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Testimony of Former employee of Moody's, Richard Michalek, Before the FCIC on Credibility of Credit Ratings

Richard Michalek

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Financial Crisis Inquiry Commission Hearing On

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

Wednesday, June 2, 2010

Testimony of Richard Michalek

Mr. Chairman, Mr. Vice Chairman, fellow commissioners: My name is Richard Michalek, and I want to thank you and your staff from inviting me to participate in today's hearing.

I am 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 at Moody's, I held the title of vice president, senior credit officer.

My general responsibilities included performing legal analysis on the structure and documentation of complex structured finance transactions in order to assign a rating to that transaction 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 at Moody's, consulting on legal matters for other groups in New York, London, and 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 semi-annual training sessions for 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 the team responsible for developing, refining and implementing the methodology for assigning ratings to highly complex credit derivative product companies and being the 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 within Moody's Investors Service. And while I had the opportunity to interact with several other groups within Moody's, 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 been 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-rating process for structured derivative products are neither surprising nor

unexpected in light of the 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. 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 the commissioners may have or have asked

Two questions keep coming up: Just how independent are these agencies, particularly within an issuer pays framework? And: What consequences do 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 a 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 and culture of the derivatives group changed dramatically during my tenure. The willingness to decline to rate or to just say no to proposed transactions steadily diminished over time. 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 of the group in particular was 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 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 rating agency, even if not realized, absolutely tilted the balance away from the independent arbiter of risk towards 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 handful of more fundamental questions. Who should bear the risk of getting it wrong, particularly when it is within reach to either not get it wrong or to choose not to rate? If we accept that the ratings ARE the rating agency's products should all the ratings be issued by a rating agency be entitled equally 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, in the extremely 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 someday pile.

I'm in the camp that believes that to significant degree 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 and net profits, a distinction based on the extent of the public good provided 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 protestations of free speech and opinion, at least for that subset of ratings on products where the benefit of the rating falls primarily to the private parties involved, the agencies would redirect some of their extraordinary profit margins into resources and research and would once again have an incentive to just say no.

I stand ready to answer any questions you may have.

Thank you.