from the banking industry, and therefore had little personal capacity to evaluate what was happening in those areas.

Have you taken some steps to broaden the pool of background on the rating committees?

MR. McDANIEL: That, again, in the category of lessons learned, greater cross-disciplinary expertise in rating committees, I think, is important, and we have made important strides in accomplishing that. And I think we've made very good progress.

COMMISSIONER GRAHAM: Could you give us some information on that subject, that we asked the first panel for, what was the status of those rating committees during the period of '05 forward.

MR. McDANIEL: Yes. With respect to being unwilling for walk away from a deal, I believe was one of the comments that you had related, I simply disagree with that.

We did not rate hundreds, probably

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thousands of residential mortgage-backed securities tranches, particularly the junior securities. Even though we looked at them, our opinions were not such that the issuers wished to have those opinions, and we did not rate those.

We have sat out entire market sectors for credit reasons where we have credit concerns. And that is because the ratings quality is paramount. We don't always get it right. Predicting the future is an uncertain process. But I think that -- I think that there has been a misunderstanding of our willingness to stay out of markets where our credit opinions are more conservative or we have credit concerns.

COMMISSIONER GRAHAM: What about this issue of misleading or manipulative activities by banks?

MR. McDANIEL: Well, certainly, if we're aware of anything that is misleading or manipulative, we would not use that information nor pursue rating a

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transaction with an institution that's providing that.

COMMISSIONER GRAHAM: Well, the testimony that we had was that the banks would not disclose information which was requested and the analysts didn't feel that they could push back against the banks to make that a requirement of their issuing the rating.

MR. McDANIEL: Our methodologies are, I believe, clear in terms of the information that we need to rate an instrument. And I believe that we pursued that information consistent with our methodologies. There may be additional information that would be interesting to review which may or may not have an influence on our thinking on credit.

But certainly, we would look to have all of the information that is consistent with our methodological approach.

COMMISSIONER GRAHAM: Mr. Buffett, this is a broader question. But I know you have an excellent reputation of being the risk manager for your firm and that you feel, as you've said today, that you feel that's a principal responsibility of the CEO.

Why do you think that, as a society, we seem to have missed so many signals across a range of areas?

MR. BUFFETT: Well, rising prices and discredited Cassandras from the past blunt sensitivities and judgment, even of people who are very smart. I mean, initially, my old boss, Ben Graham, used to say, "You get in much more trouble in investments with a sound premise than a bad premise, because the bad premise you recognize immediately doesn't make any sense."

When you have a sound premise, namely, the Internet is going to be very important and eyeballs are going to be important and all of that, initially, it makes a lot of sense. After a while, the rising prices of all internet stocks caused people to be able to raise billions of dollars for things that are nonsensical.

A home is a sound investment. I mean, 66 or 67 percent of the people are going to want to be in one. And if you believe house prices are going to go up next year, you're going to stretch to buy one this year, and the world enabled people to stretch.

After a while, rising prices became their own rationale and people decided, if buying one house was a good idea, buying three houses was a good idea. If buying a house you can afford is a good idea, buying a house you can't afford is a good idea because it's going to go up in price.

And people who lent money said, "It doesn't really make any difference whether the guy is lying about his income, because in the house goes up in price, we'll get our money back anyway."

So rising prices are a narcotic that affect the reasoning power up and down the line, of people, even, that should have had the experience.

Isaac Newton participated in the South Sea Bubble originally, got out, and then he couldn't stand prices going up any longer, so he went back in and got cleaned, you know. And this is a fellow that generally was regarded as being pretty bright. So it, rising prices are, eventually, we had it in farmland in the Midwest and it was a worse recession for us than this housing recession, because people just felt, they are not making any more farmland, there are going to be more people, they're going to eat more, farmland's going to get more productive, and the rising prices eventually created their own -- their own destruction.

CHAIRMAN ANGELIDES: On my time, just quickly, okay, it's a narcotic, but don't we expect that regulators, credit rating agencies, not partake of the narcotic? Isn't that their role?

MR. BUFFETT: Well, you would hope so, but it's not easy to avoid.

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CHAIRMAN ANGELIDES: Well, still, you don't want your police trading in crack. You want them stepping back.

MR. BUFFETT: Yeah, and we had Chairman Greenspan talk about irrational exuberance in 1996. But with all -- with the power of his podium and everything else, we had a great internet boom after that that was --

CHAIRMAN ANGELIDES: That was the nature of my questions about who's responsible; regulators, shareholders, boards, management? Someone must be. I'll turn it back to the Senator.

COMMISSIONER GRAHAM: I want to ask a different question, Mr. McDaniel.

During this period of the last five years, how frequently did representatives of various regulators, from financial institution regulators to the SEC, visit Moody's to talk about your rating methodology and to inform themselves as to what it was that you were doing? They are the ones who have imposed regulations requiring the use of your rating services. How close a supervision or at least monitoring of activities did they maintain?

MR. McDANIEL: Pursuant to the Credit Rating Agency Reform Act of 2006, which became effective in, I believe it was September of 2007, there's been multiple inspections and reviews of our rating processes and practices by the Securities and Exchange Commission.

Prior to that period, the oversight was less intensive because there was not a regulatory framework that the SEC was operating under for an inspection and review regime.

COMMISSIONER GRAHAM: Prior to that legislation, are you saying they did not seem to think that they had some responsibility, having mandated or given strong incentives to use the rating agencies' products as part of the management of regulated activities, that they had some responsibility to be aware of what that rating constituted and how it was being assumed?

MR. McDANIEL: I can't speak for the Commission. But I believe that the regulatory oversight opportunities were more limited prior to the legislation passing, and so they were not as extensive in their oversight of Moody's or the industry.

COMMISSIONER GRAHAM: Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you very much, Senator Graham. Mr. Wallison?

COMMISSIONER WALLISON: Thank you, Mr. Chairman, and thank you both for coming here, even when under compulsory process, but voluntarily still. Thank you.

Let me start with you, Mr. McDaniel. You were here this morning for the earlier panel?

MR. McDANIEL: I heard most of the earlier panel, not all of it.

COMMISSIONER WALLISON: I just was

wondering whether you heard anything about your company that was a surprise to you, or you did not know.

MR. McDANIEL: The issues that were raised by some of the individuals who were more critical of the company, I have heard before. And in fact, we have investigated those issues previously, including through use of an external law firm, and found the concerns that were raised to be without merit.

COMMISSIONER WALLISON: Well, there was this question I thought of enhanced, what you, I think, referred to when you were talking about enhanced analytical integrity. I think you were getting at the point that there were pressures, perhaps, on the talent that you had, the analytical talent, to produce ratings.

Is that what you meant by "enhanced analytical integrity?" And what did you do to prevent that from happening?

MR. McDANIEL: In the context of my prepared remarks, with respect to enhanced

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analytical integrity, I was referring to some of the actions that we have taken since 2007 to separate, for example, our credit policy function from the line-of-business ratings analysts; to have more cross-disciplinary participation in the rating committee process; and to create further separation of any person who is involved in commercial activities for the firm from people who are involved in analytical --

COMMISSIONER WALLISON: Well, let's talk specifically about this one issue, and that is, are analysts now permitted to talk to issuers or the representatives of issuers? Is that still permitted?

MR. McDANIEL: Yes, analyst do speak to issuers.

COMMISSIONER WALLISON: And you are not concerned that there are pressures brought on them as academics, or people who are academically inclined, by people who are much more ambitious and forceful? You don't see that as a problem?

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MR. McDANIEL: I think the communication between an issuer of securities and an analyst of those securities is important and should continue. The analyst may have questions about financial information or management strategy at the issuer, the issuer's future plans with respect to its capital structure, et cetera.

So I do think those communications, for purposes of creating most predictive credit ratings we can produce, are useful.

COMMISSIONER WALLISON: Is there a manager who oversees the analysts and can be available for discussion of these issues?

MR. McDANIEL: There are managers who oversee our analysts, yes, and they would be available.

COMMISSIONER WALLISON: Let me ask you one final question, a very general one. And that is, what is your view of what caused the financial crisis?

MR. McDANIEL: In terms of direct causes, certainly the weakening of the housing market, the softening of that market. And then importantly, the very rapid tightening of credit for mortgage borrowers who needed to refinance, in particular, greatly exacerbated the issue; that the sudden tightening of credit in the midst of a softening housing market I think produced the kind of large and rapid problem that we saw.

COMMISSIONER WALLISON: So it's principally a problem of people not being able to finance, refinance, which caused failures?

MR. McDANIEL: I think that was an important contributor. It acted as a catalyst.

COMMISSIONER WALLISON: Mr. Buffett, we've had housing bubbles before, quite a few, and other kinds of asset bubbles before, most recently an oil price asset bubble.

This one was really quite special. I want to press you a little bit on this, because I'd like to get your sense of why

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this one was special.

Why did it get so large? Why did someone with your astute knowledge about the economy not see that this was an extraordinarily different bubble from one we've had before?

MR. BUFFETT: Well, I wish I could give you a good answer to that. It was really the granddaddy of all bubbles and it affected an asset class of 22 trillion. I mean, it hit everybody. And Mr. McDaniel mentioned people refinancing. I mean, they were betting on the fact that the following year, if they couldn't make the payments, they could refinance. And of course, the figures show that by the hundreds and hundreds of billions, that happened.

But when it gathers momentum, you know, the internet bubble went further than I would have thought it would have. We did have that farm bubble in Nebraska where, you know, things went crazy for a while, and the early Cassandras do look kind of foolish as they go along. And when your next-door neighbor is making money, you know, very easy, buying a second house, you know, with very small down payment, after a while it sort of gets to you and maybe you figure you should be doing it, too.

It's been the history of bubbles. I never understood why tulips were worth what they were, back in --

COMMISSIONER WALLISON: But for you in particular, and you've had many years to watch our economy, and to economists in general, sharply rising prices are a signal that something is peculiarly going on in the economy. You saw the prices rising very quickly but you still didn't think that this was something that could eventually collapse?

MR. BUFFETT: I didn't think it would pop like it did, no. Interestingly enough, in 2005 and '06, and I believe I've got the time period right, I got offered businesses for sale periodically. A

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significant percentage of the publicly-traded home builders one way or another let it be known that they would like to sell out to Berkshire Hathaway, and looking back, I should have figured out what I didn't figure out.

COMMISSIONER WALLISON: Were they asking more than once?

MR. BUFFETT: It's interesting, I never heard from them in many decades in business, and all of a sudden, three or four of them showed up on the doorstep.

COMMISSIONER WALLISON: You were once an owner of Freddie Mac.

MR. BUFFETT: Right.

COMMISSIONER WALLISON: So you are familiar with how Fannie Mae and Freddie Mac operate. Do you see their activities as having any role in the growth of this bubble?

MR. BUFFETT: Well, I think they were doing what they were instructed by Congress to do to a great degree, but I -- they took on weaker forms of mortgages in greater amounts. I mean, that's been covered in some of the reports. And so they -- and they also bought, you know, they would require twenty percent down payment but then they would buy mortgage insurance from other entities.

And I've looked at the profiles of some of those loans, and material I got from the mortgage guarantee organizations. And frequently, the significant percentage of the time, more than fifty percent of the income of the borrower was going to mortgage payments.

That's not sustainable. And -- but whereas they are laying that off with the mortgage guarantee insurance company, they were still in effect helping people participate in something that was really, unless housing prices kept going up, was going to lead to big trouble.

COMMISSIONER WALLISON: Why did you sell your Freddie Mac stock?

MR. BUFFETT: I sold it for several reasons, but I think we were the largest shareholders of Freddie Mac. And at one point, it became apparent they were getting more and more entranced by trying to report increased earnings every quarter. And any financial institution that tries to do that, in my view, is going to get in trouble sooner or later. And they became quite interested in that particular, having that happen.

They also, Freddie, as I remember, it was either RJR bonds or Philip Morris bonds, but they had bought some bonds that had nothing to do with housing at all. And here they were using the government's credit to enlarge the size of this hedge-fund type portfolio, now with some corporate bonds that had nothing to do with housing.

And I just figure if you see one cockroach there's probably a lot more in the kitchen.

COMMISSIONER WALLISON: Did you follow Fannie and Freddie enough to know that they had affordable housing requirements?

MR. BUFFETT: Oh, sure, yes.

COMMISSIONER WALLISON: And did you know the size of those affordable housing requirements?

MR. BUFFETT: Yes, and of course, they are predicated on being able to use the tax credits that were involved, and they set them up as assets on their balance sheet, and of course they have no income now. So those became very dubious assets.

COMMISSIONER WALLISON: But were you aware, then, that they were buying the kinds of mortgages that they were buying in order to comply with the affordable housing requirements that --

MR. BUFFETT: Well, I certainly knew that they were -- they were mandated in many of their activities by Congress, no question about that. And they were also trying to serve Wall Street, and that's a tough balancing act.

COMMISSIONER WALLISON: How much time do I have left?

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CHAIRMAN ANGELIDES: Four minutes and 51 seconds.

COMMISSIONER WALLISON: You are quite famous for saying, among other things, and this isn't the only thing you're famous for, but you said that credit default swaps are financial instruments of mass destruction. And yet it's recently come to light that you actually participate actively in that market.

MR. BUFFETT: Yea, I think I actually said derivatives are financial -- potentially, and I think that used improperly, as they almost are certain to be, because of what they provide people to trade in them and what they provide in the way of increased leverage that's not obtainable in other ways, I think that they have, they pose system-wide problems.

COMMISSIONER WALLISON: What do you use them for?

MR. BUFFETT: I use them to make money. If I think they are mispriced, I buy them.

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COMMISSIONER WALLISON: But these are credit default swaps or other kinds of --

MR. BUFFETT: No, we've never bought a credit default swap. We've sold credit default swaps. We sell insurance.

COMMISSIONER WALLISON: You sell protection.

MR. BUFFETT: We sell insurance, we sell --

COMMISSIONER WALLISON: And then do you lay that off?

MR. BUFFETT: No.

COMMISSIONER WALLISON: You do not hedge that?

MR. BUFFETT: No, I never write it off. We sell insurance.

COMMISSIONER WALLISON: This is much like what AIG did. Didn't they --

MR. BUFFETT: I don't think it's much like it, but we sell credit insurance. And we sell auto insurance, and AIG sold auto insurance, too. I mean...

COMMISSIONER WALLISON: All right, I have no further questions. Thanks very much.

MR. BUFFETT: Could I bring up one point? Because it gets back to a point that was made earlier about the laws getting on the books and never getting changed. If you go back to the 19, late 1920s, we had a bubble then. It was in stocks and it was partly caused by extreme margin by people that didn't really know what they were doing, ten percent margins, and they had Commission hearings after that, and they decided that this was a societal problem, and Congress gave to the Federal Reserve the authority to regulate margins, and they said, "this is important."

The Federal Reserve still has that authority, as I understand it, you know, 70-plus years later. What we put into derivatives and total return swaps, at that point you could borrow a hundred percent of what you owned. And we sit here with the system -- and I've brought this up a half a dozen times, and

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sometimes people in Congress, and I say, "What in the world are we doing when we say the Federal Reserve should have margin requirements," which I believe now are fifty percent, "And you can go and get a total return swap and borrow a hundred percent or you can buy S&P index futures with a tiny percentage down?" I mean, it is something that should be addressed.

COMMISSIONER WALLISON: I thought your, maybe I've misread this in the newspapers but I thought your problem with some of the legislation that is going through had to do with the fact that you didn't want to put up the collateral which substitutes for the margin.

MR. BUFFETT: In terms of -- in terms of contracts that were negotiated several years ago, there was one price for collateralized contracts and another price for uncollateralized. And incidentally, Coca-Cola, Anheuser-Busch, thousands of companies negotiated under that basis. We say, if we're required to substitute an uncollateralized contract and make it a collateralized contract, before we send that money to Wall Street, we should get paid for the difference in those two types of contracts because they are two different contracts, just like changing the price or changing the maturity.

And there's a very significant difference in price. And not only we, but hundreds of end users would be required to send money to Wall Street firms, contrary to the contract they originally negotiated and contrary to the price differential that existed between those two types of contracts.

COMMISSIONER WALLISON: So you don't have any objection to doing it in the future --

MR. BUFFETT: Oh, no, not in the least, I don't -- I just -- I object to selling one kind of a contract and having it changed into another kind of a contract without getting paid.

COMMISSIONER WALLISON: Okay, thank

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you.

CHAIRMAN ANGELIDES: Thank you very much. Mr. Georgiou and Mr. Wallison, if you can flip that mike off, thank you.

COMMISSIONER GEORGIOU: Thank you very much, gentlemen, for joining us.

I'd like to start with Mr. Buffett, largely because my 90-year-old mother is watching and she'd be very upset with me if I didn't acknowledge your seniority. Here we are.

I take it that between AIG's selling of credit insurance and yours is that you charge enough to cover the risk that you're undertaking, is that fair for say?

MR. BUFFETT: That's fair to say. But additionally, we only take on risk we can handle ourselves, so we only have about 250 contracts or so, total. And if everything goes wrong, we can easily handle it. And that was not the case with AIG.

COMMISSIONER GEORGIOU: Indeed it was not. I want to address the general

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question which I've sort of been putting at a lot of these hearings, about how we might restructure the incentives in the market system to try to avoid these market crises in the future.

You said, Mr. Buffett, that you liked this business at Moody's, because it had pricing power, it was a natural duopoly. This gentleman Kolchinsky, who testified a little bit earlier today, who was a subordinate of Mr. McDaniel said that, in many ways, the incentives for rating agencies have become worse since the credit crisis. There are now more rating agencies and they are all chasing significantly fewer transaction dollars. The new controls put in place by regulators are too weak to significantly alter this dynamic.

And then there's a quote that you also had in your testimony that you gave privately to our team, "Market systems produce strange results in Wall Street. In general, the capital markets are so big, there's so much money, that taking a small percentage results in a huge amount of money per capita in terms of the people that work in it, and they are not inclined to give it up."

And then one last quote I want to read to you, but I will tell you the quote, "Whenever I hear the terms 'modernization' or 'innovation' in financial markets, I reach for my wallet. It's usually, what they mean is revenue-producing."

So we've seen a number of things go on in the marketplace. And you've also said that everyone should have a lot to lose in this marketplace. Well, really, in the securitization process, we've discovered through the course of our hearings that really, almost everybody involved has nothing to lose. The mortgage brokers who originate the mortgage get paid a percentage of the mortgage they originate without regard to the consequences if it succeeds or fails.

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The bankers who put the deals together, the mortgage-backed securities, are getting a percentage of the deal. The lawyers who write the prospectuses, the auditors, accountants who audit the books, and the credit rating agencies who rate the credits, are all basically paid in cash at the conclusion of the sale of these securities, really without any significant consequence to whether they actually do what people represent them to do or they fail.

And one thought that some people have suggested is that, rather than pay all these market participants in cash, that you might increase the likelihood of diligence being properly done if you paid them in the securities themselves. So if you're getting, whatever, ten basis points of the dollars, give the security to Moody's, so that you know that you're going to live with that security for a long time. You're going to be long in it. You can bonus the people that did the job

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with the same security. If they succeed, they get seven percent interest per year for ten years, then they get their money back. What do you think about that idea?

MR. BUFFETT: I like it, or put it in a deferred account and have an index of all the things in which they participated become the index factor that's applied to that deferred account when it's finally paid out at some point.

You have to, I think the most can be achieved actually by getting, at the very big institutions, the CEO and the boards, where they've got real downside.

But I can tell you, I was at Salomon almost twenty years ago, and trying to put in a new compensation system in Wall Street can be very difficult.

COMMISSIONER GEORGIOU: Right.

MR. BUFFETT: But I don't retract any of those earlier remarks. I agree with them.

COMMISSIONER GEORGIOU: I asked in the case of Jimmy Cayne at Bear Stearns, he said, "That's a great idea but they are not going to like it." So it seems to me that -- and I want to go back here to what happened at Moody's to some extent. Because really, a hundred years ago, you know, John Moody started rating railroad bonds, which you know a lot about. Relatively simple instruments.

Now, Moody's is rating exceedingly complex instruments. And some of the financial incentives, maybe I should turn to Mr. McDaniel on this question, some of the financial incentives, it seems to me, are skewed in favor of your properly rating, besides the fact, the obviously glaring one that issuers pay.

But in your pricing, I learned from our investigation that, on RMBS, on residential mortgage-backed securities, you charged 4.75 basis points for those tranches that were rated senior of the dollars in those tranches, and 3.50 basis points for the tranches that were rated subordinate.

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Which, it seems to me, gives a skewed incentive for you to put more dollars into the senior tranches and less dollars in the subordinate tranches because you're going to make almost 40 percent more per dollar rated in the higher-rated ones, which is similar to a difficulty we've discovered in the mortgage brokerage situation, where mortgage brokers sometimes were compensated at twice the rate, at the percentage rate, for generating a mortgage that had a higher interest rate payable to the lender than a traditional mortgage, which then incentivized them twice as much to direct borrowers into subprime mortgages and high-interest-rate mortgages who might otherwise qualify for regular, traditional ones.

Mr. McDaniel, do you think that's a problem? And why, if you could tell us, did you actually structure the fees payable to Moody's in that way, that gave you more if you rated them senior than

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they would if they were subordinate?

MR. McDANIEL: I think, as you heard from the panelists earlier today, first of all, they were not aware of a difference in pricing in their deliberations or analytical work and rating committee work.

And secondly, although I have not had an opportunity to do a comprehensive check, I did go back to look at RMBS applications in 2006 and 2007, and the basis point fees were identical for senior and junior tranches.

COMMISSIONER GEORGIOU: Well, our people say that they changed it in 2007 to flat, to 3.5 percent which, incidentally, is a reduction in pricing power, 3.5 basis points for all, all the way across an RMBS, starting in 2007 forward, when in 2006 prior it was a differential.

MR. McDANIEL: I was able to look at 2006, and it was identical in 2006 as well -- as I said, I did not have a chance to do a comprehensive --

COMMISSIONER GEORGIOU: Right. Maybe

you could check that out and report to us on it.

MR. McDANIEL: Yes.

COMMISSIONER GEORGIOU: The other point I think is that you got nine basis points for rating a CDO which is, again, more than twice as much as you got for rating an RMBS, which is sort of unclear to me how that could be.

And does that then incentivize you to do more CDOs because you do a billion-dollar CDO, you're going to make almost a million dollars in fees. And is that -- is it really that much harder to rate a CDO than it is to rate an RMBS?

MR. McDANIEL: Well, I'm not a CDO analyst. So I can only respond with respect to the overall approach and if there is an opportunity to charge fees that the market will bear, I think we would do that.

We have fees that range from very, very modest, particularly in the municipal bond sector, small municipalities, to fees

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that are a lot more substantial for large corporations and complex securities.

COMMISSIONER GEORGIOU: Let me try -- I want to press you a little bit -- Mr. Buffett, did you have a comment on that?

MR. BUFFETT: I was just thinking, I was looking for the modest ones, I haven't found them yet. The modest fees he referred to.

COMMISSIONER GEORGIOU: There aren't too many. I haven't seemed to find them, either. Looking back at this chart that Commissioner Graham brought in front of you, it strikes me that, when you look at this, in the face of contradictory information, the actual number of deals rated in both CDOs and residential mortgage-backed securities goes up dramatically.

And really, even after you've had four or five major downgrades, I mean, significant downgrades, you're still rating a whole bunch of deals that come forward.

And I think that -- I'll sort of give you a pass to some extent on nobody knew that the market was going to go down as fast as it did. And everybody was basically, I don't remember what your term was, Mr. Buffett, that everybody was believing in this -- as this bubble.

But once you get contradictory information, don't you then have an obligation not to go forward? And to be honest with you, it looks to me, given now that there are so few transactions in the marketplace, that what you were really trying to do was get these deals done so you could mop up the last bit of the gravy before they took the plates away. I mean, this is not -- these deals are not out there anymore. There's not nine-basis-point fees to be made on billion-dollar CDOs every day anymore. And the fact that you did it in the face of contradictory information seems to me to be highly troubling.

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Do you have a thought on that?

MR. McDANIEL: As long as securities are being offered to the marketplace, I think we have an obligation to try to offer our best opinion on those securities. So whether the markets are active and robust or whether they are quiet, what is coming to market I think we should attempt to offer an opinion on.

We obviously want those opinions to be predictive. We want those opinions to incorporate all information that we think is relevant, and incorporate our best judgment. But I do think we should try to offer the opinion.

COMMISSIONER GEORGIOU: But they weren't any more predictive, were they? In fact, they led to downgrades as significantly as they were prior to that, is that not correct?

Yes, Mr. Angelides -- I know you do. So do I.

There are two Greeks on this committee, gentlemen, which is a little

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bit dangerous for all of us here. But Mr. Buffett --

VICE-CHAIRMAN THOMAS: I'm Welsh. My hands are tied.

COMMISSIONER GEORGIOU: -- Mr. Buffett, do you fault the management of Moody's for at least that? I know you're reluctant to give them fault, but in the face of this contradictory information, how is it that they went forward and continued to rate these securities essentially no differently than they had been doing in the face of the bubble?

CHAIRMAN ANGELIDES: Can I say the reason I was waving my hands? I want to put this in perspective. Offering opinion is one thing. Offering an opinion that they are AAA is quite another. So just to frame this question on my time, I think in 2007, $500 billion of RMBS was rated AAA. About a hundred-billion-plus after July '07, when you began to do the downgrades. So there's offering an opinion, which may be that this isn't ratable, shouldn't be

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rated investment-grade, and then in fact --

COMMISSIONER GEORGIOU: Rating it AAA and then of course they were subsequently downgraded, even those later new issuances. Mr. Buffett?

MR. BUFFETT: Well, I don't know what took place internally there. But just from listening to this and what I see here on the chart and so forth, it looks like they tweaked their model when they should have gone at it with a meat axe, basically. And it is sometimes difficult for people to adjust their thinking that much in a short period of time, but they should have gone at it with a meat axe.

COMMISSIONER GEORGIOU: Too many mixed metaphors here on occasion. But I guess I'd like to ask you, if I could, I know you've testified in your internal testimony that you thought that the government made the right decision in backing up these companies, that the markets really needed reassurance at the time. This is a more generic question not having to do with Moody's.

But there are many who believe that that demonstrates the breadth and scope of this crisis, that, you know, we've had so many other crises. I mean, Enron was the seventh largest corporation in America, it want bankrupt. The tech bubble happened, a lot of things happened in the last 70 years and none of them required trillions of dollars of taxpayer money at risk to bolster the private sector, and yet you feel that it was necessary at the time. Could you elucidate?

MR. BUFFETT: I do. In September of 2008, you know, our financial system basically came to a halt. I mean, you had 30 million Americans with their money in money market funds comprising three-and-a-half trillion with close to half the deposits at the banks, and in the first three days of that week following Lehman, 170 billion flowed out. Interestingly now, that was all institutional. Individuals hadn't caught on yet.

But when thirty million people start worrying about whether their money market funds are going to be -- break the buck, when you've got -- when you've got commercial paper stopped in terms of issuance, when you have -- later we sold a Treasury bill due in April of 2009, we sold it in December for $5,000,090 when you were only going to get five million in April. So at that point your mattress wasn't even good enough. I mean, a Treasury bill was $90 better than a mattress.

So it was a paralysis of the system, and the American people knew that only the government could pull us out. They didn't trust anybody else. And the government had to act. Whether they acted perfectly in every case, who knows? But the important thing is they acted.

COMMISSIONER GEORGIOU: But now we're going forward. And part of what we're to do here is to evaluate what happened in the financial crisis and, although we're not proposing remedies, certainly, a lot of people are concerned about the debt that's been taken on to finance this bailout and so forth.

What do you do in the future to avoid this occurring?

CHAIRMAN ANGELIDES: By the way, go ahead and answer, Mr. Buffett, but that's time -- Mr. Buffett, answer, we would want your answer.

MR. BUFFETT: Yes. The two best things I know how to attack are leverage and incentives. You've got a market system and you can't rearrange the whole thing, but you can change how people behave, in one case by incentives, and secondly, you just tell them how much rope they can use by the amount of leverage they can have, particularly when they are getting the benefit of government guaranteed money.

COMMISSIONER GEORGIOU: Exactly, and

let me just, one little follow-up, and that is, your company has a huge cash cushion, which you like to keep because it puts you in a protected, safe position to take advantage of opportunities.

A lot of other people in this financial institution area did not do that. They ran every capital arbitrage possible to avoid holding back as much capital, and so that seems to me to be a related problem.

MR. BUFFETT: Yes, well, the AIG derivatives contracts you meant were to get around capital requirements in Europe. I mean, three hundred billion. So, you know, there's a lot of abuse, and if you let those instruments exist in that form and let people use them in an unlimited manner, they will get used in an unlimited manner.

CHAIRMAN ANGELIDES: Thank you very much, Mr. Georgiou. All right, let's move on. Ms. Murren?

COMMISSIONER MURREN: Thank you.

Thank you both for being here.

Mr. McDaniel, I have a question for you about the events of the crisis, and when you look back at the financial crisis, I wonder if the requirement, the legislative requirement that asks certain investors to invest only in rated securities, if those requirements had not existed, how would your business have been different? Would you have had to compete on different terms and would you have had to reward people within Moody's differently?

MR. McDANIEL: Well, I don't know exactly how the business would exist if there were different or lesser regulatory uses of the ratings. Nonetheless, I am supportive of a reduction of use of ratings in regulation. I think it -- I think the use of ratings and regulation offers rating agencies a basis for competing other than on the quality of their ratings. They can compete on the, in effect, the certification that they have as a regulatory-approved rating agency.

And I think that rating agencies should either prosper or not prosper based on whether market participants value the ratings and value the rating opinions and research that accompany that.

COMMISSIONER MURREN: With that in mind, there were comments from some of the individuals that were here before this panel that suggested that they could not determine if there was a connection between their ability to get the ratings right, their words, and their actual recognition within the firm.

Do you think that's true?

MR. McDANIEL: We certainly try to reward people in terms of their position in the firm and their compensation, based on the quality of their work. It is a business in which it can take a long time to evaluate the ultimate performance of securities. But their research, their preparedness for rating committees, their -- the robustness of their reasoning are things that can be judged and we very much try to do that.

COMMISSIONER MURREN: Those things are process-oriented though, not outcome-oriented necessarily.

MR. McDANIEL: The outcomes are able to be measured at a broad level statistically to, I think, a -- to a strong outcome. It is more difficult to judge an individual's performance, especially in the short run, on a very limited number of credits. And so it is easier to measure this at a broad level than at a narrow level.

COMMISSIONER MURREN: Thank you.

Mr. Buffett, do you think that the investing world would be a better place if everyone had to do their own due diligence?

MR. BUFFETT: Well, I certainly think at Berkshire Hathaway it's better. But there are people that aren't equipped. I mean, the banking authorities, insurance authorities, probably need to rely on some kind of standards to make sure that people don't go totally hog wild in terms of how they invest insurance funds which belong to their policyholders.

But in the end, we don't use ratings. From my -- what we really hope for is misrated securities because that would give us a chance, perhaps, to earn a profit if we disagree with how the agencies rate them.

There's one ironic point I should mention. If there were ten rating agencies, all equally well regarded, all acceptable to the market, and you only needed one when Berkshire Hathaway issues a bond, we could have any one of them, those ten would compete either on price or laxity or both. I mean, they would be out there trying to get our business, and they would try by price, but they might also try by laxity.

You can argue that if there was just one rating agency, they would have no reason to compete on either price or

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laxity. I mean, independence can really come with -- with strength in the business. Ben Franklin said it's difficult for an empty sack to stand straight. So if you really had a situation where there was a lot of competition, I'm not sure that the rating agencies would be as independent actually in coming to their credit conclusions as they are.

COMMISSIONER MURREN: I would hate to differ with you. But if you look at, for example, equity research, there are a number of boutique shops that are specifically known for the quality of their research and they do not engage in investment banking activity, so they don't have as much of a stake in the origination process.

And to me there's some parallel between this area of research and some others. So I guess my question really is, if you change the way people get paid, would you get a different outcome? So

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that really was the nature of where I was headed with this.

But I actually have an off-topic question for you, Mr. Buffett, and that is, I know that you've been largely a hands-off investor for Moody's. But I was curious about the due diligence process in your investment in Goldman Sachs, and if you could talk a little bit about your conversations with management there and how that decision was made.

MR. BUFFETT: Well, that decision was made in September of 2008. We'd been approached by just about every firm, at least every firm that went under, about putting money in. And when Goldman Sachs was willing to take money on terms I found satisfactory, which had not been the case even the week before, I came to the conclusion that, unless the American financial system totally fell apart, that it was going to be a sound investment. And I had far more confidence in their risk management than I had in some of the other Wall Street firms that had come to me earlier.

And again, if the system had fallen apart, if the Federal Reserve had not acted, in terms of commercial paper and the money market funds and all, everyone would have been toast, I think basically.

But I came to the, my basic conclusion was that the American government would do what was necessary to get the engine started again. And if that was the case, Goldman Sachs was in fine shape.

COMMISSIONER MURREN: But they did change the terms they were willing to accept for your investment as time went on.

MR. BUFFETT: Yeah. Prior to the middle of September, you know, they would not have paid us what they, remotely what they did pay us for that preferred stock and the warrants, whenever it was, September 22nd or 23rd or some time in that time frame.

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At that point, they not only wanted the money but they wanted a show of confidence, obviously, in the fact that the world wasn't going to come to an end financially.

And I didn't think the world was going to come to an end financially, because I thought that the federal government would act. I just thought it was so obvious that it had to, and only it could do it. And I felt that our five billion dollars would not be in any danger at all. And the terms were attractive, and there were a lot of other things that were attractive, then, too. But I made the decision that that was a good use for the five billion.

COMMISSIONER MURREN: Thank you.

CHAIRMAN ANGELIDES: Thank you, Mr. Holtz-Eakin?

COMMISSIONER HOLTZ-EAKIN: Thank you, Mr. Chairman; thank you, gentlemen, for spending time with us today.

Mr. McDaniel, in your opening remarks

you were very forthright about the inherent conflict between providing ratings to the market and running a public company for profit, and incentives that issuers have to use the outcome of your rating process.

How do you manage that conflict at Moody's? What do you put in place to keep that under control?

MR. McDANIEL: Well, from my office, I think it's important to emphasize and reemphasize the fact that we are trying to create long-term shareholder value, and I think the way to do that is to have credit ratings that are of high quality and predictive over time. That is why the problems we saw in the mortgage-related securities sector were so devastating to the firm, in addition to the consequences for the larger economy and to households in America.

Beyond that, though, we have structural components of the firm that are designed to insulate and protect the analytical process from some of the financial and commercial interests of the company, again, including independent credit policy function. We have also recently created a separate commercial organization in the firm that is separate and apart from either credit policy or the ratings analysts and the lines of business.

COMMISSIONER HOLTZ-EAKIN: And to be clear, those are two recent changes in response to the problems you had?

MR. McDANIEL: The credit policy function has existed for many years, but we then enhanced that function in terms of its independence in 2007. And the commercial group is a more recent introduction.

We also have formally separated the rating agency from our other operating businesses, non-credit ratings businesses. So those kinds of actions I think are useful and important, not only for our own processes, but to be able to turn around and demonstrate that those processes are proper and being handled in the right manner.

COMMISSIONER HOLTZ-EAKIN: So the quality of the ratings ends up being the key. And I think you said earlier that you want them to include all the relevant information and make them as good as possible.

MR. McDANIEL: Absolutely.

COMMISSIONER HOLTZ-EAKIN: So I am then very interested in this situation that occurred in 2007 where you had the residential mortgage-backed securities clearly up for downgrade and at the same time are rating CDOs based on the same underlying RMBSs, and went ahead and rated them AAA.

It doesn't seem like all the relevant information was brought into the rating process. And how do you feel about that, and the risk it placed to your reputation and the quality of your ratings?

MR. McDANIEL: I believe that all of

the information we thought was relevant at the time was brought into the rating process. But obviously, we had the problem of underestimating the extent to which the housing downturn was going to -- its magnitude and how widely it was going to affect home prices nationwide.

So as a result, the, even though we felt we were including relevant information, we felt we were using the best information we had available in the rating committee process, it proved to be insufficient, and --

COMMISSIONER HOLTZ-EAKIN: You couldn't wait until you found out a little bit more from your RMBS guys before you went out and rated the CDOs or was the short-term pressure too great?

MR. McDANIEL: I think the information that our RMBS teams had and their perspectives and opinions were available to other teams as they developed and evolved. I think we were trying to incorporate their changing points of view

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as we were looking at other securities related to the mortgage sector.

COMMISSIONER HOLTZ-EAKIN: Well, it at least appears, with the benefit of hindsight, that there was a rush to get this stuff done, and it strikes me as central to your role, and Mr. Buffett indeed said you as the CEO have to be your chief risk officer; and knowing the way in which these ratings were done and knowing when not to do them, wait and get more information, we heard from the panel earlier today about a great desire to learn more about the cash flows underneath the CDOs, but such a study was not done.

And pressures from outside the organization to manage the market share, all of which were pretty striking testimony to a real effort to move things out for short-term gain as the expense of what turned out to your reputation and your long run value.

MR. McDANIEL: We simply, if we thought that the housing problems and

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collateral consequences from the housing problem, if we had thought they were going to be what they in fact have turned out to be, we would have had very different opinions on those securities. We -- we just underestimated and dramatically underestimated the significance of the downturn.

COMMISSIONER HOLTZ-EAKIN: Mr. Buffett, you've said that you're interested in long-run value and not short-term profits. Were you aware of the problems in the structured credit, housing-related structured-credit ratings?

MR. BUFFETT: Certainly not sufficiently, no. We, to my knowledge, I don't think I've ever bought a CDO or a residential mortgage-backed security. Actually, we bought one recently here that we thought was mispriced. But it was not a field that I spent a lot of time on. It's just, I was more interested in straight debt and equities.

COMMISSIONER HOLTZ-EAKIN: And were

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you satisfied with the risk measures, the internal controls at Moody's and doing due diligence on all the products they provided ratings on?

MR. BUFFETT: I had no idea. I'd never been at Moody's, I don't know where they are located. You know, I know their business model is extraordinary. And they have the ability to price.

COMMISSIONER HOLTZ-EAKIN: I want to come back to that.

MR. BUFFETT: Yes.

COMMISSIONER HOLTZ-EAKIN: But isn't it at odds with being confident of their long-run value to not know if they are doing due diligence for the asset they consider most important to their reputation?

MR. BUFFETT: The long-run value basically was in their position as part of a duopoly, that arose naturally over a long --

COMMISSIONER HOLTZ-EAKIN: Independent of the quality of their ratings?

MR. BUFFETT: Well, I'm in no position to judge thousands of ratings. I think they misrate us. They've got us a notch below where Standard & Poors has us. So clearly, there's room for improvement.

But no, I've watched their process. They come out and spend -- and Standard & Poor’s does, too -- they'll spend three hours with me. They will go to all our managers, key managers in our insurance businesses, but three hours every year. And any question they ask me, you know, I give them the answer to. I give them my thoughts about the future, which I don't even with our shareholders.

They have been diligent in terms of what I have seen at the Berkshire Hathaway level, and in terms of our insurance.

Now, they also have this incredible pricing power. I think they ought to be doing it at a much lower price, as far as I'm concerned, and of course I think they ought to be rating us right up there where Standard & Poor’s has, but that's another question.

COMMISSIONER HOLTZ-EAKIN: What is the source of the pricing power?

MR. BUFFETT: What is the source of the pricing power? The source of the pricing power is that, if you're an insurance company, as an example, but if you're any issuer of securities, people expect you to have a Standard & Poor’s and Moody's rating, and it's very small, the dollars spent as a percentage of the total bond issue or whatever they may be doing, but it's required. It's like an SEC filing fee. I mean, basically, you're not going to come to market without it.

And if the SEC doubles its price for filing fees, I pay it. If they triple it, I pay it. And there are certainly things that are required as part of issuing securities. And in this country, an important part of the securities that are issued are required to have a Standard &

Poor’s and Moody's rating attached to them, and often it's by statute.

COMMISSIONER HOLTZ-EAKIN: Mr. McDaniel, in your time and, to your knowledge, for your predecessor, has Moody's ever lobbied Congress or the regulatory agency to enshrine in statute or regulation a requirement for ratings?

MR. McDANIEL: No, not to my knowledge. Just the opposite. We have been -- we have spoken repeatedly, publicly going back at least 15 years, about the risks of including ratings in regulation, and offering our support for the reduction or elimination of the use of ratings and regulation.

MR. BUFFETT: I would say that they are required by regulation in many of the --

COMMISSIONER HOLTZ-EAKIN: It's great for pricing power.

MR. BUFFETT: It is. But if they weren't, we still would have to have them. The world may change. It may be different ten years from now or 20 years from now but there's no way Berkshire Hathaway even with a good reputation and all earnings and CPA reports attesting to the fact that the 20 billion in cash is really there and all that sort of thing, we will not be able to issue a bond without a rating.

COMMISSIONER HOLTZ-EAKIN: So what I hear you saying is that from the long term value perspective, it's that pricing power that matters, not the quality of the ratings, that the internal controls were not a great concern to you?

VICE-CHAIRMAN THOMAS: May I yield the gentleman an additional two minutes?

COMMISSIONER HOLTZ-EAKIN: And the conduct of Moody's --

MR. BUFFETT: I'm not in a position to evaluate the internal workings --

COMMISSIONER HOLTZ-EAKIN: You're the majority owner. I would think you would be in a better position than most of us.

MR. BUFFETT: We own a significant position in Procter & Gamble. I don't know what their internal controls are, I don't know how they make Tide, you know, and whether the processes are proper.

We own a lot of Johnson & Johnson. They had a problem at the McNeil Lab recently. There's no way I'm going to know about that. Over time, I think Johnson & Johnson will do fine. I don't think they are going to do everything perfectly but I think, generally speaking, their management has done a good job and will continue to do a good job.

COMMISSIONER HOLTZ-EAKIN: Thank you.

CHAIRMAN ANGELIDES: I'm going to take a minute or so to probe this. Don't you believe that shareholders, and boards who shareholders elect, have a threshold responsibility for the proper conduct of a corporation? And let me add to this, I mean, forget the housing price mess. There's now a whole set of information here, SEC reports, extensive testimony, I might add, not just two or three people, about the culture at Moody's that may have jeopardized the ratings quality, information that there were inadequate resources, inadequate pay, I don't think it's any secret that pay at the rating agencies that may be good for the bottom line revenue, but that pay was not sufficient to retain, to attract and retain the kind of quality people you have.

There's a meeting with Dr. Witt, who testified this morning, talks about that as the markets are coming apart in '07-'08, there's a big employees' meeting and Mr. McDaniel's there and talking about how we're going to get it back on track, be profitable, and a managing director, after thirty minutes of this, finally stands up and says, after about thirty minutes of this, this is Dr. Witt's testimony, "One of our MDs from the corporate sector says, 'Are you going to talk about how we're going to ever salvage our reputation?'" You know, why didn't you just say, "Gee, I didn't know?"

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Don't you think a shareholder with twenty percent coupled with three or four others that have fifty percent, five shareholders, and the board, have a threshold responsibility in regard to these kind of operations? And that's number one.

And number two is, knowing what you know today, are these matters of great concern is to you as a big shareholder?

MR. BUFFETT: I would say in terms of -- in terms of the behavior of the credit agencies, recognizing all their limitations, aside from the real estate bubble, I do not have a record of where they have been further off in their ratings than I would expect normal human beings to be.

CHAIRMAN ANGELIDES: It's not a matter of ratings. Take a look at the SEC report. We'll post it on our web. It talks about threshold issues like adequacy of resources, business considerations affecting ratings. If we can't count on corporate shareholders, who can we count on?

MR. BUFFETT: I'll go back. We own a very big chunk of Johnson & Johnson. In the papers in the last week, there had been a lot of material about some children's product, the McNeil thing. Am I going to investigate that? No. I mean, overall, think I the Johnson & Johnson management is going to do a fine job over time and that they'll make mistakes and correct them. Now, if I see something, if I think they are overreaching or doing certain things --

CHAIRMAN ANGELIDES: If you see a cockroach.

MR. BUFFETT: Yeah. I do not regard -- if they have a problem at one lab, I do not regard that -- they had a Tylenol problem many years ago, as you know. I mean, every major --

CHAIRMAN ANGELIDES: I'm saying --

MR. BUFFETT: Let me say this: Today, we have 260,000 employees at

Berkshire. Somebody's doing something wrong now. I wish I knew who it was. I wish I could find out.

CHAIRMAN ANGELIDES: There's a difference between that and systemic failure.

MR. BUFFETT: I don't think it's been systemic failure. I think they made a huge mistake on --

CHAIRMAN ANGELIDES: Have you reviewed the SEC report, at least the pubic one?

MR. BUFFETT: No, I haven't.

CHAIRMAN ANGELIDES: Okay, thank you. Mr. Thompson?

COMMISSIONER THOMPSON: Thank you, Mr. Chairman. Mr. McDaniel, much can be said about tone at the top. And so would you just tell me what outcomes or results you value most from your company?

MR. McDANIEL: Well, it's somewhat similar to a remark I made a few minutes ago. Obviously, we want to, I want to have a successful business. And I believe the way to have a successful business is to have high quality products and services; in this case, ratings and related research.

It does nothing for our business to focus on the short run and to cut corners and, as I've said, that's why it is so deeply disappointing to have had the experience that we've had in the mortgage-related securities that we've rated.

COMMISSIONER THOMPSON: So quality of the product or service that you deliver would be the one outcome that you value most.

MR. McDANIEL: Yes, because I believe that leads to the long-term prosperity of the firm.

COMMISSIONER THOMPSON: So why, then, is quality not a major component in the compensation plans for the managing directors who rate these securities?

MR. McDANIEL: First of all, I think it is. And we have adjusted our compensation programs over time in order to try and align high quality product and service with compensation.

Our senior management team, the top senior-most 40 individuals in our firm now have, as part of their compensation program, a three-year performance share plan. And for everyone involved in the Moody's Investor Service rating agencies business in that group, there is, fifty percent of that plan is based on the statistical performance of our ratings over that three-year period.

COMMISSIONER THOMPSON: You said "now." When was that change made?

MR. McDANIEL: This was introduced at the end of last year.

COMMISSIONER THOMPSON: So this is after the crash, if you will.

MR. McDANIEL: And it's really an experiment. We will have to see how this works. The ability to measure ratings statistically over a multiyear period is something we can do, and we think that it's going to provide good incentive alignment for our senior management.

COMMISSIONER THOMPSON: So in keeping with the notion of tone at the top, you would say that in your communications and your most senior team's communications with the rank-and-file of Moody's, it's clear that quality trumps market share?

MR. McDANIEL: Well, from my position, I have to be concerned with all different aspects of trying to manage a successful business.

But for our more junior employees, their compensation, our analysts and support analysts, their compensation is in no way tied to the number of securities they rate or the number of companies they follow or anything of that sort.

COMMISSIONER THOMPSON: Or the share they gain in the market.

MR. McDANIEL: Or the share that we gain or may lose in the market.

COMMISSIONER THOMPSON: So the gentlemen who were here earlier were delusional about what objectives and goals they had as they were working at Moody's.

MR. McDANIEL: No. As I said, I care about market share, I care about market coverage as much as I care about market share, even if that coverage is produced on an unpaid basis. I still want to have market coverage. But I also care deeply about ratings quality, and part of my job is to balance those interests properly, and to communicate that balancing of interests throughout the firm in a way that individuals understand that the long-term success of this company has to start with quality of this company, ratings quality, research quality.

COMMISSIONER THOMPSON: Mr. Buffett, much has been said about regulatory or supervisory failure through this debacle. The SEC, OFHEO, you name the regulator that was involved, any number of them missed.

Other than over-the-counter derivatives, can you think of a major area of regulatory oversight that dictates major changes in our system?

MR. BUFFETT: Well, I would say that going beyond the OTC derivatives, I think that addressing the problems of disguised leverage, unwise leverage, which is really tough, but doing it with ratios is not the answer, is not the sole answer. But leverage is what gets people in trouble. I mean, we've run Berkshire that way, and when people stretch and they get rewards for it, they are inclined to stretch more.

I think I heard some testimony in an earlier panel you had about whether having the objective of return on equity, whether that might cause people to do different things. Well, of course it does cause people to do different things. The easiest way to jack up return on equity is to leverage.

So addressing that, addressing it wisely I think is very tough. But I think that that's the most important thing in the regulatory world.

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COMMISSIONER THOMPSON: Are you as surprised as most Americans are that, post-Enron, we could have off-balance-sheet financing that would have been perhaps at the core of this collapse?

MR. BUFFETT: Yeah, I don't know that it's necessarily at the core, but I certainly was surprised when Citigroup turned out to have SIVs, you know, in the many tens of billions, which is just a way of jacking up leverage again. I was surprised. I mean, now, I may not have read the 10-Ks carefully enough or anything, but there certainly were no flashing signs that said, "We're using a bunch of leverage off balance sheet."

So I think that -- I think we're always going to be fighting the human tendency to borrow more money than you should. And households did it because they thought that houses were going to go up next year. They really didn't think it made any difference what their income was, because they'd refi in a year or two. It's just such a human tendency that you need something on the governmental side to counterbalance that.

COMMISSIONER THOMPSON: Thank you very much.

CHAIRMAN ANGELIDES: Before we go to Ms. Born, I just -- can I just ask if we get supplied with a couple of pieces of information? Can we have made available to us the board's evaluation of your CEO? They do an annual evaluation?

MR. McDANIEL: I submit a self-evaluation which the board then reviews and discusses among themselves and --

CHAIRMAN ANGELIDES: Can you provide access to that to us?

MR. McDANIEL: Yes.

CHAIRMAN ANGELIDES: Secondly, could we also have access to any internal comprehensive reviews that have been done about practices at Moody's to the extent we haven't already received them, in other words, reviewing systemic breakdowns that might have been done? Have you done comprehensive reviews, internally, in the wake of all this?

MR. McDANIEL: Well, we've done a number of reviews, and if there's anything that we haven't provided that's appropriate, I certainly would instruct our people to do so.

CHAIRMAN ANGELIDES: And then finally, I think the company did a review with a law firm of Mr. Kolchinsky's employment retaliation allegations. Can that be made available to us?

MR. McDANIEL: I'm not sure. I don't know if there is a report on that or not.

CHAIRMAN ANGELIDES: I believe there is. I believe there is. Check it out. If Mr. Kolchinsky agrees, I would hope that you would also. Can you please check it out? Thank you.

MR. McDANIEL: I will check. Thank you.

VICE-CHAIRMAN THOMAS: For the

record, especially since we have witnesses in front of us which we say you ought to know more than about your business, and someone else's business, notwithstanding that you were looking at it from a different perspective, I would like to place on the record the fact that the Commission will examine the assertion that we've made, which we believe to be accurate, that there were various rates charged for different tranches and, if need be, correct the record and if not, be proud that we were right. But we're going to get the answer correct one way or the other.

MR. McDANIEL: As I said, I did not have the opportunity for a comprehensive check on that.

VICE-CHAIRMAN THOMAS: And neither have we, but we believe it to be accurate so we're going to get to the bottom of it. Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: Ms. Born?

COMMISSIONER BORN: Thank you very

much. And thank you both for appearing before us.

Mr. Buffett, I'm going to take advantage of your being here by asking you about derivatives and your views of them.

As Mr. Wallison has said, your 2002 Berkshire Hathaway shareholder letter famously referred to derivatives, and this is, I believe, all derivatives, not just credit derivatives, as, "financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."

You also presciently said that they are "time bombs, both for the parties that deal in them, and the economic system."

And more recently, in your 2008 shareholder letter, you said that Bear, Stearns' collapse demonstrated the time bomb of counterparty risk that you had earlier described. And I would ask that these two shareholder letters be placed in the record.

CHAIRMAN ANGELIDES: They will be.

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COMMISSIONER BORN: I would like you to describe your view of the role that derivatives has played in the current financial crisis.

MR. BUFFETT: Well, they accentuated enormously, in my view, the leverage in the system. The huge dependency on counterparties and one of the -- one of the beauties of the Stock Exchange over the years is that you've had now a three-day clearing system because people realize that if you have a contract, and it's six months later that it settles, that a lot of things can happen in those six months.

In fact, I think the Kuwait Stock Exchange got into big trouble some years back because they had got a very delayed clearing arrangement. And derivatives are contracts with sometimes unbelievably long settlement periods.

Generally, we inherited 23,000 derivative contracts. I could have hired the 50 smartest Ph.D.s out of MIT to prepare some kind of report that would tell me the risk I was bearing, and I wouldn't have gotten the answer. I mean, it was impossible to get your mind round that. I mean, we had nine hundred counterparties. I couldn't pronounce the names of a couple of hundred of them. I mean, they were foreign institutions I never heard of.

In effect, the integrity of our balance sheet at Gen Re was dependent on all these people behaving at times in the future, which strung out to almost a hundred years in a few cases.

So the only answer was to get out of the business. I couldn't design a system that would enable me to know what the hell was going on.

So if that was my problem with 23,000 of them, you know, I've read about vastly greater numbers that existed at Bear, Stearns or at Lehman and something else. I just think institutions can get out of control and I don't think that's a good thing for the system, particularly when, if they are large enough, if they get out of control, it means that society gets interrupted in a very, very major way.

COMMISSIONER BORN: Well, following up on that notion, I think you stated in your 2008 letter that the Federal Reserve rescued Bear Stearns because the counterparty risk posed by its enormous position in derivatives would have created, "a financial chain of unpredictable magnitude." Is that correct?

MR. BUFFETT: That's correct. And what happened of course, I think, in Lehman was that we saw an example of that. I think it was underappreciated. I'm not saying I would have called it right, either. But when Lehman failed, an institution that was showing 15 or so billion of book equity, some of it was real estate deals and some of that; but in the end, the debt of 140 million, or whatever it was, is now selling for maybe

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30 billion in the market, so that's 110 billion. That kind of money shouldn't disappear overnight.

COMMISSIONER BORN: And with respect to the other large derivatives dealers, AIG and the large investment banks and bank holding companies that needed TARP money, do you think that played a role with respect to them as well?

MR. BUFFETT: Yeah, I think the government did the right thing in stepping in at AIG, but I don't think AIG should have gotten there in the first place. And AIG, as you probably know better than I, I think there was three hundred billion of derivatives that were essentially designed for something called regulatory arbitrage, which was just a way of relieving the capital pressures on European banks because they got the AAA AIG transferred over.

Well, if you get enough of that sort of thing going on in financial system, you're going to have a problem.

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COMMISSIONER BORN: Well, in light of the problems that you and the other people at Berkshire Hathaway experienced with the general re derivatives position, what's your view of the ability of these enormous derivatives dealers to successfully manage their companies in light of their enormous positions? For example, they hold millions of contracts.

MR. BUFFETT: Yes.

COMMISSIONER BORN: At year-end 2009, the OCC said that JPMorgan's position was $78.6 trillion in notional amount. And can such enormous, complex books of business be successfully managed by human beings?

MR. BUFFETT: I think they are dangerous. I would say this: I don't think I could manage it. It's hard to -- it's hard for me to imagine a system -- it's hard for me to imagine a regulatory system that could supervise something like that. And of course, one of the ironies is that, with only four big auditing firms in the United States, I will guarantee you that if you take two big firms that are audited by the same auditor, you will find different prices attributed to given derivatives contracts at the same time that the auditor attests to.

I mean, it's mind-boggling, and the 23 -- you mentioned our getting out of it. We lost $400 million in a very benign period with no pressures on us, able to exit, and maybe that's why Lehman lost a hundred billion. But it's very dangerous stuff.

COMMISSIONER BORN: You also pointed out that, in your, I think, most recent shareholder letter, the 2008 one that I'm referring to, not the 2009, that it's almost impossible for an investor, looking at the financial statements of these big derivatives dealers, to really know what their financial situation is. Isn't that right?

MR. BUFFETT: And I think if you

added a thousand pages of disclosure, it would be impossible, too. I try in our report, because we only have 250 positions, I try to tell the shareholders what basically the positions are, and I think I can do that. But that's because there's only a couple of classes of them, and I can describe them. And I think so that anybody that knows accounting, at least, can understand what I'm talking about.

But I don't know how -- I don't know how to read a 10-K, whether it's three hundred pages long or three thousand pages long, that can describe a million derivative contracts.

COMMISSIONER BORN: Now, you're a very sophisticated investor and I assume in going into derivatives contracts, you carefully examine what the embedded risks are, what the leverage is.

I'm concerned that so many municipalities and other large institutional investors that may not have

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your sophistication have gone into these contracts.

I'm concerned that the embedded risks in the leverage aren't fully understood.

MR. BUFFETT: I'm sure you're right. You had Orange County, you had Jefferson County in Alabama. But more importantly, if you go back a ways, when Bankers Trust was selling them to P&G, I mean, can you imagine bamboozling the CFO of P&G? So it -- when you get these exploding type contracts where, if you hit a given threshold, everything gets multiplied by ten, or -- I don't even know, you know, why the world they are needed. But those contracts are out there, and I think many times, the people that are buying them don't know what they are doing.

COMMISSIONER BORN: There's been enormous growth in this market. The Bank for International Settlement said that globally, the market amounted to more than $614 trillion at the end of last year. There's enormous innovation that's been going on, financial innovation. There's enormous complexity in these contracts. I understand that they are very useful for hedging purposes, and I think that's a perfectly legitimate purpose. I think you need some speculators in order to allow hedgers to effectively enter into positions.

I'm concerned about the enormous growth of purely speculative transactions in the market. And I wonder what your view is as to the economic benefit to our society from that speculation.

MR. BUFFETT: I wrote a letter in 1982 to Congressman Dingell, giving my views when they were introducing the S&P index future. And I said there are legitimate uses for it in hedging out the long positions and so on, but I said, overwhelmingly, it's going to be become a gambling vehicle. And I would distinguish between speculative and gambling. Gambling involves, in my view, the creation of a risk where no risk need be created.

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Now, obviously, you plant a crop in the spring and you're going to harvest it in the fall, you're speculating on what prices are going to be in the fall for your corn or oats or whatever that it way be, and you may lay that off on some other speculator. But that's a risk that that system has to take. You can't grow it in one day.

But when you start wagering on -- well, on stock index futures, I think that gambling instincts are very strong in humans. I mean people went a thousand miles to a bunch of sand originally, you know, and they built a whole city on it, and they would travel on planes and go to all kinds of things to do mathematically unintelligent activity.

So it exists. States prey on it with their lotteries. And these contracts are made to order for it, because you can do it on a big scale, and you could do it, and it's very easy to do and you don't have to get on a plane, you don't have to

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break a sweat, and --

COMMISSIONER BORN: You don't have to put down any money.

MR. BUFFETT: Yes. And the more complex, generally speaking, the more profit there's going to be for the derivatives dealer. You can take that as a given.

When I was at Salomon, originally you talked about interest rate futures, fixed to floating or foreign exchange. And then they became known as plain vanilla contracts because there wasn't any money in them. It got competed a way. So they invented more exotic instruments and that's where the money was.

COMMISSIONER BORN: Well, I would ask is that the 1982 letter by Mr. Buffett to John Dingell be placed in the record. One last question --

CHAIRMAN ANGELIDES: We have it. It's typed on a Smith-Corona typewriter, apparently.

COMMISSIONER BORN: It's a carbon

copy. Mr. Buffett, in your view, is the derivatives market still a time bomb ticking away?

MR. BUFFETT: I would say so.

COMMISSIONER BORN: Thank you.

VICE-CHAIRMAN THOMAS: Mr. Chairman, will you yield Commissioner Holtz-Eakin one minute?

COMMISSIONER HOLTZ-EAKIN: Mr. Buffett, I really appreciated that testimony because what you said about the derivatives and your response to them was, you needed to manage your balance sheet, in which case you just got rid of balance sheets exposed to that. And that's an unusual statement in the context of these hearings. We've heard again and again and again, that whether it be a Citigroup or a Fannie Mae, that, you know, they didn't manage their balance sheet. They just got overwhelmed by something so large that it could not have been imagined, and had everybody simply managed the risks on their balance sheets appropriately, something that large could not have emerged.

And so it is important to come back to that and I think it's important in light of this hearing because, at the heart of the question that faces us today, is the question of what was the management of the balance sheet of these rating agencies? Was the asset being managed, their reputations, and if so, was due diligence done in pricing the most valuable risks, risks that are correlated with the most important thing going on in the economy, or was effort devoted elsewhere to the ability to manage volume and take advantage of pricing power? Which asset management strategy was in place? Thank you.

CHAIRMAN ANGELIDES: Go ahead --

VICE-CHAIRMAN THOMAS: Mr. Chairman, I would yield Commissioner Wallison the remainder of the time until the 2 o'clock end of this portion --

CHAIRMAN ANGELIDES: It's 2 o'clock, but why don't we just say a couple of minutes, then.

VICE-CHAIRMAN THOMAS: I kind of like the more dramatic way I said it.

CHAIRMAN ANGELIDES: Or a minute, which is an empty offer since it's 2:01.

COMMISSIONER WALLISON: Stop fighting guys, let me ask my question.

One of the issues that is central to this hearing today it seems to me is whether the problems at Moody's, and I think you'd all agree there were some problems at Moody's, are systemic in the sense that they extend across the board throughout Moody's, or are simply unique to the housing mortgage area.

And one of the ways we can address that is by looking at how successful Moody's, or unsuccessful Moody's has been in rating non-housing asset-backed securities.

So Mr. McDaniel, what I would like you to do is to assemble as much information as you can on the other kinds of non-housing asset-backed securities that Moody's has rated, and give us a sense of the number of downgrades or even upgrades that occur from time to time in those securitizations. That way, we can compare the way Moody's operates as a general rule, against what happened in the very unusual housing area which, as you've pointed out, has shocked everyone, including the estimable Mr. Buffett.

So what I think we want to do is see that data and if you if you'd furnish it to us, get it together and furnish it to us, even without a question from us, that would be very helpful.

MR. McDANIEL: Be happy to do so, sir.

COMMISSIONER WALLISON: Thank you.

CHAIRMAN ANGELIDES: Last comment as we wrap up here. As I've read the materials provided by the staff, read innumerable interviews, other background materials, I'm struck with the fact that, with respect to the credit rating agencies' practices and models, seems to

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me that the question isn't so much why did this system fail, but why has it lasted so long.

And in that vein, I just want to ask you today what risks do you see from the current credit rating models? In the same way you said there were risks for derivatives, do you see extant risks, current risks from the model essentially being unchanged from where it was when the mistakes, the disaster, however you characterize it, happened?

MR. BUFFETT: Well, the huge question, if you were running a rating agency now, if I were running a rating agency --

CHAIRMAN ANGELIDES: Or if you owned 13 percent in stock--

MR. BUFFETT: -- how would I rate states and major municipalities? I mean, if the federal government will step in to help them, they are AAA. If the Federal government won't step in to help them, who knows what they are? I mean, if you're

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looking now at something where you could look back later on and say, "These ratings were crazy," that would be the area. Because it's bimodal. I mean, basically -- I don't know how I would rate those myself now. I mean, in other words, because it's a bet on how the federal government will act over time.

CHAIRMAN ANGELIDES: But the real question -- well, but also, in that vein, have you looked at whether the resources, the discipline, the capacity is there internally at Moody's?

MR. BUFFETT: I don't think -- I don't think Moody's or Standard & Poor’s or I can come up with anything terribly insightful about the question of state and municipal finance five or ten years from now, except for the fact that there will be a terrible problem and the question become what the federal government --

CHAIRMAN ANGELIDES: But does the model, irrespective of the particular imminent risk, is the model one that still presents risk, given what you've heard and

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learned today in looking at Moody's?

MR. BUFFETT: I think-- you're talking about model--

CHAIRMAN ANGELIDES: Talking about the model, issuer pays, all the associated issues we've raised with respect to the Moody's business model.

MR. BUFFETT: I think there's utility to the rating agencies. I think there's less utility to somebody like me, who's in the business of trying to evaluate credits day by day and been doing it a lot of years. But I think there's utility to the model.

VICE-CHAIRMAN THOMAS: Mr. Chairman, we might as well end on a high note. If we're really looking at the states and municipalities and the comfort that we would get from the federal government proposing to intervene, which then makes the states and the municipalities AAA, there are a lot of folk out there wondering who watches over the watcher in terms of how the federal government is able to do that.

Of course, we know they can print their own money and do a few other things, but they have been doing that for some time now, and there is some concern about that as well. I do like to go back to what we talked about in the beginning, behavior should have consequences. That should apply to people, institutions and governments.

CHAIRMAN ANGELIDES: Thank you very much, witnesses.

We are going to take a break, members, until 2:30 and we will reconvene in this room. Thank you, Mr. Buffett, thank you, Mr. McDaniel.

(Luncheon recess: 2:05 p.m.)

A F T E R N O O N   S E S S I O N

(2:48 p.m.)

CHAIRMAN ANGELIDES: The financial crisis inquiry about will come back to order for our third and final session on the credibility of credit ratings, the investment decisions made based on those ratings and the financial crisis. In this last session, we will have with us, Mr. Mark Froeba and Mr. Richard Michalek, correct? Who will be testifying this afternoon and to whom we will then direct questions.

So, gentlemen, thank you very much for being here. We know you have now submitted written testimony and would like to ask you to give us verbal testimony of no more than five minutes to lead off this panel, and Mr. Froeba, we'll start with you.

Oh, yes, I forgot, thank you. I just got reminded.

My 56-year old brain. Will you please stand and raise right hands so I

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can swear you in.

M A R K F R O E B A ,

R I C H A R D M I C H A L E K,

Having been duly sworn, testified as follows:

CHAIRMAN ANGELIDES: Good, thank you very much. So the other thing I want for do before we start here, as our agenda reflected, Mr. Brian Clarkson, the former president and COO of Moody's, was to testify here today. He did submit, I believe, his written testimony. And I -- but he is unable to be with us. For the record, I'm going to read a statement from Christina Clarkson, whom I have been given to understand is Mr. Clarkson's spouse, and here's the statement for the record that I've been asked to read:

"Brian was rushed to the emergency room at Beth Israel Hospital late last night suffering from acute pain in his side. He's been admitted to the hospital and will undergo surgery later today. Brian has appreciated the opportunity to

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participate fully with the FCIC. He submitted his testimony to the Commission and had every intention to participate but regrets that he is unable to attend today's hearing."

So I wanted to indicate that for the record. We do have written testimony from Mr. Clarkson. We also interviewed Mr. Clarkson, and we will be presenting written interrogatories to Mr. Clarkson also.

With that, Mr. Froeba -- Mr. Vice-Chair, do you have a comment?

VICE-CHAIRMAN THOMAS: No, I just said we're putting him on the 15-day disabled list. That means that we can bring him back.

CHAIRMAN ANGELIDES: All right, terrific. With that, Mr. Froeba, if you would begin your testimony.

MR. FROEBA: Sure. Rick and I have talked about this before. I think my statement is going to be a bit longer than five minutes, which may not be appropriate. But if necessary, maybe he would be willing to yield, and with your consent, yield some of his time to me.

CHAIRMAN ANGELIDES: How long do you think your statement will take?

MR. FROEBA: I regrettably have not actually tried it out but hopefullyit will be finished in about seven minutes. But if not, I can bring it to a close whenever you want me to.

VICE-CHAIRMAN THOMAS: Mr. Chairman, I move that we adopt the quality rule rather than the quantity rule. So depending on how good it is.

MR. FROEBA: Okay. I'll try to make it entertaining. Perhaps some of you have already read it, and can tell me what you think.

Anyway, my name is Mark Froeba. I'm a lawyer. I live and work here in New York City, I am a 1990 graduate of the Harvard Law School cum laude. In 1997, I left Skadden, Arps in New York to join the derivatives group at Moody's.

I left Moody's in 2007 as a Senior

Vice-President. At that time, I was team leader of the CLO team, co-chair of most CLO rating committees and jointly responsible for evaluating all new CLO rating guidelines.

I am happy to say that the majority of CLOs have exhibited a high level of stability throughout this crisis. Today, I'm currently engaged with PF2 Securities Evaluations, a New York-based firm which consults on CDO securities.

You've asked me to answer several questions about Moody's and its role in the current financial crisis. My answer to these questions falls into three parts:

First, I will describe in general the cultural revolution that Moody's senior management imposed at Moody's and some compelling evidence of its impact;

Second, I will describe the techniques Moody's senior management used to implement this revolution, and why they were successful;

And finally, if I have time, and I

don't think I will, I will describe a particularly egregious example of how the revolution corrupted the process of rating analysis.

CHAIRMAN ANGELIDES: We can make that one of our first questions.

VICE-CHAIRMAN THOMAS: Yes, make that one first.

MR. FROEBA: Okay. Well, I'll get to it. Maybe we'll get to it. I'll at least give you a summary of it. Anyway, returning to the --

VICE-CHAIRMAN THOMAS: In all seriousness, let me say, don't worry about that one. That will be my first question and you can do it on my time.

MR. FROEBA: Thank you. The cultural revolution at Moody's:

The story of Moody's role in the financial crisis begins sometime in the year 2000, the year that Dun & Bradstreet Corporation and Moody's Corporation became separate, independent publicly-traded companies; and I might add that Moody's senior managers were first able to begin receiving compensation in the form of stock options and other interests directly in Moody's Corporation.

Before then, Moody's had an extremely conservative analytical culture. Moody's analysts were proud to work for what they believed was by far the best of the rating agencies. Everyone understood that for any new product that was unusual or complex, the Moody's rating was the one to get; and that without it, it would be difficult or even impossible to market the new product. In short, the Moody's of that time had the stature and maybe even the power to stop something like the subprime bubble, had it arisen then.

Unfortunately, by the time the bubble arrived, Moody's had deliberately abandoned its stature, surrendered its power and given up its analytical distinctiveness. How did it happen?

Under the guise of making Moody's more business-friendly, for example, making sure that analysts would return telephone calls, Moody's senior managers set in motion a radical change in Moody's analytical culture that not only changed the rating process but also profoundly affected Moody's ratings.

When I joined Moody's in late 1997 an analyst's worst fear was that we would contribute to the assignment of a rating that was wrong. When I left Moody's, an analyst's worst fear was that he would do something, or she, that would allow him or her to be singled out for jeopardizing Moody's market share.

The best example of this was described in a Wall Street Journal article about Moody's managing director, Brian Clarkson, published in April of 2008. As that article reports, Brian Clarkson quadrupled Moody's market share in the residential mortgage securities group by simply firing or transferring nearly all the analysts in the group and replacing them with analysts willing to apply a new

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rating methodology. As I am quoted saying about this new approach to the bottom line at Moody's in The Wall Street Journal article, there was never an explicit directive to subordinate rating quality to market share; there was, rather, a palpable erosion of institutional support for any rating analysis that threatened market share.

My mom asked me once what did that actually mean. It was a little dense, but now I'll explain to you what it means. Moody's senior managers never set out to make sure that Moody's rating answers were always wrong. Instead, they put in place a new culture that would not tolerate for long any answer that hurt Moody's bottom line. Such an answer became, almost by definition, the wrong answer, whatever its analytical merit.

However, arriving at an accurate answer was never objectionable, so long as that answer did not threaten market share and revenue. For this reason, there are some structured finance securities where Moody's ratings continue to be accurate and of high quality. This is not evidence of rating integrity. It is simply evidence that for these types of securities, Moody's was not exposed to rating competition.

In my opinion, wherever Moody's encountered material market share pressure, rating competition, we can expect to see that its ratings become indistinguishable from the ratings of its competitors.

Is there evidence that this is what really happened? I do not expect that you will find e-mails, minutes of meetings or memoranda setting forth the plan to change Moody's culture. However, the best evidence is the most obvious. Simply plot Moody's market share and revenue over time for any particular structured finance security, and compare it to the timing of material changes in Moody's rating methodology for that security. You should

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find that Moody's consistently responded to the onset of market share and revenue pressures by initiating material methodological changes.

There is also evidence of this from Moody's own internal business effectiveness survey, a periodic survey that allowed Moody's employees to criticize superiors anonymously. The BES results were apparently so disturbing in one survey that Brian Clarkson himself visited various structured finance group meetings, including a meeting of my group at Moody's, to report that junior analysts had complained in the BES that accurate rating analysis was more and more being subordinated to considerations of market share and revenue in the rating process, and two, to reassure everyone that this was not at all the case.

Of course, at this meeting, Brian seemed merely to pay lip service to a principle that his other words and actions contradicted. He did not describe any effort by Moody's to uncover the cause of these complaints; moreover, he did not describe anything Moody's had done to eliminate those causes. Together this had the effect of reinforcing the very view that he was supposed to be there to correct. That market share considerations really were much more important than getting the answer right. And in the end, neither he nor anyone in Moody's management did anything to unwind the many changes that provoked these BES survey results.

What were the changes, what were the techniques they used to accomplish the culture change? There were two ways --

CHAIRMAN ANGELIDES: Just to do a little check here, how far along are you?

THE WITNESS: I would same I'm about halfway.

CHAIRMAN ANGELIDES: I'm going to ask you to see if you can wrap up in the next minute or two, all right?

MR. FROEBA: All right.

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CHAIRMAN ANGELIDES: Two minutes.

MR. FROEBA: Okay. Well, Rick was going to cede me a couple minutes--

CHAIRMAN ANGELIDES: Do me a favor, just, I agree, just two minutes, hit the high points, and then we can go to questions.

MR. FROEBA: There were ways that Moody's senior management imposed a new culture on Moody's analysts. First, they used intimidation to create a docile population of analysts afraid to upset investment bankers, and ready to cooperate to the maximum extent possible.

Second, they emboldened investment bankers, gave them confidence that they could stand up to Moody's analysts and gave them reason to believe that Moody's management would, where necessary, support the bankers against its own analysts.

And I will now skip over most of my discussion of the ways in which Brian used threats of employment termination to intimidate analysts. But before I leave that topic of termination, I want to make a point that, as a tool to implement the culture change at Moody's, it is important to point out that Brian was not a rogue manager running amok.

While Moody's board and president were deceived about his conduct, they recognized in Brian the character of someone who could do uncomfortable things with ease and they exploited his character to advance their agenda. They were the ones who put Brian in charge of the RMBS group, and we can be quite confident he was not put there to improve morale. This is why it is important not to think about Brian separately from the people who were using him to implement the culture change at Moody's; first, John Rutherford, Jr., and then Ray McDaniel.

One collateral consequence of the cultural change was an inevitable and sometimes deliberate change in the quality of managers and analysts at Moody's, at least in the structured finance area. At

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a rating agency, independence of mind among managers and analysts is a very valuable thing if you are looking for the right answer, and a very inconvenient thing if you are looking for an answer to enhance revenue and profit.

For this reason, strong academic credentials and the independence of mind that comes with them came to be valued less in promotion decisions than they had once been. At first, all the MDs in the derivatives group on the quantitative side had very distinguished academic credentials. One a had a Ph.D. in economics from Stanford; other another a Ph.D. in mathematics from MIT, a third a Ph.D. in statistics from Wharton; one other did not have a Ph.D., but had both an MBA and an M.S. in statistics.

Later MDs did not have such distinguished credentials. For example, into the midst of all these academic credentials, Brian promoted a new MD, Yuri Yoshizawa, who had not earned any graduate

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degree at all. Her only academic credential is an undergraduate degree with a major emphasis in international relations.

Of course, Yuri is a capable person with undeniable skills. Nevertheless, the marked contrast between her academic qualifications and those of her predecessors and colleagues at least invites the inference that her selection was intended to keep the scope of her analytic work directed within new and more limited boundaries.

CHAIRMAN ANGELIDES: If you would please wrap it up.

MR. FROEBA: Yes. It cannot be the case with such a limited academic background that Yuri was expected to interact as an equal with bankers who themselves had much stronger and more relevant backgrounds.

And then Moody's, without completing that thought, and -- I'll just say in summary, Moody's also in addition to intimidating analysts, went through a whole series of steps that encouraged bankers against the analysts.

And that will the conclusion of my testimony.

CHAIRMAN ANGELIDES: And we can get to your comments and questions.

Mr. Michalek?

MR. MICHALEK: Mr. Chairman -- Mr. Vice Chairman, fellow commissioners. My name is Richard Michalek, and I want to thank you and your staff for inviting me to participate in today's hearings.

I'm a former employee of Moody's. I joined the structured derivatives products group at Moody's in June of 1999. My position was eliminated in December of 2007. At the end of my tenure, I held the title of Vice-President, Senior Credit Officer. My general responsibilities included performing legal analyses on the structure and documentation of complex structured finance transactions in order to assign a rating to that transaction,

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and to assist in the development and refining of rating practices, policies and methodologies used by the group.

My regular responsibilities included participating in rating committees within the group and, on request, for other groups; consulting on legal matters for other groups in New York, London and the Asian offices of Moody's when requested, and speaking at industry conferences on a wide variety of legal and structural issues.

I also prepared and published the CDO group's quarterly and annual review and survey of activity, and I assisted with the legal portion of semiannual training sessions for all new hires in the structured finance department.

During my last year at Moody's, my primary responsibilities were split between serving as a senior legal analyst on a team responsible for developing, refining and implementing the methodology for assigning ratings to highly complex

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credit derivative product companies, and being a project leader responsible for developing a methodology for rating collateral managers.

My testimony today is based on, and primarily limited to, my experience working in the CDO group at Moody's. And while I had the opportunity to interact with several other groups, I do not profess any particular expertise or advanced knowledge of the methodologies or practices employed in those groups.

My testimony today is also not being delivered with the intention to defame Moody's or bring harm to any individual or stand in judgment of individual behavior. On the contrary, as I hope my oral remarks and written statement will illustrate, I believe that imperfections, flaws and failures observed in the credit crating products for structured derivative products are neither surprising nor unexpected in light of framework of incentives presented to the competent and otherwise rational people comprising the credit rating agencies.

In theory, credit rating agencies serve the important function of providing buyers and sellers of credit, that is, investors in and issuers of a promise to pay, with an independent measure of the risk presented. Ideally, these agents are independent. And because of repeat experience and rationalization of cost, they should be able to provide this measure of risk at a lower cost than would otherwise be faced if the buyers or sellers produced the analysis themselves.

My experience as an analyst, however, in the derivatives group and as a legal resource in the derivatives group for other groups at Moody's, provides what I hope would be a useful perspective with respect to a couple of questions Commissioners may have asked or have already asked.

A few questions keep coming up. Just how independent are these agencies,

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particularly within an issuer-pays framework, and what consequences the rating agencies suffer under the current or any proposed framework, when these measures of risk either fail to perform as reasonably expected, or which can be shown to have lacked the level of care commensurate with the risk of harm that may foreseeably befall the user who relies on such measures.

As for that first question, in my view, the independence in culture of the derivatives group changed dramatically during my tenure. The willingness to decline to rate or just say no to proposed transactions steadily diminished. That unwillingness to say no grew in parallel with the company's share price and the proportion of total firm revenues represented by structured finance transactions.

In my opinion, the apparent loss of bargaining power by the rating agencies in general and the group in particular was

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coincident with the steady drive towards commoditization of the instruments we were rating. That drive was not sufficiently sensitive to the increasing complexity of the products we were being asked to rate.

As our customers, principally, the investment banks, produced more and more product for yield-hungry investors, and as the quality distinction between the different rating agencies lost some of its importance, the threat of losing business to a competitor, even if not realized, absolutely tilted the balance away from an independent arbiter of risk towards a captive facilitator of risk transfer.

The second question, in essence, what should result if a rating agency gets it wrong, is in my view asking a question of more fundamental questions. Who should bear the risk of getting it wrong, particularly when it's within reach to either not get it wrong or choose not to rate. If we accept that the ratings are the rating agency's products, should all

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the ratings issued by a rating agency he entitled to the same defenses for product liability?

I'm of the opinion that much more could have and should have been done to improve processes and procedures, but I'm not so naive as to fail to appreciate that this the competitive environment of hyper growth, where the message from management was not, "Just say no," but instead, "Must say yes." Any available resource had to be spent on remedial corrections. Installing improvements were left for the "some day" pile.

I'm in the camp that believes to a significant degree that ratings provide an important public good. I also believe that some ratings, in light of the public good they provide, deserve some measure of protection from liability and opportunistic claims of negligence.

However, to the extent that agencies are to remain wholly private entities, understandably concerned with market share

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and net profits, a distinction based on the extent of the public good might be made. Where some question can reasonably be raised as to the extent of the public benefit from rating one or more of the highly complex or novel instruments, the liability for getting it wrong might be more fairly assigned to the private parties involved.

I'm confident that if questions of negligence were not as easily dismissed by the protestations of free speech and opinion, at least for that subset of ratings on approximate with the benefit of the rating falls primarily to the private parties involved, the agencies would redirect some of their extraordinary profit margins into resources, research, and would once again have an incentive to just say no.

I stand ready to answer any questions you may have. Thank you.

CHAIRMAN ANGELIDES: Thank you very much, gentlemen. I'm going to start with a few questions, go to the other members, and then we'll probably return to ask some more at the tail end of this.

I think I actually want to start with you, Mr. Froeba, and not to ask you to complete the balance of your statement, but to talk in substance about a couple of things to which you alluded.

One is, you talked about charting model changes over time. I want you to elaborate specifically on that, you know, and I'd like to you address very specific instances of how models changed over time to the detriment of the ratings quality.

MR. FROEBA: Sure. A rating agency's primarily intellectual property is its rating methodology for a particular type of asset. That methodology is then taught to junior people and they apply it on a case-by-case basis and the rating committee endorses that application.

But the key feature of what the rating agency does is, a key tool it uses, is its methodology for assigning rating to a particular product.

I'm simply, in my comments here, saying that in order to verify what I'm saying, that you would need to -- if you plotted Moody's market share for any particular type of structured finance credit, and on the same chart, put Moody's timing of major methodological changes, I think you'll find a correspondence between changes in methodology and market share pressure. So that was the point I was trying to make.

CHAIRMAN ANGELIDES: But what I'd like to have you elaborate on, what kinds of changes in methodology did you see? Specific examples of the kind of changes in methodology.

MR. FROEBA: In the CLO area where I was primarily involved, we had almost no major methodological changes, and we had almost no rating competition. In other areas where there was more pressure, for example, in RMBS, there were major methodological changes about the time that the whole team was fired, and their market share grew substantially.

Another area --

CHAIRMAN ANGELIDES: The team being fired in the early 2000s?

MR. FROEBA: Yes. It wasn't just that they fired the team, it was that they also changed their methodology. Another example is in the area of the CDOs of ABS.

CHAIRMAN ANGELIDES: But stop there for a minute. In which ways did they change the methodology?

MR. FROEBA: I'm not an expert in the RMBS methodology.

CHAIRMAN ANGELIDES: Well, you've been told that they changed it?

MR. FROEBA: Yes.

CHAIRMAN ANGELIDES: By?

MR. FROEBA: It was understood at Moody's that the reason Moody's fired all those people, including Mark Adelson, who was the head of the group, was that the market share was 14 or 15 percent, and that his view of the asset was so conservative that it was causing Moody's to not be able to rate the bulk of the deals that were out there.

In fact, to my recollection, people described Mark Adelson's departure as being associated primarily with the fact that he allowed the market share to drop to 14 or 15 percent and that he wasn't willing to update his view.

When you say, "update his view," what do we mean? Change the methodology. Improve it. To make it more -- to keep Moody's in a position to acquire more business.

CHAIRMAN ANGELIDES: All right, keep going.

MR. FROEBA: And then my example at the end of my prepared testimony is another case where, under some market share pressure, in anticipation of more market share pressure, there was a methodological change that restored market share. So those are some examples. I -- those are just examples that happened to

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cross my path in my area, which was CLOs, and was not even related to these other areas, loosely related.

So I think what you'll find, if you -- if you were to take all the major structured finance asset classes, find the ones where there was significant market share pressure and check the timing of major methodological changes, I think you'd see some correlation between changes in methodology and market share pressure. That's the point I'm making. That becomes evidence of the culture change. It's no longer possible to tolerate methodologies which produce zero revenue, or -- not zero, but which result in Moody's having to say no to a transaction.

CHAIRMAN ANGELIDES: All right. Talk very briefly about Yuri Yoshizawa, very quickly. You didn't finish that thought, please, and don't hold the lack of a graduate degree against her, because the chair does not hold one. Just for the record.

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MR. FROEBA: I don't. I don't. I use that as an example, not because she lacks a graduate degree, but to point out that her peers at the time had them, and that she was put in a position where she needed to interact with others on a quantitative level who would be those people --

CHAIRMAN ANGELIDES: So it's the quantitative skill sets that were lacking?

MR. FROEBA: I'm not even commenting that I think she was lacking them. I'm simply saying, if you were looking at her on paper, versus the people who were her predecessors and colleagues, and versus the people whom she would be dealing with.

CHAIRMAN ANGELIDES: She was very bright, talented --

MR. FROEBA: That's possible. That's possible.

CHAIRMAN ANGELIDES: Talk specifically about the threats --

MR. FROEBA: Even most very bright people are not going to be able to handle, you know, quantitative discussions with Ph.D.s in statistics and math, if -- based on an undergraduate major in math. That would be -- that's my point. Maybe I'm wrong.

CHAIRMAN ANGELIDES: Okay.

MR. FROEBA: Maybe it doesn't depend on -- she want to Stanford, so --

CHAIRMAN ANGELIDES: I don't think that matters, and I think it goes to intrinsic capacity of a management leader. Let me ask you this question --

MR. FROEBA: You wanted me to follow up on Yuri, was that --

CHAIRMAN ANGELIDES: I think you made your point --

MR. FROEBA: Oh, there was one other, yeah.

CHAIRMAN ANGELIDES: Go ahead. Was there another point you wanted to make very quickly?

MR. FROEBA: In my prepared testimony I talked about the case where I happened to be aware of an incident in which she

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retaliated against an analyst by removing them form a deal, even though she testified recently that she remembered no such case.

CHAIRMAN ANGELIDES: Is this the Steve Lucci, is that it, Liucci, or not?

MR. FROEBA: No, he was not involved in that case.

CHAIRMAN ANGELIDES: So why don't you tell, I understand that she -- correct, Ms. Yoshizawa --

MR. FROEBA: Yes.

CHAIRMAN ANGELIDES: -- yes, that she testified before the Senate subcommittee that she never removed someone from a transaction except for scheduling purposes.

MR. FROEBA: Or, she also later on went on to say that if she thought they were being abused by bankers she would remove them, too.

CHAIRMAN ANGELIDES: So do you want to give us a specific instance?

MR. FROEBA: Yes, and I'm not

necessarily going to name the names of the people involved, although I could do so.

CHAIRMAN ANGELIDES: You should, for the record.

MR. FROEBA: But not perhaps here.

CHAIRMAN ANGELIDES: Well, there's only one place to do it.

MR. FROEBA: Anyway, the person -- maybe you don't want me to go into the story if I don't name the names.

CHAIRMAN ANGELIDES: Well, just do it quickly.

MR. FROEBA: There was a transaction in which a banker complained vociferously about an analyst who was relatively new, and Yuri took her off the deal and replaced her, and ultimately the person who was replaced was fired; and the analyst who was the replacement analyst, both the one who left and the one who stayed to work on the transaction, told me about the story, and in that -- in that story, it was clear that, from the testimony to me, of the second analyst,

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replacement analyst, that the work the first analyst had done was good work, and that it had not been defective. So --

CHAIRMAN ANGELIDES: Had it been objected to by a banker?

MR. FROEBA: Yes.

CHAIRMAN ANGELIDES: I'm going to ask you to provide the information to our staff.

MR. FROEBA: I will.

CHAIRMAN ANGELIDES: But given that there was what personnel action, I'm not going to press you right now for specific names.

MR. FROEBA: That's why I didn't quantity to put in the name.

CHAIRMAN ANGELIDES: Yes, Mr. Michalek?

MR. MICHALEK: Mr. Chairman, you had asked about specific instances where the methodology was affected by potential pressure for market share. One place that we can sort of focus is where there was the development of new methodologies. In

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the area that I worked in, the credit derivatives products companies, which Dr. Witt referred to as structured finance operating companies, because that was their nomenclature when they were still at that level of development, was one area where the methodology was under significant pressure because our competitor rating agencies, Standard & Poor’s, was developing a methodology that was significantly less onerous from a capital perspective.

Credit derivative product companies, and I wouldn't try to describe in detail what they were doing, were effectively completing with the monoline insurers. So they were providing insurance to issuers of AAA-rated obligations, because the monolines, based solely on their balance sheet, are offering this guarantee of the performance of that AAA-rated entity and if you'd -- as we've subsequently seen, the risk that these monolines were exposed to was enormous, and there wasn't actually

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a strong quantitative methodology for determining whether or not that exposure was adequately capitalized at the monolines.

So the idea came forth to develop a quantitative way of approaching the sufficiency of a AAA, which created some problems internally at Moody's because effectively, we were now competing with ourselves, because the monoline insurers were getting their AAAs only after years of demonstrated ability to perform; and these new credit derivative product companies and structured finance operating companies were effectively coming and saying, "We'll put up the right amount of capital and we'll show you that it's the right amount of capital, but we want a AAA rating today, with no prior experience."

Well, clearly, that was a high risk situation. You had to identify with certainty that you can issue a AAA rating based on largely a quantitative modeling of what was actually being presented.

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And so the development of that methodology really was quite on point, that we did have to delay and delay our release of the methodology and we were, in several cases, told that we had to go back to drawing board because our competitor rating agency was requiring a lower level of capital and therefore, people were not going to choose us as the rater but would use our competitor.

CHAIRMAN ANGELIDES: And the final outcome was the adoption of a methodology that has since met the lower bar?

MR. MICHALEK: Well, it was a compromise situation and I do think that we had a couple of potential clients who said, "I'm sorry, it's simply too onerous so we're not going to use you." But we did -- an extreme amount of pressure was actually imposed on us to come to a rating in a time that several people who were at the rating committee were suggesting was on too accelerated a basis and that we still needed to do further work.

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CHAIRMAN ANGELIDES: But was there explicit pressure or was it methodological discourse? In other words, were folks told, "Look, we can't have a standard that's so much different than Standard & Poor's," or was it "We think there are flaws in the Standard & Poor's" -- I'm just trying to get the dialogue.

MR. MICHALEK: It would have been a combination of those.

CHAIRMAN ANGELIDES: So there was explicit elements of "We've got to be in the marketplace with a product that's close," and then obviously people think about still trying to do that in a way that we can --

MR. MICHALEK: Correct. Things would always be delivered that way and I think that's the right way to --

CHAIRMAN ANGELIDES: Was there a constant tension?

MR. MICHALEK: During the development of this methodology, it was significant.

CHAIRMAN ANGELIDES: Okay. And what

time frame was this?

MR. MICHALEK: 2005. If you look at the development of the methodology, I think there's a piece that Moody's published and it's written by Dr. Radanti Tzani. She's the author, and that piece took a long time in development, and certain compromises had to be made in order to even come to the market with that published methodology.

CHAIRMAN ANGELIDES: Along those lines, was there a general understanding in these, that the -- you know, that those who give out the easier grades get the biggest number of students?

MR. MICHALEK: Yes. It was a constant case of balancing. We were trying to maintain our competitiveness. Obviously, we weren't going to get paid, we weren't going to be able to give an opinion if we weren't on the deal. But at the same time, there was a concern, particularly in this situation, that the risk was enormous. Because we were talking about a book of business that would start at five hundred million dollars, where they were needing to raise capital of that amount because of the exposure that they were going to immediately be writing.

So they needed to raise initially, the thought was, perhaps you would need as much as five hundred million dollars worth of capital to start rating and then you'd have to build a book of business that over time would ramp to ten or 15 or $20 billion, and that leverage was expected to continue to increase and it would only be over time where they reduced the amount of capital.

But that was significantly more than our competitor rating agency was actually expecting in order to issue that AAA rating.

CHAIRMAN ANGELIDES: All right. I'm going to hold -- I will ask one question, if you can do it very quickly. You mentioned specific threats against employees if they didn't, what, rate deals?

MR. FROEBA: Well, I think I left out some discussion of ways in which Brian threatened to fire people. That was a key part of his approach --

CHAIRMAN ANGELIDES: It's explicit threats?

MR. FROEBA: Are you saying, "I'm going to fire you unless you rate this transaction?" No, no. It was sort of -- it was -- it was, he would repeatedly tell you -- he would remind you repeatedly that you were vulnerable to being fired, with the example, for example, of all the, the 22 people from the -- you probably haven't heard this.

Brian was famous for his joke within Moody's that his only regret in firing 22 people from the RMBS group was that one of them got a job before he could fire him. And he repeated that joke regularly. And the point was to remind you that you were vulnerable to being fired.

There was a point which Rick has actually talked about -- Mr. Michalek has talked about a meeting that many of us who were lawyers in the derivatives group had with him, and that meeting was really designed to remind us that we, too, were vulnerable to being fired when he took over the group. And I could elaborate on that, but you wanted a short answer, so that's my answer.

CHAIRMAN ANGELIDES: Okay. I think that's it for me at this moment, and I'm going to go on now to the Vice-Chairman.

VICE-CHAIRMAN THOMAS: Thank you, Mr. Chairman. This panel, in its makeup now, unfortunately, not because of you folk, but because of someone at a higher management level, resembles more the first panel that we had than we had anticipated.

Notwithstanding the bona fides in your testimony, Mr. Froeba, I do want to ask those that I had talked to earlier, Mr. Chairman -- this is highly unusual, but I noticed off to my left, the audience's right, Dr. Witt is still here. And Dr. Kolchinsky is still here. What were the ten years that you were at Moody's?

MR. FROEBA: '97 to 2007.

VICE-CHAIRMAN THOMAS: '97-'07. That coincides. You just nod your head, because we're not going to put it on the record, but I'll signify the direction of the head movement, you were there at the same time?

A VOICE: Yes, sir, I began in --

VICE-CHAIRMAN THOMAS: You don't have to talk. Just nod your head. Both of those gentlemen nodded their heads.

MR. FROEBA: I can confirm on the record, they were both there contemporaneous with me in the same group.

VICE-CHAIRMAN THOMAS: I appreciate your telling me that, but I asked them. Okay? Okay. You heard the testimony. Would you say that the testimony was substantially accurate based upon your experiences? Nod your head yes or no.

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You have to say something, go ahead.

DR. WITT: I have to say yes or no. I substantially, I wouldn't agree with he every nuance, but I know exactly what Rick is talking about, and there were differences of opinion --

VICE-CHAIRMAN THOMAS: Rick I'm not referring to. Right now I'm referring to Mark's testimony. About individuals.

DR. WITT: And about Brian applying pressure to people, saying that they might be fired?

VICE-CHAIRMAN THOMAS: This isn't going to work. That's why I shouldn't have done it. This sounded a whole lot more like Judge Judy than most of the testimony that we've had.

You were there for ten years. This reduction in quality, this shift in management toward getting the bucks instead of getting it right, occurred roughly when along that timeline?

MR. FROEBA: I think it was a progressive development over time. I got there in '97. So the change in culture probably accelerated. It was particularly acute beginning with the time when Brian took over the group, which was, I think, the derivatives group in 2002.

VICE-CHAIRMAN THOMAS: And it accelerated from there?

MR. FROEBA: Yes.

VICE-CHAIRMAN THOMAS: So you were there roughly five years, and then you were there five years after it?

MR. FROEBA: Correct.

VICE-CHAIRMAN THOMAS: So why did you stay that long?

MR. FROEBA: I'm not sure I understand your question. You mean did I feel like I should leave because it was a culture that was disturbing?

VICE-CHAIRMAN THOMAS: That would be a good question. So I'll say, sure.

MR. FROEBA: Okay. It wasn't disturbing within my particular sphere. Like I told you, the CLO area was one where there was very little market share pressure. I think, had there been a lot of market share pressure, I would have been expose to the same difficult choices that other people at Moody's were faced with.

VICE-CHAIRMAN THOMAS: But in your testimony -- unfortunately, you weren't able to deliver it orally -- you talk about it in especially egregious case which was a CLO.

MR. FROEBA: Correct.

VICE-CHAIRMAN THOMAS: Was that one of the reasons you decided to leave?

MR. FROEBA: Well, no, I was -- my departure was not my own decision. Moody's downsized me along with Rick at the same time, Rick Michalek. It was December of 2007.

The CLO issue that I describe in my testimony is relevant to Moody's Europe. And it is an independent office, and the rating methodology that they applied, though, very similar to the one in New York, is its own. And the change I described happened there.

VICE-CHAIRMAN THOMAS: I understand that. I read it. Back to my nodders. Do you generally agree with this characterization -- and you know, I'm sorry that Mr. Clarkson has a kidney stone --

COMMISSIONER GEORGIOU: Mr. Chairman, why don't we --

CHAIRMAN ANGELIDES: I think it may be better to bring the witnesses back up.

VICE-CHAIRMAN THOMAS: Do you mind, because we --

CHAIRMAN ANGELIDES: Come back up. We even have name plates for you.

VICE-CHAIRMAN THOMAS: Dig up the old name plates.

CHAIRMAN ANGELIDES: Yes, let's do that.

MR. KOLCHINSKY: Our same seats.

(Dr. Witt and Mr. Kolchinsky are seated at the witness table.)

VICE-CHAIRMAN THOMAS: And the primary reason I'm doing this, Mr. Froeba, so you appreciate it, we never had this much direct accusatory, if you will, testimony on the shift --

CHAIRMAN ANGELIDES: Actually, before we do this, I'd like to remind both of you that you were sworn in earlier, and that, would you please acknowledge, Dr. Witt, you're still under oath?

DR. WITT: I'm still under oath.

MR. KOLCHINSKY: I'm still under oath.

CHAIRMAN ANGELIDES: Thank you, Mr. Kolchinsky. Thank you. We may now proceed with our orderly hearing.

VICE-CHAIRMAN THOMAS: I kind of liked the head nodding. Because of the relatively strong and definitive statements that it was not driven by money, your statement's probably more extreme in providing specific examples than the first panel, although there were clear innuendoes and hints of that direction.

So given the fact that yours are so

much bolder and direct, I really kind of wanted to visit the first panel to help us get a comfort level that, had you been on the first panel, they would have agreed with the statements you're making.

Mr. Michalek, your statement is similar in terms of the extreme focus on the money drive changing the culture at Moody's to get it right more so than the cost factor at Moody's.

So let me just say, do you generally agree with the emphasis, not necessarily every jot and tettle of the personal stories?

MR. KOLCHINSKY: Well, I do agree. And in my written and oral testimony, it was the same thing. I think the market share drove the methodologies down, and it created the free fall --

VICE-CHAIRMAN THOMAS: But you've got to admit -- you're both attorneys. He really was a lot more graphic than you were.

MR. KOLCHINSKY: I'm -- you know, I

generally try --

VICE-CHAIRMAN THOMAS: It's okay.

MR. KOLCHINSKY: We have a different style. It's a different style.

VICE-CHAIRMAN THOMAS: I noticed that right off. Dr. Witt?

DR. WITT: You know, I would -- Mark's characterization would be a bit, you know, was definitely more forceful than mine. Yes, I agree with some of his points, but you know, and some of them, I just don't know about. I don't know anything about this CLO issue with Europe. I mean, I heard a little bit about it. It wasn't my area.

But you know, I agree with a lot of what he says, but definitely not everything. And I think his -- if I was going to say it independently of him, it would sound a lot less -- I'm not so sure about it, you know, it's like -- it's not that I'm saying I disagree with him, it's just that I -- maybe he saw things I didn't see.

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VICE-CHAIRMAN THOMAS: Well, my concern is, the heart of his testimony is -- what I consider to be the heart of his testimony, in terms of a cause-and-effect relationship between those who had more alphabet letters behind their names versus those who didn't, with a clear implication that the analytical mind, verified by the number of diplomas on the wall, was being replaced by people who were more, if you want to use a tough term, shmoozy or understanding of the bottom line and how you get there, versus diplomas on the wall.

Her resume would not start off with her law degree or the level at which she performed in her law class.

DR. WITT: She was not a lawyer.

VICE-CHAIRMAN THOMAS: I understand that.

DR. WITT: Okay. I mean, Yuri, I mean, she was a very capable person in a lot of ways. I mean, she was an extremely good administrator --

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VICE-CHAIRMAN THOMAS: Okay. Let me direct the question then. She was a very capable person in many ways. Your primary function was rating. Would you rate her high at rating? She had other talents.

DR. WITT: I wouldn't rate her high at rating. I would not.

VICE-CHAIRMAN THOMAS: You would rate her high at shmoozing --

DR. WITT: No, administration. Managing a lot of people, remembering a lot of stuff and training junior staff, working well with the people above her.

VICE-CHAIRMAN THOMAS: That's a real talent.

DR. WITT: It is.

VICE-CHAIRMAN THOMAS: You can't necessarily get a degree to get that kind of talent --

DR. WITT: No, I agree. I didn't say -- when she and I were promoted exactly the same time to managing director, and they -- I think they expanded the number of managing directors

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at that time, and I didn't think that her promotion was unwarranted. You know, obviously, Mark did. I didn't. I mean, I thought she had a lot of talent. I thought that she and I were good complements, to be honest. We were very different, but...

VICE-CHAIRMAN THOMAS: Mr. Chairman, I'll reserve my time as well.

CHAIRMAN ANGELIDES: I'd like to ask, since you're all four back up here, each of you very quickly, so we have four individuals here in a firm with thousands of employees.

In the structured products arena in which all of you are operated, how pervasive was the feeling or the belief that market share was the driving force and that you better pay attention to it? How pervasive, do you hold a minority view?

MR. KOLCHINSKY: I would say, obviously, I can't speak for everyone; but for people I know, people who have been there more than a year, so more veterans, I think I would venture close to a hundred percent. I think the people understood that market share drives the train at that point. So...

CHAIRMAN ANGELIDES: Mr. Froeba?

MR. FROEBA: I completely agree. That's why I recommended that you look at the DES survey results. I think that will show a lot.

MR. MICHALEK: I thought that it grew over time. Towards the end it was a hundred percent the point, but initially it wasn't.

DR. WITT: I thought at the time I was there, and this is the CDO group, U.S. CDO group, it was pretty pervasive, that thinking. You know, I think most analysts, that's what they assumed. I definitely felt pressure for market share, you know. But as in my opening remarks, my mind, the question was, you know, was it too far? Did it go -- I thought -- once I became -- I say this in my written testimony. When I was an analyst, I just thought about getting the deals right. You know, I thought about ratings integrity. I didn't think about anything else.

Once I had, like, a budget to meet, I had salaries to pay, I started thinking bigger picture. I started realizing, yes, we do have shareholders and, yes, they deserved to make some money. We need to get the ratings right first, that's the most important thing; but you do have to think about market share. So I began to do the other side of it. But I definitely did question in my mind, are we going too far here.

CHAIRMAN ANGELIDES: A norm of mission creep, or perhaps someone would say mission sprint, a big shift over the last seven years? 2000 on? You're all the nodding your heads, yes.

All right, let's move on. Mr. Vice-Chairman, you want to move on to other members?

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VICE-CHAIRMAN THOMAS: Just one follow-up question.

Mr. Witt, based upon your transformation from doing the job to overseeing those to a certain extent who did the job in the CDOs area, was the 2005 assumptions for CDOs that we talked about, where did that occur in your shift from getting the rating right to looking at market share? Can you place that on a continuum between those points and your decision in '05?

DR. WITT: The new methodology that we introduced in 2005? Okay. We -- the methodology that we introduced in 2005 was in June 2005, in a paper that was, like there was a committee of people. It was decided to use the normal copy law. It was by far the most popular method on Wall Street for rating CDOs and --

VICE-CHAIRMAN THOMAS: Hundred percent ratings, 90 percent ratings, ten percent market share? Fifty-fifty?

DR. WITT: We had a committee. We

did -- there was a data analysis that was done and presented to us. There was discussions. The discussions did not center around market share at all.

VICE-CHAIRMAN THOMAS: Was it part of the discussion?

DR. WITT: I don't -- I don't remember anybody bringing it up explicitly, although I'm sure it was on everyone's minds.

VICE-CHAIRMAN THOMAS: Okay. Thank you, Mr. Chairman.

CHAIRMAN ANGELIDES: I am actually going to make one comment before we go to Senator Graham. On page 12 of your testimony -- excuse me -- page 11, you do refer to Ms. Yoshizawa's testimony under oath at the Senate Permanent Subcommittee on Investigations, correct?

MR. FROEBA: Correct.

CHAIRMAN ANGELIDES: And then what you're saying is, in your view, which is under oath, in your view that was not truthful, correct?

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MR. FROEBA: Well, she said she couldn't remember, so I can't have an opinion about whether she remembered. But I would --

CHAIRMAN ANGELIDES: All right. You said -- okay, I'm going to --

MR. FROEBA: It was doubtful to me that you would not be able to remember a case where you fired someone.

CHAIRMAN ANGELIDES: I'm going to ask our staff to follow up with both you, with the analyst involved and with Ms. Yoshizawa because, you have not made the allegation of perjury, but you noted that a statement was made and you remember a case that was contrary to those facts.

MR. FROEBA: Correct.

CHAIRMAN ANGELIDES: So this is a various matter. Our staff will follow up, with you, Ms. Yoshizawa, and the analyst who has been identified. All right.

Let's move on now to Senator Graham.

COMMISSIONER GRAHAM: Thank you, Mr. Chairman. Thank you, for those of who you have testified the first time, and those who are testifying the second time, there's no additional compensation for returning.

It seems here that we almost have a he-said/she-said, because I asked the specific question of Mr. McDaniel, was there a relationship between quality of product and aspiration for market share, and he said no. And you're saying there was such a relationship. Is that correct?

What would be, if we were to ask Moody's to provide us with data that might be able to answer the question of who was correct in this assessment of the situation, what data do you think would be most determinative in whether there was a relationship between market share and product quality?

MR. FROEBA: Well, I think the nice thing about what I was proposing in my testimony is that you don't have to believe me. I'm suggesting that you can try to look at the history of major methodological changes and see if they correspond to market share pressure and if you see that as a consistent pattern, it confirms what I'm alleging. It was certainly what we expected.

Now, I was in the CLO area and we didn't have much, you know, we didn't have much rating competition in our area. And yet I happened to see a couple of incidents where there was this pressure, one of which I described in my testimony.

COMMISSIONER GRAHAM: Is there any other piece of evidence that would be relevant to establishing this relationship?

MR. FROEBA: The problem was, you weren't going to find people coming to meetings and saying, "Let's change this so we get more market share." They would say, and perhaps this is innocuous, "Our competitors can get to this answer, are we right that we can't?" And that would begin an inquiry which could lead to a methodological change. That could be innocent. It could be not innocent.

MR. MICHALEK: What sort of evidence might be in the concept of grandfathering? And I think we need to make a distinction between market share, where we're trying to increase our market share, versus not lose a transaction. They are actually two sides of the same coin, but that is much more easily identifiable, whereby the imposition of a particular policy or revised policy, if a banker were to threaten that, you know, "If you're going to hold us to that standard, we're not going to use you," then there would be this internal discussion as to, "Well, can we grandfather them into the prior existing methodology at least for this deal."

And in that way, you could sort of see that there was this constant pressure to find a way to rate the transaction, notwithstanding that it might be in conflict with what our current or, as hard as it is to be "current" with your methodology, since it's a constantly changing process, it's one way to demonstrate that there was a response to the pressure our clients, the investment bank, to maintain a preexisting methodology as opposed to imposing a new methodology which would cause us to, in the aggregate, lose market share.

COMMISSIONER GRAHAM: Although there was one case in the staff review where an announcement had been made that there was going to be a change in methodology 90 days into the future, and that announcement seemed to have sparked an increase in applications for ratings, I assume for fear that the new standards were going to be more difficult than the current standards.

So that would seem to argue that it's not necessarily the case that all changes were watering-down changes.

MR. MICHALEK: That's correct. And that's the concept of grandfathering. And effectively, when there's a more restrictive methodology that was coming through, you would get a request to be grandfathered into the old methodology, with good reason. Potentially, it takes a long time to get a transaction up and running and you can't arbitrarily say, you know, "January 1st of next year, we're going to impose this new methodology."

If we have the information today, based on the argument that we've heard that, you know, based on all of our information today, we think the ratings were right assigned today, well, if we already have that methodology in our heads that it needs to be changed, you still have to make the judgment as to when we're going to roll that methodology out.

Some deals are going to be halfway ramped up, ready to go; and if you suddenly say, "I'm sorry, we're using a new methodology starting now, the net deal might be blown up and that's going to cost everybody a lot of money, so some judgment had to be made.

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COMMISSIONER GRAHAM: Staying with that, changes, Mr. McDaniel, when asked about some of the data that was coming from the economic unit of Moody's, particularly in October of 2006, you stated that that economic analysis was incorporated into the ratings methodology.

Was it your experience that, as units such as the economics came forward with data relative to declining house prices, increasing defaults, et cetera, that that led to a change in methodology, assumedly one that would have taken those factors into account and been more stringent? Mr. Witt, you talked a lot about research in your first round of testimony.

DR. WITT: A lot about what?

COMMISSIONER GRAHAM: Research. The need for more independent research.

DR. WITT: One of the things I was thinking about when I said that was, I listened to Paul McCauley, I think his name is, from PIMCO when he was on the shadow banking thing and I talked about how PIMCO sent out people to cities all across the country to talk to, like, real estate brokers and homeowners --

VICE-CHAIRMAN THOMAS: Shoe leather.

DR. WITT: Yes, shoe leather, and how it just, I couldn't imagine that happening in Moody's RMBS group because they just didn't have time to do that. They were really always short of staff and running so fast that, if you had an independent research group, maybe they would have thought of things like that, as well as doing, you know, surveys or sampling of data files and things like that.

But in CDOs, you know, because we were a derivative group and our ratings were derived from other groups, there wasn't as much response of looking to, say, like economists and things like that. So methodology -- the one big methodology change that occurred on my watch, the one I was talking about, the normal Copula for ABS CDOs in my perspective, that was driven not by lowering market share, but it was driven by the fact that the types of transactions that we were doing were different.

We were doing deals that were mostly residential that were highly correlated and we needed a model that reflected that. Our old model assumed that assets were not correlated and we needed a model that assumed the assets were correlated.

But I wasn't, you know, that wasn't something that comes from economists. It was driven by the market, those types of deals we received.

COMMISSIONER GRAHAM: If I have time, I'd like to come back to pick up on that issue before we finish. Let me ask a couple of other questions.

As these changes were being made in the last five plus or minus years, was there any reporting to either investors or regulatory agencies that methodologies and personnel were being altered?

DR. WITT: Not that I know of.

MR. MICHALEK: I'm sorry, I might be

misunderstanding the question but it was a part of our regular process to be telling the market how our methodology was evolving. Is that responsive?

COMMISSIONER GRAHAM: Yes.

DR. WITT: I thought you said regulators.

COMMISSIONER GRAHAM: When I say regulators I mean like the SEC or bank regulators, who have an interest in this because they are -- they passed directives requiring various entities to utilize ratings services for a variety of important economic purposes. So if you are modifying the way in which you are doing yours business, I would think that those agencies would be interested in knowing that to ask the question, is it -- does it continue to be appropriate for us to be mandating the use of these ratings services.

DR. WITT: Well, like Rick said, our methodologies in CDO group were transparent. We posted them on the website. We'd have investor conferences. We tried to publicize them as much as we could but we didn't reach out specifically to any regulatory authority that I know of with methodology changes.

COMMISSIONER GRAHAM: Let's now go to the CDO question, because I don't think we adequately have covered that, thus far.

It just, to me as a layperson, it seems counterintuitive that you can take stacks of mortgages which in their initial review were considered to be marginal in their value and, therefore, they got a relatively mediocre rating, and then strip those out of those securities and pile them up on top of each other and suddenly convert mediocre into 80 percent being AAA.

What is the theory that underlies that ability to engage in alchemy?

DR. WITT: Your staff told me that that question would probably come up, and it's actually -- and I've heard the question before, you might not be that

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surprised. It's in my written testimony. I tried to explain that.

But it, you know, obviously, we use mathematical models. A mathematical model consists of a set of assumptions, some mathematics then is used to draw conclusions.

So when people ask me that kind of question, some people are interested in the assumptions and what they were and why they were wrong and so people actually want to understand the mathematics.

COMMISSIONER GRAHAM: I mean, if my, to use an analogy, if you had a hundred homes that were all rated, not financially vulnerable but climactically vulnerable because they are, for instance, right on a coast that is subjected to periodic hurricanes, and as a Floridian, I know something about that, and you have those hundred houses, all of which have been rated vulnerable for a credible reason, now, you take the hundred houses and aggregate them together, and all of a sudden, they haven't moved, but suddenly they are less vulnerable.

That's, I don't understand how, by aggregation, you eliminate the factor that made them mediocre in their rating in the first place.

DR. WITT: That's a good example, because it's an example of the one extreme. And the method, the simple methodology that we used originally and the one that they continued to use for CLOs I think throughout Mark's career, is called the binomial expansion technique, which is based on the binomial distribution. So it's based on the idea of taking a whole lot of assets and representing them as a smaller number of assets.

The most extreme case of that would be, you've got a hundred, you know, let's just say mortgages, and you want to represent, you're going to represent them as only one mortgage because you think that they are all going to behave the same way. You think there's maybe a five percent chance they will default, but when they do it's because there's going to be a hurricane and they are all going to get wiped. So either 95 percent of the time, they are all paid off, five percent of the time, they all default. That is the extreme case.

The only way that you get to issuing 80 percent AAA against the example that your staff mentioned was if assets were BBB. So if you started with say a hundred BBB assets, and you were going to issue 80 percent AAA against it, so obviously, that's the senior 80 percent piece. The only way that could work, a BBB asset has a default probability of about five percent.

So if you think about it in terms of a binomial distribution, and if you'll allow me, I actually worked up the numbers for a 70 percent case, that was the number, the case they actually mentioned to me. But -- so for the case of a 70 percent AAA instead of 80 percent, starting with BBB assets, if you reduced it to ten, so if you said, instead of saying they are all in Florida, let's say we had a hundred mortgages but they are not all in Florida, ten of them are in Florida, and ten are in New York and ten are in California and ten are in Washington, you might think, "Well, we can represent this as ten blocks of ten mortgages and each block of ten is, you know, highly correlated with itself, but the blocks are from very different places and they are not going to default at the same time."

If you assume those blocks are independent and you got ten, so instead of having -- you actually have a hundred homes, but you're going to represent it as ten independent blocks of -- however big these are -- ten times that size.

Then, if each one of them was a BBB, you had a five percent default probability, obviously the expected default probability for the whole portfolio is still five percent. On average, you expect like, you know, a half of one of those blocks to default, because that's what you were assuming from the start. That was the BBB rating that we got from, you know, the RMBS group, which we're relying on.

But the extra secret sauce that our group puts in is this diversity score, which is essentially a correlation, which is the decision to reduce it from a hundred down to ten. If you go down to ten, whether there's a five percent default probability, if there are ten independent assets, then at 70 percent subordination, it would be AA 2. It's about one out of nine hundred chance. And what that means is that there's a one out of nine hundred chance that more than three of those blocks are going to default.

So that the average is that a half a block would default.

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COMMISSIONER GRAHAM: Let me ask -- my time is up. Let me ask -- this is my concluding question, all right? With that theory, let's say, of the CDOs that were issued by Moody's in the '06, '07, '08 time period, what percentage of them had greater defaults than the theory that you've just stated would have contemplated?

DR. WITT: You know, of course, again, I left the group in '05. It's a huge number. I don't know. It's for ABS -- for mezzanine ABS CDOs, for AAA mezzanine ABS CDOs, that was the case that was the worst, and I'm sure it's what, 90 percent or something?

COMMISSIONER GRAHAM: Is it was 90 percent instead of something in the ten percent area. Which assumptions were most found to be at fault that resulted in such a dramatic different outcome?

DR. WITT: You have to say it was both. It was both the default probability was wrong, and the correlation was wrong or the diversity score. I mean, that's the way I think of it.

You could -- you could just say "Oh, it was the RMBS group, they screwed up, we got it right, they messed up." You could have that interpretation. It would have some logical coherence to it. But I don't think that's valid. I think we both messed up.

COMMISSIONER GRAHAM: I'm system sticking with my hundred houses on the ocean. They are all going to go under.

MR. KOLCHINSKY: I think, I was in charge of the CDOs at the time and it was primarily driven by the underlying RMBS ratings. In our deals, we assumed that the expected loss in those deals was approximately one percent on the BBBs. It turned out to be a hundred percent, so off by a factor of a hundred.

But at the same time, the correlation assumptions that, diversity, using your analogy, we assumed that the houses weren't just all on the coast in Florida.

They have some in had Colorado, some in Idaho. Turned out they were on either side of 1 -- A1A. And so the hurricane came and flooded it all out.

CHAIRMAN ANGELIDES: But the original, just to pick up, the original sin was the assumption you'd have the one percent expected loss in a mezzanine tranche of what ended up being a very risky, well a pool of very risky loans that had been made, predicated essentially not on ability to pay but on continuing house price acceleration.

MR. KOLCHINSKY: Yes, in general, but also the CDO structures that also became the sole buyers of those tranches, and, because there's no real money buyers as well.

So our CDOs made it possible for those deals to get done, and because we're using these actuarial assumptions. So we were the vacuum cleaner that sucked those deals in and made those transactions possible. So yes, those ratings were wrong. I think most people in the market either believed that those ratings were wrong, or they were not getting paid for that risk, so they went away. And these CDOs basically took up all that slack that was, that the real money investors took out.

So it was a combination. The underlying ratings were wrong but our assumptions on diversity score were also wrong, and made -- created the possibility of those deals being economically feasible. Because if they had to pay more money, if they had to find investors, those deals just wouldn't get done. The economics wouldn't work.

COMMISSIONER GEORGIOU: Mr. Chairman, can I follow up on that? 'Cause this is --

CHAIRMAN ANGELIDES: Well, actually -- yes, you can. I'd like to go to Mr. Wallison but if it's just --

COMMISSIONER GEORGIOU: Well it's just the one question, you can do it on my time.

You know, Commissioner Graham and I had been talking about this quite a lot. Isn't the problem that -- first of all, to characterize this BBB tranche as mezzanine seems to me to be an overstatement as well in the RMBS world because it's the lowest-rated tranche short of equity.

So to call it mezzanine, I mean, it's kind of low, it seems to me, rather than mezzanine. Mezzanine, I have this sense, in the normal financing world, mezzanine is sort of the debt just under senior debt, which is kind of nice. But mezzanine tranche is like the ninth tranche out of ten, the tenth being equity. So to call it mezzanine is a misnomer, number one.

Number two is that its defies common sense not to assume that these tranches, which only required a modest decline in home prices across the board, to render worthless, which is actually what happened. When you take all these BBB

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tranches, a hundred BBB tranches from a hundred different RMBSs and put them into a CDO, for those of us who actually operate in the normal world, as opposed to in world that Moody's analytics was operating in, you would think that there might be some human common sense intervention that might say, "Look, we've had whatever, 90 percent price appreciation," as the Chairman constantly says, "In the last nine years, or seven years. These things all might -- all you've got to do is correct by five or seven percent in the house prices and then all of these BBB tranches will become worthless because they will -- they are the lowest, the first impaired tranches other than equity and all those RMBSs."

So the fact that you assumed that they didn't correlate seems to me to be an elevation of theory over reality in the analysis, in the analytical structure that was applied.

And, you know, that's why we've been

harping on it, again, from a common sense perspective. I mean, I understand mathematics to some extent. I was a math major in college. I'm just saying that's not infallible. You have to apply -- you have to apply some judgment to the process.

DR. WITT: Please, I -- these are like really simplistic models. This is why I keep going back to, you know, we needed independent research. I was very aware, these were very simplistic models. I wanted very much to -- we talked about -- I was trying to get into that I wanted to do a look-through analysis, one of the -- maybe Senator Graham -- someone was asking me about doing a look-through analysis.

I really wanted that when I was an MD. I went up to Boston, negotiated with this firm Intex to buy some software. They charged us a rapacious $350,000 a year. I actually, with Nicolas Weill's help, I got the money approved by senior management and the deal fell down on a non-compete clause because Moody's wanted to develop its own software. But you know, we never did, at least while I was there.

But, you know, I wanted to go further. Exactly the kind of thing you talked about. I wanted to know how much of a decline in house prices was going to cause, you know, like a default in these AAA ABS CDOs that I was rating, but I had no -- no way to do that. I was, you know, trying to get deals out the door. I thought up in my spare time a methodology that I thought was superior to normal copula that we ended up not using in the way into I had anticipated. But even that was very, very simplistic.

What we needed was more fulsome models that took into account, you know, like not the whole economy, but that linked house price sensitivity to the ratings on the -- on the CDOs, which we did not have. But there was no way we were going to have that when you were trying to do research with analysts who were, in their spare time, were just rating deals all the time, and then they had to, monitor deals, and then you had to do research in your spare time. It just wasn't going to happen.

COMMISSIONER GEORGIOU: But that begs the question, doesn't it? I mean, it still doesn't answer -- I understand. My time -- I intervened in this middle of it but I wanted to follow the point through because it makes sense to complete it.

VICE-CHAIRMAN THOMAS: One quick comment, then to Peter. I sounds to me like they wanted you to frame houses but they wouldn't give you a hammer. If it was about getting it right, that's a kind of tool that would be essential to help you getting it right.

DR. WITT: You know, I agree --

VICE-CHAIRMAN THOMAS: That's kind of an indictment, isn't it?

DR. WITT: Like I say, it wasn't that we were trying to get it wrong -- it

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wasn't that I thought what we were doing was wrong, it's just that I was so sure that we were not using enough resources to make sure that we were getting it right, and that was at a time when, you know, the profit margin for our group must have been like 80 percent or something.

VICE-CHAIRMAN THOMAS: Yes, so it was small "i" integrity, not capital "I."

CHAIRMAN ANGELIDES: Let's go to Mr. Wallison, but I must ask you, were you the witness interviewed who said your superior questioned why you were doing so much research, to quit reading reports, was that you?

MR. KOLCHINSKY: That was me.

CHAIRMAN ANGELIDES: Thank you. All right, Mr. Kolchinsky, sorry. Alright, Mr. Wallison.

COMMISSIONER WALLISON: Thank you, thank you. This morning, I think it was this morning, maybe it was this afternoon, we talked about whether the problems at Moody's were systemic, or pervasive, if you will, or limited, or rather might be an artifact of simply the confusion about maybe correlations in the housing and mortgage area. And I asked, maybe you were here, but I asked Mr. McDaniel to provide us with information about all of the asset-backed deals, that -- the different kinds of asset-backed deals that Moody's was rating so that we could compare what was happening in those deals with what happened in the housing area.

Because if it was all the same, there were lots of write-downs and downgrades going on in all the those other deals, we would really have a sense, then, that it was a systemic problem. And if that was not the case, then we might be looking simply at something that occurred because of the peculiarities of the housing business and the fact that very few people were able to predict the huge fall in housing prices.

So I'm going to ask all of you, we have four of you here, what do you think Mr. McDaniel's submission to us will show?

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Mr. Kolchinsky?

MR. KOLCHINSKY: It probably shows that it was limited, but I can suggest a few categories to the staff which they should look into. One, I credit to PF2 securities, which was Trump CDOs. Another one is CBOs, the first time go-around; market value CDOs, mobile home securitizations. Let's see, I had another one on the top -- those are all -- and CMBS hasn't gone full cycle, but it will, so those are categories I suggest look into--

COMMISSIONER WALLISON: We asked for all. So --

MR. KOLCHINSKY: Those are the categories I would look into. Mobile homes are real-estate-related, but they're more -- they're not really real estate --

COMMISSIONER WALLISON: They're credit cards --

MR. KOLCHINSKY: Credit cards are basically backed by the government, so they couldn't get that one wrong. The auto companies have now been effectively --

COMMISSIONER WALLISON: Backed by the Government?

MR. KOLCHINSKY: Because they are backed by the banks which are too big to fail and the banks can support the credit card programs, so effectively they have taken steps in the past couple of years to support their conduits by issuing class D tranches and recapitalize them. So essentially, because the credit card program is backed by a bank which is too big to fail, usually, they have done well. You're essentially, in my mind, very --

COMMISSIONER WALLISON: This is -- I don't want to use up all my time on this, but of course the banks were also issuing mortgage-backed securities.

MR. KOLCHINSKY: Yes, yes.

COMMISSIONER WALLISON: And those did fail.

MR. KOLCHINSKY: But in this case, the credit card conduits are an intrinsic part of a bank's business operating model because that's how they finance --

COMMISSIONER WALLISON: Okay, we'll get to see an awful lot of those. Now, what's your prediction, and will it show that there are as many downgrades as in the --

MR. KOLCHINSKY: There are some product, as I mentioned, that will show, probably not as bad as in the mortgage area but pretty bad.

COMMISSIONER WALLISON: Mr. Froeba?

MR. FROEBA: I don't really have much to add to what Eric said.

COMMISSIONER WALLISON: Well, your prediction is that there will be areas that we will look at that will show as many downgrades as in the mortgage area, I'd just like you to --

MR. FROEBA: Yes.

COMMISSIONER WALLISON: -- say that.

MR. FROEBA: Some.

MR. MICHALEK: I would suggest that they just decompose the transition studies into in individual asset classes, you'll get the information you're looking for.

They give you a general transition study for all the AAAs rated by Moody's. It's a large population. It includes a lot of different assets that are being rated. If you say, "Please give me a decomposed analysis so that I can see asset by asset what those transition studies are," then you can see whether --

COMMISSIONER WALLISON: That's what we will try to do.

MR. MICHALEK: Exactly.

COMMISSIONER WALLISON: And what is your prediction?

MR. MICHALEK: My prediction is that there will be, amongst the assets that Eric mentioned, I'd also mention SIBs, these CPDOs to the extent that they are actually going to acknowledge those. And what was the double -- double aircraft leasing, what is -- EETCs.

COMMISSIONER WALLISON: Okay. And Mr. Witt?

DR. WITT: As Mark said before about CLOs, you know, CLOs have done very well.

That would be a counterexample, and I think there will be some other consumer finance asset classes that have done okay. But manufactured housing was the one that always stuck in my mind that we -- because that one, the problems were in like 2003, and it was like a warning light that we just didn't pay attention to.

COMMISSIONER WALLISON: The CLO area is something I do want to cover because I gather that there was no, or little competition in that area.

Why is that?

MR. FROEBA: That's an interesting question. Fitch is the rating agency that drove competition, I think, in the RMBS area. And they were one of the reasons why Moody's market share at one point dropped so precipitously in RMBS securities. It was competition against Moody's brought by Fitch.

In the corporate area, remember that a CLO is backed by corporate loans. There was no real competition from Fitch. And that meant that for every transaction which needed two ratings, there were two rating agencies available to rate them.

The underlying credits were not being rated by Fitch so the managers weren't really interested in getting a rating from Fitch on the CLO because the underlying credits weren't rated by Fitch. That's why there was very little competition.

COMMISSIONER WALLISON: Okay. Mr. Michalek? The -- you point to this issue of competition as being very important in how opinions are given under -- under the pressure of competition. And I keep thinking back to experience that I have had with auditors and law firms, which also give opinions under very similar kinds of circumstances. And I'm not asking you to talk about them at all.

But I am wondering how Moody's or rating agencies in general are different and why you believed that, or believe that their opinions are so heavily affected by

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competition, or do you believe it's all the same and the auditors are also succumbing to competitive pressures?

MR. MICHALEK: Well, I do think that both the auditors and the law firms are subject to an enormous amount of competitive pressures, particularly during this ramp-up period when things were getting extremely busy, the response, as -- I worked at a law firm prior to coming to Moody's -- the response was to offer capped transaction costs. So effectively, they are under the same pressures to try to get the work done and the deal signed off without ruining their own profit margin.

So that was also generating, in the way that the law firms would often deal with it was, to generate a standard template opinion that would then be, you know, affected on the margins but the opinion committee would work very hard to make sure that they weren't introducing any risk to the partners for having issued an opinion that would ultimately generate liability for the firm.

But the additional work that they had to do in order to do the work necessary to get these complex transactions rated, proved to be yet another source of pressure that came back to the rating agencies, because they were directly in communication with our clients, the investment banks.

And so to the extent that we, as analysts, were working on a transaction and saying we need more time, or, you know, there's issues with this documentation, their lawyers, the investment bank's lawyer would then report back to their client and say, "The analyst at Moody's is causing us to have to run our bill up and we're going to have to ask for an exception from our cap."

So they were responding to the pressure by either pushing back on us and putting more pressure on the rating agencies, or putting pressure on the clients who put pressure on us.

COMMISSIONER WALLISON: I understand that. I was actually asking a slightly different question. I was asking for your judgment about why law firms and accounting firms, outside the issue of ratings, outside the offering of structured financings of various kinds, which are subject to the same kind of competitive pressures that you were referring to, why we don't see the same degree of elimination of standards or reduction in standards or weakening of standards as we have seen at Moody's.

MR. MICHALEK: It's an interesting question. I do think that there is a segregation of the service providers, at least by the clients. You can go to a -- I won't try to name them, top-tier law firm and then, to the extent that your budget doesn't provide, then there's the second-tier law firm and the third-tier law firm. And it's up to the law firms and their own business model as to where they want to compete. And so they will establish the quality that they are delivering and the prices that they are setting according to where they think they are going to be most effective at competing.

COMMISSIONER WALLISON: But they have, they are always under the same pressure, and that is, "If we don't give this opinion, this client is going to go to another law firm and get that opinion from another law firm," and it doesn't have anything to do with the tier of the law firm or the level of the law firm.

MR. MICHALEK: Well I think there is, in terms of the marketing of the security that they were hired to provide the opinion for. If you're going to go, and I'll just use, I don't know, Sullivan & Cromwell is a very well known firm, if you say, "I'm going to go to Dewey Cheatem & Howe down the street and get an opinion from them," that's going to come directly to the bottom line of the issuer because people might notice that. So there is this competition that says they do have the right, because of the brand that they have established, to actually stay at a higher level of quality --

COMMISSIONER WALLISON: But there are many, many law firms that are at the same level with Sullivan & Cromwell. There are probably twenty just within Manhattan. And so Sullivan & Cromwell has to worry in each case, if they don't give an opinion, that someone else will. And not only that, if that someone else does give that opinion, that someone else may become the general counsel for all of these matters.

MR. MICHALEK: Fair enough.

COMMISSIONER WALLISON: So is there, is there -- why is, and I want to just repeat the question, why are things different at Moody's when it is competing with S&P? Why did it sacrifice its standards, rather than a law firm or an accounting firm doing the same thing?

MR. MICHALEK: I think that, and I'd

be interested to hear my other colleagues opinion, I think it does relate to the fact that this was a very narrow asset class where the expertise, at least in the rating of these assets, was already captured by the two most highly intellectually capitalized agencies.

Standard & Poor's and Moody's just had more resources and a longer experience from developing these products, and so we were competing strongly with each other, but the competition we felt from another entrant was not as high.

COMMISSIONER WALLISON: How much time—

DR. WITT: Can I--

CHAIRMAN ANGELIDES: You have another two minutes, 45 seconds.

COMMISSIONER WALLISON: Was it you, Mr. Witt?

DR. WITT: You know, I think I'm sort of beginning to disagree. We're starting to say Moody's standards deteriorated, Moody's standards deteriorated. I know, like in ABS CDOs, we made one change in methodology. The impact of that change in methodology for highly concentrated RMBS

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deals, you know, mezzanine RMBS deals, that's just the name the market gives to it, I don't think that that methodology had much impact, and I actually think it probably strengthened our ratings slightly for those types of deals, and those were the deals that had by far the worst performance.

So I don't think our standards for ABS CDOs really declined in the way I would think of it. It's the underlying collateral that just completely disintegrated below us and we didn't react and we should have. But it would have taken a little more, you know, we had to be looking for a problem. And we weren't looking.

COMMISSIONER WALLISON: Do I understand that you just said that the change, the one change that occurred in your area, which I think was in 2005, when the correlation was changed --

DR. WITT: Yes.

COMMISSIONER WALLISON: -- was not

induced by a competitive issue or an effort to capture more market share?

DR. WITT: I do not believe that it was.

COMMISSIONER WALLISON: And so you disagree, then, with Mr. Froeba about that.

DR. WITT: Well, I don't know that he actually said that that particular change was --

COMMISSIONER WALLISON: His point as I understand it was that we could easily see the effect of competition by looking at changes in the standards.

MR. FROEBA: That's correct.

DR. WITT: But he also, he said specifically, though, I think, that you could look at the -- you could say there was a decline in market share. Then there's a change in methodology. And this is a case where, you know, that's true. There was a decline in market share, and there was a change in methodology.

However, that, based on what I know,

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there was not a cause and effect.

COMMISSIONER WALLISON: That's the point.

VICE-CHAIRMAN THOMAS: That's what I was talking about.

DR. WITT: The cause and effect was, the market changed, they were doing RMBS-focused deals. There had been multi-sector deals before. The ABS dealings had lots of different types of collateral. A model that assumed independence wasn't right, but it wasn't so as far wrong. Once they became all RMBS-focused deals, then the model just didn't work at all. I needed a new model.

I advocated for a, you know, a correlation-focused model. The normal copula wasn't my first choice, but it was better that what we had. But the changes to that particular category were not great, so I don't think it was a deterioration of standards, but it was a deterioration of collateral with a failure to react. But there is in my testimony, my written testimony, I do talk about what was going on with respect to market share in that particular category. I probably don't have time to discuss that now.

COMMISSIONER WALLISON: No, but that's the answer I think we were looking for.

MR. FROEBA: May I follow up on that?

CHIARMAN ANGELIDES: Very quickly then I want to Mr. Georgiou. Very -- Do you have a one minute addition?

MR. FROEBA: Moody's used the diversity score as a tool for analyzing correlation in early CDOs of ABS. And it was a thing that became a source of intense complaint by managers because -- CLO managers, managers of those transactions, because they felt, and they blamed Moody's for the fact that they were investing in securities other than RMBS securities. So the real market share pressure that Moody's experienced predates somewhat the change Gary is talking about. But there was a response to pressure from managers and from other constituents.

COMMISSIONER WALLISON: My whole point was simply, you said we could learn by looking at the changes in methodology

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to show the effect of the competition.
And here’s a case, where there was a change in methodology, it doesn't appear as though it was induced by competition so it would be very hard for us to make any decisions based on the kinds of things you were suggesting we should try.

MR. FROEBA: The main change happened before that change, that's correct. It was one in which Moody's adapted its methodology to make it possible to have a hundred percent RMBS in one CDO of ABS.

COMMISSIONER WALLISON: Thank you.

UNIDENTIFIED SPEAKER: Where was Standard & Poor's relative to that though?

MR. MICHALEK: Their methodology had changed and our change was in some sense a reaction to the fact that they had already changed.

CHAIRMAN ANGELIDES: Mr. Georgiou, on your remaining time?

COMMISSIONER GEORGIOU: Thanks. Thank you gentlemen. I guess I need to ask this question even though there are quite a number of other trained lawyers on this panel. But I'm the one who's got to ask it.

Do you think that the fact that you were insulated from liability, both statutorily and ostensibly, constitutionally, had any impact on the methodology that you pursued and the failure to comport it to reality?

MR. FROEBA: You know, at one time, I was going to jump in, in response to the question that was being asked of Rick, and say the difference between Moody's and an accounting firm or a law firm is that at least there is some theoretical risk that the accounting firm and the law firm might be found liable. Take the case of Arthur Andersen.

Nothing could be better for Moody's then that some other rating agency were to be found liable in a lawsuit and to collapse. Why? Because the fear of future lawsuits would create a discipline in the analytical process that I think

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would add a tremendous amount of integrity. That is my own opinion about the best way to solve the current problem with rating agencies.

Their lack of vulnerability is a serious problem. And another serious problem relate to it is the fact that they pay no price for degrading their reputation. They learned after Enron, that, you know, no matter how bad the reputation got, their business would grow. What do you think is going to happen now after this crisis if they pay no price? That's a question that the people on this commission should ask because all of your children and family members are facing, you know, a world economy that's vulnerable to that reality.

COMMISSIONER GEORGIOU: Right. And I take it that, well, let me hear from the rest of you with regard to this legal liability issue, if you have anything else to add.

MR. KOLCHINSKY: I think in general,

legal liability was almost -- discussions of legal liability, almost nonexistent. That was part of the problem. People didn't think. That never entered people's thoughts in thinking about, we were just offering an opinion and that was it, the bottom line.

I actually want to also add to the other question about the lawyers and accountants, lawyers and accountants have standards. Lawyers have to follow court cases, accountants have GAAP. Imagine -- again to Arthur Andersen, if Arthur Andersen, after Enron, said, "You know what? Yeah, we did this, but that was our methodology. Sorry, we're going to walk away." And that's the difference.

What you heard today was Ray McDaniel saying, "That's our methodology. Sorry." There's no standards to judge rating agencies. Each one of them has its own methodology. That's the problem I think we'd all -- but once you have the standards, then you can apply legal liability by saying, "You failed, that is fraud," and that's it.

COMMISSIONER GEORGIOU: Mr. Michalek, you’re a lawyer as well, are you not?

MR. MICHALEK: I am, and I agree, I think liability would be a necessary deterrent to lack of attention to common issues of negligence that occurred regularly.

COMMISSIONER GEORGIOU: Mr. Witt? Dr. Witt?

DR. WITT: I'm the only non-lawyer here and I don't think the courts are the best way to address this. I would, because the issue is whether or not you got the ratings right, not, you know, how did you go about getting them or did you, you know, fill out all the right forms or something.

COMMISSIONER GEORGIOU: All true. All true, but they tend to have a salutary cautionary impact. I mean, courts are extremely crude methods of enforcing these kinds of standards, but the fear of having to go there often motivates behavior in a positive way.

DR. WITT: Well, you know, the Financial Stability Act does give the SEC the power to levy fines, and I thought that a better way to go is to have the SEC basically have a menu of fines that are issued when you get the ratings wrong in a major way. Proportional to how many bonds you misrated, you pay a big fine; and you know when, you're rating it, that's what you're going to have to pay if you misrate. I think to me, that makes more sense.

COMMISSIONER GEORGIOU: You think the analysts who did it ought to have to pay part of the fine, too, or do you think just the company ought to pay the fine?

MR. FROEBA: Certainly make for a more disciplined process if the analysts had to pay.

DR. WITT: If the analyst had to pay, you may not have any analysts at rating agencies.

COMMISSIONER GEORGIOU: I'm sorry, Commissioner Wallison, go ahead and take some of my time there.

COMMISSIONER WALLISON: The bosses

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are very jealous of this, so --

CHAIRMAN ANGELIDES: Right. Well, actually, I'm going to suggest you look this way. Yes, I recognize you, Mr. Wallison. Go ahead.

COMMISSIONER WALLISON: I just had this one point to make about standards. And it is true that there are, it's easier to identify the standards for lawyers and for accountants. However, the issue in a lawsuit about an opinion has to do with whether you applied whatever standards there were negligently. If you were negligent, even if you came to the wrong answer in a legal opinion, as long as you were not negligent in coming to an answer that turned out, because of future events, to be wrong, you were not liable.

MR. KOLCHINSKY: That is correct. But in this case, you don't even have standards to judge by. You can't be found negligent if there's no standards to judge by. It's your own standards, and you're your own determinant. And that's the problem. That is a problem. And you need standards to be able to have normal legal procedures. Otherwise, if you don't have any standards and legal liability, the flip side of it, you're going to have a lot of false negatives and people just suing because they bought at the wrong time. So you need standards and you need legal liability.

COMMISSIONER GEORGIOU: Okay, let me finish back up here. We had this chart earlier today, which showed that, notwithstanding a number of cautionary warnings, either from Mark Zandi, and other downgrades that occurred along the way. Each time there was a downgrade, there appeared to be a spike up in the MBS ratings, the number of MBS rated and the number of CDOs rated.

I wonder if the two panelists who weren't here this morning, I think I asked you that this morning, did I not, as to the other two of you? Maybe the other two of you could tell me why it is that you think -- obviously, we understand that it's easy for you to rely upon the general perception that housing prices weren't going to decline thirty percent or more in certain marketplaces to justify your initial ratings.

However, why is it that, once we knew that the -- you were downgrading certain RMBS and CDOs, and that the market was declining, that there was still an attempt to utilize the same methodology to rate additional product coming in the door?

And, you know, I likened during the prior panel here, it looked like you folks were trying to mop up the last bit of gravy before they took the plates away. That really, was this just a market share deal, try to get all these deals done before they were gone? Mr. Michalek?

MR. MICHALEK: I was responsible for doing the activity reviews, quarterly activity reviews. And I did notice that there was a flush of activity in late 2006 and started through the first part of the first quarter of 2007, even though we had, at that point, already published significant research that suggested that those downgrades were potentially outliers relative to previous history.

The simple explanation for this is, is that our customers, the investment banks, were clearing their warehouses. And it was a case of, with respect to why didn't we stop and change our methodology, there is a very conservative culture at Moody's, at least while I was there, that suggested that the only thing worse than quickly getting a new methodology in place is quickly getting the wrong new methodology in place and having to unwind that and to fail to consider the unintended consequences.

So there was a lot of research as to what are we going to be doing if it turns out that this really is an outlier. There was, in fact, during the year-end review for 2006, I was pointing this out in a draft of one of the annual reviews and I

was surprised by the reaction that was
coming from the people from RMBS saying,
"You don't want to mention that this is a
big outlier because we're still analyzing
this data and we can't say as yet as to
whether or not this is a front-loading of
a normal amount or a tolerable amount of
defaults that we're going to experience
over this cohort's life" --

COMMISSIONER GEORGIOU: But couldn't
you tell this these were downside risks,
not upside risks? Couldn't you see that
the direction of this data ought to have
led you to be more skeptical, and the mere
fact that the investment banks wanted to
clear out their warehouses doesn't mean
you have to pick up a broom and help them
sweep them out the door --

MR. MICHALEK: You're asking me to
wear two different hats. As an analyst,
of course you're right. These are warning
signs. We should be saying something
about it. From a business perspective,
somebody's going to make the forceful

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argument that it could be that these are just front-loaded defaults and this isn't going to be any worse than '92. And if that's the case, we have the opportunity right now to do a lot of business.

COMMISSIONER GEORGIOU: Right. Nine basis points on a lot of billion dollar deals, that's almost a million bucks every deal.

MR. MICHALEK: And there's no question, if we step away, those are going to be rated by somebody else.

COMMISSIONER GEORGIOU: Mr. Kolchinsky was trying to answer as well.

MR. KOLCHINSKY: One thing, you know, I -- once they did make a decision to downgrade in '07, in September, and I found out about it and actually tried to stop the factory, a manager, Ms. Yoshizawa, did not want to do that. And I actually spoke to Dr. Witt. I didn't know what to do. He suggested that we go to somebody more senior-- and we did a notching procedure. But that's -- it was almost, as I said, the last couple of bits of paper. And that's one of the reasons, that is the reason, I believe, I was then asked to leave the rating agency in October of that year.

MR. MICHALEK: There's one final point that I think Mr. Buffett actually made. He was taking advantage and exploiting the possibility that they weren't rated correctly. We've already heard from the Moody's representatives effectively that their concern was, you know, downgrades are bad news, and that you don't want to prematurely downgrade; and I think that it could be seen, because of the multiple downgrades that took place, that that first downgrade was probably not going to be far enough.

So one impetus to structuring of more issuance at that particular time is, "Hey, we just got a whole bunch of things that have been downgraded three notches, but I've just done my independent analysis, and I think it should have been six notches. Let's get this stuff out the door."

COMMISSIONER GEORGIOU: Okay. But you're still rating them AAA. But the problem is that you didn't rate them down at all, you rated them AAA. And even those that you rated after you started discovering downgrading the other ones, you rated AAA and then they had to be downgraded again. I mean --

VICE-CHAIRMAN THOMAS: Grandfathered.

CHAIRMAN ANGELIDES: Quickly, I want to move on, we need to keep our schedule here -- my privilege as Chairman.

MR. FROEBA: A million dollars is really not that much revenue in the end. It was business relationships and preserving them that was key, to answer your question.

COMMISSIONER GEORGIOU: Well, but that's just one CDO, the million dollars.

MR. FROEBA: I know, but they might have a hundred million of business in the coming year.

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COMMISSIONER GEORGIOU: Of course.

MR. FROEBA: That's why they did those one million dollar deals.

CHAIRMAN ANGELIDES: Thank you. Let's move on, now, to Mr. Thompson.

COMMISSIONER THOMPSON: Thank you, Mr. Chairman.

So you had the opportunity to hear your CEO or former CEO speak of what was the most important metric or outcome, which in his mind was rating quality.

How do you respond to that, do you believe that's the tone he set at the top or not? I'll start with you, Mr. --

MR. KOLCHINSKY: No, I do not. I don't think he was against ratings quality, but certainly it was not something that I was -- there was a culture there, the old culture, but no, I don't believe that that was the tone set at the top.

COMMISSIONER THOMPSON: So would you call him something other than truthful in that representation?

MR. KOLCHINSKY: I can't judge that.

Maybe that's what he felt, but what came down to us people working in the trenches was --

COMMISSIONER THOMPSON: So the tone you heard was something other than ratings.

MR. KOLCHINSKY: Yes.

MR. FROEBA: I agree. I don’t think-- I would have a hard time identifying any particular means by which they communicated their -- that that was the value. I mean, I don't recall any.

COMMISSIONER THOMPSON: Mr. Michalek? I got it right, by the way.

MR. MICHALEK: I'm a lawyer, so I'm trained to hold two opposing thoughts in my mind at the same time.

COMMISSIONER THOMPSON: Well, just give me one and I'll come back to the other one later.

MR. MICHALEK: I think he does believe that he was telling people that ratings quality was the most important thing. I think that there were reports internally that he was already receiving suggesting that he was getting information that people were concerned about the quality of the ratings.

DR. WITT: I put this in my written testimony, but there has been other testimony and other investigations saying the same thing. In November or October of 2007, we had a global MD meeting. I'm pretty sure Eric was there. Where -- this is after the massive downgrades have already occurred.

And the CEO and CFO led off with the exact same tone that they always did, which was to focus on our profit margin relative to Standard & Poor's, and they were talking about, "Oh, it's one percent lower than Standard & Poor's, we've got to work on this."

We'd already had these massive downgrades. Morale was really shot. And somebody, one of the MDs in the corporate side raised their hand and said, "You know," this was after about thirty

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minutes, and said, "What are you doing to restore Moody's reputation?" And all of a sudden, there was this big scramble among management, like, they didn't expect the question. And to me, that was like, the smoking gun in terms of, after that, I didn't give Ray the benefit of the doubt anymore.

COMMISSIONER THOMPSON: So there was an entity within Moody's that had responsibility for credit policy. So as you were building models and anticipating how they would be applied, what interactions did you have with the credit policy organization? I'll start on this end of the table.

DR. WITT: Well, the incident that Eric was just explaining, he was concerned about -- this is in September '07, he's worried about an imminent downgrade of RMBS, and the fact that he believes that they are going to continue to rate ABS CDOs in spite of the fact that they know there’s going to be this big downgrade.

So I got in touch with the head of credit policy, Andy Kimball, and let him know about this, and he decisively intervened. And the next day, the methodology was changed. That was my main interaction with them prior to --

COMMISSIONER THOMPSON: So it did function as a check and balance but you had to go and overtly bring it to the table.

DR. WITT: Yeah, and that was when Andy was the head of it.

MR. KOLCHINSKY: That was true because of Mr. Kimball’s, as the head of credit policy. Prior to that, he was, I think head of international. At that point -- prior to that, I do not recall having any contact with credit policy whatsoever. I think we made our methodology internally. May have communicated it to others, but that was due to Mr. Kimball's sort of forceful nature and he got that done.

COMMISSIONER THOMPSON: So much has

already been said about the lack of resources or, in many instances, the lack of talent that you had to do the job as the bubble was building.

Would that also be true for the credit policy organization as its internal watchdog?

MR. KOLCHINSKY: Like I said, I think prior to Mr. Kimball signing onto credit policy, I don't believe we had an effective -- there was a nominal credit policy function. I don't believe it had any effective -- I never dealt with them. There was never any back-and-forth. I didn't know what they did.

Today, as part of my, the complaint, I was suspended for last year, that there is a nominal credit policy function. They are better, but in most respects and purposes, they are outvoted and outgunned, if you will, by the lines of business.

So it's sort of -- I forget the term. They are not effective still.

COMMISSIONER THOMPSON: Mr. Michalek,

do you have a point of view?

MR. MICHALEK: I didn't interact with credit policy. I interacted with structured credit committee, which was responsible for harmonizing the overall rating methodologies across different groups in different regions, so I can't speak directly to credit policy.

COMMISSIONER THOMPSON: Mr. Froeba?

MR. FROEBA: We had very little, if any, interaction with credit policy. I would say none.

COMMISSIONER THOMPSON: So you were allowed to do whatever you wanted to do with no oversight as long as it meant market share?

MR. FROEBA: Yes. And as I said, I was in an area where this was no market share pressure, so we were actually able to be very conservative. And right up until my departure, I -- as Gary mentioned earlier, people were proud of the work that they did. I was proud of the work that I did. I worked hard on those deals,

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and I think they will stand up, not that they're -- am I the CDO saint? No. If my group had been exposed to significant market share pressure, I would have probably been as --

COMMISSIONER THOMPSON: Vulnerable.

MR. FROEBA: Exactly.

COMMISSIONER THOMPSON: Dr. Witt?

DR. WITT: To be fair to credit policy, there were procedures about new methodologies. If you published a rating methodology piece, you had to get sign-offs. I don't remember for sure, but I suspect that you had to get a sign-off from credit policy.

COMMISSIONER THOMPSON: So they were involved in the development process of the models?

DR. WITT: Well, yeah, they were involved.

COMMISSIONER THOMPSON: I sense a reluctance there.

DR. WITT: Well, they were not heavily involved at the time that I was an

MD, but I think there was this, that involvement to that extent that they did -- they had a veto in theory, if they wanted to use it.

COMMISSIONER THOMPSON: I yield the balance of my time, Mr. Chairman.

CHAIRMAN ANGELIDES: Thank you. Mr. Holtz-Eakin.

COMMISSIONER HOLTZ-EAKIN: Thank you, Mr. Chairman, thank you gentlemen, for a depressing afternoon of testimony.

Let me just try to clarify a couple of things. I'm trying to sort out about how all this all went down. So first of all, just, I guess, for all of you, did Dun & Bradstreet not care about making money?

MR. FROEBA: No, I think they did. The theory, and probably one of the reasons why Warren Buffett invested, is because the idea is that a conglomerate is not a sufficiently pure play for the marketplace to be able to value the company. So if you split them up, and that's exactly what happened, you split them up and, voila, there was lot of value that the market wasn't acknowledging before.

I'm sure Dun & Bradstreet didn't want to get rid of Moody's. It was compelled to by its shareholders who found the combined entity unsatisfying as a performer.

COMMISSIONER HOLTZ-EAKIN: And so your testimony in particular is about the evolution of a model that would be more profitable at the expense of the quality of the ratings.

MR. FROEBA: Yes.

COMMISSIONER HOLTZ-EAKIN: So one of the things that you pointed us to is ways to understand this better, the changes in methods that are used to come to ratings, and, but we've been told pretty clearly that ratings are more than models. So I guess I'd like to hear what the non-quantitative folks on one of these ratings committees brought to the table, what information did they introduce, and how were they affected by this evolution of culture. Why don't I start with you, Mr. Witt.

DR. WITT: Well, the people who were saying that very strongly, I think it was Jay Siegel especially, that ratings are not just models, he was in the RMBS group. And ratings were not just models in CDOs either. But the CDO was more model-based in part because we could be, because we had the ratings as input, so you knew what the ratings were. So you could have more of a, just almost like a mathematical function.

But we also had a very strong culture of, you know, we had legal analysts on every deal, which they did not have, because the documentation was so much more complex.

So I thought of it as, the legal analysts were helping to make sure that the document conformed with what the model said. And that was definitely a

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non-trivial task.

COMMISSIONER HOLTZ-EAKIN: Mr. Michalek?

MR. MICHALEK: I think the non-quantitative role of the rating analyst which fell to the lawyers, largely, was as Gary describes, a task of confirming that the documentation was faithful to what the quantitative analyst was modeling. And then, we were looking for legal risks, whether or not there was an isolation of assets, all of the usual, very standard and very overpaid legal work that was being done by the law firms.

And we were also looking for some, potentially, non-easily quantifiable risks that could come from, for example, the valuation of the collateral managers. We would go, for each transaction, if there was a collateral manager that we had not recently visited, and that original -- it evolved to where, if we hadn't seen them within the past year, we needed to go see if collateral manager. So we would make a

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trip to the collateral manager and evaluate, do some due diligence on their processes, and report in the committee as to what our opinion of the collateral manager was, and were they capable of doing the work that was going to be involved in this particular transaction.

That was one of the places where there was a greater opportunity to say no and in fact, I don't think that opportunity was exploited.

COMMISSIONER HOLTZ-EAKIN: I actually want to pursue that. It think it was you, if I’m wrong, please correct the record, who said, it became pretty clear that you had some of these ratings wrong because the market wouldn't take them. So the underlying RMBSs that you referred to, the market wasn't going to buy them, it was clear that the RMBS guys had these things rated wrong, but you took their ratings anyway, put them into the CDOs and moved these.

MR. KOLCHINSKY: That was me.

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COMMISSIONER HOLTZ-EAKIN: Do not answer, sir.

So that strikes me as information that is very important to bring into the ratings process but indeed was not. Why not?

MR. KOLCHINSKY: It was very hard for us to determine where -- it became clear later in the process that a lot of this product was being sold into sort of captured and captive vehicles, even warehouses. But it's very hard to tell that day one.

As I said before, we were not told where this was being sold. So it's evidence we had to gather sort of piece by piece. Bankers would not tell us where they placed these bonds.

So because -- and if you actually look at the spreads on this product, they all kept coming down, because in the beginning, they really needed to have real investors. But by the end, the spread was driven, as somebody put it, actuarially, by the -- by the model, the CDO model. So they actually kept coming down as more investors left, when you'd expect the opposite. You would expect that if investors left, you would -- spreads go up.

But because you had a loss of real investors, and a gain of more, sort of statistical investors, if you will, the spreads were coming -- so it was very tough to tell until very late in the process, and a lot of the things that I've mentioned now are things that I've put together since the crisis through the work of commissions like this and other committees. So the information just wasn't out there, it wasn't available to us to see where the demand was coming from.

COMMISSIONER HOLTZ-EAKIN: So if no one hears from the RMBS group, but it does seem pretty clear, especially with hindsight, that they got the expected loss wrong, and that means they got the expected returns way too high, which means they totally missed the risk, because that's the only way you get that kind of return, which may explain why it was a bad idea to lower all the sensitivity to housing prices. But they at least were working off data and cash flows.

So my question for the folks doing the CDOs and the diversity scores is, how was that done in the absence of actual data on actual performance, only using the now-faulty ratings you had from the RMBS folks?

DR. WITT: Well, we had two methodologies in my career. The first one was actually, it's, they thought it up just before I got there, but I do explain it in my testimony. It was called the multi-sector paper. It was written by Jerry Gluck--

COMMISSTIONER HOLTZ-EAKIN: -- correlated.

DR. WITT: Well, it's this reduction in diversity score, and the diversity score is -- it is calculated by a some --

correlation assumptions to calculate a diversity score. Once you have the diversity score, you use this binomial framework that assumes independent assets. Those correlations if you read the paper, it's very clear, and Jerry use to say this, Jerry Gluck who wrote the paper, when people say, "Where did you get them," he'd say, "We just made them up," you know, because they didn't have any data. And they say that.

They went to the analysts in those groups, and say, "How correlated do you think these things are?" So this was in 1999. By '05, when we felt we needed to have a model that had correlation built into it, we also had more data by that time, so there was a data analysis.

It was primarily, the useful data on correlations was from rating transitions. There was not enough data on actual defaults, but, you know, they did look at rating transitions to see how correlated they were. And we used that as the basis, but in a very, very general sense, for the correlation matrix we came up with.

COMMISSIONER HOLTZ-EAKIN: So this is the point I want to try to understand in the way the culture worked mechanically.

Ongoing surveillance clearly is very important, because transitions in rating would be important information for initial rating of these securities. But I've also heard that some would be grandfathered, and thus, the ongoing surveillance would have to take place using a standard method, which is not the current one.

I've also heard that ongoing surveillance was not well tied in, especially with the RMBS. That was from the previous panel.

Would each of you tell me, in your line of business, the degree to which your ratings were informed by information coming out of the surveillance process and the way in which you communicated with them, and whether the process took advantage of the ability to be better or simply discarded the information that was learned. Mr. Kolchinsky?

MR. KOLCHINSKY: I think in our group, in the beginning, when I joined, there was no separate surveillance group, so analysts had to surveil their own deals.

In that case, we had pretty good feedback. Obviously, you see what's going on, and we had some developments that we saw from the fallout in what I've called the stage 1, which was the CBO class bond obligations, as well as the first re-securitization, multi-sector deals that we put into new methodologies.

But further on, we used actually the same methodology for, generally, for surveillance and rating. So we did not have as good a feedback because we didn't see what the folks on the surveillance side were doing. But it wasn't like on RMBS where they used two different methodologies completely.

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COMMISSIONER HOLTZ-EAKIN: I see. My time is short, so if there's anything anyone wants to add; otherwise, thank you.

CHAIRMAN ANGELIDES: Need any more time?

COMMISSIONER HOLTZ-EAKIN: Only as necessary to complete.

CHAIRMAN ANGELIDES: A couple of minutes. Anything? If not we'll take away--

MR. MICHALEK: The only question, I just wanted to revisit the idea of what non-quantitative elements went into the rating, and that was the assessment of the quality of the collateral manager. That was a case where we would have had more of an opportunity to say, "You know, this particular collateral manager isn't really up to speed or is somehow not what we would prefer." It was discussed but never implemented as to how much we were going to effectively charge the deal for a lack of quality for that particular collateral manager.

That, again, was a very, very strong

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issue, if you want to call it that, that impacted relationships with the investment bankers. You couldn't tell this particular investment banker that we were going to charge half a notch of rating to this particular collateral manager just because this was his first deal, or just because it's really three guys and a Bloomberg, which was what we would characterize the upstart collateral manager who was not particularly prepared.

So that was an opportunity where we would bring information to the ratings process and then whether or not it was going to be acted on was a function of business considerations.

COMMISSIONER HOLTZ-EAKIN: Thank you, gentlemen.

CHAIRMAN ANGELIDES: Let me, just before we go to Ms. Born, let me wrap up some of what Mr. Holtz-Eakin talked about, because one of the things that struck me, as I've looked at all the materials over the last month or so, is the extent to which this really was a blend between the quantitative with whatever deficiencies, and I say that not to say necessarily sloppy work, but a lack of, perhaps, knowledge of what was going on, an evolving knowledge of what's going on, and obviously, judgment.

I mentioned this morning that I saw a whole beam on the qualitative side. Not having, you know, that kind of knowledge on the ground, you want to look through -- and I mean, I would make an observation -- not only look through, but look all the way down to the ground. But in total, how would you characterize, two things, how would you characterize in total the ratings process if you were to -- and let me add one other thing:

I also understood that models were run, they'd be looked at qualitatively, and you'd make adjustments. Today, Mr. Stein said that, you know, for example, in the RMBS world, they might take the worst loss and then multiply it. So you'd run the model, people would look at it and essentially feed back information to have the model come out where people thought it ought to be.

How much would you say in large order of this process was qualitative, quantitative? Because I think the understanding, and here's the second part of this, which is, if you look at kind of what Moody's puts on the website, you would come away believing it's quantitative mostly; is that a fair statement?

A VOICE: Sure.

CHAIRMAN ANGELIDES: So I think the representation was quantitative. How much was folks making their best judgment, working with models that were only as good as they were? What's the blend?

MR. KOLCHINSKY: I think I would separate it in two: things that were already established, non new things were almost all qualitative, just run them through the model.

CHAIRMAN ANGELIDES: Where there was high confidence levels about the quality of the data?

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MR. KOLCHINSKY: No, it was because you were held to that standard by the bankers. This is your methodology. You better follow that.

CHAIRMAN ANGELIDES: By the bankers?

MR. KOLCHINSKY: By the bankers. Where there's qualitative --

CHAIRMAN ANGELIDES: Well, give me an example of that, and then I --

MR. KOLCHINSKY: They would, for example, as we said, our methodology was open book. They could download the models, run themselves, and they would say, this is --

CHAIRMAN ANGELIDES: Oh, the bankers saying -- bankers saying, "This is what you represent, I want it. It's on the shelf, this is" -- okay.

MR. KOLCHINSKY: For example, the simple synthetic model was a CLO model. You could download it, anybody can for free, put the portfolio in, here's it is, the banker says, "I want this." And you're kind of limited to what you could say because here's your model and there it is out there, and where you could have more qualitative is in what I call the Delta.

So this has changed from this model. And it's a question of -- what stopped is that you had less time to look at these changes, the Deltas, "Is the model no longer appropriate for this type of portfolio." You had less time to do that, you had less time to analyze it and you had less time to say what the effective change ought to be, is it five percent, is it fifty percent?

CHAIRMAN ANGELIDES: So that part was qualitative.

MR. KOLCHINSKY: That's qualitative.

CHAIRMAN ANGELIDES: But to the extent that bankers insisted on using a certain factor, I would assume they weren't insisting you use those things they thought were overly stringent.

MR. KOLCHINSKY: Of course not.

CHAIRMAN ANGELIDES: Okay, just

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checking. All right. Quickly, reactions?

MR. FROEBA: I would say it's mostly model but unless you made sure that your documents reflected the model, your analysis could be completely wrong. So the non-model part was very important. It just was not, it was not driving the ratings. You couldn't look at the document and determine something was AAA.

MR. MICHALEK: The willingness of the bankers to use and adhere to standard documentation would determine how important the non-quantitative element of the transaction was. Even if the standard swap document was going to have huge sections that would come in to a lot of play, definitions of the defaults and the credit events would be manipulated and otherwise massaged because that's where all the vig was for the bankers who were structuring this transaction.

So to the extent that you're considering that for be non-quantitative, that was, it was a hundred percent of my job.

DR. WITT: Well, I'll give an example that Rick and I worked on that was, again, it was in my written testimony, something that you guys have talked about in a previous panel, was about the liquidity puts that were used to issue CP out of CDOs. We worked on the early transactions and those, the way those agreements were crafted into the documentation in the early Citibank deals were just horrendously complicated.

And if I hadn’t had Rick there with me, you know, there's no way -- they would have been able to -- I thought that their agenda was to try to put contingencies into those liquidity puts so that, if investors didn't buy the CP, they would have some out where they would not have to buy it themselves and then investors would, you know, be holding CP that became you know, thirty years long and could well be money market funds, and I was extremely afraid of that.

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And, you know, it was only because Rick was so dogged and skilled at looking for documentation, it was just a big spaghetti bowl of back-and-forth between the prospectus and all these ISDAs and stuff. So that was an example of these very qualitative, but it had quantitative aspects.

CHAIRMAN ANGELIDES: And ISDA, for folks, the International Swap Dealers Association, or I guess they will call themselves something else today, but, correct?

DR. WITT: Right.

CHAIRMAN ANGELIDES: All right. So, okay, very interesting observation and in many respects to the extent that products were customized, particularly complex, and amplified the non-quantitative.

DR. WITT: Especially when it was a new type of product.

CHAIRMAN ANGELIDES: All right, thank you. Ms. Born?

COMMISSIONER BORN: Well, just

continuing on with that, I want to go back to the synthetic CDOs is that I was talking with Mr. Kolchinsky about earlier today.

You were saying how you saw a number of CDOs come along during 2007 that had a synthetic aspect to them; that is, they had credit default swaps in the asset pool to some extent, rather than pure RMBS; isn't that right?

MR. KOLCHINSKY: That is correct. I don't have the exact data, but I would venture that, by '07, nearly all CDOs had some exposure to synthetics, either in the RMBS or the CDO buckets for the high grade deals.

COMMISSIONER BORN: And we were talking about a number of issues that these new, more complex instruments had that you were concerned about. You've listed a number of them. And I just wanted to ask you a little bit more about that.

One is, you know, when you had a

credit default swap on a residential mortgage-backed security, rather than the residential mortgage-backed security itself in the pool, how did you rate, or what rating would you assume for the CDS? Would you go to the underlying of the CDS, that is, to the underlying residential mortgage-backed security?

MR. KOLCHINSKY: That is correct. Most of the CDS that were done on RMBS were of the pay-as-you-go variety, which meant theoretically, they sought to mimic the payments on the actual RMBS. There was some mismatch, but we did not penalize them for it.

The great problem with those were the secondary risks that came along, which were primarily the funding risks, because now you had cash on hand which wasn't invested in the RMBS. It had to be invested in something else. And the bankers wanted to take that money and increase their returns by investing it in other risky assets, and those risky assets added risk to the CDO.

COMMISSIONER BORN: So that's where the questions about collateral and other issues --

MR. KOLCHINSKY: Yes.

COMMISSIONER BORN: I wonder whether or not it was really accurate to look at the rating for the underlying RMBS when there were all these additional issues posed by the fact of the credit default swap. I mean, this was clearly a big step away from the mortgage-backed security itself.

MR. KOLCHINSKY: I think we tried to ring-fence those other risks. Some of them didn't turn out so well, and I think some of the lawyers -- I'm not a practicing lawyer, as I like to emphasize, but these practicing lawyers will tell you about the bankruptcy of Lehman and what this did to some of the protections that were in CDOs. They can probably speak to it better than I. So the ring-fencing turned out to be poor in some of these issues. But yes, those turned out to be not just, in some cases, the CDOs were funded by the CDOs themselves in the case of one underwriter. So it created these circular structures that created a mess for the banks themselves.

So yes, on a macro basis, the use of credit defaults also created many other problems within the financial system, not as much probably for the CDO itself except for this Lehman Brothers bankruptcy.

COMMISSIONER BORN: Holding that for a minute, I'd like to ask you about default correlation issues raised by the facts that these CDOs were coming along with credit defaults swaps in them, and I think you were saying in your testimony that you would see, in a series of CDOs coming in, that there could be in each of them, CDSs on the same underlying that you saw in the last CDO.

MR. KOLCHINSKY: Yes. In an all-cash-product world, your -- the probability of one bond appearing in two

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pools was limited by some economics, so there's maybe a total of ten million of that entire tranche, and that was split among ten investors, and that's it. That's the entirety of that element in the entire world.

With synthetics, you can take that tranche and you can replicate it infinitely. It was especially true of the ABX where, I believe, again, this is with hindsight, what we saw with a lot of hedge funds who wanted to short the ABX and the bankers didn't want to take just that side. So they off-loaded that risk into CDOs, which meant that there were a lot of CDOs with very similar portfolios. We didn't know about that at the time but sort of with twenty-twenty hindsight you could see that.

And we had a -- what we were concerned about with the ABX was that it was becoming, starting to become very widely used. It had somewhat of a dollar discount, which cash did not. So that

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would make it, increase the arbitrage, which means increase the probability of it occurring in multiple deals. And you can replicate it infinitely. There's no limitation on it, no natural limitation on it. So that would increase the correlation, a hundred percent correlation, effectively.

COMMISSIONER BORN: Exactly, because it's the very same asset.

MR. KOLCHINSKY: Yes.

COMMISSIONER BORN: Did you indicate in your testimony that there was a paper that was prepared on this issue --

MR. KOLCHINSKY: Yes.

COMMISSIONER BORN: -- in October of '06?

MR. KOLCHINSKY: Yes, we had a paper ready to go, the author was an analyst, Sushnita Nagarajan -- I’ll give you the spelling later. But one of the things it says, we want to limit the exposure of the ABX in any deal to a de minimis amount, and I think my manager thought that was not appropriate, given -- and she asked not to publish the paper, so we never did.

COMMISSIONER BORN: Because of the potential loss of business?

MR. KOLCHINSKY: Yes. That's what I believe, I don't know but that -- I believe that was due to potential loss of business.

CHAIRMAN ANGELIDES: Do we have that paper, do we know?

MR. KOLCHINSKY: I have a draft of that paper, and, yes.

CHAIRMAN ANGELIDES: Can you provide it? We can also request it, if you give us -- we request that document.

MR. KOLCHINSKY: Yes, I believe you already actually have it. I will identify the specific e-mail that it contained.

COMMISSIONER BORN: Let me ask Mr. Michalek about the reference to the Lehman Brothers bankruptcy and the issues posed there.

MR. MICHALEK: I don't want to expand and state something incorrectly because I know it's obviously going to turn on the facts of the individual case. But in general, the point is this, that there were assumptions being made when we were rating synthetic CDOs, that depended largely on the documentation, is the documentation and the other standard form documentation, particularly with respect to collateral and rights to collateral in the event of a bankruptcy. And the order in which the obligors or the creditors would be paid out given the contractual obligations represented by the standard documentation.

The Lehman bankruptcy case has shown that in fact, some of the assumptions were incorrect, and that the structural subordination that has been discharged, I think, was one consequence which was contrary to the assumptions that we were using when we were rating these transactions.

COMMISSIONER BORN: We may ask some follow-up written questions to you and also to Mr. Kolchinsky about the synthetic CDO issues.

Let me just ask, some of these CDOs were I think called something like actively managed assets. So you didn't actually have the pool of assets at the time you were rating them, or they could change as time went on.

Also, with some of the CDOs, they were actually -- had as the underlying assets mezzanine tranches of other CDOs; that is, they were CDO squared or CDO trebled.

How did you handle valuing the underlying in those cases? And didn't those pose some monumental issues?

MR. KOLCHINSKY: I'll take the second question first. In fact, we probably, if you would extend back, we had CDO to the infinite power because each CDO had a CDO bucket, had to be passed on and on and on. We handled each one as a separate bond, and this goes on to what Dr. Witt was saying. We didn't have the computing power to look through. Most people didn't, but that's something that you would want because that increased the correlation.

There were CDO squareds. We looked at them on an individual level. The problem with them, again, from a structural macro perspective is that they started as ways for bankers to get rid of the mezzanine tranches that nobody would buy. And that was the problem. If you didn't have a buyer for these deals because it was uneconomic. Maybe they didn't think it was going to blow up, but it wasn't economic, that changed the economics for the deals. So the only thing that made ABSs possible was this takeout through other CDO. Could you repeat the first question? I'm sorry.

COMMISSIONER BORN: The first one was about the actively-managed assets where maybe the assets weren't there to analyze at the time you were rating them, or maybe they -- if they were, they could change at any time?

I know you said you relied on the parameters outlined in the documentation for what the assets manager was supposed to purchase.

MR. KOLCHINSKY: That is correct. I think most of the trading was actually in the CLOs, but all CDOs were structured, almost all CDOs, cash CDOs were structured as actively managed in the sense we rated them to minimum average parameters.

I think on a practical basis, there was not as much trading in ABS CDOs as there were in CLOs, and these folks can talk about that. But all the managers had the ability to reinvest proceeds or sell and buy assets.

So we had to rate them to minimum covenant parameters in the documents. And the problem is, they were averages that -- in twenty-twenty hindsight, the problems, we rated them averages and we didn't anticipate the risk layering, if you will.

COMMISSIONER BORN: And just one last

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issue. In these CDOs to the -- to the infinite degree, didn't those raise some real risk parameters for these instruments as well?

MR. KOLCHINSKY: They did. We didn't -- because we didn't know where they sold them into, I think if we did know, we could track a hundred percent went into this in CDOs. We only had the other side of it and only because we rated to parameters only when they went into effect, it was hard for us to reconstruct that at the time. But I think, yes, I mean, I think if that was raised, that should have raised some bells.

I'm not sure it would have, given the market share focus, but that certainly should have raised some alarms saying, "Gee, a hundred percent of this deal is going into another deal; aren't there any real investors?" Yes. But we had a hard time finding that.

COMMISSIONER BORN: Thank you.

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CHAIRMAN ANGELIDES: Ms. Murren? The cleanup.

COMMISSIONER MURREN: Thank you. Thank you all for spending so much time with us today. Appreciate it.

One of the things we're hoping to achieve with looking at case studies is to be able to determine if there are similarities or differences in industry practices across the various participants. And so I was wondering if you could each comment on similarities or differences that you see between Moody's, S&P and Fitch in terms of the culture, the methodology and also to the extent that they did or didn't get the ratings right. Mr. Kolchinsky?

MR. KOLCHINSKY: I think the interesting part is, the methodologies are very different. Moody's rates to expect a loss, S&P and Fitch rate to probability of default. Very different concepts, and yet we all came up with the same standards.

The analyses that each firm uses are

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also extremely different. Yet, at the end of the day, due to the market share mechanism, the ratings came out exactly the same.

I would want to say about the culture, I think one of the reasons, it's my personal view, you're seeing a lot more Moody's people out here is that we had, the old culture was a bit idealistic. A lot of us liked that academic culture. And I think a lot of us have been -- again, this is a point of pride at having worked at the old Moody's, and the Moody's I still love, is that there was a great culture then which I think a lot of us have been disappointed, and I think that's one of the reasons you're seeing a lot of folks from Moody's here in front of you, because we do remember how it used to be, and liked it. So I think that's -- I never worked at S&P or Fitch but I think that's one aspect of Moody's culture.

MR. FROEBA: I said earlier, in response to a question, that I was somewhat befuddled by the example of the methodological change that Gary developed, the application of the correlated binomial to CDOs in connection with my assertion that if you tracked market share. But as I thought about it, I realized it really isn't a problem to what I'm asserting because what I'm asserting is that material changes, changes which affect the rating, that those corresponded to market share pressure.

And I think if we quiz Gary, I hope -- and I don't know the answer to this question, which is a bad sign in a lawyer, never ask a question you don't know the answer to, I think Gary will assert or confirm that there was very little material substantive difference between the two methodologies, that the correlated binomial as applied to CDOs did not really materially change the ratings. That's I think an important point.

The point is, therefore, it was fine at Moody's to change methodology if it had no impact on the ratings, and therefore, revenue and market share. Fine, you could change it, whatever. Go ahead. Right ahead.

If you change methodology, however, and it was going to cut your market share in half, that was going to have a big impact. And it wasn't going to happen. So I think if you look at what happened at Moody's, the changes, the material changes in methodology, the changes that led to a different rating occurring, only happened when there was market share pressure and the result was always that the ratings were more competitive with our competitors' ratings.

Now, why that whole preface? Because I think what was happening with the other rating agencies is that they were doing the same thing. They were watching Moody's, they were watching, S&P was watching Fitch and Moody's, Moody's was watching Fitch and S&P, and Fitch was watching Moody's and S&P.

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COMMISSIONER MURREN: Were you aware of any instances where the analysts wanted to change the methodology but essentially, that was suppressed?

MR. FROEBA: It's important to remember when you think about the process that an individual analyst had almost no capacity to change a methodology. At the margins, they could make small changes.

As I said, I think somewhat earlier, the agency's intellectual property is the methodology and that's really controlled by a small select group, with a much less formal process, and it's usually very senior people. An individual analyst -- so in response to your question, normally, an individual analyst couldn't make a material change to methodology. It would have had to have been something that was driven by people much more senior than an ordinary analyst.

COMMISSIONER MURREN: Thanks.

MR. MICHALEK: Two comments. I had an opportunity to testify in front of the

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Permanent Subcommittee of Investigations for the Senate Governmental Affairs Committee. And I was struck by what I would suggest is an even worse culture at S&P, in terms of their frustration in trying to affect meaningful changes to the methodology that was being employed.

So in that sense, I think that we probably did have -- and I'm only speculating because I can't compare, I wasn't at S&P -- we did have a stronger, deeper intellectual culture in place, at least prior, so that it was slower to erode potentially than what I saw from the exhibits and the testimony that was given regarding S&P's culture, if you will.

Regarding changed methodologies that were suppressed, I can think of one example in the market value CDOs where a quantitative, esteemed colleague of ours was suggesting that there needed to be a revision to the market value methodology, and his efforts were discouraged. Further, that he had provided, the same

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Individual, had provided some critical analysis to the SIV methodology that was being employed, and was "convinced," and I use that in air quotes, that potentially the benefit from installing his more conservative perspective would not outweigh the potential loss that would come from the market share that would occur.

And what he was effectively doing, and I can only summarize because I can't speak at his level of quantitative skill, was increasing the likelihood of a depression-level scenario in terms of defaults and risks.

Had they done that, it would have effectively made SIVs, or at least this sector of SIVs that were under examination, not possible to be rated.

COMMISSIONER MURREN: I'm guessing we may want to follow up on that.

MR. MICHALEK: Happy to cooperate.

CHAIRMAN ANGELIDES: Can you say what you said?

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DR. WITT: The name of that analyst was Cesar Crousillat, and the reason that I asked was that Cesar, along with Mark and Rick, were -- their positions were terminated in the fall of 2007. I mean, you've heard their testimony. These were really smart guys, and Moody's needed their services, and I always thought it was the personnel decisions that made me the most uncomfortable, especially at this time, in terms of what was management's real purpose. And of course the other person that they took out of the rating agency at the point in time was Eric.

They removed him to a software company. So I mean, these were, like the most independent minded, you know, people they had, and some of the best people they had.

As far as the --

CHAIRMAN ANGELIDES: Before you proceed, I just want to say that if you would please give Crousillat's information, do you know -- certainly, would you please give it to our staff so we can follow up on this.

VICE-CHAIRMAN THOMAS: At least the spelling.

DR. WITT: As the other rating agencies, this is kind of ancient history, so I'm not sure it's relevant, but I worked at Prudential Securities before I came to Moody's. And it was an investment bank, and, you know, I was working on structuring CDOs, so I had to, I dealt with S&P and Fitch from that side. And I was -- I didn't want to stay in investment banking, and I met Jerry Gluck and I got to know a few of the analysts at Moody's and I was just very impressed with the culture at that time. This was in 2000.

And I concur with Rick's opinion that, you know, it was just much more of a, you know, a bunch of smart people getting together and saying, "How can we do this right," kind of culture at Moody's, which was one of the reasons why I wanted to join.

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COMMISSIONER MURREN: Thank you. Do I still have more time?

CHAIRMAN ANGELIDES: Yes.

COMMISSIONER MURREN: Question for all of you: In your experiences at Moody's, were you ever aware of an instance where the issuer or the investment bank gave information to you as the rating agency that was either incorrect, poorly represented, or incomplete?

MR. FROEBA: Well, I just generally assume that investment bankers were lying to me whenever it was, you know, if there was any -- anything at issue. And that was a useful thing to do. I always checked. I never relied.

They would do things like do creative black-lining so this thing they didn't want you to catch wouldn't show up in the black-line. You had to be very scrupulous if you wanted to avoid -- and it was a very contentious relationship often that arose between Moody's and the banks. So yes, there were often times when things were hidden, concealed, misrepresented. Fraud, I don't think so. I didn't experience that.

MR. KOLCHINSKY: In some cases, where we rated deals using the CDO ROM model, and it was a static pool, so we actually rated to the pool. We've gotten, and I don't think it's fraud just because I don't know what, I think it was mostly copying, pasting by the analysts, but we got back a CRO form that we looked at that -- there were certain columns that we had to fill out, and unless the text was exactly the same, compared text to text, so the text strings were -- weren't exactly the same, they were treated differently.

And different bonds, the same exact bonds that should have had identical text, they were not, I think that's mostly copying, pasting, but that just -- maybe in some cases, there's no way for us to know, but something you had to check.

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MR. MICHALEK: There was an example, from -- I can't remember the exact year, 2003? Structuring bank I think was Credit Suisse. One of the processes that has been alluded to here is, I would mention a cleaning out of the warehouse. That effectively, you do deal one, and you can't sell the equity or you can't sell junior-most piece, so they take it out onto their balance sheet. And then that bond from CDO 1 would end up being an asset for CDO 2.

So they've got a period of -- they are extended a line of credit by their credit committee as to how much of this they can have, but it's important that they keep rolling this stuff off of their balance sheet, getting it into the subsequent CDOs. However, there's some restrictions are just inviolable with respect to the Moody's methodology, you can't have more than X percent that were not rated by Moody's because of the problems, et cetera, et cetera.

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Well, there was a case where, here was a structure that had gotten assembled, that had some non-qualifying assets that we only learned about at the very end, and in fact, it was after the deal had originally been rated, and we were coming to a closing, we ended up having to, “what are we going to do about this?” And we're going to have to withdraw the rating and make an announcement that says this was incorrectly rated, and it was a huge embarrassment.

So the banker at the time suggested, "Well, I think I have a solution. We'll buy back all of those bonds so that your rating will not have been at issue." It was agreed that we would do that provided that none of these bonds ended up in any CDO that Moody's subsequently rated.

And about three months later, low and behold, there's that bond sitting there and it was like, "Oh, that was just an accident, we'll buy that one back out of this one as well."

So that sort of, you know, can I say that this was fraud? No. Can I say that it was shark dealing? Daily. Daily.

COMMISSIONER MURREN: Any investment banks stands out as making the most innocent mistakes repeatedly?

VICE-CHAIRMAN THOMAS: Nicely phrased.

MR. MICHALEK: Banks don't make mistakes. The people make mistakes. You could probably find some particularly aggressive bankers, their names are well known, and those bankers have moved from bank to bank, and perhaps in your research, I'm sure these names have already come up.

Obviously Lehman Brothers, there were individuals at Lehman Brothers who were extremely aggressive and it was difficult to actually say no, and they were very aggressive about pushing back. Again, I don't want to accuse anybody of fraud without having all of the details and facts in front of me.

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COMMISSIONER MURREN: Thank you.

CHAIRMAN ANGELIDES: All right. Thank you very much, gentlemen, for being with us here today. A couple -- few thank yous -- go ahead, are Vice-Chairman. I'll wrap up.

VICE-CHAIRMAN THOMAS: No, I just wanted to thank you and I hope our two new witnesses didn't mind the expansion to the two earlier ones 'cause frankly, about three-quarters of the way through this, you kept trying to explain Moody's culture to us. And it felt a whole lot like a faculty lounge that I'm very comfortable in, and I appreciate the testimony and I think you were an extremely valuable asset for this hearing and I want to thank you.

CHAIRMAN ANGELIDES: Well, thank you. I'd like to thank our witnesses who were with us today, I'd like to thank, again, President Kerrey and staff of The New School, you've been wonderful hosts. And I just want to thank you for going out of your way to accommodate us, to make us feel at home and set us up on the road, a very difficult undertaking. You did a terrific job.

And I particularly want to just thank all my colleagues for the countless hours they are putting into this important task for the country and just the preparation and the hard work and the good questions. Frankly, it's an honor to serve on this Commission.

And finally to the staff who have put in countless hours and now will get a three-hour break before we go on to the next mission.

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Thank you all very much. Commissioners, we've been asked by Gretchen if we could all convene in the holding room together briefly. She has some materials and instructions for us on the next part of our field trip. Thank you all very much.

Oh, excuse me, there are some materials in the corner. Staff reports, a wonderful chart that the staff prepared in multicolor, with many dimensions on CDOs and CDO squareds, and those are all also on our website. Thank you all very much.

This meeting is adjourned.

(Time noted: 5:24 p.m.)