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Matthew A. Lieber

Steven H. Kasoff

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Steven H. Kasoff

Yale University School of Management

Matthew A. Lieber

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Yale Program on Financial Stability

Lessons Learned

Eric Kolchinsky

By Steven H. Kasoff and Matthew A. Lieber

Eric Kolchinsky served as managing director of ratings for ABS CDOs (asset-backed security collateralized debt obligations) at Moody's Investor Services from 2005 to 2007. Kolchinsky started his career in structured finance with stints at Goldman Sachs and Merrill Lynch. He joined Moody's in 2000 as vice president for credit. In 2007, after Kolchinsky raised questions concerning the ratings of new deals in light of subprime downgrades, Moody's removed him from his client-facing position. Kolchinsky supervised methodology for structured finance valuations at Moody's Analytics for two years, before Moody's suspended him altogether in 2009. Separated from Moody's, Kolchinsky testified before Congress about fraudulent rating agency practices and conflicts of interests. Since 2009, Kolchinsky has served at the National Association of Insurance Commissioners (NAIC), where he is presently director of structured securities and capital markets. This Lessons Learned summary is based on an interview with Kolchinsky.

In the decade before the financial crisis, rating agencies became more profit-oriented while confronting more complex products than ever.

The rating agencies played an important and widely documented role in the subprime securitization bubble of 2005–07 that triggered the Global Financial Crisis. Investors relied on the ratings to judge the risk of the securities and satisfy regulatory requirements. Eric Kolchinsky received a brief but intense media spotlight as an industry whistleblower in 2009 for signaling the contradictions between rating agencies' practices and their public role as a market referee. In our interview, Kolchinsky described in frank detail the practices of the agencies as they handled a wave of complex structured products during the boom years.

Rating agencies serve market participants, as Kolchinsky explained in a 2011 presentation,¹ by providing a reliable estimate of a security's likelihood of failure. Private companies, rating agencies originally earned revenue from investor subscriptions but increasingly began earning revenues from issuer fees in the 1970s.²

¹ Eric Kolchinsky, "The Rating Agencies: Regulatory Perspectives," presentation to Georgetown University Law School, Washington, DC, November 2, 2011.

² US securities law authorizes the Securities and Exchange Commission to designate nationally recognized statistical rating organization (NRSRO) status, qualifying an agency to rate financial institutions, broker-dealers, insurance companies, and corporate issuers of securities. Federal and state regulators have relied on NRSRO ratings to determine minimum capital levels in their supervision of banks and other financial institutions. At the direction of the 2010 Dodd-Frank Act, however, US bank regulators have adopted alternative standards of creditworthiness, introducing the "investment-grade" label. Institutional investors remain a key end-user of the NRSRO ratings. Standard & Poor's and Moody's have dominated the NRSROs, responsible for more than 80% of ratings across all asset classes in 2018.

Using a particular statistical methodology, the agency ratings provide a reasoned assessment of credit risk, based on particular estimates of the probabilities of loss or default. The agencies' ratings of all securities are, however, simply the result of a model applied to a particular security, controlling for other factors and with large, simplifying assumptions and omitted variables.

For decades, Kolchinsky said, the agencies had operated as private partnerships and functioned as a market utility, providing reliable credit analysis along professional lines. This model broke down in the 2000s, according to Kolchinsky, when the agencies became publicly held companies and when the focus of their business shifted to structured finance.

The complexity of structured products meant that there was not a single recognized methodology for evaluating them, nor a clearly optimal one. The rating agencies were ill-equipped—and improperly motivated—to rate CDOs.

Structured credit products challenged rating agencies, Kolchinsky said, to adapt from modeling the probability distribution of default for an individual company to modeling the aggregate default or loss distribution of a portfolio of bonds that have correlations among themselves. Specifically, characteristics of CDOs that he cited as increasing their complexity and opaqueness that proved challenging to the rating agencies included:

- Securitization multiplied the number of agents separating borrowers from risk bearers, as mortgages or other assets passed from originator to a residential mortgage-backed security (RMBS) and then to a CDO; and
- Each agent in the chain of production was less incentivized to act in the interest of the risk bearer and more incentivized to act for his own short-term profit. Compensation for the agents shifted from a long-term object (partnership interest) to short-term salary and annual bonus.

Furthermore, across the credit rating industry, there were fewer people qualified to analyze and rate structured products, according to Kolchinsky, than for other market segments. Conventional fixed-income securities, by contrast, had been scrutinized by ranks of professionals using methodologies developed over decades. This made CDO ratings less transparent, Kolchinsky said.

The staff in Kolchinsky's CDO group came from corporate bonds. They "lacked knowledge of how the underlying RMBS bonds worked," and they did not talk with the RMBS group. They used the methodology they knew well.

Faced with the challenge of the new complex products, Kolchinsky continued, the rating agencies employed existing models and a trial-and-error practice to determine the best methodologies. At first, he said, Moody's applied its conventional corporate bond ratings models and tools to analyze ABS CDOs and establish its foothold in structured finance products. One such model was the binomial method, an important original methodology used for rating collateralized loan obligations (CLOs). "The binomial was a heuristic that worked quite well" to generate accurate ratings on CLOs using strong assumptions,

Kolchinsky explained, but “the binomial model had zero statistical basis” when applied to RMBS CDOs.

Revenue streams from the new CDO business generated a methodological Wild West. The best model for a CDO, it turned out, was the one that was plausible and generated the most favorable rating.

Around 2004, with subprime CDO issuance starting to take off, Kolchinsky recalled that Moody’s had a problem.

The binomial method wasn’t working very well for Moody’s. When I say it wasn’t working well, Moody’s was losing business. That was in the ABS [segment], so RMBS-backed CDOs.

This was, Kolchinsky continued, due to a crucial output that would drive the ultimate rating of the security, namely the diversity score that the model generated. The diversity score of a CDO was a measure of the independence (or noncorrelation) of the underlying securities from one another. More diversity meant less correlation, and this resulted in a better rating, since the underlying securities were less likely to default simultaneously. As Kolchinsky explained it, the problem for him and for the Moody’s structured finance group that he led, however, was the output that the binomial method was producing.

The diversity score that came out was in the low teens. At low teens, basically you had a lot of cliff effects. If you have basically 12 scenarios that you’re running, because the diversity score was 12, you could have a lot of cliffs. And when you probability-weighted those, you started getting much lower ratings. Especially at the top where you needed the AAA to finance and lower the cost of funding for the deal.

However, Kolchinsky explained, the analytic challenges in rating a CDO opened up the possibility of using different models. As that market took off and shifted into ABS CDOs and RMBS, Kolchinsky described a methodological Wild West across the broader market for credit ratings. Monte Carlo simulation models, S&P’s black box simulation model, a two-moment method, and CDO-ROM were some of the methodologies being applied by the industry.

It turned out, Kolchinsky said, that the Monte Carlo simulation models were generating more favorable ratings of subprime real estate CDOs:

Eventually, the consideration was to take [the Monte Carlo simulation model] and to apply it to an area where the binomial wasn’t working well. [From then on,] we had tremendous market share, and we usually didn’t miss deals.

In the decade before the financial crisis, the rating agencies became public companies. The move incentivized rating agency directors to prioritize market share over sound methodology.

For decades, the standard revenue model at the top three rating agencies had been issuer-pay, meaning that the underwriter of the security paid a fee to the agency for completing and publishing a rating. However, important structural changes had occurred in the industry during the period immediately before the crisis. Kolchinsky emphasized two changes in particular and described the ways that these changes influenced agency ratings of CDOs:

- Moody's went public in 2000, increasing its focus on revenue growth; and
- Rating agencies shifted compensation of their staff from a long-term focus to short-term financial incentives.

When the CDO boom began a few years later, Kolchinsky explained, it introduced a stream of new business that saw more competition between the different rating agencies for profits. The surge in synthetic CDOs would accentuate these dynamics.

Kolchinsky also confirmed that management at Moody's directed ratings managers to prioritize market share over sound methodology. When asked if the CDO ratings methodology at Moody's was designed to try to more closely match S&P and Fitch ratings at the time, Kolchinsky responded, "Yeah. Of course, absolutely." Moody's was losing business because it was generating ratings that were too low relative to other rating agencies, he explained. Ratings shopping—when an issuer seeks the agency with the lowest standards to return the highest rating—was happening, and the pressure was on Kolchinsky to pursue market share.

The bottom line, Kolchinsky made clear, was that a good model for rating CDOs in this environment was one that generated a better rating.

That's how things work at rating agencies. Even if people don't say it out loud, you've got to look at the incentives. If you don't have the market share, you're going to get fired.

Around this time, Kolchinsky confirmed, rating agencies had shifted compensation of their staff from a long-term focus to short-term financial incentives. The rating agency business model has very high fixed costs, Kolchinsky explained, but also enormously high profit margins once you can add business. The pressures were obvious, Kolchinsky remembered.

If you're not keeping the lights on and you're a publicly traded company, you have a group that's sucking down a lot of money without generating that kind of marginal revenue—you're going to get fired. Nobody has to tell you, "You have to get in business." You're looking at what you're producing, you're looking at your salary and going, "How long are they going to keep me around?" It doesn't have to be said.

When these profits were threatened, recalled Kolchinsky, in 2004–07, directors at Moody’s pressured ratings managers to get more business. In addition, he said, they failed to adjust their methodologies to address mounting evidence of large-scale losses in the real estate markets. They should have refused to rate products that they could not analyze. Yet, in the pursuit of shareholder value, the directors repeatedly emphasized market share strategies, Kolchinsky explained:

These are smart people . . . And they told you what your market share was. That was the market share emails that I started receiving when I was managing the group. “Here’s your market share, here’s how you’re doing. Here are the deals you missed. Why did you miss those deals?” Nobody said directly, “Make these deals work,” but you knew where it was going. Managers were fired periodically.

Before 2000, directors at Moody’s worked for a private company that did not answer to shareholders and that, in Kolchinsky’s opinion, was significantly less beholden to investment bank clients. The issuer-pay revenue model had previously coexisted with a less profit-driven, and more reliable, rating agency industry. According to Kolchinsky, the transformation of Moody’s into a more aggressively capitalistic shareholder value–driven firm combined with the issuer-pay model and the new challenges of structured finance to cause management to chase market share and profits at the expense of their ratings and credibility.

After the financial crisis, the rating agencies received much criticism from various reviewing bodies including the Financial Crisis Inquiry Commission (FCIC), which specifically looked at Moody’s. Along with plain evidence of rating agency failures, the commission gathered significant evidence that confirmed Kolchinsky’s descriptions regarding the design of appropriate methodologies and the shift in corporate culture to a short-term revenue focus and their impacts on ratings.³ The FCIC also specifically concluded that that the division rating CDOs at Moody’s was under-resourced. But its criticisms were not limited to Moody’s. “The three credit rating agencies were key enablers of the financial meltdown . . . This crisis could not have happened without [them]. Their ratings helped the market soar and their downgrades through 2007 and 2008 wreaked havoc across markets and firms.”⁴

Kolchinsky called for a quasi-public rating agency modeled after the insurance industry.

Practitioners interviewed by the Yale Program on Financial Stability from a wide range of institutional settings have concurred in criticizing the rating agencies’ performance prior to and during the crisis. Like Kolchinsky, many pointed to the problematic incentives in the issuer-pay model, which may have influenced the use of models that delivered a majority of AAA ratings. It *is* strange that the main business of Moody’s *Investor Services* (italics added)

³ See Financial Crisis Inquiry Commission (FCIC), *The Financial Crisis Inquiry Report* (Washington, DC: US Government Printing Office, 2011), 146–50, 207–12. (Note: Kolchinsky provided evidence to the commission, which also interviewed a number of other former and then–Moody’s employees.)

⁴ FCIC, xxv.

and other major rating agencies lies in earnings from fees for services to *underwriters*—who are *not investors*.

The 2006 Credit Rating Agency Reform Act formalized US Securities and Exchange Commission (SEC) oversight of the industry in an effort to ensure that only qualified firms that had been approved by the agency as nationally recognized statistical rating organizations (NRSROs) were issuing ratings for financial instruments and entities that were being relied on by investors. The 2010 Dodd-Frank Act enhanced the SEC's oversight and pushed regulators, which had also relied on ratings in judging a bank's risk level, to develop alternative measures of creditworthiness,⁵ introducing the "investment-grade" label. Institutional investors remain a key end-user of the NRSRO ratings. Currently, nine firms are registered as NRSROs;⁶ however, Standard & Poor's and Moody's have dominated the industry, responsible for more than 80% of ratings across all asset classes in 2018.

Rating agency reforms have been piecemeal, however, and the system remains largely similar to its pre-crisis state. In 2010–11, Kolchinsky actively promoted an overhaul of the system. Asked about rating agency reform, he explained his support for a "quasi-public rating agency model," which he would base on the insurance industry, given his experience there. Kolchinsky explained that the National Association of Insurance Commissioners is a nonprofit organization of state regulators funded by industry filing fees and dedicated to supporting regulators. The NAIC's Securities Valuation Office oversees a hybrid system integrating at least three kinds of ratings by government regulators and private rating agencies:

- In-house ratings of insurance industry products for regulators,
- Fully outsourced ratings of industry products by private financial institution specialists for market participants, and
- Contracted ratings provided by private institutions with closer oversight.

In a public rating agency model such as this one, said Kolchinsky, ratings managers are salaried employees of the NAIC. As regulators, they bring that perspective to the work and are not incentivized to grow the market. While moving to such a system as it relates to NRSROs would take significant effort, Kolchinsky also stressed that the other extreme, more competition among private agencies, is not the answer.

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⁵ SEC.gov, "Learn More About NRSROs," accessed April 30, 2021, <https://www.sec.gov/ocr/ocr-learn-nrsros.html>.

⁶ SEC.gov, "Current NRSROs," accessed January 11, 2022, <https://www.sec.gov/ocr/ocr-current-nrsros.html>.