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

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2 **FINANCIAL CRISIS INQUIRY COMMISSION**

3 **Official Transcript**

4
5 **Hearing on "Credibility of Credit Ratings,**
6 **the Investment Decisions Made Based on**
7 **Those Ratings, and the Financial Crisis"**

8 **Wednesday, June 2, 2010**

9 **The New School**

10 **55 West 13th Street, New York, New York**

11 **8:30 A.M.**

12
13 **COMMISSIONERS**

14 **PHIL ANGELIDES, Chairman**

15 **HON. BILL THOMAS, Vice Chairman**

16 **BROOKSLEY BORN, Commissioner**

17 **BYRON S. GEORGIU, Commissioner**

18 **HON. BOB GRAHAM, Commissioner**

19 **DOUGLAS HOLTZ-EAKIN, Commissioner**

20 **HEATHER H. MURREN, Commissioner**

21 **JOHN W. THOMPSON, Commissioner**

22 **PETER J. WALLISON, Commissioner**

23
24 **Reported by: DAVID LEVY, CSR, Hearing Reporter**

25 **PAGES 1 - 511**

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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

Preliminary remarks

1
2 Inquiry Commission, both The New School
3 and New York City is -- are proud to
4 welcome you here this morning, and I
5 appreciate very much you praising the
6 staff because they have done all the work
7 to make this possible, and it is always
8 quite moving to me, the effort that they
9 make to accommodate these kinds of
10 extremely important efforts. I don't envy
11 your work.

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

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

1 Preliminary remarks

2 avoid and take risk to zero.

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

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

1 Preliminary remarks

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

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

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

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

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

1 Preliminary remarks

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

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

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

22 VICE CHAIRMAN THOMAS: Turn it over.

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

1 Preliminary remarks

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

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

7 PRESIDENT KERREY: Queuing up is all
8 right.

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

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

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

1 Preliminary remarks

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

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

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

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

1 Preliminary remarks

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

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

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

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

1 Preliminary remarks

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

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

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

1 Preliminary remarks

2 2006 report from Moodyseconomy.com about
3 the dangers of an overheated housing
4 market. And it didn't take a 30-percent
5 decline in housing prices for these
6 ratings to come unhinged. Housing prices
7 had only dropped four percent from their
8 peak when Moody's began its massive
9 downgrades in July 2007. Imagine if you
10 had a laboratory that tested the safety of
11 toasters. If at first a few toasters caught
12 fire, there would be an outcry about the
13 toaster inspectors. And yet, instead of
14 halting the assembly line, you sped up the
15 production of these combustible toasters.
16 After a while, if you found that 90
17 percent of the toasters you rated safe had
18 caught fire, you'd think that something
19 was fundamentally wrong.

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

1 Preliminary remarks

2 governance and management?

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

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

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

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

1 Preliminary remarks

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

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

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

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

1 Preliminary remarks

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

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

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

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

1 Preliminary remarks

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

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

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

1 Preliminary remarks

2 you very much and thank our witnesses for
3 being here.

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

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

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

18 J A Y S I E G E L ,

19 G A R Y W I T T ,

20 having been duly sworn, testified as
21 follows:

22 CHAIRMAN ANGELIDES: Thank you very
23 much. We will begin now with session 1 of
24 today's three session hearing. Session 1
25 is entitled, "The Ratings Process." It is

1 Kolchinsky - opening

2 our opportunity to hear from people at
3 Moody's who were involved in the ratings
4 process, both for residential
5 mortgage-backed securities and for
6 collateralized debt obligations. And we
7 have asked each of the witnesses who have
8 delivered written statements if they would
9 provide us with a five-minute opening
10 statement, or an opening statement of no
11 more than five minutes.

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

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

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

1 Kolchinsky - opening

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

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

25 The answers lie primarily in the

1 Kolchinsky - opening

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

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

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

1 Kolchinsky - opening

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

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

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

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

1 Kolchinsky - opening

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

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

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

1 Kolchinsky - opening

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

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

1 Kolchinsky - opening

2 exceptional.

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

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

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

1 Kolchinsky - opening

2 Synthetics also changed the dynamics
3 of the ratings process. While a cash
4 transaction would have taken months to
5 accumulate the collateral it needed to
6 close, a synthetic transaction could ramp
7 up in a week. This significantly
8 shortened the window for analysts to be
9 able to analyze their transactions.

10 Pressure from bankers --

11 VICE CHAIRMAN THOMAS:

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

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

1 Kolchinsky - opening

2 have your written testimony.

3 MR. KOLCHINSKY: Thank you --

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

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

22 As the market began to falter after
23 the collapse of the Bear, Stearns hedge
24 funds, I was asked to post senior
25 management on the developments in the

1 Siegel - opening

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

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

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

17 The role of ratings agencies in the
18 market is to provide a public opinion that
19 speaks to one aspect of the
20 securitization; specifically, the relative
21 risk of credit default associated with the
22 particular security. As with all
23 securities that Moody's rates, the
24 methodology for rating RMBS incorporates
25 qualitative and quantitative factors that

1 Siegel - opening

2 are weighed and assessed by Moody's
3 analysts.

4 Quantitative factors may include the
5 degree of credit enhancement provided by
6 the structure, the historical performance
7 of similar assets created by the
8 originator, and metrics relating to
9 borrowers' credit history. Qualitative
10 factors may include an assessment of the
11 bankruptcy-remoteness of the issuing
12 entity, the integrity of the legal
13 structure, and management and servicing
14 quality.

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

1 Siegel - opening

2 every transaction.

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

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

23 Rating committee members are selected
24 based on relevant expertise and diversity
25 of opinion. Each member is encouraged to

1 Siegel - opening

2 express dissenting or controversial views,
3 and to discuss differences openly and
4 frankly. Once a full discussion has taken
5 place, the members then vote, with the
6 most senior members voting last so as to
7 not unduly influence the votes of junior
8 members. Each vote carries equal weight
9 and the majority vote decides the outcome.

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

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

20 Beginning in 2003, Moody's observed
21 and commented on the trends of loosening
22 mortgage underwriting processes and
23 escalating housing prices. Moody's
24 published on and incorporated these trends
25 into its analysis of RMBS. As a result,

1 Siegel - opening

2 Moody's steadily increased its loss
3 expectations on pools of subprime loans
4 and the levels of credit protection
5 required for a given rating so that RMBS
6 backed by subprime mortgages issued in
7 2006 and rated by Moody's had more credit
8 protection than bonds issued in earlier
9 years.

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

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

1 Siegel - opening

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

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

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

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

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

1 Weill - opening

2 additional changes may be appropriate.

3 Thank you, I am happy to respond to any
4 questions.

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

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

10 My name is Nicolas Weill. I'm the
11 Chief Credit Officer for structured
12 finance in Moody's Investors Service. In
13 2007, I was managing director of U.S. RMBS
14 surveillance. Today, I will describe
15 Moody's rating monitoring processes and
16 will detail our monitoring activities and
17 the actions we took in response to the
18 challenging environment of 2007.

19 As we entered 2007, Moody's believed
20 that residential mortgage-backed
21 securities, RMBS, had sufficient credit
22 protection to withstand a market downturn
23 of similar depth and duration as the
24 previous real estate downturns.
25 Unfortunately, Moody's, like others in the

1 Weill - opening

2 market, did not anticipate the severity or
3 speed of deterioration that occurred in
4 the U.S. housing market, nor the speed of
5 credit tightening that followed and
6 exacerbated the situation.

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

23 Finally, when necessary, a rating
24 committee convenes to debate and to vote.
25 Any rating change is then published as

1 Weill - opening

2 soon as practically possible.

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

19 Moody's first downgrade and reviews
20 for downgrade on securities backed by
21 2006-vintage subprime loans took place in
22 November 2006. Further rating actions
23 occurred in December 2006 and January
24 2007.

25 Our first comprehensive set of rating

1 Weill - opening

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

10 Indeed, as Moody's monitored the
11 actual performance of the 2006 subprime
12 RMBS, it appeared that the earliest loan
13 delinquency data for the 2006 vintage were
14 largely in line with the delinquency data
15 observed during the recession of
16 2000-2001. This performance was
17 consistent with the higher loss
18 expectations that were already anticipated
19 for the vintage.

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

1 Weill - opening

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

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

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

25 DR. WITT: Chairman Angelides,

1 Witt - opening

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

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

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

1 Witt - opening

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

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

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

24 The biggest problem in my opinion
25 during that time period was the absence of

1 Witt - opening

2 any reserve staff to develop, maintain and
3 test new rating methods. After 18 months,
4 in September 2005, I was transferred out
5 of the CDO group.

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

10 During the crisis, during the
11 financial crisis, many people have been
12 very quick to assign blame to the rating
13 agencies. This is definitely appropriate,
14 but up to a point. We at Moody's, along
15 with almost every major participant in the
16 capital markets, failed to grasp the
17 magnitude of the housing bubble before
18 2007. And I know you're tired of hearing
19 that from every participant in the market,
20 but, you know, it was the same, we were
21 all in -- had the same lack of knowledge
22 about what the future held. The crystal
23 ball just didn't get passed around.

24 However, there is always a strong
25 tendency to blame rating agencies far more

1 Witt - opening

2 than is justified by their previously
3 mistaken opinions. I believe this
4 tendency to blame rating agencies results
5 from three reasons:

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

21 Second, rating downgrades are bad
22 news. It's bad news for the issuer, bad
23 news for investors. By definition, it's
24 the rating agency that is the bearer of
25 this particular bad news and they are the

1 Witt - opening

2 messenger that is so often shot.

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

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

21 I can say that it is difficult to
22 know where the line should be drawn
23 between these two competing interests.
24 While short-term profits are easy to
25 measure, bondholders' interests are served

1 Witt - opening

2 by the zealous pursuit of an elusive but
3 distant goal, the right rating.

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

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

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

Q & A - Session 1

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

11 I think, Mr. Kolchinsky, you've
12 spoken on this, and I'm going to ask a
13 couple of the other folks. In August of
14 2007, the SEC did a report on Moody's. It
15 was part of a larger report which they did
16 on all rating agencies. And I'd like to
17 actually enter that SEC report on Moody's
18 into the record. It's, I believe, tab 1.
19 So if the staff would please note.

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

Q & A - Session 1

1
2 kept up with revenues and the number of
3 deals, in a sense there had been almost a
4 conveyer belt moving faster and faster, as
5 no revenues -- and this is not the SEC but
6 this is my notation -- revenues at Moody's
7 went from 600 million in 2003 to over 2.2
8 billion in '07, profit margins grew from
9 26 percent to 37 percent by 2007.

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

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

1 Q & A - Session 1

2 characterization, yes.

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

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

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

Q & A - Session 1

1
2 CHAIRMAN ANGELIDES: Didn't you
3 express some concern in your interview
4 with our staff that there were some people
5 you wanted to bring on and you couldn't
6 get the approval for their salary levels
7 and the talent you needed?

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

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

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

1 Q & A - Session 1

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

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

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

12 MR. WEILL: No.

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

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

23 CHAIRMAN ANGELIDES: Now, my
24 understanding is that you did do visits to
25 originators in the RMBS group, but my

Q & A - Session 1

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2 understanding is, you would look at
3 originators but, beyond going to
4 originators, because I understand there
5 were some adjustments made for different
6 originators, did Moody's ever do any
7 actual due diligence on loans, borrowers,
8 go to places like Inland Empire,
9 Bakersfield, Sacramento, Las Vegas, and
10 actually do on the ground assessments of
11 the housing market, places where, you
12 know, there was a national housing price
13 increase of 89 percent from 2002-2006?
14 And in many of these markets, from which
15 many of us hail, there was extraordinary
16 price escalation. Were there any teams
17 sent on to the ground to assess the market
18 to your knowledge?

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

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

Q & A - Session 1

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

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

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

19 But part of the originator review
20 would include an assessment of their
21 checks for fraud. I don't recall
22 specifically that FBI report, but I do
23 recall substantial industry discussion
24 about the increased sophistication of
25 fraud availability over the internet of

1 Q & A - Session 1

2 fake W-2s --

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

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

11 CHAIRMAN ANGELIDES: With respect to
12 that specifically.

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

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

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

Q & A - Session 1

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

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

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

1 Q & A - Session 1

2 inform --

3 VICE-CHAIRMAN THOMAS: Did you
4 yourself sample it or was this others
5 providing material to you?6 MR. SIEGEL: The -- we didn't open
7 the check and -- the envelope and see if
8 the borrower was making the full payment
9 or not, but the servicer would report on
10 this pool of loans, that ten borrowers are
11 delinquent and Moody's would use that information.12 VICE-CHAIRMAN THOMAS: Last aspect of
13 the question. Do you do sampling now
14 based upon your recent experience?15 MR. SIEGEL: I'm sorry, I left
16 Moody's in --17 VICE-CHAIRMAN THOMAS: Ah, Mr. Weill,
18 you're the one who is still there.

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

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

25 MR. WEILL: Appreciate the privilege.

Q & A - Session 1

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

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

19 VICE-CHAIRMAN THOMAS: When did that
20 start?

21 MR. WEILL: The process on
22 representation and warranties, as stated
23 earlier, has started a long time ago. We
24 have indeed published recently in 2008, I
25 think, various reports suggesting various

1 Q & A - Session 1

2 enhancements for the RMBS markets.

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

9 MR. WEILL: I'm referring to recent
10 2008 publications where we have discussed
11 sampling and --

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

17 CHAIRMAN ANGELIDES: Thank you.
18 Let's see, picking back up on this, so,
19 let me ask you a question. Was there any
20 discussion ever in Moody's as housing
21 prices began to escalate at an
22 extraordinary rate -- here is, by the way,
23 a graph of the Case-Shiller index, if you
24 can all see that. You'll see that about
25 2000, there is an historic and

1 Q & A - Session 1

2 unprecedented rise in housing prices, it
3 says 89 percent, in the last, from
4 2000-2007.

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

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

16 CHAIRMAN ANGELIDES: Or CDOs also.

17 MR. KOLCHINSKY: Not for CDOs.

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

24 MR. SIEGEL: No. There were
25 discussions with Moody's economist as to

1 Q & A - Session 1

2 what he -- his views were on national real
3 estate prices.

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

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

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

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

Q & A - Session 1

1 securities had would easily take into
2 account a ten --

3
4 CHAIRMAN ANGELIDES: Well, let me
5 query you on that. Then why is it when
6 prices dropped by four percent in July
7 2007, you're already downgrading? Your
8 models haven't withstood a ten or 15
9 percent decline. You're in downgrade mode
10 by July when prices have just come four
11 percent off their peak. Why is that
12 happening?

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

Q & A - Session 1

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2 the --

3 CHAIRMAN ANGELIDES: Well, the
4 expected loss, correct?

5 MR. WEILL: That's correct.

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

10 MR. WEILL: Mr. Chairman, the rating
11 actions are not based on the macro view.
12 The rating actions that we took in July
13 '07 and that we always take are based on
14 an analysis of security by security. So
15 what is driving the downgrade is a lot
16 more the performance, the level of
17 delinquencies, the servicer reports
18 showing the severity of loss upon liquidation not--

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

Q & A - Session 1

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

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

1 Q & A - Session 1

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

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

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

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

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

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

1 Q & A - Session 1

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

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

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

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

23 MR. KOLCHINSKY: I actually never
24 received a formal evaluation as a managing
25 director. But it was very clear to me

Q & A - Session 1

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2 that my future at the firm and my
3 compensation would be based on the market
4 share that was brought in. And that was
5 reinforced in many ways, especially with
6 these e-mails that were sent out, at least
7 quarterly, and occasionally monthly. I
8 recall one e-mail that was sent out, I
9 believe in October of '07. This was right
10 around the same time that three thousand
11 tranches were downgraded by Mr. Weill's
12 team.

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

22 CHAIRMAN ANGELIDES: Mr. Siegel?

23 MR. SIEGEL: Mr. Chairman, I never
24 found that to be the case during my tenure
25 at RMBS. First of all, the performance

1 Q & A - Session 1

2 evaluation metrics you described sound
3 like they are for managing directors and
4 above. The analysts were never evaluated
5 based on market coverage. That was a
6 component of the managing directors'
7 evaluation.

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

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

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

1 Q & A - Session 1

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

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

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

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

19 Let me -- last question here, before
20 I move on to the Vice-Chair, we looked at
21 a couple of specific deals that struck me.
22 Just to see how this worked, we looked at
23 a 2006 RMBS sponsored by Citigroup. It
24 was a bunch of New Century loans, \$948
25 million; 75 percent were adjustable rate,

Q & A - Session 1

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2 33 percent were 228 loans, balloon
3 payment. It was issued in '06. Within a
4 year, 13 percent of the mortgaged
5 properties had been foreclosed upon. By
6 June 2009, 31 percent.

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

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

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

23 You know, I look at that and I think
24 when you go into a store and you get, you
25 see grade A eggs, you assume maybe one of

1 Q & A - Session 1

2 those eggs will be cracked. Turns out all
3 twelve are cracked and it was originally
4 rated AAA.

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

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

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

25 The severe downgrades in the subprime

Q & A - Session 1

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2 area, and there's concentrated heavily in
3 subprime, drove the ratings down.

4 Eventually this deal suffered an event of
5 default, and none of the ratings there
6 actually -- the notes are at this point
7 not making any payments.

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

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

25 But because bankers knew that we

Q & A - Session 1

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

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

25 CHAIRMAN ANGELIDES: Am I reading

1 Q & A - Session 1

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

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

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

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

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

20 VICE-CHAIRMAN THOMAS: Thank you,
21 Mr. Chairman. I want to pursue a similar
22 line, but in a slightly different way.
23 You're interesting and useful to me
24 because at least in my mind, and any time
25 I make a statement that you don't feel is,

Q & A - Session 1

1
2 you know, accurate depicting the general
3 scene as you looked at it, let me know.
4 Because I see you as a choke point, not in
5 a negative sense, but it's a very limited
6 number of people doing what you do. And I
7 guess, given the volume and the history,
8 you're probably as good as any of them
9 doing it. So someone would want to get
10 your label, and that's one of the reasons
11 they came to you.

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

Q & A - Session 1

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

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

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

Q & A - Session 1

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2 of compensation?

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

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

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

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

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

22 DR. WITT: We got a salary and a
23 bonus which sounds like, you know, just
24 like the rest of Wall Street. But the
25 bonus that we got was a fraction of our

1 Q & A - Session 1

2 salary, not multiples of it like it was on
3 Wall Street. So the variable compensation
4 component was not nearly as large as it
5 was for investment bankers. But it did
6 vary --

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

9 DR. WITT: It was an incentive.

10 VICE-CHAIRMAN THOMAS: A realistic
11 incentive.

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

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

1 Q & A - Session 1

2 questions in the first place.

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

9 MR. KOLCHINSKY: Yes, certainly.

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

12 MR. SIEGEL: Yes, after my tenure
13 there.

14 DR. WITT: Sure.

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

25 You're a rating company. People want

Q & A - Session 1

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

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

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

19 MR. SIEGEL: We did want the market
20 to appreciate the quality of the Moody's
21 ratings. So we would speak to investors,
22 we would publish on trends in the market,
23 we would publish on rating methodologies,
24 we would publish on risk. We would also
25 meet with issuers so, if an issuer did a

Q & A - Session 1

1
2 hundred deals and we were on 90, we would
3 inquire as to why we weren't on the
4 others. And if it was, again, customer
5 service, of course we would pursue, "Oh,
6 you want us to have an analyst available
7 on Saturdays? Let me try to arrange
8 that."

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

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

Q & A - Session 1

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

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

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

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

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

25 VICE-CHAIRMAN THOMAS: Okay. We're

Q & A - Session 1

1 going to accept that as the statement.

2 Does anyone want to say that that sounds
3 good but it wasn't always that way?
4

5 Mr. Weill?

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

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

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

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

25 MR. SIEGEL: This goes back, I

1 Q & A - Session 1

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

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

16 So what I'm looking at -- or Mr. Witt
17 did -- what I'm looking at are these
18 teams, the committees in making decisions,
19 as the process sped up, and obviously
20 people understood that if you're simply
21 going for the letters, if they shortened
22 the time in which you had to consider what
23 it was, notwithstanding they have made
24 significant changes in the product, if
25 they could indicate to you, or structure

1 Q & A - Session 1

2 it in a way that it looked like similar
3 products, you would have a tendency to
4 give it the same rating, notwithstanding
5 the fact the internal structure wasn't the
6 same? Did you have that feeling as you
7 were looking at products over this
8 timeline?

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

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

Q & A - Session 1

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2 they just got passed through because
3 quantitatively, the numbers, the headline
4 numbers were great. Underneath, and this
5 goes to explain some of the factors in
6 RMBS, the quantitative numbers, the
7 performance numbers looked great.

8 Underneath that, what the originators, the
9 bankers did, they undermined credit
10 quality by changing things, creating
11 different structures, new products that
12 looked like the old products but were in
13 fact different.

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

21 VICE-CHAIRMAN THOMAS: Okay, going to
22 the Lucille Ball, "I Love Lucy" chocolate
23 conveyer belt, if you started out with
24 caramels, you could handle them pretty
25 quickly because they are solid, but if you

Q & A - Session 1

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2 get into the creams, you've got to be
3 fairly careful as to what you do with
4 them, and as I recall, she just started
5 mashing them all.

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

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

16 VICE-CHAIRMAN THOMAS: So part of the
17 problem was, you are analyzing this, you
18 were coming up with new models. So you
19 met as committees. Probably, Mr. Weill
20 more than anyone else, did you ever have a
21 session with a committee where you kind of
22 looked at each other and said, "This thing
23 is changing rapidly, it's different than
24 what we thought it was, let's go get some
25 reserve and reconvene as a committee a

Q & A - Session 1

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2 little bit later to examine what in fact
3 we have this gut feeling that it's
4 slightly different than what it was"? Did
5 that occur?

6 MR. WEILL: That's exactly what we
7 did in the first couple of months of 2007.
8 Where we published at the beginning of
9 2007 a special report on early payment
10 defaults. We saw that there was a
11 changing in borrower behavior, in
12 homeowners' behavior, and we had a lot
13 more early payment defaults. And what we
14 did is, we paused and we convened a larger
15 group of people to think about what was
16 happening there, whether there was a
17 change, a departure from annual existing
18 trend to a new trend, whether the --
19 whether this was a macroeconomic trend,
20 whether this was a refinancing trend,
21 whether it was a homeowner behaviors
22 trend, an originator trend, certain
23 behavior on reps and warranties, on
24 appraisals, on servicing and loan
25 modifications. We put a lot of effort and

1 Q & A - Session 1

2 people together to try to think through
3 those issues. That's exactly, I think,
4 what you are describing here.

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

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

19 MR. SIEGEL: Mr. Vice-Chairman, on my
20 team, the staffing levels did grow
21 substantially during this time period to
22 keep up with the increasing complexity in
23 the market. We did walk away from deals
24 where we had a more conservative approach.
25 So there were -- there were many cases

Q & A - Session 1

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2 where the analysts would look at the deal
3 and they would be able to present an
4 analysis to committee as the structures
5 were changing. In some cases, we'd feel
6 it was in response to risks that we may
7 have identified. So if we identified a
8 risk of increasing interest rates, we
9 might see a deal come back with a swap.
10 So the investment bank would say, "We'll
11 put a swap and we'll take out that risk.
12 Now what do you think about the deal?"

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

24 MR. SIEGEL: I think it's very
25 important that we distinguish our

1 Q & A - Session 1

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

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

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

19 MR. KOLCHINSKY: One example of that
20 occurred in about second quarter of '07.
21 We, in the CDO group, actually had a
22 methodology that prevented deals from
23 getting full credit for bonds that were
24 being priced at a discount. A discount
25 pricing rule. It worked very well with

Q & A - Session 1

1
2 cash instruments but because synthetics
3 were too flexible, you could change the
4 price, you could change the spread, it was
5 very hard to nail down what the actual
6 discount was. And as the prices in the
7 market started deteriorating as evidenced
8 by the ABX index, the subprime index, we
9 always enforced this rule.

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

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

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

1 Q & A - Session 1

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

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

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

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

22 But this is a source of confusion
23 among a number of people because AAA meant
24 something to you who delivered it, it
25 meant something to the people who were

Q & A - Session 1

1 seeking it, obviously, with the
2 game-playing, and it meant something to
3 those who purchased it. And it turns out
4 in the end, the people who purchased it
5 didn't have any conception, often, what it
6 was and what it meant. And that we need
7 to focus on more. But we can't do it with
8 the time we have.

9
10 Thank you, Mr. Chairman, I'll reserve
11 the balance of my time.

12 CHAIRMAN ANGELIDES: Yes, very
13 quickly as a follow-up, it seems to me
14 listening this morning so far, there's
15 kind of two big issues. One is, why the
16 heck were the ratings so wrong? And they
17 were. I just want to put in perspective.
18 They weren't off by small measure. You
19 know, 83 percent of the AAA in 2006 was
20 downgraded. In 2007, 89 percent of the
21 investment-grade products were reduced to
22 junk. I mean, this was way off. And
23 without using the legal term, without
24 casting aspersions, to the extent you're
25 providing a product, this comes as close

Q & A - Session 1

1
2 as you can to the very product being
3 fraudulent or of no use to the marketplace
4 in reality. So one is the quality of
5 ratings. But I'm more struck or equally
6 struck but, I think what you referred to,
7 Dr. Witt, is just the structural problem
8 here. The very system that didn't allow
9 you really to say no to 30 to 40 percent
10 of the deals. You might miss a deal or
11 two, but you really couldn't say no to a
12 whole market slice because you're paid by
13 issuers, and your profit, and that was, it
14 seemed to me always predominant, versus
15 quality of rating.

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

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

1 Q & A - Session 1

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

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

24 CHAIRMAN ANGELIDES: Okay. Because
25 I'm asking, could you have made that

Q & A - Session 1

1
2 decision? Mr. Weill, could you have gone
3 to your superiors and say -- look, I mean,
4 if you think of United Labs for a minute,
5 they are not going to keep rating
6 defective electronic equipment if in fact
7 they don't believe that it should make it.
8 Consumer Reports has a very different
9 model, you know, no payments by products
10 being rated.

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

17 MR. WEILL: Mr. Chairman, I would
18 offer you a surveillance perspective to
19 this. When we were surveilling 2007
20 transactions, and we were seeing an
21 increase in delinquencies or potential for
22 defaults on the mortgages, we were
23 constantly closing a feedback loop with
24 the various teams. And I think this was
25 part of a great interest from senior

1 Q & A - Session 1

2 management to know how the pools were
3 performing in order to know what to do
4 with new ratings, potentially.

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

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

22 CHAIRMAN ANGELIDES: Thank you.

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

Q & A - Session 1

1
2 Mr. Weill, because he's the one who was
3 there in June of '07, in the application
4 to the Securities and Exchange Commission
5 by Moody's, under the heading,
6 "Interacting with the Management of an
7 Issuer," Moody's said to the SEC, "Most
8 issuers operate in good faith and provide
9 reliable information to the securities
10 markets and to MIS. And we rely on
11 issuers and their agents to do so," da,
12 da, da. "Nevertheless, our analysts seek
13 to exercise skepticism with respect to an
14 issuer's claims. If we believe we have
15 inadequate information to provide an
16 informed credit rating to the market, we
17 will exercise our editorial discretion and
18 will either refrain from publishing the
19 opinion or withdraw an outstanding credit
20 rating."

21 What I'm going to be asking for in
22 writing from all of you from memory, but
23 especially the more recent situations,
24 what skepticism did you exercise? Do you
25 have specific examples of exercising

1 Q & A - Session 1

2 skepticism based upon it? And when you
3 were in the situation of having to produce
4 volume versus exercising the professional
5 skepticism that you told the SEC you were
6 going to exercise, I just want to see some
7 examples of that skepticism being
8 exercised. So I'll get it to you in
9 writing and you can give me some examples.

10 Thank you very much, Mr. Chairman.

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

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

15 I wanted to inquire really of all of
16 you. I think I'm finally getting to the
17 point where I'm understanding how the
18 money is made in this business, and one of
19 the things we've learned in prior hearings
20 is that a significant element of fraud
21 occurred when we double-incentivized
22 mortgage brokers in the origination of
23 mortgages by paying them a higher
24 percentage of the mortgage if they put a

Q & A - Session 1

1
2 person into a mortgage that paid a higher
3 rate of interest, and was more valuable to
4 the lender.

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

18 Now, I learned from our staff's
19 investigation report, and I want to
20 clarify this, I want to make sure it's
21 true, that, for many years, Moody's, in
22 charging issuers on RMBS analysis, you
23 charged a certain rate, in this instance
24 4.75 basis points for the dollars that
25 were in the senior tranches, and 3.75

Q & A - Session 1

1
2 basis points for the dollars that were put
3 in subordinate tranches, which strikes me
4 as an incentive, creating a financial
5 incentive for Moody's to put a greater
6 percentage of the dollars in the senior,
7 superior tranches as opposed to
8 subordinate tranches, which may help to
9 explain why it is that, in these RMBS
10 structures, often some, as much as 90
11 percent of the issue of the tranches are
12 rated at the very, very high end.

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

16 MR. SIEGEL: Commissioner, I don't
17 recall the exact fee schedule. The
18 initial analysis of a deal would have
19 almost a fixed component, analyzing the
20 collateral, and then the tranching, where
21 you would get these senior classes, and
22 subordinate classes would come later. But
23 in no case was there any distinction in my
24 mind, as the manager who knew about the
25 fees, that there should be a shift based

1 Q & A - Session 1

2 on the potential fee income to Moody's.
3 And the analysts who constituted the
4 majority of committee would not even have
5 known about that differential.

6 COMMISSIONER GEORGIU: But then why
7 was it structured in that way? In other
8 words, if you have got a \$250 million RMBS
9 that you're analyzing, why would you ask
10 the issuers to pay you a higher fee per
11 dollar on the senior tranches than you
12 would on the subordinate tranches?

13 Dr. Witt, do you have any views on that?

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

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

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

24 COMMISSIONER GEORGIU: Which was
25 more than double the highest rate that you

1 Q & A - Session 1

2 got for rating RMBS, which may also speak
3 to why people were incentivized to rate
4 CDOs significantly, because --

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

8 COMMISSIONER GEORGIU: Right, and
9 paid at twice the rate.

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

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

16 COMMISSIONER GEORGIU: So who was in
17 RMBS, Mr. Weill?

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

1 Q & A - Session 1

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

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

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

14 MR. SIEGEL: I don't.

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

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

1 Q & A - Session 1

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

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

15 COMMISSIONER GEORGIU: Right.

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

21 CHAIRMAN ANGELIDES: So done.

22 COMMISSIONER GEORGIU: -- and also,
23 it says in here in our investigative
24 report that all fees were due and payable
25 at the time the rating was issued. But

1 Q & A - Session 1

2 you were never paid until the actual issue
3 was sold, were you?

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

10 COMMISSIONER GEORGIOU: Correct.

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

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

22 MR. KOLCHINSKY: That is correct.
23 There was, in our contracts in CDO, there
24 was a breakup fee but that was almost
25 never enforced. It was difficult -- it

1 Q & A - Session 1

2 was a fraction of the number. It was very
3 difficult to actually get that fee. In my
4 experience, I don't believe we've ever
5 actually charged that breakup fee.

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

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

18 COMMISSIONER GEORGIU: Right.
19 Dr. Witt, do you have a thought on that?

20 DR. WITT: Well, I don't know that
21 that had a big component to, you know,
22 people's incentives. But I did, I just
23 noticed there was an article in The Times,
24 I think yesterday or today, and they were
25 talking about the timing of when the

Q & A - Session 1

1 rating is issued. The rating was normally
2 issued, if you look at the prospectus, it
3 will say it's a condition of issuance that
4 the ratings be certain levels. So the
5 rating came out like coincident with the
6 deal. And that fact meant that there had
7 to be this interchange between the rating
8 agencies and the structuring, the
9 investment bank.

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

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

1 Q & A - Session 1

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

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

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

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

Q & A - Session 1

1
2 that in many ways, the incentives for
3 rating agencies have become worse since
4 the credit crisis. That there are now
5 more rating agencies and they are all
6 chasing significantly fewer transaction
7 dollars. And the new controls put in
8 place by regulators are too weak to
9 significantly alter this dynamic. Can you
10 elaborate on that, please?

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

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

25 So the incentives to play around with

Q & A - Session 1

1
2 your methodology are much greater. If you
3 want to maintain your business, you want
4 to maintain your title, you want to
5 maintain your position in the company, you
6 have to compete a lot more. You have a
7 lot less business you're competing for.
8 And frankly, the structural, up to that
9 point, and probably true going forward, so
10 far, that have been put in place, have
11 been fairly weak on that, in terms of
12 maintaining, improving ratings quality.
13 So again, you have a lot more rating
14 issuers competing for a smaller pie.

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

23 "As more complex exotic investments
24 have been created and sold to investors,
25 the rating agencies 'got it wrong,' either

Q & A - Session 1

1
2 because their vetting was superficial or
3 they were unduly influenced by the
4 creators of the investment and needed to
5 get the deal done. When the rating
6 agencies chose to rate complex and
7 market-sensitive instruments such as
8 structured investment vehicles as
9 risk-free as U.S. Government bonds, they
10 failed the investors who were depending
11 upon their independent, thorough analysis.
12 This board and other public investors are
13 still living with the impacts of that
14 failure."

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

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

1 Q & A - Session 1

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

7 COMMISSIONER GEORGIU: All right.

8 Thank you, Mr. Chairman.

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

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

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

24 COMMISSIONER WALLISON: We'll talk
25 about the same period that we've been

1 Q & A - Session 1

2 talking about here from 2005 to 2007.

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

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

14 MR. WEILL: Absolutely.

15 COMMISSIONER WALLISON: Let me just
16 say this, that I'm listening to all of you
17 and I think you're all well-intentioned
18 people. We've had what anyone would
19 regard as a terrible failure here. And so
20 my inclination always is to wonder whether
21 there was not an information problem more
22 than anything else. And so my questions
23 are going to be about the information that
24 was available to you and the extent to
25 which this information was or was not

Q & A - Session 1

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2 sufficient for you to make the kinds of
3 judgments that you were making.

4 So the first question I would like to
5 ask here is, and I think this is obvious,
6 the ratings depend, do they not, on
7 assumptions about housing prices?

8 Mr. Siegel?

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

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

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

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

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

1 Q & A - Session 1

2 off of that best guess.

3 CHAIRMAN ANGELIDES: Mr. Witt?

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

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

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

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

1 Q & A - Session 1

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

5 COMMISSIONER WALLISON: Mr. Weill?

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

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

20 In other words, if borrowers are
21 feeling that they are underwater on their
22 mortgage because they see home price
23 declining, their first reaction would be,
24 try to get out of this financial
25 obligation in a way that would be ideal,

1 Q & A - Session 1

2 i.e., selling the properties and avoiding
3 foreclosure and a default.

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

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

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

13 COMMISSIONER WALLISON: Mr. Siegel,
14 the same?

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

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

1 Q & A - Session 1

2 a whole throughout the country?

3 Mr. Siegel?

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

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

11 MR. SIEGEL: Right.

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

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

1 Q & A - Session 1

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

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

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

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

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

1 Q & A - Session 1

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

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

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

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

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

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

1 Q & A - Session 1

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

5 COMMISSIONER WALLISON: Mr. Weill?

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

9 COMMISSIONER WALLISON: I'm sorry?

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

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

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

22 COMMISSIONER WALLISON: I understand.
23 I understand. And this basically is my
24 question. How can you make a rating on a
25 subprime or Alt-A pool when you actually

Q & A - Session 1

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2 don't know the effect that the total
3 number of outstanding subprime and Alt-A
4 loans might have on that particular pool?

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

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

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

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

1 Q & A - Session 1

2 loans, will you not?

3 MR. SIEGEL: It would follow, yes.

4 COMMISSIONER WALLISON: And if you
5 have many such failures of subprime and
6 Alt-A loans, that would affect the loans
7 that are in the pool that you're rating,
8 true?9 MR. SIEGEL: Yes, that would follow
10 as well.11 COMMISSIONER WALLISON: So this is
12 the question:13 Since there was tremendous
14 correlation among mortgages in the sense
15 that a mortgage fails, it has an effect on
16 the housing prices in the area, many
17 mortgage failures produce sharp declines
18 in housing prices in the area, and as
19 those failures multiply, housing prices
20 dive and actually, we've seen that.

21 MR. SIEGEL: Yes.

22 COMMISSIONER WALLISON: So my
23 question then is, how could you possibly
24 have rated a pool without knowing the
25 number of subprime and Alt-A mortgages

Q & A - Session 1

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2 that were outstanding in the market at
3 large, not just in that pool?

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

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

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

1 Q & A - Session 1

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

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

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

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

1 Q & A - Session 1

2 affect substantially the way your
3 particular pools perform?

4 MR. SIEGEL: Commissioner --

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

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

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

24 MR. SIEGEL: I would have to check
25 the figures, but subprime grew, subprime

1 Q & A - Session 1

2 and Alt-A grew to exceed the prime
3 securitized markets of Moody's rated
4 deals, so half sounds about right.

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

10 MR. SIEGEL: Sure.

11 VICE-CHAIRMAN THOMAS: Dr. Witt?

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

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

1 Q & A - Session 1

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

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

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

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

1 Q & A - Session 1

2 conclusion that it's an important issue.

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

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

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

25 The second caveat is that risk is a

Q & A - Session 1

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

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

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

Q & A - Session 1

1
2 than resident-owned properties; and
3 increase in the number of cash-out
4 refinancing loans that lowered the
5 borrower's home equity. All of those
6 changes were significantly altering what
7 the word "mortgage" meant in America.

8 Then, beginning in 2000, and the
9 Chairman has already shown the chart of
10 the increase in housing prices that began
11 in the year 2000, running up to the year
12 2005.

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

15 CHAIRMAN ANGELIDES: A big chart.

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

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

24 VICE-CHAIRMAN THOMAS: I have a
25 smaller version.

1 Q & A - Session 1

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

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

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

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

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

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

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

24 COMMISSIONER GRAHAM: The chart
25 demonstrates three -

26 VICE CHAIRMAN THOMAS: Excuse me. Angle it

Q & A - Session 1

1 slightly so the cameras can look at it.

2 It makes no sense to have that big a chart
3 if people at home can't see it.

4
5 CHAIRMAN ANGELIDES: Let's move it
6 over, and pull it over a little so you
7 don't obscure Ms. Born, please.

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

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

14 COMMISSIONER GRAHAM: First, the blue
15 mountain reflects in billions of dollars
16 of issuance of RMBS; the red mountain,
17 billions of dollars of issued CDOs; and
18 then the yellow boxes, historic events,
19 starting with an event in October of 2006,
20 when the Moody's research unit issued a
21 study called, "Housing at the Tipping
22 Point," the introductory paragraph in the
23 executive summary reading, "The U.S.
24 housing market downturn is in full swing.
25 New and existing home sales and single

Q & A - Session 1

1 family housing construction are sliding.
2 Inventories of unsold homes are surging to
3 new record highs and house prices are
4 falling in an increasing number of areas."

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

11 Then, in January of 2007, Moody's
12 issued a special report detailing
13 abnormally high rates of early default in
14 mortgage securitizations issued in late
15 2005 and early 2006. Almost immediately
16 after that, another sharp incline in both
17 the RMBSs and the CDOs; in the case of the
18 CDOs, going from less than ten billion to
19 approximately 55 billion in 60 days.

20 Then in March of 2007, Moody's issues
21 a special comment noting that CDOs
22 containing large concentrations of RMBSs
23 as collateral were likely to experience
24 steep downgrades in the event that the
25

1 Q & A - Session 1

2 subprime collateral defaults.

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

10 Finally, in July of 2007, Moody's and
11 S&P downgrade hundreds of RMBSs totaling
12 5.3 billion in value, and place CDOs
13 backed by RMBSs on watch for possible
14 downgrades.

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

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

24 DR. WITT: I was wondering the same
25 thing, you know. I was out of the CDO

1 Q & A - Session 1

2 group. I left in September '05, a year
3 before this graph starts. So...

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

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

11 COMMISSIONER GRAHAM: Yes.

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

18 CHAIRMAN ANGELIDES: Can I just --

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

1 Q & A - Session 1

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

4 Did that information not get to those
5 responsible for ratings?

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

13 MR. WEILL: My team and myself, we
14 read the research we get, including the
15 research from Moodyseconomy.com. We get
16 more detailed reports with actual numbers
17 on the home price declines, and we need to
18 get the actual numbers, and then when we
19 look at the numbers that were produced in
20 2007, most economic forecasters were
21 predicting a national decline of about
22 five percent. Soft landing first, then
23 five percent, then maybe ten.

24 There were some. I must say, some
25 pockets within the country where maybe

Q & A - Session 1

1
2 more significant price declines were
3 envisioned. But over the course of 2007,
4 if you look back at the research that was
5 produced, most economists were talking
6 about a soft landing and maybe five or ten
7 percent.

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

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

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

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

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

1 Q & A - Session 1

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

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

22 So if you put things in perspective,
23 as long as -- it does sort of correlate
24 quite well that there is a view out there
25 in the market, or more views that prices

1 Q & A - Session 1

2 are declining and early payment defaults
3 are increasing.

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

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

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

Q & A - Session 1

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2 price declines. From the bankers'
3 perspective, as opposed to the taxpayer
4 who provides the guarantee for the bank,
5 these were arbitrage opportunities. They
6 made the economics better. So that's
7 something we saw in the first quarter of
8 '07, second quarter of '07. People
9 stepped on the gas and they issued as many
10 deals as they could.

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

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

24 COMMISSIONER GRAHAM: Did the rating
25 agencies, were you aware of this perverse

Q & A - Session 1

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2 incentive and actions by the bankers?

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

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

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

15 COMMISSIONER GRAHAM: Why not?

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

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

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

1 Q & A - Session 1

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

4 MR. KOLCHINSKY: That's correct.

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

8 Isn't that an important factor?

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

18 COMMISSIONER GRAHAM: Could I take
19 another minute?

20 CHAIRMAN ANGELIDES: Yes, just one
21 minute.

22 COMMISSIONER GRAHAM: The Chairman
23 asked in his opening comments some
24 questions relative to, did you have
25 anybody on your committees that were

Q & A - Session 1

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2 making the judgment who had actually had
3 experience in housing, and the answer was
4 no.

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

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

21 But the nature of this market
22 changed. As more and more structured
23 vehicles, you know, the RMBS collateral, a
24 lot of it went into CDOs or into SIVs.
25 The CDOs themselves were repackaged and

Q & A - Session 1

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2 sold into other CDOs or into SIVs, and the
3 super seniors were held on the balance
4 sheet. So that factory structure really
5 changed the nature of banking from even
6 the time I was there.

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

11 MR. KOLCHINSKY: No.

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

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

Q & A - Session 1

1 packaged it into other securities.

2
3 CHAIRMAN ANGELIDES: Thank you very
4 much. Ms. Born?

5 COMMISSIONER BORN: Thank you very
6 much. And thank you all for appearing.
7 Let me just follow up, Mr. Kolchinsky,
8 with something that you just said.

9 You said that there was no penalty if
10 an issuer or an investment bank who was
11 working with you lied about aspects of the
12 deal. Is that correct?

13 MR. KOLCHINSKY: That is correct.
14 For practical purposes, we would not walk
15 away from a deal. We couldn't say no, so
16 that would be the most obvious penalty,
17 that you do in any normal business, if you
18 find that your trading partner is not
19 being truthful to you, you say, "I'm not
20 going to do any business with you."

21 So once that avenue is closed off
22 because you want to increase market share,
23 there's no penalty. We were in the
24 position of being a quasi regulator, which
25 means we had no power to compel people to

Q & A - Session 1

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

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

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

24 MR. KOLCHINSKY: I had never
25 considered that, but I think it would

Q & A - Session 1

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2 be -- it would take a chain of events
3 to -- which were of very low probability.
4 We would have had to find out, which could
5 be difficult. It would have to be
6 material; and, to be perfectly honest with
7 you, you would have to get the management
8 to agree to take action against large fee
9 providers, which probably is the most
10 difficult. So that probably would not
11 occur.

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

17 COMMISSIONER BORN: Mr. Siegel, do
18 you disagree?

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

1 Q & A - Session 1

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

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

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

25 COMMISSIONER BORN: Thank you.

Q & A - Session 1

1
2 Mr. Kolchinsky, I take it from your
3 testimony, from your written testimony,
4 that you feel that Moody's quest for
5 market share, market coverage and revenues
6 tended to undermine the quality of the
7 credit ratings, at least in the structured
8 finance area, is that correct?

9 MR. KOLCHINSKY: That is correct.

10 COMMISSIONER BORN: So a profit
11 motive corrupted the --

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

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

24 DR. WITT: I don't know of any, like,
25 cases where there was a really bright line

1 Q & A - Session 1

2 that anybody crossed that I knew of where
3 it was really obvious that somebody was
4 changing standards or inventing standards
5 to get a deal or to get market share.

6 COMMISSIONER BORN: Was there a
7 gradual erosion?

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

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

20 MR. KOLCHINSKY: Yes.

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

25 MR. KOLCHINSKY: That is correct. By

Q & A - Session 1

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2 '07, most of the deals, instead of having
3 cash assets, had credit default swaps that
4 referenced the subprime and Alt-A
5 collateral, yes.

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

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

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

Q & A - Session 1

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

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

13 COMMISSIONER BORN: They wanted to
14 see these bonds fail.

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

20 And finally, it really changed the
21 dynamic of the rating timeline. When I
22 started, we probably had one-and-a-half to
23 two months to look at a deal. Go back and
24 forth with a banker while they actually
25 had to -- actually gather that collateral,

1 Q & A - Session 1

2 either in the primary or secondary, which
3 took some time. When you had synthetics,
4 that could be done in a week.

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

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

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

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

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

Q & A - Session 1

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2 Moody's once-distinguished history?

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

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

15 MR. KOLCHINSKY: Yes.

16 COMMISSIONER BORN: Thank you.

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

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

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

Q & A - Session 1

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

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

20 It seems to me that there are three
21 levels of questions involved. One is,
22 what exactly is it that you did in rating
23 these various securities; the second is
24 the nature of the business model in which
25 your activities were embedded and the

Q & A - Session 1

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2 degree to which that shaped your actions;
3 and the third is the role the ratings
4 themselves played in market dynamics and
5 what was ultimately an enormous financial
6 crisis.

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

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

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

Q & A - Session 1

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

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

22 In turn, the most senior investor
23 would be protected by about 20 percent of
24 subordination below them. So it was
25 assessing whether the collateral dynamics

1 Q & A - Session 1

2 projected forward compared to the
3 protection provided within the structure,
4 what level of risk that resulted in to
5 buyers of the security.

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

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

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

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

1 Q & A - Session 1

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

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

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

14 MR. SIEGEL: Exactly, our ratings
15 were --

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

25 MR. SIEGEL: Well, the models were

1 Q & A - Session 1

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

3 COMMISSIONER HOLTZ-EAKIN: How often
4 were they updated?

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

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

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

24 Rather, we would analyze the
25 additional risk. So an interest-only loan

Q & A - Session 1

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2 we didn't have historical performance on
3 interest-only loans but everyone can
4 imagine that if the borrower is not
5 amortizing their loan, if they're simply
6 paying interest over time, it's going to
7 be risk.

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

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

Q & A - Session 1

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2 characterization of what went on?

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

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

8 MR. SIEGEL: Let's--it's going back to the
9 1996, thereabouts, model?

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

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

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

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

1 Q & A - Session 1

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

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

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

16 MR. SIEGEL: Again, if that was what
17 was done in the subprime, I'll take it
18 from the question, but I don't know that's
19 what happened in the subprime arena. A
20 committee, when we did the economics for
21 the model that I worked on, which sounds a
22 similar case, we had historical home price
23 data and were able to project out, not
24 just the expected case, but the stress
25 cases and a correlation across states,

1 Q & A - Session 1

2 which is critical. All that based on
3 observations available to us through that
4 date.

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

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

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

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

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

Q & A - Session 1

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

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

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

1 Q & A - Session 1

2 and one from the CDO perspective.

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

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

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

21 COMMISSIONER HOLTZ-EAKIN: Yes.

22 CHAIRMAN ANGELIDES: Brisk answers,
23 please.

24 COMMISSIONER HOLTZ-EAKIN: Imagine
25 you're the Vice-Chairman. Go ahead.

1 Q & A - Session 1

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

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

15 COMMISSIONER HOLTZ-EAKIN: Recovered?

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

22 All the information we get on the
23 delinquent portion informs what our
24 thoughts are on the non-delinquent
25 portion. In other words, if we see a

Q & A - Session 1

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2 significant trend of delinquencies, we do
3 increase our views on the non-delinquent
4 portion of the pools on the surveillance
5 side.

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

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

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

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

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

1 Q & A - Session 1

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

5 COMMISSIONER HOLTZ-EAKIN: What did
6 you look at?

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

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

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

22 DR. WITT: It didn't have to be but
23 if it was a rating from another rating
24 agency, we decremented it, because we
25 assumed that our ratings, you know, we

1 Q & A - Session 1

2 believed our ratings. We weren't sure
3 about other people's. It's called
4 notching.

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

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

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

24 COMMISSIONER HOLTZ-EAKIN:
25 Mr. Kolchinsky, I'm going to come back to

1 Q & A - Session 1

2 you in writing. I apologize

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

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

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

1 Q & A - Session 1

2 that may be going on in the marketplace.

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

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

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

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

1 Q & A - Session 1

2 communicating effectively.

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

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

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

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

25 COMMISSIONER THOMPSON: Dr. Witt, in

Q & A - Session 1

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

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

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

25 It wasn't that I thought that we were

1 Q & A - Session 1

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

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

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

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

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

22 When I first joined Moody's I was
23 asked to opine on a new deal that was
24 being brought to us by a banker that
25 contained primarily telecommunications

Q & A - Session 1

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2 loans, and they wanted to convince us that
3 it was just as good as any other CMO, and
4 I was asked to look into it. I was
5 brand-new. I said, "No, we can't really
6 justify this. We can't rate this deal."
7 And that was okay, "Great, thank you very
8 much."

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

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

1 Q & A - Session 1

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

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

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

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

16 COMMISSIONER THOMPSON: Is it
17 similar, though?

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

1 Q & A - Session 1

2 to do so.

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

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

17 COMMISSIONER THOMPSON: Thank you very
18 much.

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

22 With respect to Mr. Holtz-Eakin's
23 questions, I'd like to enter into the
24 record an excerpt from a testimony from
25 Mr. Roger Stein about the ratings process
26 and the extent to which it was a matter of

Q & A - Session 1

1
2 human involvement, recalibrating the
3 assumptions, some of the things you talked
4 about. I think it's an interesting part
5 of that excerpt.

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

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

16 You had mentioned earlier in your
17 commentary that your job was to get the
18 ratings right. And I'm curious, from your
19 standpoint, does getting the ratings right
20 mean that they conform to your internal
21 modeling and that they've gone through the
22 appropriate processes through your
23 committee, or does it mean that, down the
24 road in the future, that the ratings that
25 you've assigned appear to be the ones that

1 Q & A - Session 1

2 are accurate?

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

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

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

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

1 Q & A - Session 1

2 experience, no.

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

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

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

19 MR. SIEGEL: Yes.

20 COMMISSIONER MURREN: On a pretty
21 regular basis?

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

25 COMMISSIONER MURREN: But it's again

1 Q & A - Session 1

2 with the issuers themselves.

3 MR. WEILL: Issuers or their agents.

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

14 How often did you have contact with
15 them?

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

25 We also were participating to

1 Q & A - Session 1

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

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

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

1 Q & A - Session 1

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

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

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

1 Q & A - Session 1

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

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

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

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

1 Q & A - Session 1

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

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

16 COMMISSIONER MURREN: So it's
17 somewhat subjective.

18 MR. WEILL: There is --

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

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

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

Q & A - Session 1

1
2 had mentioned that there was some pressure
3 from bankers that related to what ratings
4 you assigned within your group.

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

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

22 You know, they definitely -- they
23 would just use, pull any lever, basically,
24 that they could. And, you know, pressure
25 might mean, you know, calling one of our

1 Q & A - Session 1

2 superiors and, you know, describing some
3 situation in terms that wasn't really, you
4 know, accurate, to try and, you know, kind
5 of, you know, put me on the defensive.

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

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

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

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

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

1 Q & A - Session 1

2 prospects and practically, very difficult
3 to say no.

4 COMMISSIONER MURREN: So did you ever
5 say no?

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

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

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

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

1 Q & A - Session 1

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

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

7 DR. WITT: Often, yes.

8 COMMISSIONER MURREN: Thank you.

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

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

24 VICE-CHAIRMAN THOMAS: Well,
25 actually, I have a couple of quick

1 Q & A - Session 1

2 questions as well.

3 CHAIRMAN ANGELIDES: I would not defy
4 you.

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

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

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

19 DR. WITT: Absolutely.

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

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

25 VICE-CHAIRMAN THOMAS: Okay. And

1 Q & A - Session 1

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

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

9 What was the major cause of the
10 economic crisis?

11 MR. KOLCHINSKY: Actually, it's --

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

14 MR. KOLCHINSKY: Everybody.
15 Everybody in the chain.

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

18 MR. KOLCHINSKY: Not a practicing
19 one.

20 VICE-CHAIRMAN THOMAS: Mr. Siegel?

21 MR. SIEGEL: The housing market
22 decline.

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

1 Q & A - Session 1

2 Mr. Weill?

3 MR. WEILL: Housing market decline
4 combined with hard refinancing
5 opportunities.6 DR. WITT: The housing market
7 decline, you could talk about --8 VICE-CHAIRMAN THOMAS: Well, the
9 question is, what was the cause of the
10 housing market decline, was it AAA ratings
11 on stuff that weren't?12 DR. WITT: A lot of
13 inappropriate financing, and definitely to some
14 extent --15 VICE-CHAIRMAN THOMAS: And
16 inappropriate rating?17 DR. WITT: -- and to some extent,
18 inappropriate rating contributed to that.
19 Yes.20 VICE-CHAIRMAN THOMAS: All right.
21 That is all --22 CHAIRMAN ANGELIDES: The only thing I
23 wanted to note is in response to
24 Ms. Murren's question, I thought you were
25 very delicate. Just for the record, in

1 Q & A - Session 1

2 your interview with our staff, Dr. Witt,
3 when asked about pressure from bankers,
4 you said, "Oh God, are you kidding? All
5 the time. I mean, that's routine. I
6 mean, they would threaten you all the
7 time."

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

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

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

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

22 (Recess taken.)

23 CHAIRMAN ANGELIDES: We will now come
24 back into session. We are going to begin
25 the second session of today's hearing on

1 Proceedings

2 the credibility of credit ratings, the
3 investment decisions made based on those
4 ratings and the financial crisis. The
5 second session is, "Credit Ratings and the
6 Financial Crisis."

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

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

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

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

20 Having been duly sworn, testified as
21 follows:

22 CHAIRMAN ANGELIDES: Thank you very
23 much. We will begin by offering both of
24 you the opportunity to make an opening
25 statement of no more than five minutes. I

1 Opening - McDaniel

2 don't know if I -- I know that
3 Mr. McDaniel has prepared a statement, I
4 don't know, Mr. Buffett, if you want to
5 avail yourself of that opportunity.

6 MR. BUFFETT: I have no statement.

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

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

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

25 Over the past several years, we've

1 Opening - McDaniel

2 witnessed events who magnitude many of us
3 would have thought highly unlikely. The
4 turmoil in the U.S. housing market is that
5 began in the subprime residential mortgage
6 sector led to a global liquidity crisis
7 and a loss of confidence in the U.S. and
8 global financial system. The impact has
9 created a great hardship for many
10 Americans. American families have lost
11 jobs, homes and college and retirement
12 savings as a result of this financial
13 crisis.

14 Moody's is well aware that the crisis
15 of confidence in the market has also
16 impacted the confidence in the credit
17 ratings industry.

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

1 Opening - McDaniel

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

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

12 Starting in 2003, Moody's did observe
13 a trend of loosening mortgage underwriting
14 standards and escalating housing prices.
15 We repeatedly highlighted those trends in
16 our research and we incorporated them into
17 our analysis of the securities. By 2006,
18 we were requiring an unprecedented level
19 of credit protection. However, neither we
20 nor most other market participants,
21 observers or regulators, anticipated the
22 severity or speed of deterioration that
23 occurred in the U.S. housing market or the
24 rapidity of credit tightening that
25 followed and exacerbated the situation.

1 Opening - McDaniel

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

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

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

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

1 Opening - McDaniel

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

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

21 In each area, we've made good
22 progress. Still, I believe more can and
23 should be done. We wholeheartedly support
24 legislative and regulatory reform efforts
25 that will reinforce high quality ratings

1 Q & A - Session 2

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

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

18 Under your leadership, there were, in
19 the end, for whatever reasons, very
20 significant failures of Moody's. The
21 product that your company offered, which
22 are ratings for the benefit of investors,
23 proved to be highly defective, and not
24 just by small measure but by a large
25 amount. 83 percent of your AAA-rated

Q & A - Session 2

1 securities in the RMBS area in 2006 were
2 downgraded. In 2007, 89 percent of those
3 which were investment-grade rated were
4 downgraded to junk. And massive
5 downgrades, I ought to note, started in
6 July '07, when housing prices had declined
7 just four percent from the peak.
8

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

18 Your shareholders have lost 73
19 percent of the value in the stock from the
20 peak to today. The ratings enabled the
21 issuance of trillions of dollars of
22 mortgage securities which we now know were
23 rife with significant problems from fraud
24 to misrepresentation that may have well
25 fueled the housing bubbles. Investors who

Q & A - Session 2

1
2 relied on the ratings suffered enormous
3 losses and your company's reputation,
4 something that I know that Mr. Buffett has
5 held important, reputation within
6 business, is certainly under significant
7 criticism.

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

14 MR. McDANIEL: The performance of the
15 housing sector and as a result of ratings
16 that are associated with housing assets
17 clearly have exhibited very poor
18 performance in recent years. There was
19 decades of strong performance leading up
20 to the current crisis. We believed that
21 our ratings were our best opinion at the
22 time that we assigned them. As we
23 obtained new information and were able to
24 update our judgments based on the new
25 information and the trends we were seeing

Q & A - Session 2

1
2 in the housing market, we made what I
3 think are appropriate changes to our
4 ratings.

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

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

20 Your firm rated 42,000 tranches of
21 RMBS AAA from about 2000-2007 in a context
22 where there's four corporations in the
23 country -- used to be a few more -- that
24 were rated AAA. In that context you were
25 rating about 90 percent of these

Q & A - Session 2

1 securities as AAA when, in terms of the
2 corporate debt world, where you actually
3 have more transparency, you can get in,
4 look at all the public filings, understand
5 the corporate debt, only about 1.4 percent
6 of that was rated AAA. You led an
7 enterprise for which you were compensated
8 pretty handsomely, \$39 million over this
9 period.
10

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

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

Q & A - Session 2

1
2 are --

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

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

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

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

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

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

Q & A - Session 2

1
2 societal reasons, that the CEO should
3 basically go away broke, and I think his
4 spouse should go away broke. I think
5 there should be a real downside, and I
6 think incentives are an important
7 aspect in behavior.

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

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

Q & A - Session 2

1
2 mass delusions of sorts.

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

9 CHAIRMAN ANGELIDES: Well, let me
10 probe that a little. Because, you know, I
11 just want to say for the record, I do
12 think around the country, there were
13 people who thought the bubble was
14 unsustainable. I don't think there was a
15 secret here. There were a number of
16 experts, whether it was Robert Schiller or
17 Mr. Rubini or Mr. Baker, Dean Baker, there
18 were a number of people who saw this
19 bubble. We had this unprecedented rise,
20 89 percent in home price appreciation in seven years,
21 something we had never seen historically.

22 But moving beyond that for a minute,
23 the rating agencies did play a fundamental
24 role in accelerating essentially the
25 securitization, therefore, some would

Q & A - Session 2

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2 argue, the origination of products that
3 tended to be highly deficient. We're
4 talking about low teaser rates, negative
5 amortization.

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

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

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

1 Q & A - Session 2

2 they are going to get booed?

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

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

1 Q & A - Session 2

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

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

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

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

1 Q & A - Session 2

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

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

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

Q & A - Session 2

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2 my stock.

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

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

21 MR. BUFFETT: I would say that in
22 this particular case, I think they made a
23 mistake that virtually everybody in the
24 country made. And going back to that
25 OFHEO report, March 30th of 2007, it was

1 Q & A - Session 2

2 reported the enterprise's overall asset
3 quality is strong. That was March of
4 2007, and all they owned was mortgages.

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

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

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

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

24 We interviewed a member of the
25 Moody's board, Nancy Newcomb, who

Q & A - Session 2

1 indicated the board wasn't particularly
2 involved, and didn't discuss significant
3 issues like the ratings process. There
4 was a recent press account, I think in the
5 McClatchy newspapers, about the
6 disengaged nature of the board, but also
7 said that two senior executives approached
8 you with significant problems at the
9 company?
10

11 MR. BUFFETT: No.

12 CHAIRMAN ANGELIDES: No?

13 MR. BUFFETT: No.

14 CHAIRMAN ANGELIDES: Okay, so not
15 accurate.

16 MR. BUFFETT: No.

17 CHAIRMAN ANGELIDES: Okay, thank you.

18 I want to talk to both of you about the
19 model for credit rating agencies in the
20 context of this marketplace. It seems to
21 me there are, you know, the worst of many
22 worlds here. You have an issuer-pay model
23 by its nature that creates pressure to
24 produce credit ratings that serve the
25 interest of the issuer, not the

Q & A - Session 2

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2 beneficiary of those. In fact, Charlie
3 Munger has said, I think, as you know,
4 "Whose bread I eat, his song I sing."
5 I've seen him say that a number of times.

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

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

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

1 Q & A - Session 2

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

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

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

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

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

Q & A - Session 2

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

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

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

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

Q & A - Session 2

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2 issuers, for example, by a panel?

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

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

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

17 MR. McDANIEL: Well, there are
18 several alternative business models that
19 rating agencies operate under. The
20 largest rating agencies you were under an
21 issuer-pays model, and I think it's
22 important for us to acknowledge and
23 recognize that any business model in which
24 the fee payer has an interest in the
25 outcome is a model that has potential

Q & A - Session 2

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2 conflicts of interest and that those
3 conflicts must be managed transparently
4 and properly.

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

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

Q & A - Session 2

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

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

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

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

Q & A - Session 2

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

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

Q & A - Session 2

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2 standpoint to really do structured
3 products well.

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

11 We've spent countless hours here
12 trying to understand the modeling and the
13 truth is, if you look at the modeling,
14 data was put in that was relatively,
15 frankly, incomplete, inadequate. There
16 was a lot of human judgments but there
17 wasn't a lot of ground-level due
18 diligence; in fact, none other than visits
19 to originators.

20 So isn't that a significant
21 management failure, to not have built in
22 the capacity? Might you have missed this
23 less had you been truly on top of this in
24 terms of understanding the products?

25 MR. McDANIEL: I think that we

Q & A - Session 2

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2 certainly believed we were on top of this
3 and we believed that the information that
4 was being made available was adequate.

5 There are other parties in the marketplace
6 who have other roles and responsibilities
7 with respect to valuation of properties
8 and review of mortgage applications. So
9 we are analysts. We consume that
10 information.

11 We believe our role is to look at the
12 information and look at the data and
13 process that as part of our rating
14 committee analytical process, not to
15 replicate or duplicate roles that others
16 in the market --

17 CHAIRMAN ANGELIDES: Which they
18 didn't do.

19 MR. McDANIEL: It would appear that
20 in some cases they did not.

21 CHAIRMAN ANGELIDES: They didn't,
22 they didn't have fraud protection.
23 Underwriting standards went to hell in
24 hand basket.

25 Mr. Buffett, any observations on

Q & A - Session 2

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2 whether this was just a pure modeling
3 mistake or whether in fact it was also a
4 lack of attention in terms of the depth of
5 due diligence? I mean -- can I say
6 something? You're a big advocate, let me
7 just -- you're a big advocate, "Do your
8 own due diligence."

9 MR. BUFFETT: Absolutely.

10 CHAIRMAN ANGELIDES: So here you have
11 an entity that's a surrogate due diligence
12 provider in a sense, and, you know, even
13 whether people fully rely, having looked
14 at real estate investments, you can ask a
15 third party. But if you're going to
16 outsource due diligence, you would hope
17 your due diligence entity would be doing
18 due diligence. Shouldn't rating agencies,
19 shouldn't they have done actual
20 ground-level due diligence, sipping those blizzards
21 at a Dairy Queen, rather than just looking
22 at the revenues?

23 MR. BUFFETT: Looking back, they
24 should have recognized. But like I say, I
25 didn't recognize it, and most everybody I

Q & A - Session 2

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2 know didn't recognize it. They should
3 have recognized that this was a huge
4 bubble. And as I understand it, they had
5 something in the model, and I may be wrong
6 on this, that there wouldn't be a
7 correlation throughout the country of the
8 same experience. And it's true that in
9 the past, you'd have housing booms
10 someplace that have been sort of
11 localized; but this was a nationwide
12 bubble, and diversification among states
13 didn't really make that much difference.
14 It was worse to be Nevada and Arizona and
15 Florida, but it happened everywhere.

16 CHAIRMAN ANGELIDES: '91 to '93, we
17 had actual national two percent decline in
18 house prices because of the big drops in
19 places, and you know there is that old
20 line, you know, one rotten apple can spoil
21 the bunch. And this was an instance where
22 half the apples may have been rotten. I
23 mean, the correlation assumptions I think
24 were not very well defined or thought out.

25 All right, I've asked you plenty for

Q & A - Session 2

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2 right now. Let's move on to the
3 Vice-Chairman. Thank you very much.

4 VICE-CHAIRMAN THOMAS: Thank you,
5 Mr. Chairman. Now, Mr. Buffett,
6 notwithstanding the subpoena, I want to
7 thank you for coming.

8 MR. BUFFETT: I want to thank you for
9 the subpoena.

10 CHAIRMAN ANGELIDES: I wanted you to
11 have a framed copy for your wall.

12 MR. BUFFETT: It's already up.

13 VICE-CHAIRMAN THOMAS: I think it was
14 good cover, because then you can tell
15 others that you don't want to go to, "If
16 you've got the power, use it."

17 MR. BUFFETT: I admire that sort of
18 instruction.

19 VICE-CHAIRMAN THOMAS: I also don't
20 have anything for you to sign. But when I
21 was younger, when Monday Night Football
22 began, Don Meredith and Howard Cosell were
23 the team and Don Meredith would launch in
24 at least once a game with the, "If 'ifs'
25 and 'buts' were candy and nuts, we would

Q & A - Session 2

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2 all have a merry Christmas." And at this
3 point, I'm not interested in going after
4 the 'ifs' and 'buts' because there were
5 plenty to go around. I am a very strong
6 supporter and have tried to maintain the
7 argument that behavior has consequences.

8 You can do it when your ability to
9 threaten someone with something, either as
10 an incentive or as a negative, can
11 influence that behavior. But I am very
12 concerned about the amounts of money that
13 were generated in a structure that
14 provided those short-term opportunities,
15 and no long-term downside, and apparently
16 no moral angst over having done it. And
17 there is to a degree, I think, an argument
18 that this is basically, you know,
19 somebody's idea of unfettered capitalism
20 to a very great extent.

21 You've made comments in that regard.
22 How concerned are you that we're able to
23 get this genie back in the bottle to the
24 point that if behavior has consequences,
25 you want to claw back monies that they

Q & A - Session 2

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2 have? I don't see anybody being able to
3 put that structure in place. How do you
4 feel?

5 MR. BUFFETT: I think it can be put
6 in place but it requires a whole new level
7 of thinking. But I think you're
8 absolutely right. That incentives affect
9 behavior and when you run a huge financial
10 institution whose stability or instability
11 can affect the entire society, I think
12 there ought to be a tremendous downside.
13 It's fine if there's a tremendous upside,
14 too. I don't have a problem with that.

15 But I think that for somebody's -- if
16 somebody's personal equation as CEO of
17 some large financial institution is that
18 if they ruin the place, they walk away
19 with a hundred million instead of five
20 hundred million, and if they succeed,
21 maybe they get a billion, I think that is
22 a crazy structure. And I think that
23 boards of directors should not sign on to
24 such a structure, and I think that the
25 boards themselves should bear heavy

Q & A - Session 2

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2 penalties when an institution has to go to
3 the federal government, and I think that
4 that should not be insurable.

5 So it wouldn't be as Draconian as I
6 have with the CEO, but I would want to
7 focus the attention of somebody running a
8 huge financial institution on the fact
9 that their mistakes could cause big
10 problems for the society.

11 VICE-CHAIRMAN THOMAS: Thank you. I
12 thought I got out of the business. I did
13 32 years and I didn't think I was going to
14 be back on this side of the desk asking
15 questions of witnesses again. But I said
16 yes to this because of the way this
17 Commission has been structured. It's
18 basically my belief that it's just pure
19 public service. I thought it was wise of
20 the Congress to structure us not to look
21 for answers to those 'ifs' and 'buts' in
22 terms of projecting forward what we ought
23 to do, because frankly, Congress is trying
24 to address those, and I'll have a question
25 on that in a moment. But our job is just

1 Q & A - Session 2

2 basically to try to explain the financial
3 crisis and do it as accurately as we're
4 able with the resources that we have.

5 So one of the reasons I was pleased
6 to have, notwithstanding the subpoena, the
7 coincidence of you being in New York and
8 our desire to be in New York to have you
9 in front of us, so that I would hope that
10 the answer that you would give me to your
11 question isn't the one that virtually
12 everyone else has given, because it's not
13 unlike the behavior and the consequences.
14 The answer is, "somebody else."

15 And given your reputation, but
16 frankly, reputations are only as good as
17 your balance sheet, you've got a really
18 good reputation in terms --

19 MR. BUFFETT: I'll settle for that
20 definition.

21 VICE-CHAIRMAN THOMAS: -- in terms of
22 understanding how things work. In your
23 estimation, I don't want to drag us
24 through this business of woulda, coulda,
25 shoulda, ifs and buts. We have

Q & A - Session 2

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2 legislation moving through the House and
3 Senate that hasn't gone to conference yet
4 and isn't locked up, and I have kind of
5 preached to anyone who wants to hear that
6 committees have such narrow jurisdiction
7 that you're not going to be able to solve
8 the fundamental problems, whatever they
9 are, as we examine them, with a single
10 bill that's principally gone through two
11 committees that have roughly the same
12 jurisdiction. You're just not going to
13 hit it.

14 So what I would like you to do, and I
15 would ask both of you that if the
16 Commission provides you questions in
17 writing, would you be willing to answer
18 them, because we do not have the ability
19 in the time we have to get to what we need
20 to do. Mr. Buffett, would you be willing to do that?

21 MR. BUFFETT: Sure, I would be
22 willing to do that. And incidentally, I
23 did have a very good session with your
24 staff that was recorded for two hours
25 and --

Q & A - Session 2

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2 VICE-CHAIRMAN THOMAS: And we have
3 that and we read it.

4 MR. BUFFETT: I really think they did
5 a good job of asking both good questions
6 and good follow-up questions. So I would
7 hope some of the material might be in that
8 record.

9 VICE-CHAIRMAN THOMAS: And we're
10 reviewing it to make sure it is.

11
12 MR. McDANIEL: Yes, we would do so also.

13 VICE-CHAIRMAN THOMAS: What do you
14 think the House and the Senate has gotten
15 mostly right in the legislation that's
16 moving through Congress, and where, if
17 there are obvious misses? I don't think
18 we need to deal with subtleties now. It
19 might be in some follow-up written
20 questions.

21 MR. BUFFETT: I haven't read the
22 1,500-page bill --

23 VICE-CHAIRMAN THOMAS: No one has,
24 including some of the cosponsors of that.
25 That's a denial that's okay.

Q & A - Session 2

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2 MR. BUFFETT: Okay. But I've got two
3 thoughts basically. I think I would
4 address if I were -- one is this question
5 of incentives. I mean, I think it is very
6 important -- I think it's -- I think no
7 one has any business running a huge
8 financial institution unless they regard
9 themselves as the chief risk officer.

10 They are responsible for the ship. And if
11 they aren't, they should be willing to
12 take that on or somebody else should be in
13 that position. So I think there has to be
14 huge downside for the CEO and significant
15 downside for the board if government help
16 is required.

17 The second thing I think is that part
18 of any huge bubble is excessive leverage.
19 And it's very hard to define leverage,
20 because you're going to have some
21 institution that's ten for one and their
22 assets are all treasury bills and it
23 doesn't make any difference, and you can
24 have somebody that's three for one and it
25 can be all second mortgages and you've got

Q & A - Session 2

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2 lots of trouble, so it's not easy to
3 define.

4 But the size of the pop of the bubble
5 was accentuated in an enormous way because
6 of the leverage that existed in the system
7 and some of it was hidden, you know,
8 off-balance-sheet type things. And -- but
9 I would -- those would be two points I
10 would try very hard to address
11 intelligently.

12 VICE-CHAIRMAN THOMAS: Thank you.
13 Mr. Chairman, did you want to ask a
14 question?

15 CHAIRMAN ANGELIDES: Yes, just one on
16 the kind of incentives, upside and
17 downside, and I do want to just return,
18 because you've talked about financial
19 institutions.

20 But the very structure, again, of
21 credit rating agencies, it does seem in
22 the end, there's lots of upside, you know,
23 as a structured product business group,
24 very little downside. Legal
25 protections -- and by the way, I think

1 Q & A - Session 2

2 there's a fine distinction between
3 financial institutions that receive
4 federal money --

5 MR. BUFFETT: I do, too.

6 CHAIRMAN ANGELIDES: -- and, I might
7 add, a credit rating agency that's a full
8 participant in the system that got us
9 there.

10 So wasn't this system tilted in terms
11 of lots of upside and no downside?

12 MR. BUFFETT: I think much of
13 corporate America is tilted that way.

14 CHAIRMAN ANGELIDES: But you'd say
15 that applies to credit rating agencies --
16 I know you're an owner, but come on.

17 MR. BUFFETT: We've seen significant
18 downside. I mean, there's no question
19 that the mistakes that were made at
20 Moody's and Standard & Poor's are have
21 affected both Moody's stock and
22 McGraw-Hill stock in a big way.

23 VICE-CHAIRMAN THOMAS: I have no
24 right to ask you this, but just as the
25 rating agencies produced whatever a

Q & A - Session 2

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2 AAA was, and then investment banks and
3 others were able to take the leftovers,
4 restructure them and turn them into more
5 AAAs rated by an agency, you really need
6 to speak out even more than you have about
7 fundamentals. There are aren't very many
8 people who can command the respect, and I
9 know you were really busy out there on a
10 chair in front of a number of different
11 channels. But you've got to do more of
12 this. This may be your real legacy.

13 MR. BUFFETT: Well, I've spoken out
14 on some things, but I don't disagree with
15 you that perhaps no one spoke out enough,
16 you know, in the past years, during the
17 bubble. But certainly, I could have done
18 more. My partner, Charlie Mungers, makes
19 up for me. He speaks very loudly. But I
20 agree with you, Mr. Thomas.

21 VICE-CHAIRMAN THOMAS: Because once
22 Congress acts, the ability, as you well know, to act again,
23 to move into areas they weren't able to
24 initially, political becomes virtually
25 impossible. You only try to clean up the

1 Q & A - Session 2

2 area that you moved with first.

3 This isn't nearly as comprehensive as
4 it needs to be. It may even need to move
5 to tort and other areas. So I'm going to
6 turn my time over to others who might want
7 to quiz you from a very particular point
8 of view. Mine is simple.

9 Capitalism has changed in your
10 lifetime. And my concern is that in those
11 who are watching, it gets better. Which
12 means responsibility, moral obligation,
13 and behavior has consequences. Thank you.

14 MR. BUFFETT: Thank you.

15 CHAIRMAN ANGELIDES: All right, thank
16 you very much, Mr. Thomas. We're now
17 going to move to Senator Graham and yes,
18 wheel the chart.

19 COMMISSIONER GRAHAM: Thank you very
20 much, Mr. Chairman.

21 CHAIRMAN ANGELIDES: Microphone?

22 COMMISSIONER GRAHAM: Thank you very
23 much, Mr. Buffett and Mr. McDaniel for
24 your insightful comments.

25 Mr. McDaniel, you said that Moody's

Q & A - Session 2

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2 had incorporated the research into its
3 rating process.

4 The chart that's about to be
5 placed --

6 CHAIRMAN ANGELIDES: Can we please
7 place it where we placed it before, Karen,
8 so we do not obscure Commissioners? And
9 if you have to move the chairs, move the
10 chairs. Stop the clock. Even though we
11 should charge the Senator for this.

12 (A pause in the proceedings.)

13 CHAIRMAN ANGELIDES: All right, move
14 on.

15 COMMISSIONER GRAHAM: This chart
16 indicates the mountain of RMBS securities
17 that were rated by Moody's as the blue,
18 and the red are the CDOs and then in
19 yellow boxes are some important events.

20 The first of the yellow boxes is in
21 October of 2006 when, for instance, on the
22 CDO line, it was something south of ten
23 billion dollars issued. When Moody's
24 Research Service issued a report, the
25 first paragraph, the executive summary

Q & A - Session 2

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2 saying, "The U.S. housing market downturn
3 is in full swing; new and existing home
4 sales and single-family housing
5 construction are sliding, inventories of
6 unsold homes are surging to new record
7 highs, house prices are falling in an
8 increasing number of areas," and the word
9 "crash" is used to describe the situation,
10 in areas of the country which represented
11 about half of the outstanding mortgages.

12 How was that information incorporated
13 into the subsequent rating processes of
14 Moody's?

15 MR. McDANIEL: The Moody's analysts
16 and Moody's rating committees have
17 information from other parts of Moody's as
18 well as information from other firms, and
19 governmental services available to
20 include in their rating committee
21 deliberations and their analysis. So, and
22 they do use multiple sources of
23 information, including a source from
24 Moodyseconomy.com.

25 COMMISSIONER GRAHAM: Recognizing

Q & A - Session 2

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2 that this internal document, as well as
3 external information is available, the
4 question is how, in October of 2006, was
5 this incorporated into the rating process?

6 MR. McDANIEL: I don't know exactly
7 how it was used in the rating committees.

8 COMMISSIONER GRAHAM: The concern is
9 that, immediately after that dire
10 prediction was issued, the number of CDOs
11 went from \$10 billion a month to over \$40
12 billion a month in less than ninety days.
13 It doesn't seem as if the announcement of
14 severe problems correlated with the
15 actions that were taken.

16 MR. McDANIEL: I believe that the
17 rating committees would include any
18 information that they believe relevant in
19 their deliberations.

20 COMMISSIONER GRAHAM: Could you, as a
21 follow-up, give us some more specific
22 information as to what did in fact happen
23 in terms of incorporating this research
24 into the rating process in October of
25 2006?

1 Q & A - Session 2

2 MR. McDANIEL: Yes.

3 CHAIRMAN ANGELIDES: On my time,
4 could I just amplify that? Because this
5 came from obviously, Moody's.com,
6 Mr. Zandi and his team, very well
7 respected.

8 Could you, as part of that, actually
9 do a chronology of what management did
10 very specifically, how folks reacted to
11 that report, because it's pretty dramatic.
12 It uses the words, "The market is going to
13 crash in 20 metropolitan areas."

14 So if you could give a very specific
15 timeline about who did what when, from the
16 top levels on down.

17 MR. McDANIEL: I will do that, and I
18 should just add that I believe at this
19 time, even with the analysis that
20 Moodyseconomy.com was producing, their
21 expectations were far more moderate in
22 terms of what was going to happen in the
23 housing market than what in fact has
24 eventuated. So I just want to make sure
25 that there's no misunderstanding in the

Q & A - Session 2

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2 degree of downturn that they were
3 expecting at that time compared to what
4 we've seen.

5 COMMISSIONER GRAHAM: One of my
6 concerns which is not peculiar to the
7 financial industry or to rating agencies
8 but seems to be endemic across our
9 culture, is the avoidance of warning signs
10 until the situation degenerates into a
11 catastrophe; whether it's the failure to
12 see the consequences of new technologies
13 in deep water petroleum extraction but not
14 changing safety and response capabilities,
15 or some of the signs that have led to the,
16 now, the financial collapse.

17 The first panel made up of people who
18 all had experience at Moody's gave a
19 number of reasons why these warning
20 signals were not acted upon. Those
21 included the desire to increase market
22 share, the lack of ability to walk away
23 from a deal, the lack of human resources
24 to keep pace with the rapid increase in
25 the number of CDOs that were being

Q & A - Session 2

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2 evaluated, the lack of adequate
3 independent research capabilities, the
4 fact that the banks were misleading the
5 rating agencies, manipulating the process.
6 Those were some of the items that were
7 listed.

8 Do you concur with that list and are
9 there other items that you would add to
10 the list of why were the warning signs
11 missed?

12 MR. McDANIEL: There were some things
13 that I would concur with, and other things
14 that I would not. And to highlight two
15 that I think are important, first of all,
16 we agree that having a robust, independent
17 research and credit policy function is
18 important, and we have made changes in
19 both the number of individuals and the
20 independence of the credit policy function
21 over the past three years.

22 COMMISSIONER GRAHAM: Excuse me,
23 could I ask, one other issue was the fact
24 that the committees that were doing the
25 rating seemed to be devoid of people

Q & A - Session 2

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2 either from the real estate industry or
3 from the banking industry, and therefore
4 had little personal capacity to evaluate
5 what was happening in those areas.

6 Have you taken some steps to broaden
7 the pool of background on the rating
8 committees?

9 MR. McDANIEL: That, again, in the
10 category of lessons learned, greater
11 cross-disciplinary expertise in rating
12 committees, I think, is important, and we
13 have made important strides in
14 accomplishing that. And I think we've
15 made very good progress.

16 COMMISSIONER GRAHAM: Could you give
17 us some information on that subject, that
18 we asked the first panel for, what was the
19 status of those rating committees during
20 the period of '05 forward.

21 MR. McDANIEL: Yes. With respect to
22 being unwilling for walk away from a deal,
23 I believe was one of the comments that you
24 had related, I simply disagree with that.

25 We did not rate hundreds, probably

Q & A - Session 2

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2 thousands of residential mortgage-backed
3 securities tranches, particularly the
4 junior securities. Even though we looked
5 at them, our opinions were not such that
6 the issuers wished to have those opinions,
7 and we did not rate those.

8 We have sat out entire market sectors
9 for credit reasons where we have credit
10 concerns. And that is because the ratings
11 quality is paramount. We don't always get
12 it right. Predicting the future is an
13 uncertain process. But I think that -- I
14 think that there has been a
15 misunderstanding of our willingness to
16 stay out of markets where our credit
17 opinions are more conservative or we have
18 credit concerns.

19 COMMISSIONER GRAHAM: What about this
20 issue of misleading or manipulative
21 activities by banks?

22 MR. McDANIEL: Well, certainly, if
23 we're aware of anything that is misleading
24 or manipulative, we would not use that
25 information nor pursue rating a

Q & A - Session 2

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2 transaction with an institution that's
3 providing that.

4 COMMISSIONER GRAHAM: Well, the
5 testimony that we had was that the banks
6 would not disclose information which was
7 requested and the analysts didn't feel
8 that they could push back against the
9 banks to make that a requirement of their
10 issuing the rating.

11 MR. McDANIEL: Our methodologies are,
12 I believe, clear in terms of the
13 information that we need to rate an
14 instrument. And I believe that we pursued
15 that information consistent with our
16 methodologies. There may be additional
17 information that would be interesting to
18 review which may or may not have an
19 influence on our thinking on credit.

20 But certainly, we would look to have
21 all of the information that is consistent
22 with our methodological approach.

23 COMMISSIONER GRAHAM: Mr. Buffett,
24 this is a broader question. But I know
25 you have an excellent reputation of being

Q & A - Session 2

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2 the risk manager for your firm and that
3 you feel, as you've said today, that you
4 feel that's a principal responsibility of
5 the CEO.

6 Why do you think that, as a society,
7 we seem to have missed so many signals
8 across a range of areas?

9 MR. BUFFETT: Well, rising prices and
10 discredited Cassandras from the past blunt
11 sensitivities and judgment, even of
12 people who are very smart. I mean,
13 initially, my old boss, Ben Graham, used
14 to say, "You get in much more trouble in
15 investments with a sound premise than a
16 bad premise, because the bad premise you
17 recognize immediately doesn't make any
18 sense."

19 When you have a sound premise,
20 namely, the Internet is going to be very
21 important and eyeballs are going to be
22 important and all of that, initially, it
23 makes a lot of sense. After a while, the
24 rising prices of all internet stocks
25 caused people to be able to raise billions

Q & A - Session 2

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2 of dollars for things that are
3 nonsensical.

4 A home is a sound investment. I
5 mean, 66 or 67 percent of the people are
6 going to want to be in one. And if you
7 believe house prices are going to go up
8 next year, you're going to stretch to buy
9 one this year, and the world enabled
10 people to stretch.

11 After a while, rising prices became
12 their own rationale and people decided, if
13 buying one house was a good idea, buying
14 three houses was a good idea. If buying a
15 house you can afford is a good idea,
16 buying a house you can't afford is a good
17 idea because it's going to go up in price.

18 And people who lent money said, "It
19 doesn't really make any difference whether
20 the guy is lying about his income, because
21 in the house goes up in price, we'll get
22 our money back anyway."

23 So rising prices are a narcotic that
24 affect the reasoning power up and down the
25 line, of people, even, that should have

Q & A - Session 2

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2 had the experience.

3 Isaac Newton participated in the
4 South Sea Bubble originally, got out, and
5 then he couldn't stand prices going up any
6 longer, so he went back in and got
7 cleaned, you know. And this is a fellow
8 that generally was regarded as being
9 pretty bright. So it, rising prices are,
10 eventually, we had it in farmland in the
11 Midwest and it was a worse recession for
12 us than this housing recession, because
13 people just felt, they are not making any
14 more farmland, there are going to be more
15 people, they're going to eat more,
16 farmland's going to get more productive,
17 and the rising prices eventually created
18 their own -- their own destruction.

19 CHAIRMAN ANGELIDES: On my time, just
20 quickly, okay, it's a narcotic, but don't
21 we expect that regulators, credit rating
22 agencies, not partake of the narcotic?
23 Isn't that their role?

24 MR. BUFFETT: Well, you would hope
25 so, but it's not easy to avoid.

1 Q & A - Session 2

2 CHAIRMAN ANGELIDES: Well, still, you
3 don't want your police trading in crack.
4 You want them stepping back.

5 MR. BUFFETT: Yeah, and we had
6 Chairman Greenspan talk about irrational
7 exuberance in 1996. But with all -- with
8 the power of his podium and everything
9 else, we had a great internet boom after
10 that that was --

11 CHAIRMAN ANGELIDES: That was the
12 nature of my questions about who's
13 responsible; regulators, shareholders,
14 boards, management? Someone must be.
15 I'll turn it back to the Senator.

16 COMMISSIONER GRAHAM: I want to ask a
17 different question, Mr. McDaniel.

18 During this period of the last five
19 years, how frequently did representatives
20 of various regulators, from financial
21 institution regulators to the SEC, visit
22 Moody's to talk about your rating
23 methodology and to inform themselves as to
24 what it was that you were doing? They are
25 the ones who have imposed regulations

Q & A - Session 2

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2 requiring the use of your rating services.
3 How close a supervision or at least
4 monitoring of activities did they
5 maintain?

6 MR. McDANIEL: Pursuant to the Credit
7 Rating Agency Reform Act of 2006, which
8 became effective in, I believe it was
9 September of 2007, there's been multiple
10 inspections and reviews of our rating
11 processes and practices by the Securities
12 and Exchange Commission.

13 Prior to that period, the oversight
14 was less intensive because there was not a
15 regulatory framework that the SEC was
16 operating under for an inspection and
17 review regime.

18 COMMISSIONER GRAHAM: Prior to that
19 legislation, are you saying they did not
20 seem to think that they had some
21 responsibility, having mandated or given
22 strong incentives to use the rating
23 agencies' products as part of the
24 management of regulated activities, that
25 they had some responsibility to be aware

1 Q & A - Session 2

2 of what that rating constituted and how it
3 was being assumed?

4 MR. McDANIEL: I can't speak for the
5 Commission. But I believe that the
6 regulatory oversight opportunities were
7 more limited prior to the legislation
8 passing, and so they were not as extensive
9 in their oversight of Moody's or the
10 industry.

11 COMMISSIONER GRAHAM: Thank you,
12 Mr. Chairman.

13 CHAIRMAN ANGELIDES: Thank you very
14 much, Senator Graham. Mr. Wallison?

15 COMMISSIONER WALLISON: Thank you,
16 Mr. Chairman, and thank you both for
17 coming here, even when under compulsory
18 process, but voluntarily still. Thank
19 you.

20 Let me start with you, Mr. McDaniel.
21 You were here this morning for the earlier
22 panel?

23 MR. McDANIEL: I heard most of the
24 earlier panel, not all of it.

25 COMMISSIONER WALLISON: I just was

Q & A - Session 2

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2 wondering whether you heard anything about
3 your company that was a surprise to you,
4 or you did not know.

5 MR. McDANIEL: The issues that were
6 raised by some of the individuals who were
7 more critical of the company, I have heard
8 before. And in fact, we have investigated
9 those issues previously, including through
10 use of an external law firm, and found the
11 concerns that were raised to be without
12 merit.

13 COMMISSIONER WALLISON: Well, there
14 was this question I thought of enhanced,
15 what you, I think, referred to when you
16 were talking about enhanced analytical
17 integrity. I think you were getting at
18 the point that there were pressures,
19 perhaps, on the talent that you had, the
20 analytical talent, to produce ratings.

21 Is that what you meant by "enhanced
22 analytical integrity?" And what did you
23 do to prevent that from happening?

24 MR. McDANIEL: In the context of my
25 prepared remarks, with respect to enhanced

1 Q & A - Session 2

2 analytical integrity, I was referring to
3 some of the actions that we have taken
4 since 2007 to separate, for example, our
5 credit policy function from the
6 line-of-business ratings analysts; to have
7 more cross-disciplinary participation in
8 the rating committee process; and to
9 create further separation of any person
10 who is involved in commercial activities
11 for the firm from people who are involved
12 in analytical --

13 COMMISSIONER WALLISON: Well, let's
14 talk specifically about this one issue,
15 and that is, are analysts now permitted to
16 talk to issuers or the representatives of
17 issuers? Is that still permitted?

18 MR. McDANIEL: Yes, analyst do speak to
19 issuers.

20 COMMISSIONER WALLISON: And you are
21 not concerned that there are pressures
22 brought on them as academics, or people
23 who are academically inclined, by people
24 who are much more ambitious and forceful? You
25 don't see that as a problem?

1 Q & A - Session 2

2 MR. McDANIEL: I think the
3 communication between an issuer of
4 securities and an analyst of those
5 securities is important and should
6 continue. The analyst may have questions
7 about financial information or management
8 strategy at the issuer, the issuer's
9 future plans with respect to its capital
10 structure, et cetera.

11 So I do think those communications,
12 for purposes of creating most predictive
13 credit ratings we can produce, are useful.

14 COMMISSIONER WALLISON: Is there a
15 manager who oversees the analysts and can
16 be available for discussion of these issues?

17 MR. McDANIEL: There are managers who
18 oversee our analysts, yes, and they would
19 be available.

20 COMMISSIONER WALLISON: Let me ask
21 you one final question, a very general
22 one. And that is, what is your view of
23 what caused the financial crisis?

24 MR. McDANIEL: In terms of direct
25 causes, certainly the weakening of the

Q & A - Session 2

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2 housing market, the softening of that
3 market. And then importantly, the very
4 rapid tightening of credit for mortgage
5 borrowers who needed to refinance, in
6 particular, greatly exacerbated the issue;
7 that the sudden tightening of credit in
8 the midst of a softening housing market I
9 think produced the kind of large and rapid
10 problem that we saw.

11 COMMISSIONER WALLISON: So it's
12 principally a problem of people not being
13 able to finance, refinance, which caused
14 failures?

15 MR. McDANIEL: I think that was an
16 important contributor. It acted as a
17 catalyst.

18 COMMISSIONER WALLISON: Mr. Buffett,
19 we've had housing bubbles before, quite a
20 few, and other kinds of asset bubbles
21 before, most recently an oil price asset
22 bubble.

23 This one was really quite special. I
24 want to press you a little bit on this,
25 because I'd like to get your sense of why

Q & A - Session 2

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2 this one was special.

3 Why did it get so large? Why did
4 someone with your astute knowledge about
5 the economy not see that this was an
6 extraordinarily different bubble from one
7 we've had before?

8 MR. BUFFETT: Well, I wish I could
9 give you a good answer to that. It was
10 really the granddaddy of all bubbles and
11 it affected an asset class of 22 trillion.
12 I mean, it hit everybody. And
13 Mr. McDaniel mentioned people refinancing.
14 I mean, they were betting on the fact that
15 the following year, if they couldn't make
16 the payments, they could refinance. And
17 of course, the figures show that by the
18 hundreds and hundreds of billions, that
19 happened.

20 But when it gathers momentum, you
21 know, the internet bubble went further
22 than I would have thought it would have.
23 We did have that farm bubble in Nebraska
24 where, you know, things went crazy for a
25 while, and the early Cassandras do look

Q & A - Session 2

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2 kind of foolish as they go along. And
3 when your next-door neighbor is making
4 money, you know, very easy, buying a
5 second house, you know, with very small
6 down payment, after a while it sort of gets
7 to you and maybe you figure you should be
8 doing it, too.

9 It's been the history of bubbles. I
10 never understood why tulips were worth
11 what they were, back in --

12 COMMISSIONER WALLISON: But for you
13 in particular, and you've had many years
14 to watch our economy, and to economists in
15 general, sharply rising prices are a
16 signal that something is peculiarly going
17 on in the economy. You saw the prices
18 rising very quickly but you still didn't
19 think that this was something that could
20 eventually collapse?

21 MR. BUFFETT: I didn't think it would
22 pop like it did, no. Interestingly
23 enough, in 2005 and '06, and I believe I've
24 got the time period right, I got offered
25 businesses for sale periodically. A

Q & A - Session 2

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2 significant percentage of the
3 publicly-traded home builders one way or
4 another let it be known that they would
5 like to sell out to Berkshire Hathaway,
6 and looking back, I should have figured
7 out what I didn't figure out.

8 COMMISSIONER WALLISON: Were they
9 asking more than once?

10 MR. BUFFETT: It's interesting, I
11 never heard from them in many decades in
12 business, and all of a sudden, three or
13 four of them showed up on the doorstep.

14 COMMISSIONER WALLISON: You were once
15 an owner of Freddie Mac.

16 MR. BUFFETT: Right.

17 COMMISSIONER WALLISON: So you are
18 familiar with how Fannie Mae and Freddie
19 Mac operate. Do you see their activities
20 as having any role in the growth of this
21 bubble?

22 MR. BUFFETT: Well, I think they were
23 doing what they were instructed by
24 Congress to do to a great degree, but I --
25 they took on weaker forms of mortgages in

Q & A - Session 2

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2 greater amounts. I mean, that's been
3 covered in some of the reports. And so
4 they -- and they also bought, you know,
5 they would require twenty percent
6 down payment but then they would buy
7 mortgage insurance from other entities.

8 And I've looked at the profiles of
9 some of those loans, and material I got
10 from the mortgage guarantee organizations.
11 And frequently, the significant percentage
12 of the time, more than fifty percent of
13 the income of the borrower was going to
14 mortgage payments.

15 That's not sustainable. And -- but
16 whereas they are laying that off with the
17 mortgage guarantee insurance company, they
18 were still in effect helping people
19 participate in something that was really,
20 unless housing prices kept going up, was
21 going to lead to big trouble.

22 COMMISSIONER WALLISON: Why did you
23 sell your Freddie Mac stock?

24 MR. BUFFETT: I sold it for several
25 reasons, but I think we were the largest

Q & A - Session 2

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2 shareholders of Freddie Mac. And at one
3 point, it became apparent they were
4 getting more and more entranced by trying
5 to report increased earnings every
6 quarter. And any financial institution
7 that tries to do that, in my view, is
8 going to get in trouble sooner or later.
9 And they became quite interested in that
10 particular, having that happen.

11 They also, Freddie, as I remember, it
12 was either RJR bonds or Philip Morris
13 bonds, but they had bought some bonds that
14 had nothing to do with housing at all.
15 And here they were using the government's
16 credit to enlarge the size of this
17 hedge-fund type portfolio, now with some
18 corporate bonds that had nothing to do
19 with housing.

20 And I just figure if you see one
21 cockroach there's probably a lot more in
22 the kitchen.

23 COMMISSIONER WALLISON: Did you
24 follow Fannie and Freddie enough to know
25 that they had affordable housing

Q & A - Session 2

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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?

1 Q & A - Session 2

2 CHAIRMAN ANGELIDES: Four minutes and
3 51 seconds.

4 COMMISSIONER WALLISON: You are quite
5 famous for saying, among other things, and
6 this isn't the only thing you're famous
7 for, but you said that credit default
8 swaps are financial instruments of mass
9 destruction. And yet it's recently come
10 to light that you actually participate
11 actively in that market.

12 MR. BUFFETT: Yea, I think I actually said
13 derivatives are financial -- potentially,
14 and I think that used improperly, as they
15 almost are certain to be, because of what
16 they provide people to trade in them and
17 what they provide in the way of increased
18 leverage that's not obtainable in other
19 ways, I think that they have, they pose
20 system-wide problems.

21 COMMISSIONER WALLISON: What do you
22 use them for?

23 MR. BUFFETT: I use them to make
24 money. If I think they are mispriced, I
25 buy them.

1 Q & A - Session 2

2 COMMISSIONER WALLISON: But these are
3 credit default swaps or other kinds of --

4 MR. BUFFETT: No, we've never bought a
5 credit default swap. We've sold credit
6 default swaps. We sell insurance.

7 COMMISSIONER WALLISON: You sell
8 protection.

9 MR. BUFFETT: We sell insurance, we
10 sell --

11 COMMISSIONER WALLISON: And then do
12 you lay that off?

13 MR. BUFFETT: No.

14 COMMISSIONER WALLISON: You do not
15 hedge that?

16 MR. BUFFETT: No, I never write it
17 off. We sell insurance.

18 COMMISSIONER WALLISON: This is much
19 like what AIG did. Didn't they --

20 MR. BUFFETT: I don't think it's much
21 like it, but we sell credit insurance.
22 And we sell auto insurance, and AIG sold
23 auto insurance, too. I mean...

24 COMMISSIONER WALLISON: All right, I
25 have no further questions. Thanks very

Q & A - Session 2

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2 much.

3 MR. BUFFETT: Could I bring up one
4 point? Because it gets back to a point
5 that was made earlier about the laws
6 getting on the books and never getting
7 changed. If you go back to the 19, late
8 1920s, we had a bubble then. It was in
9 stocks and it was partly caused by extreme
10 margin by people that didn't really know
11 what they were doing, ten percent margins,
12 and they had Commission hearings after
13 that, and they decided that this was a
14 societal problem, and Congress gave to the
15 Federal Reserve the authority to regulate
16 margins, and they said, "this is
17 important."

18 The Federal Reserve still has that
19 authority, as I understand it, you know,
20 70-plus years later. What we put into
21 derivatives and total return swaps, at
22 that point you could borrow a hundred
23 percent of what you owned. And we sit
24 here with the system -- and I've brought
25 this up a half a dozen times, and

Q & A - Session 2

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2 sometimes people in Congress, and I say,
3 "What in the world are we doing when we
4 say the Federal Reserve should have margin
5 requirements," which I believe now are
6 fifty percent, "And you can go and get a
7 total return swap and borrow a hundred
8 percent or you can buy S&P index futures
9 with a tiny percentage down?" I mean, it
10 is something that should be addressed.

11 COMMISSIONER WALLISON: I thought
12 your, maybe I've misread this in the
13 newspapers but I thought your problem with
14 some of the legislation that is going
15 through had to do with the fact that you
16 didn't want to put up the collateral which
17 substitutes for the margin.

18 MR. BUFFETT: In terms of -- in terms
19 of contracts that were negotiated several
20 years ago, there was one price for
21 collateralized contracts and another price
22 for uncollateralized. And incidentally,
23 Coca-Cola, Anheuser-Busch, thousands of
24 companies negotiated under that basis. We
25 say, if we're required to substitute an

Q & A - Session 2

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2 uncollateralized contract and make it a
3 collateralized contract, before we send
4 that money to Wall Street, we should get
5 paid for the difference in those two types
6 of contracts because they are two
7 different contracts, just like changing
8 the price or changing the maturity.

9 And there's a very significant
10 difference in price. And not only we, but
11 hundreds of end users would be required to
12 send money to Wall Street firms, contrary
13 to the contract they originally negotiated
14 and contrary to the price differential
15 that existed between those two types of
16 contracts.

17 COMMISSIONER WALLISON: So you don't
18 have any objection to doing it in the
19 future --

20 MR. BUFFETT: Oh, no, not in the
21 least, I don't -- I just -- I object to
22 selling one kind of a contract and having
23 it changed into another kind of a contract
24 without getting paid.

25 COMMISSIONER WALLISON: Okay, thank

Q & A - Session 2

1
2 you.

3 CHAIRMAN ANGELIDES: Thank you very
4 much. Mr. Georgiou and Mr. Wallison, if
5 you can flip that mike off, thank you.

6 COMMISSIONER GEORGIOU: Thank you
7 very much, gentlemen, for joining us.

8 I'd like to start with Mr. Buffett,
9 largely because my 90-year-old mother is
10 watching and she'd be very upset with me
11 if I didn't acknowledge your seniority.
12 Here we are.

13 I take it that between AIG's selling
14 of credit insurance and yours is that you
15 charge enough to cover the risk that
16 you're undertaking, is that fair for say?

17 MR. BUFFETT: That's fair to say.
18 But additionally, we only take on risk we
19 can handle ourselves, so we only have
20 about 250 contracts or so, total. And if
21 everything goes wrong, we can easily
22 handle it. And that was not the case with
23 AIG.

24 COMMISSIONER GEORGIOU: Indeed it was
25 not. I want to address the general

Q & A - Session 2

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2 question which I've sort of been putting
3 at a lot of these hearings, about how we
4 might restructure the incentives in the
5 market system to try to avoid these market
6 crises in the future.

7 You said, Mr. Buffett, that you liked
8 this business at Moody's, because it had
9 pricing power, it was a natural duopoly.
10 This gentleman Kolchinsky, who testified a
11 little bit earlier today, who was a
12 subordinate of Mr. McDaniel said that, in
13 many ways, the incentives for rating
14 agencies have become worse since the
15 credit crisis. There are now more rating
16 agencies and they are all chasing
17 significantly fewer transaction dollars.
18 The new controls put in place by
19 regulators are too weak to significantly
20 alter this dynamic.

21 And then there's a quote that you
22 also had in your testimony that you gave
23 privately to our team, "Market systems
24 produce strange results in Wall Street.
25 In general, the capital markets are so

Q & A - Session 2

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2 big, there's so much money, that taking a
3 small percentage results in a huge amount
4 of money per capita in terms of the people
5 that work in it, and they are not inclined
6 to give it up."

7 And then one last quote I want to
8 read to you, but I will tell you the
9 quote, "Whenever I hear the terms
10 'modernization' or 'innovation' in
11 financial markets, I reach for my wallet.
12 It's usually, what they mean is
13 revenue-producing."

14 So we've seen a number of things go
15 on in the marketplace. And you've also
16 said that everyone should have a lot to
17 lose in this marketplace. Well, really,
18 in the securitization process, we've
19 discovered through the course of our
20 hearings that really, almost everybody
21 involved has nothing to lose. The
22 mortgage brokers who originate the
23 mortgage get paid a percentage of the
24 mortgage they originate without regard to
25 the consequences if it succeeds or fails.

Q & A - Session 2

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2 The bankers who put the deals together,
3 the mortgage-backed securities, are
4 getting a percentage of the deal. The
5 lawyers who write the prospectuses, the
6 auditors, accountants who audit the books,
7 and the credit rating agencies who rate
8 the credits, are all basically paid in
9 cash at the conclusion of the sale of
10 these securities, really without any
11 significant consequence to whether they
12 actually do what people represent them to
13 do or they fail.

14 And one thought that some people have
15 suggested is that, rather than pay all
16 these market participants in cash, that
17 you might increase the likelihood of
18 diligence being properly done if you paid
19 them in the securities themselves. So if
20 you're getting, whatever, ten basis points
21 of the dollars, give the security to
22 Moody's, so that you know that you're
23 going to live with that security for a
24 long time. You're going to be long in it.
25 You can bonus the people that did the job

1 Q & A - Session 2

2 with the same security. If they succeed,
3 they get seven percent interest per year
4 for ten years, then they get their money
5 back. What do you think about that idea?

6 MR. BUFFETT: I like it, or put it in
7 a deferred account and have an index of
8 all the things in which they participated
9 become the index factor that's applied to
10 that deferred account when it's finally
11 paid out at some point.

12 You have to, I think the most can be
13 achieved actually by getting, at the very
14 big institutions, the CEO and the boards,
15 where they've got real downside.

16 But I can tell you, I was at Salomon
17 almost twenty years ago, and trying to put
18 in a new compensation system in Wall
19 Street can be very difficult.

20 COMMISSIONER GEORGIU: Right.

21 MR. BUFFETT: But I don't retract any
22 of those earlier remarks. I agree with
23 them.

24 COMMISSIONER GEORGIU: I asked in
25 the case of Jimmy Cayne at Bear Stearns,

Q & A - Session 2

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2 he said, "That's a great idea but they are
3 not going to like it." So it seems to me
4 that -- and I want to go back here to what
5 happened at Moody's to some extent.
6 Because really, a hundred years ago, you
7 know, John Moody started rating railroad
8 bonds, which you know a lot about.
9 Relatively simple instruments.

10 Now, Moody's is rating exceedingly
11 complex instruments. And some of the
12 financial incentives, maybe I should turn
13 to Mr. McDaniel on this question, some of
14 the financial incentives, it seems to me,
15 are skewed in favor of your properly
16 rating, besides the fact, the obviously
17 glaring one that issuers pay.

18 But in your pricing, I learned from
19 our investigation that, on RMBS, on
20 residential mortgage-backed securities,
21 you charged 4.75 basis points for those
22 tranches that were rated senior of the
23 dollars in those tranches, and 3.50 basis
24 points for the tranches that were rated
25 subordinate.

Q & A - Session 2

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2 Which, it seems to me, gives a skewed
3 incentive for you to put more dollars into
4 the senior tranches and less dollars in
5 the subordinate tranches because you're
6 going to make almost 40 percent more per
7 dollar rated in the higher-rated ones,
8 which is similar to a difficulty we've
9 discovered in the mortgage brokerage
10 situation, where mortgage brokers
11 sometimes were compensated at twice the
12 rate, at the percentage rate, for
13 generating a mortgage that had a higher
14 interest rate payable to the lender than a
15 traditional mortgage, which then
16 incentivized them twice as much to direct
17 borrowers into subprime mortgages and
18 high-interest-rate mortgages who might
19 otherwise qualify for regular, traditional
20 ones.

21 Mr. McDaniel, do you think that's a
22 problem? And why, if you could tell us,
23 did you actually structure the fees
24 payable to Moody's in that way, that gave
25 you more if you rated them senior than

Q & A - Session 2

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2 they would if they were subordinate?

3 MR. McDANIEL: I think, as you heard
4 from the panelists earlier today, first of
5 all, they were not aware of a difference
6 in pricing in their deliberations or
7 analytical work and rating committee work.

8 And secondly, although I have not had
9 an opportunity to do a comprehensive
10 check, I did go back to look at RMBS
11 applications in 2006 and 2007, and the
12 basis point fees were identical for senior
13 and junior tranches.

14 COMMISSIONER GEORGIU: Well, our
15 people say that they changed it in 2007 to
16 flat, to 3.5 percent which, incidentally,
17 is a reduction in pricing power, 3.5 basis
18 points for all, all the way across an
19 RMBS, starting in 2007 forward, when in
20 2006 prior it was a differential.

21 MR. McDANIEL: I was able to look at
22 2006, and it was identical in 2006 as
23 well -- as I said, I did not have a chance
24 to do a comprehensive --

25 COMMISSIONER GEORGIU: Right. Maybe

Q & A - Session 2

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2 you could check that out and report to us
3 on it.

4 MR. McDANIEL: Yes.

5 COMMISSIONER GEORGIU: The other
6 point I think is that you got nine basis
7 points for rating a CDO which is, again,
8 more than twice as much as you got for
9 rating an RMBS, which is sort of unclear
10 to me how that could be.

11 And does that then incentivize you to
12 do more CDOs because you do a
13 billion-dollar CDO, you're going to make
14 almost a million dollars in fees. And is
15 that -- is it really that much harder to
16 rate a CDO than it is to rate an RMBS?

17 MR. McDANIEL: Well, I'm not a CDO
18 analyst. So I can only respond with
19 respect to the overall approach and if
20 there is an opportunity to charge fees
21 that the market will bear, I think we
22 would do that.

23 We have fees that range from very,
24 very modest, particularly in the municipal
25 bond sector, small municipalities, to fees

Q & A - Session 2

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2 that are a lot more substantial for large
3 corporations and complex securities.

4 COMMISSIONER GEORGIU: Let me try --
5 I want to press you a little bit --
6 Mr. Buffett, did you have a comment on
7 that?

8 MR. BUFFETT: I was just thinking, I
9 was looking for the modest ones, I haven't
10 found them yet. The modest fees he
11 referred to.

12 COMMISSIONER GEORGIU: There aren't
13 too many. I haven't seemed to find them,
14 either. Looking back at this chart that
15 Commissioner Graham brought in front of
16 you, it strikes me that, when you look at
17 this, in the face of contradictory
18 information, the actual number of deals
19 rated in both CDOs and residential
20 mortgage-backed securities goes up
21 dramatically.

22 And really, even after you've had
23 four or five major downgrades, I mean,
24 significant downgrades, you're still
25 rating a whole bunch of deals that come

Q & A - Session 2

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2 forward.

3 And I think that -- I'll sort of give
4 you a pass to some extent on nobody knew
5 that the market was going to go down as
6 fast as it did. And everybody was
7 basically, I don't remember what your term
8 was, Mr. Buffett, that everybody was
9 believing in this -- as this bubble.

10 But once you get contradictory
11 information, don't you then have an
12 obligation not to go forward? And to be
13 honest with you, it looks to me, given now
14 that there are so few transactions in the
15 marketplace, that what you were really
16 trying to do was get these deals done so
17 you could mop up the last bit of the gravy
18 before they took the plates away. I mean,
19 this is not -- these deals are not out
20 there anymore. There's not
21 nine-basis-point fees to be made on
22 billion-dollar CDOs every day anymore.
23 And the fact that you did it in the face
24 of contradictory information seems to me
25 to be highly troubling.

1 Q & A - Session 2

2 Do you have a thought on that?

3 MR. McDANIEL: As long as securities
4 are being offered to the marketplace, I
5 think we have an obligation to try to
6 offer our best opinion on those
7 securities. So whether the markets are
8 active and robust or whether they are
9 quiet, what is coming to market I think we
10 should attempt to offer an opinion on.

11 We obviously want those opinions to
12 be predictive. We want those opinions to
13 incorporate all information that we think
14 is relevant, and incorporate our best
15 judgment. But I do think we should try
16 to offer the opinion.

17 COMMISSIONER GEORGIU: But they
18 weren't any more predictive, were they?
19 In fact, they led to downgrades as
20 significantly as they were prior to that,
21 is that not correct?

22 Yes, Mr. Angelides -- I know you do.
23 So do I.

24 There are two Greeks on this
25 committee, gentlemen, which is a little

Q & A - Session 2

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2 bit dangerous for all of us here. But Mr.
3 Buffett --

4 VICE-CHAIRMAN THOMAS: I'm Welsh. My
5 hands are tied.

6 COMMISSIONER GEORGIU: -- Mr. Buffett,
7 do you fault the management of Moody's for
8 at least that? I know you're reluctant to
9 give them fault, but in the face of this
10 contradictory information, how is it that
11 they went forward and continued to rate
12 these securities essentially no
13 differently than they had been doing in
14 the face of the bubble?

15 CHAIRMAN ANGELIDES: Can I say the
16 reason I was waving my hands? I want to
17 put this in perspective. Offering opinion
18 is one thing. Offering an opinion that
19 they are AAA is quite another. So just to
20 frame this question on my time, I think in
21 2007, \$500 billion of RMBS was rated AAA.
22 About a hundred-billion-plus after July
23 '07, when you began to do the downgrades.
24 So there's offering an opinion, which may
25 be that this isn't ratable, shouldn't be

Q & A - Session 2

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2 rated investment-grade, and then in
3 fact --

4 COMMISSIONER GEORGIU: Rating it AAA
5 and then of course they were subsequently
6 downgraded, even those later new
7 issuances. Mr. Buffett?

8 MR. BUFFETT: Well, I don't know what
9 took place internally there. But just
10 from listening to this and what I see here
11 on the chart and so forth, it looks like
12 they tweaked their model when they should
13 have gone at it with a meat axe,
14 basically. And it is sometimes difficult
15 for people to adjust their thinking that
16 much in a short period of time, but they
17 should have gone at it with a meat axe.

18 COMMISSIONER GEORGIU: Too many
19 mixed metaphors here on occasion. But I
20 guess I'd like to ask you, if I could, I
21 know you've testified in your internal
22 testimony that you thought that the
23 government made the right decision in
24 backing up these companies, that the
25 markets really needed reassurance at the

Q & A - Session 2

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2 time. This is a more generic question not
3 having to do with Moody's.

4 But there are many who believe that
5 that demonstrates the breadth and scope of
6 this crisis, that, you know, we've had so
7 many other crises. I mean, Enron was the
8 seventh largest corporation in America, it
9 went bankrupt. The tech bubble happened,
10 a lot of things happened in the last 70
11 years and none of them required trillions
12 of dollars of taxpayer money at risk to
13 bolster the private sector, and yet you
14 feel that it was necessary at the time.
15 Could you elucidate?

16 MR. BUFFETT: I do. In September of
17 2008, you know, our financial system
18 basically came to a halt. I mean, you had
19 30 million Americans with their money in
20 money market funds comprising
21 three-and-a-half trillion with close to
22 half the deposits at the banks, and in the
23 first three days of that week following
24 Lehman, 170 billion flowed out.
25 Interestingly now, that was all

Q & A - Session 2

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2 institutional. Individuals hadn't caught
3 on yet.

4 But when thirty million people start
5 worrying about whether their money market
6 funds are going to be -- break the buck,
7 when you've got -- when you've got
8 commercial paper stopped in terms of
9 issuance, when you have -- later we sold a
10 Treasury bill due in April of 2009, we
11 sold it in December for \$5,000,090 when
12 you were only going to get five million in
13 April. So at that point your mattress
14 wasn't even good enough. I mean, a
15 Treasury bill was \$90 better than a
16 mattress.

17 So it was a paralysis of the system,
18 and the American people knew that only the
19 government could pull us out. They didn't
20 trust anybody else. And the government
21 had to act. Whether they acted perfectly
22 in every case, who knows? But the
23 important thing is they acted.

24 COMMISSIONER GEORGIU: But now we're
25 going forward. And part of what we're to

1 Q & A - Session 2

2 do here is to evaluate what happened in
3 the financial crisis and, although we're
4 not proposing remedies, certainly, a lot
5 of people are concerned about the debt
6 that's been taken on to finance this
7 bailout and so forth.

8 What do you do in the future to avoid
9 this occurring?

10 CHAIRMAN ANGELIDES: By the way, go
11 ahead and answer, Mr. Buffett, but that's
12 time -- Mr. Buffett, answer, we would want
13 your answer.

14 MR. BUFFETT: Yes. The two best
15 things I know how to attack are leverage
16 and incentives. You've got a market
17 system and you can't rearrange the whole
18 thing, but you can change how people
19 behave, in one case by incentives, and
20 secondly, you just tell them how much rope
21 they can use by the amount of leverage
22 they can have, particularly when they are
23 getting the benefit of government
24 guaranteed money.

25 COMMISSIONER GEORGIU: Exactly, and

1 Q & A - Session 2

2 let me just, one little follow-up, and
3 that is, your company has a huge cash
4 cushion, which you like to keep because it
5 puts you in a protected, safe position to
6 take advantage of opportunities.

7 A lot of other people in this
8 financial institution area did not do
9 that. They ran every capital arbitrage
10 possible to avoid holding back as much
11 capital, and so that seems to me to be a
12 related problem.

13 MR. BUFFETT: Yes, well, the AIG
14 derivatives contracts you meant were to
15 get around capital requirements in Europe.
16 I mean, three hundred billion. So, you
17 know, there's a lot of abuse, and if you
18 let those instruments exist in that form
19 and let people use them in an unlimited
20 manner, they will get used in an unlimited
21 manner.

22 CHAIRMAN ANGELIDES: Thank you very
23 much, Mr. Georgiou. All right, let's move
24 on. Ms. Murren?

25 COMMISSIONER MURREN: Thank you.

Q & A - Session 2

1 Thank you both for being here.

2
3 Mr. McDaniel, I have a question for you
4 about the events of the crisis, and when
5 you look back at the financial crisis, I
6 wonder if the requirement, the legislative
7 requirement that asks certain investors to
8 invest only in rated securities, if those
9 requirements had not existed, how would
10 your business have been different? Would
11 you have had to compete on different terms
12 and would you have had to reward people
13 within Moody's differently?

14 MR. McDANIEL: Well, I don't know
15 exactly how the business would exist if
16 there were different or lesser regulatory
17 uses of the ratings. Nonetheless, I am
18 supportive of a reduction of use of
19 ratings in regulation. I think it -- I
20 think the use of ratings and regulation
21 offers rating agencies a basis for
22 competing other than on the quality of
23 their ratings. They can compete on the,
24 in effect, the certification that they
25 have as a regulatory-approved rating

1 Q & A - Session 2

2 agency.

3 And I think that rating agencies
4 should either prosper or not prosper based
5 on whether market participants value the
6 ratings and value the rating opinions and
7 research that accompany that.

8 COMMISSIONER MURREN: With that in
9 mind, there were comments from some of the
10 individuals that were here before this
11 panel that suggested that they could not
12 determine if there was a connection
13 between their ability to get the ratings
14 right, their words, and their actual
15 recognition within the firm.

16 Do you think that's true?

17 MR. McDANIEL: We certainly try to
18 reward people in terms of their position
19 in the firm and their compensation, based
20 on the quality of their work. It is a
21 business in which it can take a long time
22 to evaluate the ultimate performance of
23 securities. But their research, their
24 preparedness for rating committees,
25 their -- the robustness of their reasoning

1 Q & A - Session 2

2 are things that can be judged and we very
3 much try to do that.

4 COMMISSIONER MURREN: Those things
5 are process-oriented though, not
6 outcome-oriented necessarily.

7 MR. McDANIEL: The outcomes are able
8 to be measured at a broad level
9 statistically to, I think, a -- to a
10 strong outcome. It is more difficult to
11 judge an individual's performance,
12 especially in the short run, on a very
13 limited number of credits. And so it is
14 easier to measure this at a broad level
15 than at a narrow level.

16 COMMISSIONER MURREN: Thank you.

17 Mr. Buffett, do you think that the
18 investing world would be a better place if
19 everyone had to do their own due
20 diligence?

21 MR. BUFFETT: Well, I certainly think
22 at Berkshire Hathaway it's better. But
23 there are people that aren't equipped. I
24 mean, the banking authorities, insurance
25 authorities, probably need to rely on some

Q & A - Session 2

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2 kind of standards to make sure that people
3 don't go totally hog wild in terms of how
4 they invest insurance funds which belong
5 to their policyholders.

6 But in the end, we don't use ratings.
7 From my -- what we really hope for is
8 misrated securities because that would
9 give us a chance, perhaps, to earn a
10 profit if we disagree with how the
11 agencies rate them.

12 There's one ironic point I should
13 mention. If there were ten rating
14 agencies, all equally well regarded, all
15 acceptable to the market, and you only
16 needed one when Berkshire Hathaway issues
17 a bond, we could have any one of them,
18 those ten would compete either on price or
19 laxity or both. I mean, they would be out
20 there trying to get our business, and they
21 would try by price, but they might also
22 try by laxity.

23 You can argue that if there was just
24 one rating agency, they would have no
25 reason to compete on either price or

Q & A - Session 2

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2 laxity. I mean, independence can really
3 come with -- with strength in the
4 business. Ben Franklin said it's
5 difficult for an empty sack to stand
6 straight. So if you really had a
7 situation where there was a lot of
8 competition, I'm not sure that the rating
9 agencies would be as independent actually
10 in coming to their credit conclusions as
11 they are.

12 COMMISSIONER MURREN: I would hate to
13 differ with you. But if you look at, for
14 example, equity research, there are a
15 number of boutique shops that are
16 specifically known for the quality of
17 their research and they do not engage in
18 investment banking activity, so they don't
19 have as much of a stake in the origination
20 process.

21 And to me there's some parallel
22 between this area of research and some
23 others. So I guess my question really is,
24 if you change the way people get paid,
25 would you get a different outcome? So

Q & A - Session 2

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2 that really was the nature of where I was
3 headed with this.

4 But I actually have an off-topic
5 question for you, Mr. Buffett, and that
6 is, I know that you've been largely a
7 hands-off investor for Moody's. But I was
8 curious about the due diligence process in
9 your investment in Goldman Sachs, and if
10 you could talk a little bit about your
11 conversations with management there and
12 how that decision was made.

13 MR. BUFFETT: Well, that decision was
14 made in September of 2008. We'd been
15 approached by just about every firm, at
16 least every firm that went under, about
17 putting money in. And when Goldman Sachs
18 was willing to take money on terms I found
19 satisfactory, which had not been the case
20 even the week before, I came to the
21 conclusion that, unless the American
22 financial system totally fell apart, that
23 it was going to be a sound investment.
24 And I had far more confidence in their
25 risk management than I had in some of the

1 Q & A - Session 2

2 other Wall Street firms that had come to
3 me earlier.

4 And again, if the system had fallen
5 apart, if the Federal Reserve had not
6 acted, in terms of commercial paper and
7 the money market funds and all, everyone
8 would have been toast, I think basically.

9 But I came to the, my basic
10 conclusion was that the American
11 government would do what was necessary to
12 get the engine started again. And if that
13 was the case, Goldman Sachs was in fine
14 shape.

15 COMMISSIONER MURREN: But they did
16 change the terms they were willing to
17 accept for your investment as time went
18 on.

19 MR. BUFFETT: Yeah. Prior to the
20 middle of September, you know, they would
21 not have paid us what they, remotely what
22 they did pay us for that preferred stock
23 and the warrants, whenever it was,
24 September 22nd or 23rd or some time in
25 that time frame.

Q & A - Session 2

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2 At that point, they not only wanted
3 the money but they wanted a show of
4 confidence, obviously, in the fact that
5 the world wasn't going to come to an end
6 financially.

7 And I didn't think the world was
8 going to come to an end financially,
9 because I thought that the federal
10 government would act. I just thought it
11 was so obvious that it had to, and only it
12 could do it. And I felt that our five
13 billion dollars would not be in any danger
14 at all. And the terms were attractive,
15 and there were a lot of other things that
16 were attractive, then, too. But I made
17 the decision that that was a good use for
18 the five billion.

19 COMMISSIONER MURREN: Thank you.

20 CHAIRMAN ANGELIDES: Thank you,
21 Mr. Holtz-Eakin?

22 COMMISSIONER HOLTZ-EAKIN: Thank you,
23 Mr. Chairman; thank you, gentlemen, for
24 spending time with us today.

25 Mr. McDaniel, in your opening remarks

Q & A - Session 2

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2 you were very forthright about the
3 inherent conflict between providing
4 ratings to the market and running a public
5 company for profit, and incentives that
6 issuers have to use the outcome of your
7 rating process.

8 How do you manage that conflict at
9 Moody's? What do you put in place to keep
10 that under control?

11 MR. McDANIEL: Well, from my office,
12 I think it's important to emphasize and
13 reemphasize the fact that we are trying to
14 create long-term shareholder value, and I
15 think the way to do that is to have credit
16 ratings that are of high quality and
17 predictive over time. That is why the
18 problems we saw in the mortgage-related
19 securities sector were so devastating to
20 the firm, in addition to the consequences
21 for the larger economy and to households
22 in America.

23 Beyond that, though, we have
24 structural components of the firm that are
25 designed to insulate and protect the

Q & A - Session 2

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2 analytical process from some of the
3 financial and commercial interests of the
4 company, again, including independent
5 credit policy function. We have also
6 recently created a separate commercial
7 organization in the firm that is separate
8 and apart from either credit policy or the
9 ratings analysts and the lines of
10 business.

11 COMMISSIONER HOLTZ-EAKIN: And to be
12 clear, those are two recent changes in
13 response to the problems you had?

14 MR. McDANIEL: The credit policy
15 function has existed for many years, but
16 we then enhanced that function in terms of
17 its independence in 2007. And the
18 commercial group is a more recent
19 introduction.

20 We also have formally separated the
21 rating agency from our other operating
22 businesses, non-credit ratings businesses.
23 So those kinds of actions I think are
24 useful and important, not only for our own
25 processes, but to be able to turn around

1 Q & A - Session 2

2 and demonstrate that those processes are
3 proper and being handled in the right
4 manner.

5 COMMISSIONER HOLTZ-EAKIN: So the
6 quality of the ratings ends up being the
7 key. And I think you said earlier that
8 you want them to include all the relevant
9 information and make them as good as
10 possible.

11 MR. McDANIEL: Absolutely.

12 COMMISSIONER HOLTZ-EAKIN: So I am
13 then very interested in this situation
14 that occurred in 2007 where you had the
15 residential mortgage-backed securities
16 clearly up for downgrade and at the same
17 time are rating CDOs based on the same
18 underlying RMBSs, and went ahead and rated
19 them AAA.

20 It doesn't seem like all the relevant
21 information was brought into the rating
22 process. And how do you feel about that,
23 and the risk it placed to your reputation
24 and the quality of your ratings?

25 MR. McDANIEL: I believe that all of

Q & A - Session 2

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2 the information we thought was relevant at
3 the time was brought into the rating
4 process. But obviously, we had the
5 problem of underestimating the extent to
6 which the housing downturn was going to --
7 its magnitude and how widely it was going
8 to affect home prices nationwide.

9 So as a result, the, even though we
10 felt we were including relevant
11 information, we felt we were using the
12 best information we had available in the
13 rating committee process, it proved to be
14 insufficient, and --

15 COMMISSIONER HOLTZ-EAKIN: You
16 couldn't wait until you found out a little
17 bit more from your RMBS guys before you
18 went out and rated the CDOs or was the
19 short-term pressure too great?

20 MR. McDANIEL: I think the
21 information that our RMBS teams had and
22 their perspectives and opinions were
23 available to other teams as they developed
24 and evolved. I think we were trying to
25 incorporate their changing points of view

Q & A - Session 2

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2 as we were looking at other securities
3 related to the mortgage sector.

4 COMMISSIONER HOLTZ-EAKIN: Well, it
5 at least appears, with the benefit of
6 hindsight, that there was a rush to get
7 this stuff done, and it strikes me as
8 central to your role, and Mr. Buffett
9 indeed said you as the CEO have to be your
10 chief risk officer; and knowing the way in
11 which these ratings were done and knowing
12 when not to do them, wait and get more
13 information, we heard from the panel
14 earlier today about a great desire to
15 learn more about the cash flows underneath
16 the CDOs, but such a study was not done.

17 And pressures from outside the
18 organization to manage the market share,
19 all of which were pretty striking
20 testimony to a real effort to move things
21 out for short-term gain as the expense of
22 what turned out to your reputation and
23 your long run value.

24 MR. McDANIEL: We simply, if we
25 thought that the housing problems and

Q & A - Session 2

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2 collateral consequences from the housing
3 problem, if we had thought they were going
4 to be what they in fact have turned out to
5 be, we would have had very different
6 opinions on those securities. We -- we
7 just underestimated and dramatically
8 underestimated the significance of the
9 downturn.

10 COMMISSIONER HOLTZ-EAKIN:

11 Mr. Buffett, you've said that you're
12 interested in long-run value and not
13 short-term profits. Were you aware of the
14 problems in the structured credit,
15 housing-related structured-credit ratings?

16 MR. BUFFETT: Certainly not
17 sufficiently, no. We, to my knowledge, I
18 don't think I've ever bought a CDO or a
19 residential mortgage-backed security.
20 Actually, we bought one recently here that
21 we thought was mispriced. But it was not
22 a field that I spent a lot of time on.
23 It's just, I was more interested in
24 straight debt and equities.

25 COMMISSIONER HOLTZ-EAKIN: And were

Q & A - Session 2

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2 you satisfied with the risk measures, the
3 internal controls at Moody's and doing due
4 diligence on all the products they
5 provided ratings on?

6 MR. BUFFETT: I had no idea. I'd
7 never been at Moody's, I don't know where
8 they are located. You know, I know their
9 business model is extraordinary. And they
10 have the ability to price.

11 COMMISSIONER HOLTZ-EAKIN: I want to
12 come back to that.

13 MR. BUFFETT: Yes.

14 COMMISSIONER HOLTZ-EAKIN: But isn't
15 it at odds with being confident of their
16 long-run value to not know if they are
17 doing due diligence for the asset they
18 consider most important to their
19 reputation?

20 MR. BUFFETT: The long-run value
21 basically was in their position as part of
22 a duopoly, that arose naturally over a
23 long --

24 COMMISSIONER HOLTZ-EAKIN:
25 Independent of the quality of their

Q & A - Session 2

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2 ratings?

3 MR. BUFFETT: Well, I'm in no
4 position to judge thousands of ratings. I
5 think they misrate us. They've got us a
6 notch below where Standard & Poors has
7 us. So clearly, there's room for
8 improvement.

9 But no, I've watched their process.
10 They come out and spend -- and Standard &
11 Poor's does, too -- they'll spend three
12 hours with me. They will go to all our
13 managers, key managers in our insurance
14 businesses, but three hours every year.
15 And any question they ask me, you know, I
16 give them the answer to. I give them my
17 thoughts about the future, which I don't
18 even with our shareholders.

19 They have been diligent in terms of
20 what I have seen at the Berkshire Hathaway
21 level, and in terms of our insurance.

22 Now, they also have this incredible
23 pricing power. I think they ought to be
24 doing it at a much lower price, as far as
25 I'm concerned, and of course I think they

1 Q & A - Session 2

2 ought to be rating us right up there where
3 Standard & Poor's has, but that's another
4 question.

5 COMMISSIONER HOLTZ-EAKIN: What is
6 the source of the pricing power?

7 MR. BUFFETT: What is the source of
8 the pricing power? The source of the
9 pricing power is that, if you're an
10 insurance company, as an example, but if
11 you're any issuer of securities, people
12 expect you to have a Standard & Poor's and
13 Moody's rating, and it's very small, the
14 dollars spent as a percentage of the total
15 bond issue or whatever they may be doing,
16 but it's required. It's like an SEC
17 filing fee. I mean, basically, you're not
18 going to come to market without it.

19 And if the SEC doubles its price for
20 filing fees, I pay it. If they triple it,
21 I pay it. And there are certainly things
22 that are required as part of issuing
23 securities. And in this country, an
24 important part of the securities that are
25 issued are required to have a Standard &

Q & A - Session 2

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2 Poor's and Moody's rating attached to them,
3 and often it's by statute.

4 COMMISSIONER HOLTZ-EAKIN:

5 Mr. McDaniel, in your time and, to your
6 knowledge, for your predecessor, has
7 Moody's ever lobbied Congress or the
8 regulatory agency to enshrine in statute
9 or regulation a requirement for ratings?

10 MR. McDANIEL: No, not to my
11 knowledge. Just the opposite. We have
12 been -- we have spoken repeatedly,
13 publicly going back at least 15 years,
14 about the risks of including ratings in
15 regulation, and offering our support for
16 the reduction or elimination of the use of
17 ratings and regulation.

18 MR. BUFFETT: I would say that they
19 are required by regulation in many of
20 the --

21 COMMISSIONER HOLTZ-EAKIN: It's great
22 for pricing power.

23 MR. BUFFETT: It is. But if they
24 weren't, we still would have to have them.
25 The world may change. It may be different

1 Q & A - Session 2

2 ten years from now or 20 years from now
3 but there's no way Berkshire Hathaway even
4 with a good reputation and all earnings
5 and CPA reports attesting to the fact that
6 the 20 billion in cash is really there and
7 all that sort of thing, we will not be
8 able to issue a bond without a rating.

9 COMMISSIONER HOLTZ-EAKIN: So what I
10 hear you saying is that from the long term
11 value perspective, it's that pricing power
12 that matters, not the quality of the
13 ratings, that the internal controls were
14 not a great concern to you?

15 VICE-CHAIRMAN THOMAS: May I yield
16 the gentleman an additional two minutes?

17 COMMISSIONER HOLTZ-EAKIN: And the
18 conduct of Moody's --

19 MR. BUFFETT: I'm not in a position
20 to evaluate the internal workings --

21 COMMISSIONER HOLTZ-EAKIN: You're the
22 majority owner. I would think you would
23 be in a better position than most of us.

24 MR. BUFFETT: We own a significant
25 position in Procter & Gamble. I don't

Q & A - Session 2

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2 know what their internal controls are, I
3 don't know how they make Tide, you know,
4 and whether the processes are proper.

5 We own a lot of Johnson & Johnson.
6 They had a problem at the McNeil Lab
7 recently. There's no way I'm going to
8 know about that. Over time, I think
9 Johnson & Johnson will do fine. I don't
10 think they are going to do everything
11 perfectly but I think, generally speaking,
12 their management has done a good job and
13 will continue to do a good job.

14 COMMISSIONER HOLTZ-EAKIN: Thank you.

15 CHAIRMAN ANGELIDES: I'm going to
16 take a minute or so to probe this. Don't
17 you believe that shareholders, and boards
18 who shareholders elect, have a threshold
19 responsibility for the proper conduct of a
20 corporation? And let me add to this, I
21 mean, forget the housing price mess.
22 There's now a whole set of information
23 here, SEC reports, extensive testimony, I
24 might add, not just two or three people,
25 about the culture at Moody's that may have

Q & A - Session 2

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2 jeopardized the ratings quality,
3 information that there were inadequate
4 resources, inadequate pay, I don't think
5 it's any secret that pay at the rating
6 agencies that may be good for the bottom
7 line revenue, but that pay was not
8 sufficient to retain, to attract and
9 retain the kind of quality people you
10 have.

11 There's a meeting with Dr. Witt, who
12 testified this morning, talks about that
13 as the markets are coming apart in
14 '07-'08, there's a big employees' meeting
15 and Mr. McDaniel's there and talking about
16 how we're going to get it back on track,
17 be profitable, and a managing director,
18 after thirty minutes of this, finally
19 stands up and says, after about thirty
20 minutes of this, this is Dr. Witt's
21 testimony, "One of our MDs from the
22 corporate sector says, 'Are you going to
23 talk about how we're going to ever salvage
24 our reputation?'" You know, why didn't
25 you just say, "Gee, I didn't know?"

Q & A - Session 2

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2 Don't you think a shareholder with
3 twenty percent coupled with three or four
4 others that have fifty percent, five
5 shareholders, and the board, have a
6 threshold responsibility in regard to
7 these kind of operations? And that's
8 number one.

9 And number two is, knowing what you
10 know today, are these matters of great
11 concern is to you as a big shareholder?

12 MR. BUFFETT: I would say in terms
13 of -- in terms of the behavior of the
14 credit agencies, recognizing all their
15 limitations, aside from the real estate
16 bubble, I do not have a record of where
17 they have been further off in their
18 ratings than I would expect normal human
19 beings to be.

20 CHAIRMAN ANGELIDES: It's not a
21 matter of ratings. Take a look at the SEC
22 report. We'll post it on our web. It
23 talks about threshold issues like adequacy of
24 resources, business considerations
25 affecting ratings. If we can't count on

Q & A - Session 2

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2 corporate shareholders, who can we count
3 on?

4 MR. BUFFETT: I'll go back. We own a
5 very big chunk of Johnson & Johnson. In
6 the papers in the last week, there had
7 been a lot of material about some
8 children's product, the McNeil thing. Am
9 I going to investigate that? No. I mean,
10 overall, think I the Johnson & Johnson
11 management is going to do a fine job over
12 time and that they'll make mistakes and
13 correct them. Now, if I see something, if
14 I think they are overreaching or doing
15 certain things --

16 CHAIRMAN ANGELIDES: If you see a
17 cockroach.

18 MR. BUFFETT: Yeah. I do not
19 regard -- if they have a problem at one
20 lab, I do not regard that -- they had a
21 Tylenol problem many years ago, as you
22 know. I mean, every major --

23 CHAIRMAN ANGELIDES: I'm saying --

24 MR. BUFFETT: Let me say this:
25 Today, we have 260,000 employees at

1 Q & A - Session 2

2 Berkshire. Somebody's doing something
3 wrong now. I wish I knew who it was. I
4 wish I could find out.

5 CHAIRMAN ANGELIDES: There's a
6 difference between that and systemic
7 failure.

8 MR. BUFFETT: I don't think it's been
9 systemic failure. I think they made a
10 huge mistake on --

11 CHAIRMAN ANGELIDES: Have you
12 reviewed the SEC report, at least the
13 public one?

14 MR. BUFFETT: No, I haven't.

15 CHAIRMAN ANGELIDES: Okay, thank you.
16 Mr. Thompson?

17 COMMISSIONER THOMPSON: Thank you,
18 Mr. Chairman. Mr. McDaniel, much can be
19 said about tone at the top. And so would
20 you just tell me what outcomes or results
21 you value most from your company?

22 MR. McDANIEL: Well, it's somewhat
23 similar to a remark I made a few minutes
24 ago. Obviously, we want to, I want to
25 have a successful business. And I believe

1 Q & A - Session 2

2 the way to have a successful business is
3 to have high quality products and
4 services; in this case, ratings and
5 related research.

6 It does nothing for our business to
7 focus on the short run and to cut corners
8 and, as I've said, that's why it is so
9 deeply disappointing to have had the
10 experience that we've had in the
11 mortgage-related securities that we've
12 rated.

13 COMMISSIONER THOMPSON: So quality of
14 the product or service that you deliver
15 would be the one outcome that you value
16 most.

17 MR. McDANIEL: Yes, because I believe
18 that leads to the long-term prosperity of
19 the firm.

20 COMMISSIONER THOMPSON: So why, then,
21 is quality not a major component in the
22 compensation plans for the managing
23 directors who rate these securities?

24 MR. McDANIEL: First of all, I think
25 it is. And we have adjusted our

1 Q & A - Session 2

2 compensation programs over time in order
3 to try and align high quality product and
4 service with compensation.

5 Our senior management team, the top
6 senior-most 40 individuals in our firm now
7 have, as part of their compensation
8 program, a three-year performance share
9 plan. And for everyone involved in the
10 Moody's Investor Service rating agencies business
11 in that group, there is, fifty percent of
12 that plan is based on the statistical
13 performance of our ratings over that
14 three-year period.

15 COMMISSIONER THOMPSON: You said
16 "now." When was that change made?

17 MR. McDANIEL: This was introduced at
18 the end of last year.

19 COMMISSIONER THOMPSON: So this is
20 after the crash, if you will.

21 MR. McDANIEL: And it's really an
22 experiment. We will have to see how this
23 works. The ability to measure ratings
24 statistically over a multiyear period is
25 something we can do, and we think that

1 Q & A - Session 2

2 it's going to provide good incentive
3 alignment for our senior management.

4 COMMISSIONER THOMPSON: So in keeping
5 with the notion of tone at the top, you
6 would say that in your communications and
7 your most senior team's communications
8 with the rank-and-file of Moody's, it's
9 clear that quality trumps market share?

10 MR. McDANIEL: Well, from my
11 position, I have to be concerned with all
12 different aspects of trying to manage a
13 successful business.

14 But for our more junior employees,
15 their compensation, our analysts and
16 support analysts, their compensation is in
17 no way tied to the number of securities
18 they rate or the number of companies they
19 follow or anything of that sort.

20 COMMISSIONER THOMPSON: Or the share
21 they gain in the market.

22 MR. McDANIEL: Or the share that we
23 gain or may lose in the market.

24 COMMISSIONER THOMPSON: So the
25 gentlemen who were here earlier were

1 Q & A - Session 2

2 delusional about what objectives and goals
3 they had as they were working at Moody's.

4 MR. McDANIEL: No. As I said, I care
5 about market share, I care about market
6 coverage as much as I care about market
7 share, even if that coverage is produced
8 on an unpaid basis. I still want to have
9 market coverage. But I also care deeply
10 about ratings quality, and part of my job
11 is to balance those interests properly,
12 and to communicate that balancing of
13 interests throughout the firm in a way
14 that individuals understand that the
15 long-term success of this company has to
16 start with quality of this company,
17 ratings quality, research quality.

18 COMMISSIONER THOMPSON: Mr. Buffett,
19 much has been said about regulatory or
20 supervisory failure through this debacle.
21 The SEC, OFHEO, you name the regulator
22 that was involved, any number of them
23 missed.

24 Other than over-the-counter
25 derivatives, can you think of a major area

Q & A - Session 2

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2 of regulatory oversight that dictates
3 major changes in our system?

4 MR. BUFFETT: Well, I would say that
5 going beyond the OTC derivatives, I think
6 that addressing the problems of disguised
7 leverage, unwise leverage, which is really
8 tough, but doing it with ratios is not the
9 answer, is not the sole answer. But
10 leverage is what gets people in trouble.
11 I mean, we've run Berkshire that way, and
12 when people stretch and they get rewards
13 for it, they are inclined to stretch more.

14 I think I heard some testimony in an
15 earlier panel you had about whether having
16 the objective of return on equity, whether
17 that might cause people to do different
18 things. Well, of course it does cause
19 people to do different things. The
20 easiest way to jack up return on equity is
21 to leverage.

22 So addressing that, addressing it
23 wisely I think is very tough. But I think
24 that that's the most important thing in
25 the regulatory world.

1 Q & A - Session 2

2 COMMISSIONER THOMPSON: Are you as
3 surprised as most Americans are that,
4 post-Enron, we could have
5 off-balance-sheet financing that would
6 have been perhaps at the core of this
7 collapse?

8 MR. BUFFETT: Yeah, I don't know that
9 it's necessarily at the core, but I
10 certainly was surprised when Citigroup
11 turned out to have SIVs, you know, in the
12 many tens of billions, which is just a way
13 of jacking up leverage again. I was
14 surprised. I mean, now, I may not have
15 read the 10-Ks carefully enough or
16 anything, but there certainly were no
17 flashing signs that said, "We're using a
18 bunch of leverage off balance sheet."

19 So I think that -- I think we're
20 always going to be fighting the human
21 tendency to borrow more money than you
22 should. And households did it because
23 they thought that houses were going to go
24 up next year. They really didn't think it
25 made any difference what their income was,

1 Q & A - Session 2

2 because they'd refi in a year or two.

3 It's just such a human tendency that you
4 need something on the governmental side to
5 counterbalance that.

6 COMMISSIONER THOMPSON: Thank you
7 very much.

8 CHAIRMAN ANGELIDES: Before we go to
9 Ms. Born, I just -- can I just ask if we
10 get supplied with a couple of pieces of
11 information? Can we have made available
12 to us the board's evaluation of your CEO?
13 They do an annual evaluation?

14 MR. McDANIEL: I submit a
15 self-evaluation which the board then
16 reviews and discusses among themselves
17 and --

18 CHAIRMAN ANGELIDES: Can you provide
19 access to that to us?

20 MR. McDANIEL: Yes.

21 CHAIRMAN ANGELIDES: Secondly, could
22 we also have access to any internal
23 comprehensive reviews that have been done
24 about practices at Moody's to the extent
25 we haven't already received them, in other

1 Q & A - Session 2

2 words, reviewing systemic breakdowns that
3 might have been done? Have you done
4 comprehensive reviews, internally, in the
5 wake of all this?

6 MR. McDANIEL: Well, we've done a
7 number of reviews, and if there's anything
8 that we haven't provided that's
9 appropriate, I certainly would instruct
10 our people to do so.

11 CHAIRMAN ANGELIDES: And then
12 finally, I think the company did a review
13 with a law firm of Mr. Kolchinsky's
14 employment retaliation allegations. Can
15 that be made available to us?

16 MR. McDANIEL: I'm not sure. I don't
17 know if there is a report on that or not.

18 CHAIRMAN ANGELIDES: I believe there
19 is. I believe there is. Check it out.
20 If Mr. Kolchinsky agrees, I would hope
21 that you would also. Can you please check
22 it out? Thank you.

23 MR. McDANIEL: I will check. Thank
24 you.

25 VICE-CHAIRMAN THOMAS: For the

Q & A - Session 2

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2 record, especially since we have witnesses
3 in front of us which we say you ought to
4 know more than about your business, and
5 someone else's business, notwithstanding
6 that you were looking at it from a
7 different perspective, I would like to
8 place on the record the fact that the
9 Commission will examine the assertion that
10 we've made, which we believe to be
11 accurate, that there were various rates
12 charged for different tranches and, if
13 need be, correct the record and if not, be
14 proud that we were right. But we're going
15 to get the answer correct one way or the
16 other.

17 MR. McDANIEL: As I said, I did not
18 have the opportunity for a comprehensive
19 check on that.

20 VICE-CHAIRMAN THOMAS: And neither
21 have we, but we believe it to be accurate
22 so we're going to get to the bottom of it.
23 Thank you, Mr. Chairman.

24 CHAIRMAN ANGELIDES: Ms. Born?

25 COMMISSIONER BORN: Thank you very

Q & A - Session 2

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2 much. And thank you both for appearing
3 before us.

4 Mr. Buffett, I'm going to take
5 advantage of your being here by asking you
6 about derivatives and your views of them.

7 As Mr. Wallison has said, your 2002
8 Berkshire Hathaway shareholder letter
9 famously referred to derivatives, and this
10 is, I believe, all derivatives, not just
11 credit derivatives, as, "financial weapons
12 of mass destruction, carrying dangers
13 that, while now latent, are potentially
14 lethal."

15 You also presciently said that they
16 are "time bombs, both for the parties that
17 deal in them, and the economic system."

18 And more recently, in your 2008
19 shareholder letter, you said that Bear,
20 Stearns' collapse demonstrated the time
21 bomb of counterparty risk that you had
22 earlier described. And I would ask that
23 these two shareholder letters be placed in
24 the record.

25 CHAIRMAN ANGELIDES: They will be.

1 Q & A - Session 2

2 COMMISSIONER BORN: I would like you
3 to describe your view of the role that
4 derivatives has played in the current
5 financial crisis.

6 MR. BUFFETT: Well, they accentuated
7 enormously, in my view, the leverage in
8 the system. The huge dependency on
9 counterparties and one of the -- one of
10 the beauties of the Stock Exchange over
11 the years is that you've had now a
12 three-day clearing system because people
13 realize that if you have a contract, and
14 it's six months later that it settles,
15 that a lot of things can happen in those
16 six months.

17 In fact, I think the Kuwait Stock
18 Exchange got into big trouble some years
19 back because they had got a very delayed
20 clearing arrangement. And derivatives are
21 contracts with sometimes unbelievably long
22 settlement periods.

23 Generally, we inherited 23,000
24 derivative contracts. I could have hired
25 the 50 smartest Ph.D.s out of MIT to

Q & A - Session 2

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2 prepare some kind of report that would
3 tell me the risk I was bearing, and I
4 wouldn't have gotten the answer. I mean,
5 it was impossible to get your mind round
6 that. I mean, we had nine hundred
7 counterparties. I couldn't pronounce the
8 names of a couple of hundred of them. I
9 mean, they were foreign institutions I
10 never heard of.

11 In effect, the integrity of our
12 balance sheet at Gen Re was dependent on
13 all these people behaving at times in the
14 future, which strung out to almost a
15 hundred years in a few cases.

16 So the only answer was to get out of
17 the business. I couldn't design a system
18 that would enable me to know what the hell
19 was going on.

20 So if that was my problem with 23,000
21 of them, you know, I've read about vastly
22 greater numbers that existed at Bear,
23 Stearns or at Lehman and something else.
24 I just think institutions can get out of
25 control and I don't think that's a good

Q & A - Session 2

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2 thing for the system, particularly when,
3 if they are large enough, if they get out
4 of control, it means that society gets
5 interrupted in a very, very major way.

6 COMMISSIONER BORN: Well, following
7 up on that notion, I think you stated in
8 your 2008 letter that the Federal Reserve
9 rescued Bear Stearns because the
10 counterparty risk posed by its enormous
11 position in derivatives would have
12 created, "a financial chain of
13 unpredictable magnitude." Is that
14 correct?

15 MR. BUFFETT: That's correct. And
16 what happened of course, I think, in
17 Lehman was that we saw an example of that.
18 I think it was underappreciated. I'm not
19 saying I would have called it right,
20 either. But when Lehman failed, an
21 institution that was showing 15 or so
22 billion of book equity, some of it was
23 real estate deals and some of that; but in
24 the end, the debt of 140 million, or
25 whatever it was, is now selling for maybe

Q & A - Session 2

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2 30 billion in the market, so that's 110
3 billion. That kind of money shouldn't
4 disappear overnight.

5 COMMISSIONER BORN: And with respect
6 to the other large derivatives dealers,
7 AIG and the large investment banks and
8 bank holding companies that needed TARP
9 money, do you think that played a role
10 with respect to them as well?

11 MR. BUFFETT: Yeah, I think the
12 government did the right thing in stepping
13 in at AIG, but I don't think AIG should
14 have gotten there in the first place. And
15 AIG, as you probably know better than I, I
16 think there was three hundred billion of
17 derivatives that were essentially designed
18 for something called regulatory arbitrage,
19 which was just a way of relieving the
20 capital pressures on European banks
21 because they got the AAA AIG transferred
22 over.

23 Well, if you get enough of that sort
24 of thing going on in financial system,
25 you're going to have a problem.

Q & A - Session 2

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2 COMMISSIONER BORN: Well, in light of
3 the problems that you and the other people
4 at Berkshire Hathaway experienced with the
5 general re derivatives position, what's
6 your view of the ability of these enormous
7 derivatives dealers to successfully manage
8 their companies in light of their enormous
9 positions? For example, they hold
10 millions of contracts.

11 MR. BUFFETT: Yes.

12 COMMISSIONER BORN: At year-end 2009,
13 the OCC said that JPMorgan's position was
14 \$78.6 trillion in notional amount. And
15 can such enormous, complex books of
16 business be successfully managed by human
17 beings?

18 MR. BUFFETT: I think they are
19 dangerous. I would say this: I don't
20 think I could manage it. It's hard
21 to -- it's hard for me to imagine a
22 system -- it's hard for me to imagine a
23 regulatory system that could supervise
24 something like that. And of course, one
25 of the ironies is that, with only four big

Q & A - Session 2

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2 auditing firms in the United States, I
3 will guarantee you that if you take two
4 big firms that are audited by the same
5 auditor, you will find different prices
6 attributed to given derivatives contracts
7 at the same time that the auditor attests
8 to.

9 I mean, it's mind-boggling, and the
10 23 -- you mentioned our getting out of it.
11 We lost \$400 million in a very benign
12 period with no pressures on us, able to
13 exit, and maybe that's why Lehman lost a
14 hundred billion. But it's very dangerous
15 stuff.

16 COMMISSIONER BORN: You also pointed
17 out that, in your, I think, most recent
18 shareholder letter, the 2008 one that I'm
19 referring to, not the 2009, that it's
20 almost impossible for an investor, looking
21 at the financial statements of these big
22 derivatives dealers, to really know what
23 their financial situation is. Isn't that
24 right?

25 MR. BUFFETT: And I think if you

Q & A - Session 2

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2 added a thousand pages of disclosure, it
3 would be impossible, too. I try in our
4 report, because we only have 250
5 positions, I try to tell the shareholders
6 what basically the positions are, and I
7 think I can do that. But that's because
8 there's only a couple of classes of them,
9 and I can describe them. And I think so
10 that anybody that knows accounting, at
11 least, can understand what I'm talking
12 about.

13 But I don't know how -- I don't know
14 how to read a 10-K, whether it's three
15 hundred pages long or three thousand pages
16 long, that can describe a million
17 derivative contracts.

18 COMMISSIONER BORN: Now, you're a
19 very sophisticated investor and I assume
20 in going into derivatives contracts, you
21 carefully examine what the embedded risks
22 are, what the leverage is.

23 I'm concerned that so many
24 municipalities and other large
25 institutional investors that may not have

Q & A - Session 2

1
2 your sophistication have gone into these
3 contracts.

4 I'm concerned that the embedded risks
5 in the leverage aren't fully understood.

6 MR. BUFFETT: I'm sure you're right.
7 You had Orange County, you had Jefferson
8 County in Alabama. But more importantly,
9 if you go back a ways, when Bankers Trust
10 was selling them to P&G, I mean, can you
11 imagine bamboozling the CFO of P&G? So
12 it -- when you get these exploding type
13 contracts where, if you hit a given
14 threshold, everything gets multiplied by
15 ten, or -- I don't even know, you know,
16 why the world they are needed. But those
17 contracts are out there, and I think many
18 times, the people that are buying them
19 don't know what they are doing.

20 COMMISSIONER BORN: There's been
21 enormous growth in this market. The Bank
22 for International Settlement said that
23 globally, the market amounted to more than
24 \$614 trillion at the end of last year.
25 There's enormous innovation that's been

Q & A - Session 2

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2 going on, financial innovation. There's
3 enormous complexity in these contracts. I
4 understand that they are very useful for
5 hedging purposes, and I think that's a
6 perfectly legitimate purpose. I think you
7 need some speculators in order to allow
8 hedgers to effectively enter into
9 positions.

10 I'm concerned about the enormous
11 growth of purely speculative transactions
12 in the market. And I wonder what your
13 view is as to the economic benefit to our
14 society from that speculation.

15 MR. BUFFETT: I wrote a letter in
16 1982 to Congressman Dingell, giving my
17 views when they were introducing the S&P
18 index future. And I said there are
19 legitimate uses for it in hedging out the
20 long positions and so on, but I said,
21 overwhelmingly, it's going to be become a
22 gambling vehicle. And I would distinguish
23 between speculative and gambling.
24 Gambling involves, in my view, the creation
25 of a risk where no risk need be created.

Q & A - Session 2

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2 Now, obviously, you plant a crop in
3 the spring and you're going to harvest it
4 in the fall, you're speculating on what
5 prices are going to be in the fall for
6 your corn or oats or whatever that it may
7 be, and you may lay that off on some other
8 speculator. But that's a risk that that
9 system has to take. You can't grow it in
10 one day.

11 But when you start wagering on --
12 well, on stock index futures, I think that
13 gambling instincts are very strong in
14 humans. I mean people went a thousand
15 miles to a bunch of sand originally, you
16 know, and they built a whole city on it,
17 and they would travel on planes and go to
18 all kinds of things to do mathematically
19 unintelligent activity.

20 So it exists. States prey on it with
21 their lotteries. And these contracts are
22 made to order for it, because you can do
23 it on a big scale, and you could do it,
24 and it's very easy to do and you don't
25 have to get on a plane, you don't have to

1 Q & A - Session 2

2 break a sweat, and --

3 COMMISSIONER BORN: You don't have to
4 put down any money.

5 MR. BUFFETT: Yes. And the more
6 complex, generally speaking, the more
7 profit there's going to be for the
8 derivatives dealer. You can take that as
9 a given.

10 When I was at Salomon, originally you
11 talked about interest rate futures, fixed
12 to floating or foreign exchange. And then
13 they became known as plain vanilla
14 contracts because there wasn't any money
15 in them. It got competed a way. So they
16 invented more exotic instruments and
17 that's where the money was.

18 COMMISSIONER BORN: Well, I would ask
19 is that the 1982 letter by Mr. Buffett to
20 John Dingell be placed in the record. One
21 last question --

22 CHAIRMAN ANGELIDES: We have it.
23 It's typed on a Smith-Corona typewriter,
24 apparently.

25 COMMISSIONER BORN: It's a carbon

Q & A - Session 2

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2 copy. Mr. Buffett, in your view, is the
3 derivatives market still a time bomb
4 ticking away?

5 MR. BUFFETT: I would say so.

6 COMMISSIONER BORN: Thank you.

7 VICE-CHAIRMAN THOMAS: Mr. Chairman,
8 will you yield Commissioner Holtz-Eakin
9 one minute?

10 COMMISSIONER HOLTZ-EAKIN:

11 Mr. Buffett, I really appreciated that
12 testimony because what you said about the
13 derivatives and your response to them was,
14 you needed to manage your balance sheet,
15 in which case you just got rid of balance
16 sheets exposed to that. And that's an
17 unusual statement in the context of these
18 hearings. We've heard again and again and
19 again, that whether it be a Citigroup or a
20 Fannie Mae, that, you know, they didn't
21 manage their balance sheet. They just got
22 overwhelmed by something so large that it
23 could not have been imagined, and had
24 everybody simply managed the risks on their balance sheets
25 appropriately, something that large could

1 Q & A - Session 2

2 not have emerged.

3 And so it is important to come back
4 to that and I think it's important in
5 light of this hearing because, at the
6 heart of the question that faces us today,
7 is the question of what was the management
8 of the balance sheet of these rating
9 agencies? Was the asset being managed,
10 their reputations, and if so, was due
11 diligence done in pricing the most
12 valuable risks, risks that are correlated
13 with the most important thing going on in
14 the economy, or was effort devoted
15 elsewhere to the ability to manage volume
16 and take advantage of pricing power?
17 Which asset management strategy was in
18 place? Thank you.

19 CHAIRMAN ANGELIDES: Go ahead --

20 VICE-CHAIRMAN THOMAS: Mr. Chairman,
21 I would yield Commissioner Wallison the
22 remainder of the time until the 2 o'clock
23 end of this portion --

24 CHAIRMAN ANGELIDES: It's 2 o'clock,
25 but why don't we just say a couple of

1 Q & A - Session 2

2 minutes, then.

3 VICE-CHAIRMAN THOMAS: I kind of like
4 the more dramatic way I said it.

5 CHAIRMAN ANGELIDES: Or a minute, which
6 is an empty offer since it's 2:01.

7 COMMISSIONER WALLISON: Stop fighting
8 guys, let me ask my question.

9 One of the issues that is central to
10 this hearing today it seems to me is
11 whether the problems at Moody's, and I
12 think you'd all agree there were some
13 problems at Moody's, are systemic in the
14 sense that they extend across the board
15 throughout Moody's, or are simply unique
16 to the housing mortgage area.

17 And one of the ways we can address
18 that is by looking at how successful
19 Moody's, or unsuccessful Moody's has been
20 in rating non-housing asset-backed
21 securities.

22 So Mr. McDaniel, what I would like
23 you to do is to assemble as much
24 information as you can on the other kinds
25 of non-housing asset-backed securities

Q & A - Session 2

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2 that Moody's has rated, and give us a
3 sense of the number of downgrades or even
4 upgrades that occur from time to time in
5 those securitizations. That way, we can
6 compare the way Moody's operates as a
7 general rule, against what happened in the
8 very unusual housing area which, as you've
9 pointed out, has shocked everyone,
10 including the estimable Mr. Buffett.

11 So what I think we want to do is see
12 that data and if you if you'd furnish it
13 to us, get it together and furnish it to
14 us, even without a question from us, that
15 would be very helpful.

16 MR. McDANIEL: Be happy to do so,
17 sir.

18 COMMISSIONER WALLISON: Thank you.

19 CHAIRMAN ANGELIDES: Last comment as
20 we wrap up here. As I've read the
21 materials provided by the staff, read
22 innumerable interviews, other background
23 materials, I'm struck with the fact that,
24 with respect to the credit rating
25 agencies' practices and models, seems to

Q & A - Session 2

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2 me that the question isn't so much why did
3 this system fail, but why has it lasted so
4 long.

5 And in that vein, I just want to ask
6 you today what risks do you see from the
7 current credit rating models? In the same
8 way you said there were risks for
9 derivatives, do you see extant risks,
10 current risks from the model essentially
11 being unchanged from where it was when the
12 mistakes, the disaster, however you
13 characterize it, happened?

14 MR. BUFFETT: Well, the huge
15 question, if you were running a rating
16 agency now, if I were running a rating
17 agency --

18 CHAIRMAN ANGELIDES: Or if you owned
19 13 percent in stock--

20 MR. BUFFETT: -- how would I rate
21 states and major municipalities? I mean,
22 if the federal government will step in to
23 help them, they are AAA. If the Federal
24 government won't step in to help them, who
25 knows what they are? I mean, if you're

Q & A - Session 2

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2 looking now at something where you could
3 look back later on and say, "These ratings
4 were crazy," that would be the area.
5 Because it's bimodal. I mean,
6 basically -- I don't know how I would rate
7 those myself now. I mean, in other words,
8 because it's a bet on how the federal
9 government will act over time.

10 CHAIRMAN ANGELIDES: But the real
11 question -- well, but also, in that vein,
12 have you looked at whether the resources,
13 the discipline, the capacity is there
14 internally at Moody's?

15 MR. BUFFETT: I don't think -- I
16 don't think Moody's or Standard & Poor's or
17 I can come up with anything terribly
18 insightful about the question of state and
19 municipal finance five or ten years from
20 now, except for the fact that there will
21 be a terrible problem and the question become what the federal
22 government --

23 CHAIRMAN ANGELIDES: But does the
24 model, irrespective of the particular
25 imminent risk, is the model one that still
26 presents risk, given what you've heard and

Q & A - Session 2

1
2 learned today in looking at Moody's?

3 MR. BUFFETT: I think-- you're talking
4 about model--

5 CHAIRMAN ANGELIDES: Talking about
6 the model, issuer pays, all the associated
7 issues we've raised with respect to the
8 Moody's business model.

9 MR. BUFFETT: I think there's utility
10 to the rating agencies. I think there's
11 less utility to somebody like me, who's in
12 the business of trying to evaluate credits
13 day by day and been doing it a lot of
14 years. But I think there's utility to the
15 model.

16 VICE-CHAIRMAN THOMAS: Mr. Chairman,
17 we might as well end on a high note. If
18 we're really looking at the states and
19 municipalities and the comfort that we
20 would get from the federal government
21 proposing to intervene, which then makes
22 the states and the municipalities AAA,
23 there are a lot of folk out there
24 wondering who watches over the watcher in
25 terms of how the federal government is

Q & A - Session 2

1
2 able to do that.

3 Of course, we know they can print
4 their own money and do a few other things,
5 but they have been doing that for some
6 time now, and there is some concern about
7 that as well. I do like to go back to
8 what we talked about in the beginning,
9 behavior should have consequences. That
10 should apply to people, institutions and
11 governments.

12 CHAIRMAN ANGELIDES: Thank you very
13 much, witnesses.

14 We are going to take a break,
15 members, until 2:30 and we will reconvene
16 in this room. Thank you, Mr. Buffett,
17 thank you, Mr. McDaniel.

18 (Luncheon recess: 2:05 p.m.)
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2 A F T E R N O O N S E S S I O N

3 (2:48 p.m.)

4 CHAIRMAN ANGELIDES: The financial
5 crisis inquiry about will come back to
6 order for our third and final session on
7 the credibility of credit ratings, the
8 investment decisions made based on those
9 ratings and the financial crisis. In this
10 last session, we will have with us,
11 Mr. Mark Froeba and Mr. Richard Michalek,
12 correct? Who will be testifying this
13 afternoon and to whom we will then direct
14 questions.

15 So, gentlemen, thank you very much
16 for being here. We know you have now
17 submitted written testimony and would like
18 to ask you to give us verbal testimony of
19 no more than five minutes to lead off this
20 panel, and Mr. Froeba, we'll start with
21 you.

22 Oh, yes, I forgot, thank you. I just
23 got reminded.

24 My 56-year old brain. Will you
25 please stand and raise right hands so I

1 Proceedings

2 can swear you in.

3 M A R K F R O E B A ,

4 R I C H A R D M I C H A L E K,

5 Having been duly sworn, testified as
6 follows:

7 CHAIRMAN ANGELIDES: Good, thank you
8 very much. So the other thing I want for
9 do before we start here, as our agenda
10 reflected, Mr. Brian Clarkson, the former
11 president and COO of Moody's, was to
12 testify here today. He did submit, I
13 believe, his written testimony. And I --
14 but he is unable to be with us. For the
15 record, I'm going to read a statement from
16 Christina Clarkson, whom I have been given
17 to understand is Mr. Clarkson's spouse,
18 and here's the statement for the record
19 that I've been asked to read:

20 "Brian was rushed to the emergency
21 room at Beth Israel Hospital late last
22 night suffering from acute pain in his
23 side. He's been admitted to the hospital
24 and will undergo surgery later today.
25 Brian has appreciated the opportunity to

Proceedings

1
2 participate fully with the FCIC. He
3 submitted his testimony to the Commission
4 and had every intention to participate
5 but regrets that he is unable to attend
6 today's hearing."

7 So I wanted to indicate that for the
8 record. We do have written testimony from
9 Mr. Clarkson. We also interviewed
10 Mr. Clarkson, and we will be presenting
11 written interrogatories to Mr. Clarkson
12 also.

13 With that, Mr. Froeba --
14 Mr. Vice-Chair, do you have a comment?

15 VICE-CHAIRMAN THOMAS: No, I just
16 said we're putting him on the 15-day
17 disabled list. That means that we can
18 bring him back.

19 CHAIRMAN ANGELIDES: All right,
20 terrific. With that, Mr. Froeba, if you
21 would begin your testimony.

22 MR. FROEBA: Sure. Rick and I have
23 talked about this before. I think my
24 statement is going to be a bit longer than
25 five minutes, which may not be

1 Opening - Froeba

2 appropriate. But if necessary, maybe he
3 would be willing to yield, and with your
4 consent, yield some of his time to me.

5 CHAIRMAN ANGELIDES: How long do you
6 think your statement will take?

7 MR. FROEBA: I regrettably have not actually tried it out
8 but hopefully it will be

9 finished in about seven minutes. But if
10 not, I can bring it to a close whenever
11 you want me to.

12 VICE-CHAIRMAN THOMAS: Mr. Chairman,
13 I move that we adopt the quality rule
14 rather than the quantity rule. So
15 depending on how good it is.

16 MR. FROEBA: Okay. I'll try to make
17 it entertaining. Perhaps some of you have
18 already read it, and can tell me what you
19 think.

20 Anyway, my name is Mark Froeba. I'm
21 a lawyer. I live and work here in New
22 York City, I am a 1990 graduate of the
23 Harvard Law School cum laude. In 1997, I
24 left Skadden, Arps in New York to join the
25 derivatives group at Moody's.

26 I left Moody's in 2007 as a Senior

Opening - Froeba

1
2 Vice-President. At that time, I was team
3 leader of the CLO team, co-chair of most
4 CLO rating committees and jointly
5 responsible for evaluating all new CLO
6 rating guidelines.

7 I am happy to say that the majority
8 of CLOs have exhibited a high level of
9 stability throughout this crisis. Today,
10 I'm currently engaged with PF2 Securities
11 Evaluations, a New York-based firm which
12 consults on CDO securities.

13 You've asked me to answer several
14 questions about Moody's and its role in
15 the current financial crisis. My answer
16 to these questions falls into three parts:

17 First, I will describe in general the
18 cultural revolution that Moody's senior
19 management imposed at Moody's and some
20 compelling evidence of its impact;

21 Second, I will describe the
22 techniques Moody's senior management used
23 to implement this revolution, and why they
24 were successful;

25 And finally, if I have time, and I

1 Opening - Froeba

2 don't think I will, I will describe a
3 particularly egregious example of how the
4 revolution corrupted the process of rating
5 analysis.

6 CHAIRMAN ANGELIDES: We can make that
7 one of our first questions.

8 VICE-CHAIRMAN THOMAS: Yes, make that
9 one first.

10 MR. FROEBA: Okay. Well, I'll get to
11 it. Maybe we'll get to it. I'll at least
12 give you a summary of it. Anyway,
13 returning to the --

14 VICE-CHAIRMAN THOMAS: In all
15 seriousness, let me say, don't worry about
16 that one. That will be my first question
17 and you can do it on my time.

18 MR. FROEBA: Thank you. The cultural
19 revolution at Moody's:

20 The story of Moody's role in the
21 financial crisis begins sometime in the
22 year 2000, the year that Dun & Bradstreet
23 Corporation and Moody's Corporation became
24 separate, independent publicly-traded
25 companies; and I might add that Moody's

1 Opening - Froeba

2 senior managers were first able to begin
3 receiving compensation in the form of
4 stock options and other interests directly
5 in Moody's Corporation.

6 Before then, Moody's had an extremely
7 conservative analytical culture. Moody's
8 analysts were proud to work for what they
9 believed was by far the best of the rating
10 agencies. Everyone understood that for
11 any new product that was unusual or
12 complex, the Moody's rating was the one to
13 get; and that without it, it would be
14 difficult or even impossible to market
15 the new product. In short, the Moody's
16 of that time had the stature and maybe
17 even the power to stop something like the
18 subprime bubble, had it arisen then.

19 Unfortunately, by the time the bubble
20 arrived, Moody's had deliberately
21 abandoned its stature, surrendered its
22 power and given up its analytical
23 distinctiveness. How did it happen?

24 Under the guise of making Moody's
25 more business-friendly, for example,

1 Opening - Froeba

2 making sure that analysts would return
3 telephone calls, Moody's senior managers
4 set in motion a radical change in Moody's
5 analytical culture that not only changed
6 the rating process but also profoundly
7 affected Moody's ratings.

8 When I joined Moody's in late 1997 an
9 analyst's worst fear was that we would
10 contribute to the assignment of a rating
11 that was wrong. When I left Moody's, an
12 analyst's worst fear was that he would do
13 something, or she, that would allow him or
14 her to be singled out for jeopardizing
15 Moody's market share.

16 The best example of this was
17 described in a Wall Street Journal article
18 about Moody's managing director, Brian
19 Clarkson, published in April of 2008. As
20 that article reports, Brian Clarkson
21 quadrupled Moody's market share in the
22 residential mortgage securities group by
23 simply firing or transferring nearly all
24 the analysts in the group and replacing
25 them with analysts willing to apply a new

Opening - Froeba

1 rating methodology. As I am quoted saying
2 about this new approach to the bottom line
3 at Moody's in The Wall Street Journal
4 article, there was never an explicit
5 directive to subordinate rating quality to
6 market share; there was, rather, a
7 palpable erosion of institutional support
8 for any rating analysis that threatened
9 market share.
10

11 My mom asked me once what did that
12 actually mean. It was a little dense, but
13 now I'll explain to you what it means.
14 Moody's senior managers never set out to
15 make sure that Moody's rating answers were
16 always wrong. Instead, they put in place
17 a new culture that would not tolerate for
18 long any answer that hurt Moody's bottom
19 line. Such an answer became, almost by
20 definition, the wrong answer, whatever its
21 analytical merit.

22 However, arriving at an accurate
23 answer was never objectionable, so long as
24 that answer did not threaten market share
25 and revenue. For this reason, there are

1 Opening - Froeba

2 some structured finance securities where
3 Moody's ratings continue to be accurate
4 and of high quality. This is not evidence
5 of rating integrity. It is simply
6 evidence that for these types of
7 securities, Moody's was not exposed to
8 rating competition.

9 In my opinion, wherever Moody's
10 encountered material market share
11 pressure, rating competition, we can
12 expect to see that its ratings become
13 indistinguishable from the ratings of its
14 competitors.

15 Is there evidence that this is what
16 really happened? I do not expect that you
17 will find e-mails, minutes of meetings or
18 memoranda setting forth the plan to change
19 Moody's culture. However, the best
20 evidence is the most obvious. Simply plot
21 Moody's market share and revenue over time
22 for any particular structured finance
23 security, and compare it to the timing of
24 material changes in Moody's rating
25 methodology for that security. You should

1 Opening - Froeba

2 find that Moody's consistently responded
3 to the onset of market share and revenue
4 pressures by initiating material
5 methodological changes.

6 There is also evidence of this from
7 Moody's own internal business
8 effectiveness survey, a periodic survey
9 that allowed Moody's employees to
10 criticize superiors anonymously. The BES
11 results were apparently so disturbing in
12 one survey that Brian Clarkson himself
13 visited various structured finance group
14 meetings, including a meeting of my group
15 at Moody's, to report that junior analysts
16 had complained in the BES that accurate
17 rating analysis was more and more being
18 subordinated to considerations of market
19 share and revenue in the rating process,
20 and two, to reassure everyone that this
21 was not at all the case.

22 Of course, at this meeting, Brian
23 seemed merely to pay lip service to a
24 principle that his other words and actions
25 contradicted. He did not describe any

1 Opening - Froeba

2 effort by Moody's to uncover the cause of
3 these complaints; moreover, he did not
4 describe anything Moody's had done to
5 eliminate those causes. Together this had
6 the effect of reinforcing the very view
7 that he was supposed to be there to
8 correct. That market share considerations
9 really were much more important than
10 getting the answer right. And in the end,
11 neither he nor anyone in Moody's
12 management did anything to unwind the many
13 changes that provoked these BES survey
14 results.

15 What were the changes, what were the
16 techniques they used to accomplish the
17 culture change? There were two ways --

18 CHAIRMAN ANGELIDES: Just to do a
19 little check here, how far along are you?

20 THE WITNESS: I would say I'm about
21 halfway.

22 CHAIRMAN ANGELIDES: I'm going to ask
23 you to see if you can wrap up in the next
24 minute or two, all right?

25 MR. FROEBA: All right.

1 Opening - Froeba

2 CHAIRMAN ANGELIDES: Two minutes.

3 MR. FROEBA: Okay. Well, Rick was
4 going to cede me a couple minutes--

5 CHAIRMAN ANGELIDES: Do me a favor,
6 just, I agree, just two minutes, hit the
7 high points, and then we can go to
8 questions.

9 MR. FROEBA: There were ways that
10 Moody's senior management imposed a new
11 culture on Moody's analysts. First, they
12 used intimidation to create a docile
13 population of analysts afraid to upset
14 investment bankers, and ready to cooperate
15 to the maximum extent possible.

16 Second, they emboldened investment
17 bankers, gave them confidence that they
18 could stand up to Moody's analysts and
19 gave them reason to believe that Moody's
20 management would, where necessary, support
21 the bankers against its own analysts.

22 And I will now skip over most of my
23 discussion of the ways in which Brian used
24 threats of employment termination to
25 intimidate analysts. But before I leave

1 Opening - Froeba

2 a rating agency, independence of mind
3 among managers and analysts is a very
4 valuable thing if you are looking for the
5 right answer, and a very inconvenient
6 thing if you are looking for an answer to
7 enhance revenue and profit.

8 For this reason, strong academic
9 credentials and the independence of mind
10 that comes with them came to be valued
11 less in promotion decisions than they had
12 once been. At first, all the MDs in the
13 derivatives group on the quantitative side
14 had very distinguished academic
15 credentials. One had a Ph.D. in
16 economics from Stanford; other another a
17 Ph.D. in mathematics from MIT, a third a
18 Ph.D. in statistics from Wharton; one
19 other did not have a Ph.D., but had both
20 an MBA and an M.S. in statistics.

21 Later MDs did not have such
22 distinguished credentials. For example,
23 into the midst of all these academic
24 credentials, Brian promoted a new MD, Yuri
25 Yoshizawa, who had not earned any graduate

1 Opening - Froeba

2 degree at all. Her only academic
3 credential is an undergraduate degree with
4 a major emphasis in international
5 relations.

6 Of course, Yuri is a capable person
7 with undeniable skills. Nevertheless, the
8 marked contrast between her academic
9 qualifications and those of her
10 predecessors and colleagues at least
11 invites the inference that her selection
12 was intended to keep the scope of her
13 analytic work directed within new and more
14 limited boundaries.

15 CHAIRMAN ANGELIDES: If you would
16 please wrap it up.

17 MR. FROEBA: Yes. It cannot be the
18 case with such a limited academic
19 background that Yuri was expected to
20 interact as an equal with bankers who
21 themselves had much stronger and more
22 relevant backgrounds.

23 And then Moody's, without completing
24 that thought, and -- I'll just say in
25 summary, Moody's also in addition to

1 Opening - Michalek

2 intimidating analysts, went through a
3 whole series of steps that encouraged
4 bankers against the analysts.

5 And that will be the conclusion of my
6 testimony.

7 CHAIRMAN ANGELIDES: And we can get
8 to your comments and questions.

9 Mr. Michalek?

10 MR. MICHALEK: Mr. Chairman --
11 Mr. Vice Chairman, fellow commissioners.
12 My name is Richard Michalek, and I want to
13 thank you and your staff for inviting me
14 to participate in today's hearings.

15 I'm a former employee of Moody's. I
16 joined the structured derivatives products
17 group at Moody's in June of 1999. My
18 position was eliminated in December of
19 2007. At the end of my tenure, I held the
20 title of Vice-President, Senior Credit
21 Officer. My general responsibilities
22 included performing legal analyses on the
23 structure and documentation of complex
24 structured finance transactions in order
25 to assign a rating to that transaction,

1 Opening - Michalek

2 and to assist in the development and
3 refining of rating practices, policies and
4 methodologies used by the group.

5 My regular responsibilities included
6 participating in rating committees within
7 the group and, on request, for other
8 groups; consulting on legal matters for
9 other groups in New York, London and the
10 Asian offices of Moody's when requested,
11 and speaking at industry conferences on a
12 wide variety of legal and structural
13 issues.

14 I also prepared and published the CDO
15 group's quarterly and annual review and
16 survey of activity, and I assisted with
17 the legal portion of semiannual training
18 sessions for all new hires in the
19 structured finance department.

20 During my last year at Moody's, my
21 primary responsibilities were split
22 between serving as a senior legal analyst
23 on a team responsible for developing,
24 refining and implementing the methodology
25 for assigning ratings to highly complex

1 Opening - Michalek

2 credit derivative product companies, and
3 being a project leader responsible for
4 developing a methodology for rating
5 collateral managers.

6 My testimony today is based on, and
7 primarily limited to, my experience
8 working in the CDO group at Moody's. And
9 while I had the opportunity to interact
10 with several other groups, I do not
11 profess any particular expertise or
12 advanced knowledge of the methodologies or
13 practices employed in those groups.

14 My testimony today is also not being
15 delivered with the intention to defame
16 Moody's or bring harm to any individual or
17 stand in judgment of individual behavior.
18 On the contrary, as I hope my oral remarks
19 and written statement will illustrate, I
20 believe that imperfections, flaws and
21 failures observed in the credit crating
22 products for structured derivative
23 products are neither surprising nor
24 unexpected in light of framework of
25 incentives presented to the competent and

1 Opening - Michalek

2 otherwise rational people comprising the
3 credit rating agencies.

4 In theory, credit rating agencies
5 serve the important function of providing
6 buyers and sellers of credit, that is,
7 investors in and issuers of a promise to
8 pay, with an independent measure of the
9 risk presented. Ideally, these agents are
10 independent. And because of repeat
11 experience and rationalization of cost,
12 they should be able to provide this
13 measure of risk at a lower cost than would
14 otherwise be faced if the buyers or
15 sellers produced the analysis themselves.

16 My experience as an analyst, however,
17 in the derivatives group and as a legal
18 resource in the derivatives group for
19 other groups at Moody's, provides what I
20 hope would be a useful perspective with
21 respect to a couple of questions
22 Commissioners may have asked or have already
23 asked.

24 A few questions keep coming up. Just
25 how independent are these agencies,

1 Opening - Michalek

2 particularly within an issuer-pays
3 framework, and what consequences the
4 rating agencies suffer under the current
5 or any proposed framework, when these
6 measures of risk either fail to perform as
7 reasonably expected, or which can be shown
8 to have lacked the level of care
9 commensurate with the risk of harm that
10 may foreseeably befall the user who relies
11 on such measures.

12 As for that first question, in my
13 view, the independence in culture of the
14 derivatives group changed dramatically
15 during my tenure. The willingness to
16 decline to rate or just say no to proposed
17 transactions steadily diminished. That
18 unwillingness to say no grew in parallel
19 with the company's share price and the
20 proportion of total firm revenues
21 represented by structured finance
22 transactions.

23 In my opinion, the apparent loss of
24 bargaining power by the rating agencies in
25 general and the group in particular was

1 Opening - Michalek

2 the ratings issued by a rating agency he
3 entitled to the same defenses for product
4 liability?

5 I'm of the opinion that much more
6 could have and should have been done to
7 improve processes and procedures, but I'm
8 not so naive as to fail to appreciate that
9 this the competitive environment of hyper
10 growth, where the message from management
11 was not, "Just say no," but instead, "Must
12 say yes." Any available resource had to
13 be spent on remedial corrections.
14 Installing improvements were left for the
15 "some day" pile.

16 I'm in the camp that believes to a
17 significant degree that ratings provide an
18 important public good. I also believe
19 that some ratings, in light of the public
20 good they provide, deserve some measure of
21 protection from liability and
22 opportunistic claims of negligence.

23 However, to the extent that agencies
24 are to remain wholly private entities,
25 understandably concerned with market share

1 Opening - Michalek

2 and net profits, a distinction based on
3 the extent of the public good might be
4 made. Where some question can reasonably
5 be raised as to the extent of the public
6 benefit from rating one or more of the
7 highly complex or novel instruments, the
8 liability for getting it wrong might be
9 more fairly assigned to the private
10 parties involved.

11 I'm confident that if questions of
12 negligence were not as easily dismissed by
13 the protestations of free speech and
14 opinion, at least for that subset of
15 ratings on approximate with the benefit of
16 the rating falls primarily to the private
17 parties involved, the agencies would
18 redirect some of their extraordinary
19 profit margins into resources, research,
20 and would once again have an incentive to
21 just say no.

22 I stand ready to answer any questions
23 you may have. Thank you.

24 CHAIRMAN ANGELIDES: Thank you very
25 much, gentlemen. I'm going to start with

Q & A - Session 3

1
2 a few questions, go to the other members,
3 and then we'll probably return to ask some
4 more at the tail end of this.

5 I think I actually want to start with
6 you, Mr. Froeba, and not to ask you to
7 complete the balance of your statement,
8 but to talk in substance about a couple of
9 things to which you alluded.

10 One is, you talked about charting
11 model changes over time. I want you to
12 elaborate specifically on that, you know,
13 and I'd like to you address very specific
14 instances of how models changed over time
15 to the detriment of the ratings quality.

16 MR. FROEBA: Sure. A rating agency's
17 primarily intellectual property is its
18 rating methodology for a particular type
19 of asset. That methodology is then taught
20 to junior people and they apply it on a
21 case-by-case basis and the rating
22 committee endorses that application.

23 But the key feature of what the
24 rating agency does is, a key tool it uses,
25 is its methodology for assigning rating to

Q & A - Session 3

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2 a particular product.

3 I'm simply, in my comments here,
4 saying that in order to verify what I'm
5 saying, that you would need to -- if you
6 plotted Moody's market share for any
7 particular type of structured finance
8 credit, and on the same chart, put Moody's
9 timing of major methodological changes, I
10 think you'll find a correspondence between
11 changes in methodology and market share
12 pressure. So that was the point I was
13 trying to make.

14 CHAIRMAN ANGELIDES: But what I'd
15 like to have you elaborate on, what kinds
16 of changes in methodology did you see?
17 Specific examples of the kind of changes
18 in methodology.

19 MR. FROEBA: In the CLO area where I
20 was primarily involved, we had almost no
21 major methodological changes, and we had
22 almost no rating competition. In other
23 areas where there was more pressure, for
24 example, in RMBS, there were major
25 methodological changes about the time that

1 Q & A - Session 3

2 the whole team was fired, and their market
3 share grew substantially.

4 Another area --

5 CHAIRMAN ANGELIDES: The team being
6 fired in the early 2000s?

7 MR. FROEBA: Yes. It wasn't just
8 that they fired the team, it was that they
9 also changed their methodology. Another
10 example is in the area of the CDOs of ABS.

11 CHAIRMAN ANGELIDES: But stop there
12 for a minute. In which ways did they
13 change the methodology?

14 MR. FROEBA: I'm not an expert in the
15 RMBS methodology.

16 CHAIRMAN ANGELIDES: Well, you've
17 been told that they changed it?

18 MR. FROEBA: Yes.

19 CHAIRMAN ANGELIDES: By?

20 MR. FROEBA: It was understood at
21 Moody's that the reason Moody's fired all
22 those people, including Mark Adelson, who
23 was the head of the group, was that the
24 market share was 14 or 15 percent, and
25 that his view of the asset was so

Q & A - Session 3

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2 conservative that it was causing Moody's
3 to not be able to rate the bulk of the
4 deals that were out there.

5 In fact, to my recollection, people
6 described Mark Adelson's departure as
7 being associated primarily with the fact
8 that he allowed the market share to drop
9 to 14 or 15 percent and that he wasn't
10 willing to update his view.

11 When you say, "update his view," what
12 do we mean? Change the methodology.
13 Improve it. To make it more -- to keep
14 Moody's in a position to acquire more
15 business.

16 CHAIRMAN ANGELIDES: All right, keep
17 going.

18 MR. FROEBA: And then my example at
19 the end of my prepared testimony is
20 another case where, under some market
21 share pressure, in anticipation of more
22 market share pressure, there was a
23 methodological change that restored market
24 share. So those are some examples. I --
25 those are just examples that happened to

Q & A - Session 3

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2 cross my path in my area, which was CLOs,
3 and was not even related to these other
4 areas, loosely related.

5 So I think what you'll find, if
6 you -- if you were to take all the major
7 structured finance asset classes, find the
8 ones where there was significant market
9 share pressure and check the timing of
10 major methodological changes, I think
11 you'd see some correlation between changes
12 in methodology and market share pressure.
13 That's the point I'm making. That becomes
14 evidence of the culture change. It's no
15 longer possible to tolerate methodologies
16 which produce zero revenue, or -- not
17 zero, but which result in Moody's having
18 to say no to a transaction.

19 CHAIRMAN ANGELIDES: All right. Talk
20 very briefly about Yuri Yoshizawa, very
21 quickly. You didn't finish that thought,
22 please, and don't hold the lack of a
23 graduate degree against her, because the
24 chair does not hold one. Just for the
25 record.

1 Q & A - Session 3

2 MR. FROEBA: I don't. I don't. I
3 use that as an example, not because she
4 lacks a graduate degree, but to point out
5 that her peers at the time had them, and
6 that she was put in a position where she
7 needed to interact with others on a
8 quantitative level who would be those
9 people --

10 CHAIRMAN ANGELIDES: So it's the
11 quantitative skill sets that were lacking?

12 MR. FROEBA: I'm not even commenting
13 that I think she was lacking them. I'm
14 simply saying, if you were looking at her
15 on paper, versus the people who were her
16 predecessors and colleagues, and versus
17 the people whom she would be dealing with.

18 CHAIRMAN ANGELIDES: She was very
19 bright, talented --

20 MR. FROEBA: That's possible. That's
21 possible.

22 CHAIRMAN ANGELIDES: Talk
23 specifically about the threats --

24 MR. FROEBA: Even most very bright
25 people are not going to be able to handle,

Q & A - Session 3

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2 you know, quantitative discussions with
3 Ph.D.s in statistics and math, if -- based
4 on an undergraduate major in math. That
5 would be -- that's my point. Maybe I'm
6 wrong.

7 CHAIRMAN ANGELIDES: Okay.

8 MR. FROEBA: Maybe it doesn't depend
9 on -- she want to Stanford, so --

10 CHAIRMAN ANGELIDES: I don't think
11 that matters, and I think it goes to
12 intrinsic capacity of a management leader.
13 Let me ask you this question --

14 MR. FROEBA: You wanted me to follow
15 up on Yuri, was that --

16 CHAIRMAN ANGELIDES: I think you made
17 your point --

18 MR. FROEBA: Oh, there was one other,
19 yeah.

20 CHAIRMAN ANGELIDES: Go ahead. Was
21 there another point you wanted to make
22 very quickly?

23 MR. FROEBA: In my prepared testimony
24 I talked about the case where I happened
25 to be aware of an incident in which she

Q & A - Session 3

1
2 retaliated against an analyst by removing
3 them from a deal, even though she
4 testified recently that she remembered no
5 such case.

6 CHAIRMAN ANGELIDES: Is this the
7 Steve Lucci, is that it, Liucci, or not?

8 MR. FROEBA: No, he was not involved
9 in that case.

10 CHAIRMAN ANGELIDES: So why don't you
11 tell, I understand that she -- correct,
12 Ms. Yoshizawa --

13 MR. FROEBA: Yes.

14 CHAIRMAN ANGELIDES: -- yes, that she
15 testified before the Senate subcommittee
16 that she never removed someone from a
17 transaction except for scheduling
18 purposes.

19 MR. FROEBA: Or, she also later on
20 went on to say that if she thought they
21 were being abused by bankers she would
22 remove them, too.

23 CHAIRMAN ANGELIDES: So do you want
24 to give us a specific instance?

25 MR. FROEBA: Yes, and I'm not

1 Q & A - Session 3

2 necessarily going to name the names of the
3 people involved, although I could do so.

4 CHAIRMAN ANGELIDES: You should, for
5 the record.

6 MR. FROEBA: But not perhaps here.

7 CHAIRMAN ANGELIDES: Well, there's
8 only one place to do it.

9 MR. FROEBA: Anyway, the person --
10 maybe you don't want me to go into the
11 story if I don't name the names.

12 CHAIRMAN ANGELIDES: Well, just do it
13 quickly.

14 MR. FROEBA: There was a transaction
15 in which a banker complained vociferously
16 about an analyst who was relatively new,
17 and Yuri took her off the deal and
18 replaced her, and ultimately the person
19 who was replaced was fired; and the
20 analyst who was the replacement analyst,
21 both the one who left and the one who
22 stayed to work on the transaction, told me
23 about the story, and in that -- in that
24 story, it was clear that, from the
25 testimony to me, of the second analyst,

1 Q & A - Session 3

2 replacement analyst, that the work the
3 first analyst had done was good work, and
4 that it had not been defective. So --

5 CHAIRMAN ANGELIDES: Had it been
6 objected to by a banker?

7 MR. FROEBA: Yes.

8 CHAIRMAN ANGELIDES: I'm going to ask
9 you to provide the information to our
10 staff.

11 MR. FROEBA: I will.

12 CHAIRMAN ANGELIDES: But given that
13 there was what personnel action, I'm not
14 going to press you right now for specific
15 names.

16 MR. FROEBA: That's why I didn't
17 quantity to put in the name.

18 CHAIRMAN ANGELIDES: Yes,
19 Mr. Michalek?

20 MR. MICHALEK: Mr. Chairman, you had
21 asked about specific instances where the
22 methodology was affected by potential
23 pressure for market share. One place that
24 we can sort of focus is where there was
25 the development of new methodologies. In

Q & A - Session 3

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2 the area that I worked in, the credit
3 derivatives products companies,
4 which Dr. Witt referred to as structured
5 finance operating companies, because that
6 was their nomenclature when they were
7 still at that level of development, was
8 one area where the methodology was under
9 significant pressure because our
10 competitor rating agencies, Standard &
11 Poor's, was developing a methodology that
12 was significantly less onerous from a
13 capital perspective.

14 Credit derivative product companies,
15 and I wouldn't try to describe in detail
16 what they were doing, were effectively
17 completing with the monoline insurers. So
18 they were providing insurance to issuers
19 of AAA-rated obligations, because the
20 monolines, based solely on their balance
21 sheet, are offering this guarantee of the
22 performance of that AAA-rated entity and
23 if you'd -- as we've subsequently seen,
24 the risk that these monolines were exposed
25 to was enormous, and there wasn't actually

Q & A - Session 3

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2 a strong quantitative methodology for
3 determining whether or not that exposure
4 was adequately capitalized at the
5 monolines.

6 So the idea came forth to develop a
7 quantitative way of approaching the
8 sufficiency of a AAA, which created some
9 problems internally at Moody's because
10 effectively, we were now competing with
11 ourselves, because the monoline insurers
12 were getting their AAAs only after years
13 of demonstrated ability to perform; and
14 these new credit derivative product
15 companies and structured finance operating
16 companies were effectively coming and
17 saying, "We'll put up the right amount of
18 capital and we'll show you that it's the
19 right amount of capital, but we want a AAA
20 rating today, with no prior experience."

21 Well, clearly, that was a high risk
22 situation. You had to identify with
23 certainty that you can issue a AAA rating
24 based on largely a quantitative modeling
25 of what was actually being presented.

Q & A - Session 3

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2 And so the development of that
3 methodology really was quite on point,
4 that we did have to delay and delay our
5 release of the methodology and we were, in
6 several cases, told that we had to go back
7 to drawing board because our competitor
8 rating agency was requiring a lower level
9 of capital and therefore, people were not
10 going to choose us as the rater but would
11 use our competitor.

12 CHAIRMAN ANGELIDES: And the final
13 outcome was the adoption of a methodology
14 that has since met the lower bar?

15 MR. MICHALEK: Well, it was a
16 compromise situation and I do think that
17 we had a couple of potential clients who
18 said, "I'm sorry, it's simply too onerous
19 so we're not going to use you." But we
20 did -- an extreme amount of pressure was
21 actually imposed on us to come to a rating
22 in a time that several people who were at
23 the rating committee were suggesting was
24 on too accelerated a basis and that we
25 still needed to do further work.

Q & A - Session 3

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2 CHAIRMAN ANGELIDES: But was there
3 explicit pressure or was it methodological
4 discourse? In other words, were folks
5 told, "Look, we can't have a standard
6 that's so much different than Standard &
7 Poor's," or was it "We think there are
8 flaws in the Standard & Poor's" -- I'm
9 just trying to get the dialogue.

10 MR. MICHALEK: It would have been a
11 combination of those.

12 CHAIRMAN ANGELIDES: So there was
13 explicit elements of "We've got to be in
14 the marketplace with a product that's
15 close," and then obviously people think
16 about still trying to do that in a way
17 that we can --

18 MR. MICHALEK: Correct. Things would
19 always be delivered that way and I think
20 that's the right way to --

21 CHAIRMAN ANGELIDES: Was there a
22 constant tension?

23 MR. MICHALEK: During the development
24 of this methodology, it was significant.

25 CHAIRMAN ANGELIDES: Okay. And what

Q & A - Session 3

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2 time frame was this?

3 MR. MICHALEK: 2005. If you look at
4 the development of the methodology, I
5 think there's a piece that Moody's
6 published and it's written by Dr. Radanti
7 Tzani. She's the author, and that piece
8 took a long time in development, and
9 certain compromises had to be made in
10 order to even come to the market with that
11 published methodology.

12 CHAIRMAN ANGELIDES: Along those
13 lines, was there a general understanding
14 in these, that the -- you know, that those
15 who give out the easier grades get the
16 biggest number of students?

17 MR. MICHALEK: Yes. It was a
18 constant case of balancing. We were
19 trying to maintain our competitiveness.
20 Obviously, we weren't going to get paid,
21 we weren't going to be able to give an
22 opinion if we weren't on the deal. But at
23 the same time, there was a concern,
24 particularly in this situation, that the
25 risk was enormous. Because we were

Q & A - Session 3

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2 talking about a book of business that
3 would start at five hundred million
4 dollars, where they were needing to raise
5 capital of that amount because of the
6 exposure that they were going to
7 immediately be writing.

8 So they needed to raise initially,
9 the thought was, perhaps you would need as
10 much as five hundred million dollars
11 worth of capital to start rating and then
12 you'd have to build a book of business
13 that over time would ramp to ten or 15 or
14 \$20 billion, and that leverage was
15 expected to continue to increase and it
16 would only be over time where they reduced
17 the amount of capital.

18 But that was significantly more than
19 our competitor rating agency was actually
20 expecting in order to issue that AAA
21 rating.

22 CHAIRMAN ANGELIDES: All right. I'm
23 going to hold -- I will ask one question,
24 if you can do it very quickly. You
25 mentioned specific threats against

Q & A - Session 3

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2 employees if they didn't, what, rate
3 deals?

4 MR. FROEBA: Well, I think I left out
5 some discussion of ways in which Brian
6 threatened to fire people. That was a key
7 part of his approach --

8 CHAIRMAN ANGELIDES: It's explicit
9 threats?

10 MR. FROEBA: Are you saying, "I'm
11 going to fire you unless you rate this
12 transaction?" No, no. It was sort of --
13 it was -- it was, he would repeatedly tell
14 you -- he would remind you repeatedly that
15 you were vulnerable to being fired, with
16 the example, for example, of all the, the
17 22 people from the -- you probably haven't
18 heard this.

19 Brian was famous for his joke within
20 Moody's that his only regret in firing 22
21 people from the RMBS group was that one of
22 them got a job before he could fire him.
23 And he repeated that joke regularly. And
24 the point was to remind you that you were
25 vulnerable to being fired.

Q & A - Session 3

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2 There was a point which Rick has
3 actually talked about -- Mr. Michalek has
4 talked about a meeting that many of us who
5 were lawyers in the derivatives group had
6 with him, and that meeting was really
7 designed to remind us that we, too, were
8 vulnerable to being fired when he took
9 over the group. And I could elaborate on
10 that, but you wanted a short answer, so
11 that's my answer.

12 CHAIRMAN ANGELIDES: Okay. I think
13 that's it for me at this moment, and I'm
14 going to go on now to the Vice-Chairman.

15 VICE-CHAIRMAN THOMAS: Thank you,
16 Mr. Chairman. This panel, in its makeup
17 now, unfortunately, not because of you
18 folk, but because of someone at a higher
19 management level, resembles more the first
20 panel that we had than we had anticipated.

21 Notwithstanding the bona fides in
22 your testimony, Mr. Froeba, I do want to
23 ask those that I had talked to earlier,
24 Mr. Chairman -- this is highly unusual,
25 but I noticed off to my left, the

Q & A - Session 3

1 audience's right, Dr. Witt is still here.
2 And Dr. Kolchinsky is still here. What
3 were the ten years that you were at
4 Moody's?
5

6 MR. FROEBA: '97 to 2007.

7 VICE-CHAIRMAN THOMAS: '97-'07. That
8 coincides. You just nod your head,
9 because we're not going to put it on the
10 record, but I'll signify the direction of
11 the head movement, you were there at the
12 same time?

13 A VOICE: Yes, sir, I began in --

14 VICE-CHAIRMAN THOMAS: You don't have
15 to talk. Just nod your head. Both of
16 those gentlemen nodded their heads.

17 MR. FROEBA: I can confirm on the
18 record, they were both there
19 contemporaneous with me in the same group.

20 VICE-CHAIRMAN THOMAS: I appreciate
21 your telling me that, but I asked them.
22 Okay? Okay. You heard the testimony.
23 Would you say that the testimony was
24 substantially accurate based upon your
25 experiences? Nod your head yes or no.

1 Q & A - Session 3

2 You have to say something, go ahead.

3 DR. WITT: I have to say yes or no.

4 I substantially, I wouldn't agree with he
5 every nuance, but I know exactly what Rick
6 is talking about, and there were
7 differences of opinion --

8 VICE-CHAIRMAN THOMAS: Rick I'm not
9 referring to. Right now I'm referring to
10 Mark's testimony. About individuals.

11 DR. WITT: And about Brian applying
12 pressure to people, saying that they might
13 be fired?

14 VICE-CHAIRMAN THOMAS: This isn't
15 going to work. That's why I shouldn't
16 have done it. This sounded a whole lot
17 more like Judge Judy than most of the
18 testimony that we've had.

19 You were there for ten years. This
20 reduction in quality, this shift in
21 management toward getting the bucks
22 instead of getting it right, occurred
23 roughly when along that timeline?

24 MR. FROEBA: I think it was a
25 progressive development over time. I got

Q & A - Session 3

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2 there in '97. So the change in culture
3 probably accelerated. It was particularly
4 acute beginning with the time when Brian
5 took over the group, which was, I think,
6 the derivatives group in 2002.

7 VICE-CHAIRMAN THOMAS: And it
8 accelerated from there?

9 MR. FROEBA: Yes.

10 VICE-CHAIRMAN THOMAS: So you were
11 there roughly five years, and then you
12 were there five years after it?

13 MR. FROEBA: Correct.

14 VICE-CHAIRMAN THOMAS: So why did you
15 stay that long?

16 MR. FROEBA: I'm not sure I
17 understand your question. You mean did I
18 feel like I should leave because it was a
19 culture that was disturbing?

20 VICE-CHAIRMAN THOMAS: That would be
21 a good question. So I'll say, sure.

22 MR. FROEBA: Okay. It wasn't
23 disturbing within my particular sphere.
24 Like I told you, the CLO area was one
25 where there was very little market share

Q & A - Session 3

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2 pressure. I think, had there been a lot
3 of market share pressure, I would have
4 been expose to the same difficult choices
5 that other people at Moody's were faced
6 with.

7 VICE-CHAIRMAN THOMAS: But in your
8 testimony -- unfortunately, you weren't
9 able to deliver it orally -- you talk
10 about it in especially egregious case
11 which was a CLO.

12 MR. FROEBA: Correct.

13 VICE-CHAIRMAN THOMAS: Was that one
14 of the reasons you decided to leave?

15 MR. FROEBA: Well, no, I was -- my
16 departure was not my own decision.
17 Moody's downsized me along with Rick at
18 the same time, Rick Michalek. It was
19 December of 2007.

20 The CLO issue that I describe in my
21 testimony is relevant to Moody's Europe.
22 And it is an independent office, and the
23 rating methodology that they applied,
24 though, very similar to the one in New
25 York, is its own. And the change I

Q & A - Session 3

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2 described happened there.

3 VICE-CHAIRMAN THOMAS: I understand
4 that. I read it. Back to my noddors.
5 Do you generally agree with this
6 characterization -- and you know, I'm
7 sorry that Mr. Clarkson has a kidney
8 stone --

9 COMMISSIONER GEORGIU: Mr. Chairman,
10 why don't we --

11 CHAIRMAN ANGELIDES: I think it may
12 be better to bring the witnesses back up.

13 VICE-CHAIRMAN THOMAS: Do you mind,
14 because we --

15 CHAIRMAN ANGELIDES: Come back up. We even have
16 name plates for you.

17 VICE-CHAIRMAN THOMAS: Dig up the old
18 name plates.

19 CHAIRMAN ANGELIDES: Yes, let's do
20 that.

21 MR. KOLCHINSKY: Our same seats.

22 (Dr. Witt and Mr. Kolchinsky are
23 seated at the witness table.)

24 VICE-CHAIRMAN THOMAS: And the
25 primary reason I'm doing this, Mr. Froeba,

Q & A - Session 3

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2 so you appreciate it, we never had this
3 much direct accusatory, if you will,
4 testimony on the shift --

5 CHAIRMAN ANGELIDES: Actually, before
6 we do this, I'd like to remind both of you
7 that you were sworn in earlier, and that,
8 would you please acknowledge, Dr. Witt,
9 you're still under oath?

10 DR. WITT: I'm still under oath.

11 MR. KOLCHINSKY: I'm still under
12 oath.

13 CHAIRMAN ANGELIDES: Thank you,
14 Mr. Kolchinsky. Thank you. We may now
15 proceed with our orderly hearing.

16 VICE-CHAIRMAN THOMAS: I kind of
17 liked the head nodding. Because of the
18 relatively strong and definitive
19 statements that it was not driven by
20 money, your statement's probably more
21 extreme in providing specific examples
22 than the first panel, although there were
23 clear innuendoes and hints of that
24 direction.

25 So given the fact that yours are so

Q & A - Session 3

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2 much bolder and direct, I really kind of
3 wanted to visit the first panel to help us
4 get a comfort level that, had you been on
5 the first panel, they would have agreed
6 with the statements you're making.

7 Mr. Michalek, your statement is
8 similar in terms of the extreme focus on
9 the money drive changing the culture at
10 Moody's to get it right more so than the
11 cost factor at Moody's.

12 So let me just say, do you generally
13 agree with the emphasis, not necessarily
14 every jot and tittle of the personal
15 stories?

16 MR. KOLCHINSKY: Well, I do agree.
17 And in my written and oral testimony, it
18 was the same thing. I think the market
19 share drove the methodologies down, and it
20 created the free fall --

21 VICE-CHAIRMAN THOMAS: But you've got
22 to admit -- you're both attorneys. He
23 really was a lot more graphic than you
24 were.

25 MR. KOLCHINSKY: I'm -- you know, I

Q & A - Session 3

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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.

Q & A - Session 3

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2 VICE-CHAIRMAN THOMAS: Well, my
3 concern is, the heart of his testimony
4 is -- what I consider to be the heart of
5 his testimony, in terms of a
6 cause-and-effect relationship between
7 those who had more alphabet letters behind
8 their names versus those who didn't, with
9 a clear implication that the analytical
10 mind, verified by the number of diplomas
11 on the wall, was being replaced by people
12 who were more, if you want to use a tough
13 term, shmoozy or understanding of the
14 bottom line and how you get there, versus
15 diplomas on the wall.

16 Her resume would not start off with
17 her law degree or the level at which she
18 performed in her law class.

19 DR. WITT: She was not a lawyer.

20 VICE-CHAIRMAN THOMAS: I understand
21 that.

22 DR. WITT: Okay. I mean, Yuri, I
23 mean, she was a very capable person in a
24 lot of ways. I mean, she was an extremely
25 good administrator --

Q & A - Session 3

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2 VICE-CHAIRMAN THOMAS: Okay. Let me
3 direct the question then. She was a very
4 capable person in many ways. Your primary
5 function was rating. Would you rate her
6 high at rating? She had other talents.

7 DR. WITT: I wouldn't rate her high
8 at rating. I would not.

9 VICE-CHAIRMAN THOMAS: You would rate
10 her high at shmoozing --

11 DR. WITT: No, administration.
12 Managing a lot of people, remembering a
13 lot of stuff and training junior staff,
14 working well with the people above her.

15 VICE-CHAIRMAN THOMAS: That's a real
16 talent.

17 DR. WITT: It is.

18 VICE-CHAIRMAN THOMAS: You can't
19 necessarily get a degree to get that kind
20 of talent --

21 DR. WITT: No, I agree. I didn't
22 say -- when she and I were promoted
23 exactly the same time to managing
24 director, and they -- I think they
25 expanded the number of managing directors

1 Q & A - Session 3

2 at that time, and I didn't think that her
3 promotion was unwarranted. You know,
4 obviously, Mark did. I didn't. I mean, I
5 thought she had a lot of talent. I
6 thought that she and I were good
7 complements, to be honest. We were very
8 different, but...

9 VICE-CHAIRMAN THOMAS: Mr. Chairman,
10 I'll reserve my time as well.

11 CHAIRMAN ANGELIDES: I'd like to ask,
12 since you're all four back up here, each
13 of you very quickly, so we have four
14 individuals here in a firm with thousands
15 of employees.

16 In the structured products arena in
17 which all of you are operated, how
18 pervasive was the feeling or the belief
19 that market share was the driving force
20 and that you better pay attention to it?
21 How pervasive, do you hold a minority
22 view?

23 MR. KOLCHINSKY: I would say,
24 obviously, I can't speak for everyone; but
25 for people I know, people who have been

Q & A - Session 3

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2 there more than a year, so more veterans,
3 I think I would venture close to a hundred
4 percent. I think the people understood
5 that market share drives the train at that
6 point. So...

7 CHAIRMAN ANGELIDES: Mr. Froeba?

8 MR. FROEBA: I completely agree.
9 That's why I recommended that you look at
10 the DES survey results. I think that will
11 show a lot.

12 MR. MICHALEK: I thought that it grew
13 over time. Towards the end it was a
14 hundred percent the point, but initially
15 it wasn't.

16 DR. WITT: I thought at the time I
17 was there, and this is the CDO group, U.S.
18 CDO group, it was pretty pervasive, that
19 thinking. You know, I think most
20 analysts, that's what they assumed. I
21 definitely felt pressure for market share,
22 you know. But as in my opening remarks,
23 my mind, the question was, you know, was
24 it too far? Did it go -- I thought --
25 once I became -- I say this in my written

Q & A - Session 3

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2 testimony. When I was an analyst, I just
3 thought about getting the deals right.
4 You know, I thought about ratings
5 integrity. I didn't think about anything
6 else.

7 Once I had, like, a budget to meet, I
8 had salaries to pay, I started thinking
9 bigger picture. I started realizing, yes,
10 we do have shareholders and, yes, they
11 deserved to make some money. We need to
12 get the ratings right first, that's the
13 most important thing; but you do have to
14 think about market share. So I began to
15 do the other side of it. But I definitely
16 did question in my mind, are we going too
17 far here.

18 CHAIRMAN ANGELIDES: A norm of
19 mission creep, or perhaps someone would
20 say mission sprint, a big shift over the
21 last seven years? 2000 on? You're all
22 the nodding your heads, yes.

23 All right, let's move on.

24 Mr. Vice-Chairman, you want to move on to
25 other members?

Q & A - Session 3

1
2 VICE-CHAIRMAN THOMAS: Just one
3 follow-up question.

4 Mr. Witt, based upon your
5 transformation from doing the job to
6 overseeing those to a certain extent who
7 did the job in the CDOs area, was the 2005
8 assumptions for CDOs that we talked about,
9 where did that occur in your shift from
10 getting the rating right to looking at
11 market share? Can you place that on a
12 continuum between those points and your
13 decision in '05?

14 DR. WITT: The new methodology that
15 we introduced in 2005? Okay. We -- the
16 methodology that we introduced in 2005 was
17 in June 2005, in a paper that was, like
18 there was a committee of people. It was
19 decided to use the normal copy law. It
20 was by far the most popular method on Wall
21 Street for rating CDOs and --

22 VICE-CHAIRMAN THOMAS: Hundred
23 percent ratings, 90 percent ratings, ten
24 percent market share? Fifty-fifty?

25 DR. WITT: We had a committee. We

1 Q & A - Session 3

2 did -- there was a data analysis that was
3 done and presented to us. There was
4 discussions. The discussions did not
5 center around market share at all.

6 VICE-CHAIRMAN THOMAS: Was it part of
7 the discussion?

8 DR. WITT: I don't -- I don't
9 remember anybody bringing it up
10 explicitly, although I'm sure it was on
11 everyone's minds.

12 VICE-CHAIRMAN THOMAS: Okay. Thank
13 you, Mr. Chairman.

14 CHAIRMAN ANGELIDES: I am actually
15 going to make one comment before we go to
16 Senator Graham. On page 12 of your
17 testimony -- excuse me -- page 11, you do
18 refer to Ms. Yoshizawa's testimony under
19 oath at the Senate Permanent Subcommittee
20 on Investigations, correct?

21 MR. FROEBA: Correct.

22 CHAIRMAN ANGELIDES: And then what
23 you're saying is, in your view, which is
24 under oath, in your view that was not
25 truthful, correct?

1 Q & A - Session 3

2 MR. FROEBA: Well, she said she
3 couldn't remember, so I can't have an
4 opinion about whether she remembered. But
5 I would --

6 CHAIRMAN ANGELIDES: All right. You
7 said -- okay, I'm going to --

8 MR. FROEBA: It was doubtful to me
9 that you would not be able to remember a
10 case where you fired someone.

11 CHAIRMAN ANGELIDES: I'm going to ask
12 our staff to follow up with both you, with
13 the analyst involved and with Ms.
14 Yoshizawa because, you have not made the
15 allegation of perjury, but you noted that
16 a statement was made and you remember a
17 case that was contrary to those facts.

18 MR. FROEBA: Correct.

19 CHAIRMAN ANGELIDES: So this is a
20 various matter. Our staff will follow up,
21 with you, Ms. Yoshizawa, and the analyst
22 who has been identified. All right.

23 Let's move on now to Senator Graham.

24 COMMISSIONER GRAHAM: Thank you,
25 Mr. Chairman. Thank you, for those of who

Q & A - Session 3

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2 you have testified the first time, and
3 those who are testifying the second time,
4 there's no additional compensation for
5 returning.

6 It seems here that we almost have a
7 he-said/she-said, because I asked the
8 specific question of Mr. McDaniel, was
9 there a relationship between quality of
10 product and aspiration for market share,
11 and he said no. And you're saying there
12 was such a relationship. Is that correct?

13 What would be, if we were to ask
14 Moody's to provide us with data that might
15 be able to answer the question of who was
16 correct in this assessment of the
17 situation, what data do you think would be
18 most determinative in whether there was a
19 relationship between market share and
20 product quality?

21 MR. FROEBA: Well, I think the nice
22 thing about what I was proposing in my
23 testimony is that you don't have to
24 believe me. I'm suggesting that you can
25 try to look at the history of major

Q & A - Session 3

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2 methodological changes and see if they
3 correspond to market share pressure and if
4 you see that as a consistent pattern, it confirms
5 what I'm alleging. It was certainly what
6 we expected.

7 Now, I was in the CLO area and we
8 didn't have much, you know, we didn't have
9 much rating competition in our area. And
10 yet I happened to see a couple of
11 incidents where there was this pressure,
12 one of which I described in my testimony.

13 COMMISSIONER GRAHAM: Is there any
14 other piece of evidence that would be
15 relevant to establishing this
16 relationship?

17 MR. FROEBA: The problem was, you
18 weren't going to find people coming to
19 meetings and saying, "Let's change this so
20 we get more market share." They would
21 say, and perhaps this is innocuous, "Our
22 competitors can get to this answer, are we
23 right that we can't?" And that would
24 begin an inquiry which could lead to a
25 methodological change. That could be

Q & A - Session 3

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2 innocent. It could be not innocent.

3 MR. MICHALEK: What sort of evidence
4 might be in the concept of grandfathering?
5 And I think we need to make a distinction
6 between market share, where we're trying
7 to increase our market share, versus not
8 lose a transaction. They are actually two
9 sides of the same coin, but that is much
10 more easily identifiable, whereby the
11 imposition of a particular policy or
12 revised policy, if a banker were to
13 threaten that, you know, "If you're going
14 to hold us to that standard, we're not
15 going to use you," then there would be
16 this internal discussion as to, "Well, can
17 we grandfather them into the prior
18 existing methodology at least for this
19 deal."

20 And in that way, you could sort of
21 see that there was this constant pressure
22 to find a way to rate the transaction,
23 notwithstanding that it might be in
24 conflict with what our current or, as hard
25 as it is to be "current" with your

Q & A - Session 3

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2 methodology, since it's a constantly
3 changing process, it's one way to
4 demonstrate that there was a response to
5 the pressure our clients, the investment
6 bank, to maintain a preexisting
7 methodology as opposed to imposing a new
8 methodology which would cause us to, in
9 the aggregate, lose market share.

10 COMMISSIONER GRAHAM: Although there
11 was one case in the staff review where an
12 announcement had been made that there was
13 going to be a change in methodology 90
14 days into the future, and that
15 announcement seemed to have sparked an
16 increase in applications for ratings, I
17 assume for fear that the new standards
18 were going to be more difficult than the
19 current standards.

20 So that would seem to argue that it's
21 not necessarily the case that all changes
22 were watering-down changes.

23 MR. MICHALEK: That's correct. And
24 that's the concept of grandfathering. And
25 effectively, when there's a more

Q & A - Session 3

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2 restrictive methodology that was coming
3 through, you would get a request to be
4 grandfathered into the old methodology,
5 with good reason. Potentially, it takes a
6 long time to get a transaction up and
7 running and you can't arbitrarily say, you
8 know, "January 1st of next year, we're
9 going to impose this new methodology."

10 If we have the information today,
11 based on the argument that we've heard
12 that, you know, based on all of our
13 information today, we think the ratings
14 were right assigned today, well, if we
15 already have that methodology in our heads
16 that it needs to be changed, you still
17 have to make the judgment as to when
18 we're going to roll that methodology out.

19 Some deals are going to be halfway
20 ramped up, ready to go; and if you
21 suddenly say, "I'm sorry, we're using a
22 new methodology starting now, the net deal
23 might be blown up and that's going to
24 cost everybody a lot of money, so some
25 judgment had to be made.

Q & A - Session 3

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2 COMMISSIONER GRAHAM: Staying with
3 that, changes, Mr. McDaniel, when asked
4 about some of the data that was coming
5 from the economic unit of Moody's,
6 particularly in October of 2006, you
7 stated that that economic analysis was
8 incorporated into the ratings methodology.

9 Was it your experience that, as units
10 such as the economics came forward with
11 data relative to declining house prices,
12 increasing defaults, et cetera, that that
13 led to a change in methodology, assumedly
14 one that would have taken those factors
15 into account and been more stringent?
16 Mr. Witt, you talked a lot about research
17 in your first round of testimony.

18 DR. WITT: A lot about what?

19 COMMISSIONER GRAHAM: Research. The
20 need for more independent research.

21 DR. WITT: One of the things I was
22 thinking about when I said that was, I
23 listened to Paul McCauley, I think his
24 name is, from PIMCO when he was on the
25 shadow banking thing and I talked about

Q & A - Session 3

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2 how PIMCO sent out people to cities all
3 across the country to talk to, like, real
4 estate brokers and homeowners --

5 VICE-CHAIRMAN THOMAS: Shoe leather.

6 DR. WITT: Yes, shoe leather, and how
7 it just, I couldn't imagine that happening
8 in Moody's RMBS group because they just
9 didn't have time to do that. They were
10 really always short of staff and running
11 so fast that, if you had an independent
12 research group, maybe they would have
13 thought of things like that, as well as
14 doing, you know, surveys or sampling of
15 data files and things like that.

16 But in CDOs, you know, because we
17 were a derivative group and our ratings
18 were derived from other groups, there
19 wasn't as much response of looking to,
20 say, like economists and things like that.
21 So methodology -- the one big methodology
22 change that occurred on my watch, the one
23 I was talking about, the normal Copula for
24 ABS CDOs in my perspective, that was
25 driven not by lowering market share, but

1 Q & A - Session 3

2 it was driven by the fact that the types
3 of transactions that we were doing were
4 different.

5 We were doing deals that were mostly
6 residential that were highly correlated
7 and we needed a model that reflected that.
8 Our old model assumed that assets were not
9 correlated and we needed a model that
10 assumed the assets were correlated.

11 But I wasn't, you know, that wasn't
12 something that comes from economists. It
13 was driven by the market, those types of
14 deals we received.

15 COMMISSIONER GRAHAM: If I have time,
16 I'd like to come back to pick up on that
17 issue before we finish. Let me ask a
18 couple of other questions.

19 As these changes were being made in
20 the last five plus or minus years, was
21 there any reporting to either investors or
22 regulatory agencies that methodologies and
23 personnel were being altered?

24 DR. WITT: Not that I know of.

25 MR. MICHALEK: I'm sorry, I might be

1 Q & A - Session 3

2 misunderstanding the question but it was a
3 part of our regular process to be telling
4 the market how our methodology was
5 evolving. Is that responsive?

6 COMMISSIONER GRAHAM: Yes.

7 DR. WITT: I thought you said
8 regulators.

9 COMMISSIONER GRAHAM: When I say
10 regulators I mean like the SEC or bank
11 regulators, who have an interest in this
12 because they are -- they passed directives
13 requiring various entities to utilize
14 ratings services for a variety of
15 important economic purposes. So if you
16 are modifying the way in which you are
17 doing yours business, I would think that
18 those agencies would be interested in
19 knowing that to ask the question, is it --
20 does it continue to be appropriate for us
21 to be mandating the use of these ratings
22 services.

23 DR. WITT: Well, like Rick said, our
24 methodologies in CDO group were
25 transparent. We posted them on the

Q & A - Session 3

1 website. We'd have investor conferences.
2 We tried to publicize them as much as we
3 could but we didn't reach out specifically
4 to any regulatory authority that I know of
5 with methodology changes.
6

7 COMMISSIONER GRAHAM: Let's now go to
8 the CDO question, because I don't think we
9 adequately have covered that, thus far.

10 It just, to me as a layperson, it
11 seems counterintuitive that you can take
12 stacks of mortgages which in their initial
13 review were considered to be marginal in
14 their value and, therefore, they got a
15 relatively mediocre rating, and then strip
16 those out of those securities and pile
17 them up on top of each other and suddenly
18 convert mediocre into 80 percent being
19 AAA.

20 What is the theory that underlies
21 that ability to engage in alchemy?

22 DR. WITT: Your staff told me that
23 that question would probably come up, and
24 it's actually -- and I've heard the
25 question before, you might not be that

Q & A - Session 3

1 surprised. It's in my written testimony.
2 I tried to explain that.

3 But it, you know, obviously, we use
4 mathematical models. A mathematical model
5 consists of a set of assumptions, some
6 mathematics then is used to draw
7 conclusions.

8 So when people ask me that kind of
9 question, some people are interested in
10 the assumptions and what they were and why
11 they were wrong and so people actually
12 want to understand the mathematics.

13 COMMISSIONER GRAHAM: I mean, if my,
14 to use an analogy, if you had a hundred
15 homes that were all rated, not financially
16 vulnerable but climactically vulnerable
17 because they are, for instance, right on a
18 coast that is subjected to periodic
19 hurricanes, and as a Floridian, I know
20 something about that, and you have those
21 hundred houses, all of which have been
22 rated vulnerable for a credible reason,
23 now, you take the hundred houses and
24 aggregate them together, and all of a
25

Q & A - Session 3

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2 sudden, they haven't moved, but suddenly
3 they are less vulnerable.

4 That's, I don't understand how, by
5 aggregation, you eliminate the factor that
6 made them mediocre in their rating in the
7 first place.

8 DR. WITT: That's a good example,
9 because it's an example of the one
10 extreme. And the method, the simple
11 methodology that we used originally and
12 the one that they continued to use for
13 CLOs I think throughout Mark's career, is
14 called the binomial expansion technique,
15 which is based on the binomial
16 distribution. So it's based on the idea
17 of taking a whole lot of assets and
18 representing them as a smaller number of
19 assets.

20 The most extreme case of that would
21 be, you've got a hundred, you know, let's
22 just say mortgages, and you want to
23 represent, you're going to represent them
24 as only one mortgage because you think
25 that they are all going to behave the same

Q & A - Session 3

1 way. You think there's maybe a five
2 percent chance they will default, but when
3 they do it's because there's going to be a
4 hurricane and they are all going to get
5 wiped. So either 95 percent of the time,
6 they are all paid off, five percent of the
7 time, they all default. That is the
8 extreme case.
9

10 The only way that you get to issuing
11 80 percent AAA against the example that
12 your staff mentioned was if assets were
13 BBB. So if you started with say a hundred
14 BBB assets, and you were going to issue 80
15 percent AAA against it, so obviously,
16 that's the senior 80 percent piece. The
17 only way that could work, a BBB asset has
18 a default probability of about five
19 percent.

20 So if you think about it in terms of
21 a binomial distribution, and if you'll
22 allow me, I actually worked up the numbers
23 for a 70 percent case, that was the
24 number, the case they actually mentioned
25 to me. But -- so for the case of a 70

Q & A - Session 3

1 percent AAA instead of 80 percent,
2 starting with BBB assets, if you reduced
3 it to ten, so if you said, instead of
4 saying they are all in Florida, let's say
5 we had a hundred mortgages but they are
6 not all in Florida, ten of them are in
7 Florida, and ten are in New York and ten
8 are in California and ten are in
9 Washington, you might think, "Well, we can
10 represent this as ten blocks of ten
11 mortgages and each block of ten is, you
12 know, highly correlated with itself, but
13 the blocks are from very different places
14 and they are not going to default at the
15 same time."

17 If you assume those blocks are
18 independent and you got ten, so instead of
19 having -- you actually have a hundred
20 homes, but you're going to represent it as
21 ten independent blocks of --
22 however big these are -- ten times that size.

23 Then, if each one of them was a BBB,
24 you had a five percent default
25 probability, obviously the expected

Q & A - Session 3

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2 default probability for the whole
3 portfolio is still five percent. On
4 average, you expect like, you know, a half
5 of one of those blocks to default, because
6 that's what you were assuming from the
7 start. That was the BBB rating that we
8 got from, you know, the RMBS group, which
9 we're relying on.

10 But the extra secret sauce that our
11 group puts in is this diversity score,
12 which is essentially a correlation, which
13 is the decision to reduce it from a
14 hundred down to ten. If you go down to
15 ten, whether there's a five percent
16 default probability, if there are ten
17 independent assets, then at 70 percent
18 subordination, it would be AA 2. It's
19 about one out of nine hundred chance. And
20 what that means is that there's a one out
21 of nine hundred chance that more than
22 three of those blocks are going to
23 default.

24 So that the average is that a half a
25 block would default.

1 Q & A - Session 3

2 COMMISSIONER GRAHAM: Let me ask --
3 my time is up. Let me ask -- this is my
4 concluding question, all right? With that
5 theory, let's say, of the CDOs that were
6 issued by Moody's in the '06, '07, '08
7 time period, what percentage of them had
8 greater defaults than the theory that
9 you've just stated would have
10 contemplated?

11 DR. WITT: You know, of course,
12 again, I left the group in '05. It's a
13 huge number. I don't know. It's for
14 ABS -- for mezzanine ABS CDOs, for AAA
15 mezzanine ABS CDOs, that was the case that
16 was the worst, and I'm sure it's what, 90
17 percent or something?

18 COMMISSIONER GRAHAM: Is it was 90
19 percent instead of something in the ten
20 percent area. Which assumptions were most
21 found to be at fault that resulted in such
22 a dramatic different outcome?

23 DR. WITT: You have to say it was
24 both. It was both the default probability
25 was wrong, and the correlation was wrong

Q & A - Session 3

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2 or the diversity score. I mean, that's
3 the way I think of it.

4 You could -- you could just say "Oh,
5 it was the RMBS group, they screwed up, we
6 got it right, they messed up." You could
7 have that interpretation. It would have
8 some logical coherence to it. But I don't
9 think that's valid. I think we both
10 messed up.

11 COMMISSIONER GRAHAM: I'm system
12 sticking with my hundred houses on the
13 ocean. They are all going to go under.

14 MR. KOLCHINSKY: I think, I was in
15 charge of the CDOs at the time and it was
16 primarily driven by the underlying RMBS
17 ratings. In our deals, we assumed that
18 the expected loss in those deals was
19 approximately one percent on the BBBs. It
20 turned out to be a hundred percent, so off
21 by a factor of a hundred.

22 But at the same time, the correlation
23 assumptions that, diversity, using your
24 analogy, we assumed that the houses
25 weren't just all on the coast in Florida.

Q & A - Session 3

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2 They have some in had Colorado, some in
3 Idaho. Turned out they were on either
4 side of 1 -- A1A. And so the hurricane
5 came and flooded it all out.

6 CHAIRMAN ANGELIDES: But the
7 original, just to pick up, the original
8 sin was the assumption you'd have the one
9 percent expected loss in a mezzanine
10 tranche of what ended up being a very
11 risky, well a pool of very risky loans that
12 had been made, predicated essentially not
13 on ability to pay but on continuing house
14 price acceleration.

15 MR. KOLCHINSKY: Yes, in general, but
16 also the CDO structures that also became
17 the sole buyers of those tranches, and,
18 because there's no real money buyers as
19 well.

20 So our CDOs made it possible for
21 those deals to get done, and because we're
22 using these actuarial assumptions. So we
23 were the vacuum cleaner that sucked those
24 deals in and made those transactions
25 possible. So yes, those ratings were

Q & A - Session 3

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2 wrong. I think most people in the market
3 either believed that those ratings were
4 wrong, or they were not getting paid for
5 that risk, so they went away. And these
6 CDOs basically took up all that slack that
7 was, that the real money investors took
8 out.

9 So it was a combination. The
10 underlying ratings were wrong but our
11 assumptions on diversity score were also
12 wrong, and made -- created the possibility
13 of those deals being economically
14 feasible. Because if they had to pay more
15 money, if they had to find investors,
16 those deals just wouldn't get done. The
17 economics wouldn't work.

18 COMMISSIONER GEORGIOU: Mr. Chairman,
19 can I follow up on that? 'Cause this
20 is --

21 CHAIRMAN ANGELIDES: Well,
22 actually -- yes, you can. I'd like to go
23 to Mr. Wallison but if it's just --

24 COMMISSIONER GEORGIOU: Well it's
25 just the one question, you can do it on my

Q & A - Session 3

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2 time.

3 You know, Commissioner Graham and I
4 had been talking about this quite a lot.
5 Isn't the problem that -- first of all, to
6 characterize this BBB tranche as mezzanine
7 seems to me to be an overstatement as well
8 in the RMBS world because it's the
9 lowest-rated tranche short of equity.

10 So to call it mezzanine, I mean, it's
11 kind of low, it seems to me, rather than
12 mezzanine. Mezzanine, I have this sense,
13 in the normal financing world, mezzanine
14 is sort of the debt just under senior
15 debt, which is kind of nice. But
16 mezzanine tranche is like the ninth
17 tranche out of ten, the tenth being
18 equity. So to call it mezzanine is a
19 misnomer, number one.

20 Number two is that it defies common
21 sense not to assume that these tranches,
22 which only required a modest decline in
23 home prices across the board, to render
24 worthless, which is actually what
25 happened. When you take all these BBB

Q & A - Session 3

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2 tranches, a hundred BBB tranches from a
3 hundred different RMBSs and put them into
4 a CDO, for those of us who actually
5 operate in the normal world, as opposed to
6 in world that Moody's analytics was
7 operating in, you would think that there
8 might be some human common sense
9 intervention that might say, "Look, we've
10 had whatever, 90 percent price
11 appreciation," as the Chairman constantly
12 says, "In the last nine years, or seven
13 years. These things all might -- all
14 you've got to do is correct by five or seven
15 percent in the house prices and then all
16 of these BBB tranches will become
17 worthless because they will -- they are
18 the lowest, the first impaired tranches
19 other than equity and all those RMBSs."

20 So the fact that you assumed that
21 they didn't correlate seems to me to be an
22 elevation of theory over reality in the
23 analysis, in the analytical structure that
24 was applied.

25 And, you know, that's why we've been

Q & A - Session 3

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2 harping on it, again, from a common sense
3 perspective. I mean, I understand
4 mathematics to some extent. I was a math
5 major in college. I'm just saying that's
6 not infallible. You have to apply -- you
7 have to apply some judgment to the
8 process.

9 DR. WITT: Please, I -- these are
10 like really simplistic models. This is
11 why I keep going back to, you know, we
12 needed independent research. I was very
13 aware, these were very simplistic models.
14 I wanted very much to -- we talked
15 about -- I was trying to get into that I
16 wanted to do a look-through analysis, one
17 of the -- maybe Senator Graham -- someone was asking me about
18 doing a look-through analysis.

19 I really wanted that when I was an
20 MD. I went up to Boston, negotiated with
21 this firm Intex to buy some software.
22 They charged us a rapacious \$350,000 a
23 year. I actually, with Nicolas Weill's
24 help, I got the money approved by senior
25 management and the deal fell down on a

Q & A - Session 3

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2 non-compete clause because Moody's wanted
3 to develop its own software. But you
4 know, we never did, at least while I was
5 there.

6 But, you know, I wanted to go
7 further. Exactly the kind of thing you
8 talked about. I wanted to know how much
9 of a decline in house prices was going to
10 cause, you know, like a default in these
11 AAA ABS CDOs that I was rating, but I had
12 no -- no way to do that. I was, you know,
13 trying to get deals out the door. I
14 thought up in my spare time a methodology
15 that I thought was superior to normal
16 copula that we ended up not using in the
17 way into I had anticipated. But even that
18 was very, very simplistic.

19 What we needed was more fulsome
20 models that took into account, you know,
21 like not the whole economy, but that
22 linked house price sensitivity to the
23 ratings on the -- on the CDOs, which we
24 did not have. But there was no way we
25 were going to have that when you were

Q & A - Session 3

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2 trying to do research with analysts who
3 were, in their spare time, were just
4 rating deals all the time, and then they
5 had to, monitor deals, and then you had
6 to do research in your spare time. It
7 just wasn't going to happen.

8 COMMISSIONER GEORGIU: But that begs
9 the question, doesn't it? I mean, it
10 still doesn't answer -- I understand. My
11 time -- I intervened in this middle of it
12 but I wanted to follow the point through
13 because it makes sense to complete it.

14 VICE-CHAIRMAN THOMAS: One quick
15 comment, then to Peter. I sounds to me
16 like they wanted you to frame houses but
17 they wouldn't give you a hammer. If it
18 was about getting it right, that's a kind
19 of tool that would be essential to help
20 you getting it right.

21 DR. WITT: You know, I agree --

22 VICE-CHAIRMAN THOMAS: That's kind of
23 an indictment, isn't it?

24 DR. WITT: Like I say, it wasn't that
25 we were trying to get it wrong -- it

Q & A - Session 3

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2 wasn't that I thought what we were doing
3 was wrong, it's just that I was so sure
4 that we were not using enough resources to
5 make sure that we were getting it right,
6 and that was at a time when, you know, the
7 profit margin for our group must have been
8 like 80 percent or something.

9 VICE-CHAIRMAN THOMAS: Yes, so it was
10 small "i" integrity, not capital "I."

11 CHAIRMAN ANGELIDES: Let's go to
12 Mr. Wallison, but I must ask you, were you
13 the witness interviewed who said your
14 superior questioned why you were doing so
15 much research, to quit reading reports,
16 was that you?

17 MR. KOLCHINSKY: That was me.

18 CHAIRMAN ANGELIDES: Thank you. All
19 right, Mr. Kolchinsky, sorry. Alright, Mr. Wallison.

20 COMMISSIONER WALLISON: Thank you,
21 thank you. This morning, I think it was
22 this morning, maybe it was this afternoon,
23 we talked about whether the problems at
24 Moody's were systemic, or pervasive, if
25 you will, or limited, or rather might be

Q & A - Session 3

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2 an artifact of simply the confusion about
3 maybe correlations in the housing and
4 mortgage area. And I asked, maybe you
5 were here, but I asked Mr. McDaniel to
6 provide us with information about all of
7 the asset-backed deals, that -- the
8 different kinds of asset-backed deals that
9 Moody's was rating so that we could
10 compare what was happening in those deals
11 with what happened in the housing area.

12 Because if it was all the same, there
13 were lots of write-downs and downgrades
14 going on in all the those other deals, we
15 would really have a sense, then, that it
16 was a systemic problem. And if that was
17 not the case, then we might be looking
18 simply at something that occurred because
19 of the peculiarities of the housing
20 business and the fact that very few people
21 were able to predict the huge fall in
22 housing prices.

23 So I'm going to ask all of you, we
24 have four of you here, what do you think
25 Mr. McDaniel's submission to us will show?

Q & A - Session 3

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2 Mr. Kolchinsky?

3 MR. KOLCHINSKY: It probably shows
4 that it was limited, but I can suggest a
5 few categories to the staff which they
6 should look into. One, I credit to PF2
7 securities, which was Trump CDOs. Another
8 one is CBOs, the first time go-around;
9 market value CDOs, mobile home
10 securitizations. Let's see, I had another
11 one on the top -- those are all -- and
12 CMBS hasn't gone full cycle, but it will,
13 so those are categories I suggest look into--

14 COMMISSIONER WALLISON: We asked for
15 all. So --

16 MR. KOLCHINSKY: Those are the
17 categories I would look into. Mobile
18 homes are real-estate-related, but they're
19 more -- they're not really real estate --

20 COMMISSIONER WALLISON: They're
21 credit cards --

22 MR. KOLCHINSKY: Credit cards are
23 basically backed by the government, so
24 they couldn't get that one wrong. The
25 auto companies have now been

1 Q & A - Session 3

2 effectively --

3 COMMISSIONER WALLISON: Backed by the
4 Government?

5 MR. KOLCHINSKY: Because they are
6 backed by the banks which are too big to
7 fail and the banks can support the credit
8 card programs, so effectively they have
9 taken steps in the past couple of years to
10 support their conduits by issuing class D
11 tranches and recapitalize them. So
12 essentially, because the credit card
13 program is backed by a bank which is too
14 big to fail, usually, they have done well.
15 You're essentially, in my mind, very --

16 COMMISSIONER WALLISON: This is -- I
17 don't want to use up all my time on this,
18 but of course the banks were also issuing
19 mortgage-backed securities.

20 MR. KOLCHINSKY: Yes, yes.

21 COMMISSIONER WALLISON: And those did
22 fail.

23 MR. KOLCHINSKY: But in this case,
24 the credit card conduits are an intrinsic
25 part of a bank's business operating model

Q & A - Session 3

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2 because that's how they finance --

3 COMMISSIONER WALLISON: Okay, we'll get to see
4 an awful lot of those. Now, what's
5 your prediction, and will it show that
6 there are as many downgrades as in the --

7 MR. KOLCHINSKY: There are some
8 product, as I mentioned, that will show,
9 probably not as bad as in the mortgage
10 area but pretty bad.

11 COMMISSIONER WALLISON: Mr. Froeba?

12 MR. FROEBA: I don't really have much
13 to add to what Eric said.

14 COMMISSIONER WALLISON: Well, your
15 prediction is that there will be areas
16 that we will look at that will show as
17 many downgrades as in the mortgage area,
18 I'd just like you to --

19 MR. FROEBA: Yes.

20 COMMISSIONER WALLISON: -- say that.

21 MR. FROEBA: Some.

22 MR. MICHALEK: I would suggest that
23 they just decompose the transition studies
24 into in individual asset classes, you'll
25 get the information you're looking for.

Q & A - Session 3

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2 They give you a general transition study for all
3 the AAAs rated by Moody's. It's a large
4 population. It includes a lot of
5 different assets that are being rated. If
6 you say, "Please give me a decomposed
7 analysis so that I can see asset by asset
8 what those transition studies are," then
9 you can see whether --

10 COMMISSIONER WALLISON: That's what
11 we will try to do.

12 MR. MICHALEK: Exactly.

13 COMMISSIONER WALLISON: And what is
14 your prediction?

15 MR. MICHALEK: My prediction is that
16 there will be, amongst the assets that
17 Eric mentioned, I'd also mention SIBs,
18 these CPDOs to the extent that they are
19 actually going to acknowledge those. And
20 what was the double -- double aircraft
21 leasing, what is -- EETCs.

22 COMMISSIONER WALLISON: Okay. And
23 Mr. Witt?

24 DR. WITT: As Mark said before about
25 CLOs, you know, CLOs have done very well.

Q & A - Session 3

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2 That would be a counterexample, and I
3 think there will be some other consumer
4 finance asset classes that have done okay.
5 But manufactured housing was the one that
6 always stuck in my mind that we -- because
7 that one, the problems were in like 2003,
8 and it was like a warning light that we
9 just didn't pay attention to.

10 COMMISSIONER WALLISON: The CLO area
11 is something I do want to cover because I
12 gather that there was no, or little
13 competition in that area.

14 Why is that?

15 MR. FROEBA: That's an interesting
16 question. Fitch is the rating agency that
17 drove competition, I think, in the RMBS
18 area. And they were one of the reasons
19 why Moody's market share at one point
20 dropped so precipitously in RMBS
21 securities. It was competition against
22 Moody's brought by Fitch.

23 In the corporate area, remember that
24 a CLO is backed by corporate loans. There
25 was no real competition from Fitch. And

Q & A - Session 3

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2 that meant that for every transaction
3 which needed two ratings, there were two
4 rating agencies available to rate them.

5 The underlying credits were not being
6 rated by Fitch so the managers weren't
7 really interested in getting a rating from
8 Fitch on the CLO because the underlying
9 credits weren't rated by Fitch. That's
10 why there was very little competition.

11 COMMISSIONER WALLISON: Okay.

12 Mr. Michalek? The -- you point to this
13 issue of competition as being very
14 important in how opinions are given
15 under -- under the pressure of
16 competition. And I keep thinking back to
17 experience that I have had with auditors
18 and law firms, which also give opinions
19 under very similar kinds of circumstances.
20 And I'm not asking you to talk about them
21 at all.

22 But I am wondering how Moody's or
23 rating agencies in general are different
24 and why you believed that, or believe that
25 their opinions are so heavily affected by

Q & A - Session 3

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2 competition, or do you believe it's all
3 the same and the auditors are also
4 succumbing to competitive pressures?

5 MR. MICHALEK: Well, I do think that
6 both the auditors and the law firms are
7 subject to an enormous amount of
8 competitive pressures, particularly during
9 this ramp-up period when things were
10 getting extremely busy, the response,
11 as -- I worked at a law firm prior to
12 coming to Moody's -- the response was to
13 offer capped transaction costs. So
14 effectively, they are under the same
15 pressures to try to get the work done and
16 the deal signed off without ruining their
17 own profit margin.

18 So that was also generating, in the
19 way that the law firms would often deal
20 with it was, to generate a standard
21 template opinion that would then be, you
22 know, affected on the margins but the
23 opinion committee would work very hard to
24 make sure that they weren't introducing
25 any risk to the partners for having issued

Q & A - Session 3

1
2 an opinion that would ultimately generate
3 liability for the firm.

4 But the additional work that they had
5 to do in order to do the work necessary to
6 get these complex transactions rated,
7 proved to be yet another source of
8 pressure that came back to the rating
9 agencies, because they were directly in
10 communication with our clients, the
11 investment banks.

12 And so to the extent that we, as
13 analysts, were working on a transaction
14 and saying we need more time, or, you
15 know, there's issues with this
16 documentation, their lawyers, the
17 investment bank's lawyer would then report
18 back to their client and say, "The analyst
19 at Moody's is causing us to have to run
20 our bill up and we're going to have to ask
21 for an exception from our cap."

22 So they were responding to the
23 pressure by either pushing back on us and
24 putting more pressure on the rating
25 agencies, or putting pressure on the

Q & A - Session 3

1 clients who put pressure on us.

2
3 COMMISSIONER WALLISON: I understand
4 that. I was actually asking a slightly
5 different question. I was asking for your
6 judgment about why law firms and
7 accounting firms, outside the issue of
8 ratings, outside the offering of
9 structured financings of various kinds,
10 which are subject to the same kind of
11 competitive pressures that you were
12 referring to, why we don't see the same
13 degree of elimination of standards or
14 reduction in standards or weakening of
15 standards as we have seen at Moody's.

16 MR. MICHALEK: It's an interesting
17 question. I do think that there is a
18 segregation of the service providers, at
19 least by the clients. You can go to a --
20 I won't try to name them, top-tier law
21 firm and then, to the extent that your
22 budget doesn't provide, then there's the
23 second-tier law firm and the third-tier
24 law firm. And it's up to the law firms
25 and their own business model as to where they

Q & A - Session 3

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2 want to compete. And so they will
3 establish the quality that they are
4 delivering and the prices that they are
5 setting according to where they think they
6 are going to be most effective at
7 competing.

8 COMMISSIONER WALLISON: But they
9 have, they are always under the same
10 pressure, and that is, "If we don't give
11 this opinion, this client is going to go
12 to another law firm and get that opinion
13 from another law firm," and it doesn't
14 have anything to do with the tier of the
15 law firm or the level of the law firm.

16 MR. MICHALEK: Well I think there is,
17 in terms of the marketing of the security
18 that they were hired to provide the
19 opinion for. If you're going to go, and
20 I'll just use, I don't know, Sullivan &
21 Cromwell is a very well known firm, if you
22 say, "I'm going to go to Dewey Cheatem &
23 Howe down the street and get an opinion
24 from them," that's going to come directly
25 to the bottom line of the issuer because

1 Q & A - Session 3

2 people might notice that. So there is
3 this competition that says they do have
4 the right, because of the brand that they
5 have established, to actually stay at a
6 higher level of quality --

7 COMMISSIONER WALLISON: But there are
8 many, many law firms that are at the same
9 level with Sullivan & Cromwell. There are
10 probably twenty just within Manhattan.
11 And so Sullivan & Cromwell has to worry in
12 each case, if they don't give an opinion,
13 that someone else will. And not only
14 that, if that someone else does give that
15 opinion, that someone else may become the
16 general counsel for all of these matters.

17 MR. MICHALEK: Fair enough.

18 COMMISSIONER WALLISON: So is there,
19 is there -- why is, and I want to just
20 repeat the question, why are things
21 different at Moody's when it is competing
22 with S&P? Why did it sacrifice its
23 standards, rather than a law firm or an
24 accounting firm doing the same thing?

25 MR. MICHALEK: I think that, and I'd

Q & A - Session 3

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2 be interested to hear my other colleagues
3 opinion, I think it does relate to the fact
4 that this was a very narrow asset class
5 where the expertise, at least in the
6 rating of these assets, was already
7 captured by the two most highly
8 intellectually capitalized agencies.

9 Standard & Poor's and Moody's just
10 had more resources and a longer experience
11 from developing these products, and so we
12 were competing strongly with each other,
13 but the competition we felt from another
14 entrant was not as high.

15 COMMISSIONER WALLISON: How much time--

16 DR. WITT: Can I--

17 CHAIRMAN ANGELIDES: You
18 have another two minutes, 45 seconds.

19 COMMISSIONER WALLISON: Was it you,
20 Mr. Witt?

21 DR. WITT: You know, I think I'm sort
22 of beginning to disagree. We're starting
23 to say Moody's standards deteriorated,
24 Moody's standards deteriorated. I know,
25 like in ABS CDOs, we made one change in
26 methodology. The impact of that change in
27 methodology for highly concentrated RMBS

1 A - Session 3

2 deals, you know, mezzanine RMBS deals,
3 that's just the name the market gives to
4 it, I don't think that that methodology
5 had much impact, and I actually think it
6 probably strengthened our ratings slightly
7 for those types of deals, and those were
8 the deals that had by far the worst
9 performance.

10 So I don't think our standards for
11 ABS CDOs really declined in the way I
12 would think of it. It's the underlying
13 collateral that just completely
14 disintegrated below us and we didn't
15 react and we should have. But it would
16 have taken a little more, you know, we had
17 to be looking for a problem. And we
18 weren't looking.

19 COMMISSIONER WALLISON: Do I
20 understand that you just said that the
21 change, the one change that occurred in
22 your area, which I think was in 2005, when
23 the correlation was changed --

24 DR. WITT: Yes.

25 COMMISSIONER WALLISON: -- was not

Q & A - Session 3

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2 induced by a competitive issue or an
3 effort to capture more market share?

4 DR. WITT: I do not believe that it
5 was.

6 COMMISSIONER WALLISON: And so you
7 disagree, then, with Mr. Froeba about
8 that.

9 DR. WITT: Well, I don't know that he
10 actually said that that particular change
11 was --

12 COMMISSIONER WALLISON: His point as
13 I understand it was that we could easily
14 see the effect of competition by looking
15 at changes in the standards.

16 MR. FROEBA: That's correct.

17 DR. WITT: But he also, he said
18 specifically, though, I think, that you
19 could look at the -- you could say there
20 was a decline in market share. Then
21 there's a change in methodology. And this
22 is a case where, you know, that's true.
23 There was a decline in market share, and
24 there was a change in methodology.

25 However, that, based on what I know,

1 Q & A - Session 3

2 there was not a cause and effect.

3 COMMISSIONER WALLISON: That's the
4 point.

5 VICE-CHAIRMAN THOMAS: That's what I
6 was talking about.

7 DR. WITT: The cause and effect was,
8 the market changed, they were doing
9 RMBS-focused deals. There had been
10 multi-sector deals before. The ABS
11 dealings had lots of different types of
12 collateral. A model that assumed
13 independence wasn't right, but it wasn't
14 so as far wrong. Once they became all
15 RMBS-focused deals, then the model just
16 didn't work at all. I needed a new model.

17 I advocated for a, you know, a
18 correlation-focused model. The normal
19 copula wasn't my first choice, but it was
20 better than what we had. But the changes
21 to that particular category were not
22 great, so I don't think it was a
23 deterioration of standards, but it was a
24 deterioration of collateral with a failure
25 to react. But there is in my testimony,

Q & A - Session 3

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2 my written testimony, I do talk about what
3 was going on with respect to market share
4 in that particular category. I probably
5 don't have time to discuss that now.

6 COMMISSIONER WALLISON: No, but
7 that's the answer I think we were looking
8 for.

9 MR. FROEBA: May I follow up on that?

10 CHIARMAN ANGELIDES: Very quickly then I want to Mr.
11 Georgiou. Very -- Do you have a one minute addition?

12 MR. FROEBA: Moody's used the diversity score as a tool
13 for analyzing correlation in early CDOs of
14 ABS. And it was a thing that became a
15 source of intense complaint by managers
16 because -- CLO managers, managers of those
17 transactions, because they felt, and they
18 blamed Moody's for the fact that they were
19 investing in securities other than RMBS
20 securities. So the real market share
21 pressure that Moody's experienced predates
22 somewhat the change Gary is talking about.
23 But there was a response to pressure from
24 managers and from other constituents.

25 COMMISSIONER WALLISON: My whole
26 point was simply, you said we could learn
27 by looking at the changes in methodology

1 & A - Session 3

2 to show the effect of the competition.

3 And here's a case, where there was a change in
4 methodology, it doesn't appear as though
5 it was induced by competition so it would
6 be very hard for us to make any decisions
7 based on the kinds of things you were
8 suggesting we should try.

9 MR. FROEBA: The main change happened
10 before that change, that's correct. It
11 was one in which Moody's adapted its
12 methodology to make it possible to have a
13 hundred percent RMBS in one CDO of ABS.

14 COMMISSIONER WALLISON: Thank you.

15 UNIDENTIFIED SPEAKER: Where was Standard & Poor's relative
16 to that though?

17 MR. MICHALEK: Their methodology had
18 changed and our change was in some sense a
19 reaction to the fact that they had already
20 changed.

21 CHAIRMAN ANGELIDES: Mr. Georgiou, on
22 your remaining time?

23 COMMISSIONER GEORGIOU: Thanks.
24 Thank you gentlemen. I guess I need to
25 ask this question even though there are

Q & A - Session 3

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2 quite a number of other trained lawyers on
3 this panel. But I'm the one who's got to
4 ask it.

5 Do you think that the fact that you
6 were insulated from liability, both
7 statutorily and ostensibly,
8 constitutionally, had any impact on the
9 methodology that you pursued and the
10 failure to comport it to reality?

11 MR. FROEBA: You know, at one time, I
12 was going to jump in, in response to the
13 question that was being asked of Rick, and
14 say the difference between Moody's and an
15 accounting firm or a law firm is that at
16 least there is some theoretical risk that
17 the accounting firm and the law firm might be
18 found liable. Take the case of Arthur
19 Andersen.

20 Nothing could be better for Moody's
21 then that some other rating agency were to
22 be found liable in a lawsuit and to
23 collapse. Why? Because the fear of
24 future lawsuits would create a discipline
25 in the analytical process that I think

Q & A - Session 3

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2 would add a tremendous amount of
3 integrity. That is my own opinion about
4 the best way to solve the current problem
5 with rating agencies.

6 Their lack of vulnerability is a
7 serious problem. And another serious
8 problem relate to it is the fact that they
9 pay no price for degrading their
10 reputation. They learned after Enron,
11 that, you know, no matter how bad the
12 reputation got, their business would grow.
13 What do you think is going to happen now
14 after this crisis if they pay no price?
15 That's a question that the people on this
16 commission should ask because all of your
17 children and family members are facing,
18 you know, a world economy that's
19 vulnerable to that reality.

20 COMMISSIONER GEORGIU: Right. And I
21 take it that, well, let me hear from the
22 rest of you with regard to this legal
23 liability issue, if you have anything else
24 to add.

25 MR. KOLCHINSKY: I think in general,

Q & A - Session 3

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2 legal liability was almost -- discussions
3 of legal liability, almost nonexistent.
4 That was part of the problem. People
5 didn't think. That never entered people's
6 thoughts in thinking about, we were just
7 offering an opinion and that was it, the
8 bottom line.

9 I actually want to also add to the
10 other question about the lawyers and
11 accountants, lawyers and accountants have
12 standards. Lawyers have to follow court
13 cases, accountants have GAAP. Imagine --
14 again to Arthur Andersen, if Arthur
15 Andersen, after Enron, said, "You
16 know what? Yeah, we did this, but that
17 was our methodology. Sorry, we're going
18 to walk away." And that's the difference.

19 What you heard today was Ray McDaniel saying,
20 "That's our methodology. Sorry." There's
21 no standards to judge rating agencies.
22 Each one of them has its own methodology.
23 That's the problem I think we'd all -- but
24 once you have the standards, then you can
25 apply legal liability by saying, "You

1 Q & A - Session 3

2 failed, that is fraud," and that's it.

3 COMMISSIONER GEORGIU: Mr. Michalek, you're a lawyer as
4 well, are you not?

5 MR. MICHALEK: I am, and I agree, I think
6 liability would be a necessary deterrent
7 to lack of attention to common issues of
8 negligence that occurred regularly.

9 COMMISSIONER GEORGIU: Mr. Witt?
10 Dr. Witt?

11 DR. WITT: I'm the only non-lawyer
12 here and I don't think the courts are the
13 best way to address this. I would,
14 because the issue is whether or not you
15 got the ratings right, not, you know, how
16 did you go about getting them or did you,
17 you know, fill out all the right forms or
18 something.

19 COMMISSIONER GEORGIU: All true.
20 All true, but they tend to have a salutary cautionary
21 impact. I mean, courts are extremely
22 crude methods of enforcing these kinds of
23 standards, but the fear of having to go
24 there often motivates behavior in a
25 positive way.

26 DR. WITT: Well, you know, the
27 Financial Stability Act does give the SEC

Q & A - Session 3

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2 the power to levy fines, and I thought
3 that a better way to go is to have the SEC
4 basically have a menu of fines that are
5 issued when you get the ratings wrong in a
6 major way. Proportional to how many bonds
7 you misrated, you pay a big fine; and you
8 know when, you're rating it, that's what
9 you're going to have to pay if you
10 misrate. I think to me, that makes more
11 sense.

12 COMMISSIONER GEORGIU: You think the
13 analysts who did it ought to have to pay
14 part of the fine, too, or do you think
15 just the company ought to pay the fine?

16 MR. FROEBA: Certainly make for a
17 more disciplined process if the analysts
18 had to pay.

19 DR. WITT: If the analyst had to pay,
20 you may not have any analysts at rating
21 agencies.

22 COMMISSIONER GEORGIU: I'm sorry,
23 Commissioner Wallison, go ahead and take
24 some of my time there.

25 COMMISSIONER WALLISON: The bosses

1 Q & A - Session 3

2 are very jealous of this, so --

3 CHAIRMAN ANGELIDES: Right. Well,
4 actually, I'm going to suggest you look
5 this way. Yes, I recognize you,
6 Mr. Wallison. Go ahead.

7 COMMISSIONER WALLISON: I just had
8 this one point to make about standards.
9 And it is true that there are, it's easier
10 to identify the standards for lawyers and
11 for accountants. However, the issue in a
12 lawsuit about an opinion has to do with
13 whether you applied whatever standards
14 there were negligently. If you were
15 negligent, even if you came to the wrong
16 answer in a legal opinion, as long as you
17 were not negligent in coming to an answer
18 that turned out, because of future events,
19 to be wrong, you were not liable.

20 MR. KOLCHINSKY: That is correct.
21 But in this case, you don't even have
22 standards to judge by. You can't be found
23 negligent if there's no standards to judge
24 by. It's your own standards, and you're
25 your own determinant. And that's the

Q & A - Session 3

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2 problem. That is a problem. And you need
3 standards to be able to have normal legal
4 procedures. Otherwise, if you don't have
5 any standards and legal liability, the
6 flip side of it, you're going to have a
7 lot of false negatives and people just
8 suing because they bought at the wrong
9 time. So you need standards and you need
10 legal liability.

11 COMMISSIONER GEORGIU: Okay, let me
12 finish back up here. We had this chart
13 earlier today, which showed that,
14 notwithstanding a number of cautionary
15 warnings, either from Mark Zandi, and other
16 downgrades that occurred along the way.
17 Each time there was a downgrade, there
18 appeared to be a spike up in the MBS
19 ratings, the number of MBS rated and the
20 number of CDOs rated.

21 I wonder if the two panelists who
22 weren't here this morning, I think I asked
23 you that this morning, did I not, as to
24 the other two of you? Maybe the other two
25 of you could tell me why it is that you

Q & A - Session 3

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2 think -- obviously, we understand that
3 it's easy for you to rely upon the general
4 perception that housing prices weren't
5 going to decline thirty percent or more in
6 certain marketplaces to justify your
7 initial ratings.

8 However, why is it that, once we knew
9 that the -- you were downgrading certain
10 RMBS and CDOs, and that the market was
11 declining, that there was still an attempt
12 to utilize the same methodology to rate
13 additional product coming in the door?

14 And, you know, I likened during the
15 prior panel here, it looked like you folks
16 were trying to mop up the last bit of
17 gravy before they took the plates away.
18 That really, was this just a market share
19 deal, try to get all these deals done
20 before they were gone? Mr. Michalek?

21 MR. MICHALEK: I was responsible for
22 doing the activity reviews, quarterly
23 activity reviews. And I did notice that
24 there was a flush of activity in late 2006
25 and started through the first part of the

Q & A - Session 3

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2 first quarter of 2007, even though we had,
3 at that point, already published
4 significant research that suggested that
5 those downgrades were potentially outliers
6 relative to previous history.

7 The simple explanation for this is, is
8 that our customers, the investment banks,
9 were clearing their warehouses. And it
10 was a case of, with respect to why didn't
11 we stop and change our methodology, there
12 is a very conservative culture at Moody's,
13 at least while I was there, that suggested
14 that the only thing worse than quickly
15 getting a new methodology in place is
16 quickly getting the wrong new methodology
17 in place and having to unwind that and to
18 fail to consider the unintended
19 consequences.

20 So there was a lot of research as to
21 what are we going to be doing if it turns
22 out that this really is an outlier. There
23 was, in fact, during the year-end review
24 for 2006, I was pointing this out in a
25 draft of one of the annual reviews and I

Q & A - Session 3

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2 was surprised by the reaction that was
3 coming from the people from RMBS saying,
4 "You don't want to mention that this is a
5 big outlier because we're still analyzing
6 this data and we can't say as yet as to
7 whether or not this is a front-loading of
8 a normal amount or a tolerable amount of
9 defaults that we're going to experience
10 over this cohort's life" --

11 COMMISSIONER GEORGIOU: But couldn't
12 you tell this these were downside risks,
13 not upside risks? Couldn't you see that
14 the direction of this data ought to have
15 led you to be more skeptical, and the mere
16 fact that the investment banks wanted to
17 clear out their warehouses doesn't mean
18 you have to pick up a broom and help them
19 sweep them out the door --

20 MR. MICHALEK: You're asking me to
21 wear two different hats. As an analyst,
22 of course you're right. These are warning
23 signs. We should be saying something
24 about it. From a business perspective,
25 somebody's going to make the forceful

Q & A - Session 3

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2 argument that it could be that these are
3 just front-loaded defaults and this isn't
4 going to be any worse than '92. And if
5 that's the case, we have the opportunity
6 right now to do a lot of business.

7 COMMISSIONER GEORGIOU: Right. Nine
8 basis points on a lot of billion dollar
9 deals, that's almost a million bucks every
10 deal.

11 MR. MICHALEK: And there's no
12 question, if we step away, those are going
13 to be rated by somebody else.

14 COMMISSIONER GEORGIOU: Mr. Kolchinsky
15 was trying to answer as well.

16 MR. KOLCHINSKY: One thing, you know,
17 I -- once they did make a decision to
18 downgrade in '07, in September, and I
19 found out about it and actually tried to
20 stop the factory, a manager,
21 Ms. Yoshizawa, did not want to do that.
22 And I actually spoke to Dr. Witt. I
23 didn't know what to do. He suggested that
24 we go to somebody more senior-- and we did a notching procedure.
25 But that's -- it was almost, as I said,

Q & A - Session 3

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2 the last couple of bits of paper. And
3 that's one of the reasons, that is the
4 reason, I believe, I was then asked to
5 leave the rating agency in October of that
6 year.

7 MR. MICHALEK: There's one final
8 point that I think Mr. Buffett actually
9 made. He was taking advantage and
10 exploiting the possibility that they
11 weren't rated correctly. We've already
12 heard from the Moody's representatives
13 effectively that their concern was, you
14 know, downgrades are bad news, and that
15 you don't want to prematurely downgrade;
16 and I think that it could be seen, because
17 of the multiple downgrades that took
18 place, that that first downgrade was
19 probably not going to be far enough.

20 So one impetus to structuring of more
21 issuance at that particular time is, "Hey,
22 we just got a whole bunch of things that
23 have been downgraded three notches, but
24 I've just done my independent analysis,
25 and I think it should have been six

Q & A - Session 3

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2 notches. Let's get this stuff out the
3 door."

4 COMMISSIONER GEORGIU: Okay. But
5 you're still rating them AAA. But the
6 problem is that you didn't rate them down
7 at all, you rated them AAA. And even
8 those that you rated after you started
9 discovering downgrading the other ones,
10 you rated AAA and then they had to be
11 downgraded again. I mean --

12 VICE-CHAIRMAN THOMAS: Grandfathered.

13 CHAIRMAN ANGELIDES: Quickly, I want
14 to move on, we need to keep our schedule
15 here -- my privilege as Chairman.

16 MR. FROEBA: A million dollars is
17 really not that much revenue in the end.
18 It was business relationships and
19 preserving them that was key, to answer
20 your question.

21 COMMISSIONER GEORGIU: Well, but
22 that's just one CDO, the million dollars.

23 MR. FROEBA: I know, but they might
24 have a hundred million of business in the
25 coming year.

1 Q & A - Session 3

2 COMMISSIONER GEORGIU: Of course.

3 MR. FROEBA: That's why they did
4 those one million dollar deals.5 CHAIRMAN ANGELIDES: Thank you.
6 Let's move on, now, to Mr. Thompson.7 COMMISSIONER THOMPSON: Thank you,
8 Mr. Chairman.9 So you had the opportunity to hear
10 your CEO or former CEO speak of what was
11 the most important metric or outcome,
12 which in his mind was rating quality.13 How do you respond to that, do you
14 believe that's the tone he set at the top
15 or not? I'll start with you, Mr. --16 MR. KOLCHINSKY: No, I do not. I don't
17 think he was against ratings quality, but
18 certainly it was not something that I
19 was -- there was a culture there, the old
20 culture, but no, I don't believe that that
21 was the tone set at the top.22 COMMISSIONER THOMPSON: So would you
23 call him something other than truthful in
24 that representation?

25 MR. KOLCHINSKY: I can't judge that.

Q & A - Session 3

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2 Maybe that's what he felt, but what came
3 down to us people working in the trenches
4 was --

5 COMMISSIONER THOMPSON: So the tone
6 you heard was something other than
7 ratings.

8 MR. KOLCHINSKY: Yes.

9 MR. FROEBA: I agree. I don't think-- I would have a
10 hard time identifying any particular means
11 by which they communicated their -- that
12 that was the value. I mean, I don't
13 recall any.

14 COMMISSIONER THOMPSON: Mr. Michalek?
15 I got it right, by the way.

16 MR. MICHALEK: I'm a lawyer, so I'm
17 trained to hold two opposing thoughts in
18 my mind at the same time.

19 COMMISSIONER THOMPSON: Well, just
20 give me one and I'll come back to the
21 other one later.

22 MR. MICHALEK: I think he does
23 believe that he was telling people that
24 ratings quality was the most important
25 thing. I think that there were reports

Q & A - Session 3

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2 internally that he was already receiving
3 suggesting that he was getting information
4 that people were concerned about the
5 quality of the ratings.

6 DR. WITT: I put this in my written
7 testimony, but there has been other
8 testimony and other investigations saying
9 the same thing. In November or October of
10 2007, we had a global MD meeting. I'm
11 pretty sure Eric was there. Where -- this
12 is after the massive downgrades have
13 already occurred.

14 And the CEO and CFO led off with the
15 exact same tone that they always did,
16 which was to focus on our profit margin
17 relative to Standard & Poor's, and they
18 were talking about, "Oh, it's one percent
19 lower than Standard & Poor's, we've got to
20 work on this."

21 We'd already had these massive
22 downgrades. Morale was really shot. And
23 somebody, one of the MDs in the corporate
24 side raised their hand and said, "You
25 know," this was after about thirty

Q & A - Session 3

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2 minutes, and said, "What are you doing to
3 restore Moody's reputation?" And all of a
4 sudden, there was this big scramble among
5 management, like, they didn't expect the
6 question. And to me, that was like, the
7 smoking gun in terms of, after that, I
8 didn't give Ray the benefit of the doubt
9 anymore.

10 COMMISSIONER THOMPSON: So there was
11 an entity within Moody's that had
12 responsibility for credit policy. So as
13 you were building models and anticipating
14 how they would be applied, what
15 interactions did you have with the credit
16 policy organization? I'll start on this
17 end of the table.

18 DR. WITT: Well, the incident that
19 Eric was just explaining, he was concerned
20 about -- this is in September '07, he's
21 worried about an imminent downgrade of
22 RMBS, and the fact that he believes that
23 they are going to continue to rate ABS
24 CDOs in spite of the fact that they know
25 there's going to be this big downgrade.

Q & A - Session 3

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2 So I got in touch with the head of
3 credit policy, Andy Kimball, and let him
4 know about this, and he decisively
5 intervened. And the next day, the
6 methodology was changed. That was my
7 main interaction with them prior to --

8 COMMISSIONER THOMPSON: So it did
9 function as a check and balance but you
10 had to go and overtly bring it to the
11 table.

12 DR. WITT: Yeah, and that was when
13 Andy was the head of it.

14 MR. KOLCHINSKY: That was true
15 because of Mr. Kimball's, as the head of
16 credit policy. Prior to that, he was, I
17 think head of international. At that
18 point -- prior to that, I do not recall
19 having any contact with credit policy
20 whatsoever. I think we made our
21 methodology internally. May have
22 communicated it to others, but that was
23 due to Mr. Kimball's sort of forceful
24 nature and he got that done.

25 COMMISSIONER THOMPSON: So much has

Q & A - Session 3

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2 already been said about the lack of
3 resources or, in many instances, the lack
4 of talent that you had to do the job as
5 the bubble was building.

6 Would that also be true for the
7 credit policy organization as its internal
8 watchdog?

9 MR. KOLCHINSKY: Like I said, I think
10 prior to Mr. Kimball signing onto
11 credit policy, I don't believe we had an
12 effective -- there was a nominal credit
13 policy function. I don't believe it had
14 any effective -- I never dealt with them.
15 There was never any back-and-forth. I
16 didn't know what they did.

17 Today, as part of my, the complaint,
18 I was suspended for last year, that there
19 is a nominal credit policy function. They
20 are better, but in most respects and
21 purposes, they are outvoted and outgunned,
22 if you will, by the lines of business.

23 So it's sort of -- I forget the term.
24 They are not effective still.

25 COMMISSIONER THOMPSON: Mr. Michalek,

Q & A - Session 3

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2 do you have a point of view?

3 MR. MICHALEK: I didn't interact with
4 credit policy. I interacted with
5 structured credit committee, which was
6 responsible for harmonizing the overall
7 rating methodologies across different
8 groups in different regions, so I can't
9 speak directly to credit policy.

10 COMMISSIONER THOMPSON: Mr. Froeba?

11 MR. FROEBA: We had very little, if
12 any, interaction with credit policy. I
13 would say none.

14 COMMISSIONER THOMPSON: So you were
15 allowed to do whatever you wanted to do
16 with no oversight as long as it meant
17 market share?

18 MR. FROEBA: Yes. And as I said, I
19 was in an area where this was no market
20 share pressure, so we were actually able
21 to be very conservative. And right up
22 until my departure, I -- as Gary mentioned
23 earlier, people were proud of the work
24 that they did. I was proud of the work
25 that I did. I worked hard on those deals,

Q & A - Session 3

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2 and I think they will stand up, not that
3 they're -- am I the CDO saint? No. If my
4 group had been exposed to significant
5 market share pressure, I would have
6 probably been as --

7 COMMISSIONER THOMPSON: Vulnerable.

8 MR. FROEBA: Exactly.

9 COMMISSIONER THOMPSON: Dr. Witt?

10 DR. WITT: To be fair to credit
11 policy, there were procedures about new
12 methodologies. If you published a rating
13 methodology piece, you had to get
14 sign-offs. I don't remember for sure, but
15 I suspect that you had to get a sign-off
16 from credit policy.

17 COMMISSIONER THOMPSON: So they were
18 involved in the development process of the
19 models?

20 DR. WITT: Well, yeah, they were
21 involved.

22 COMMISSIONER THOMPSON: I sense a
23 reluctance there.

24 DR. WITT: Well, they were not
25 heavily involved at the time that I was an

Q & A - Session 3

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2 MD, but I think there was this, that
3 involvement to that extent that they
4 did -- they had a veto in theory, if they
5 wanted to use it.

6 COMMISSIONER THOMPSON: I yield the
7 balance of my time, Mr. Chairman.

8 CHAIRMAN ANGELIDES: Thank you.
9 Mr. Holtz-Eakin.

10 COMMISSIONER HOLTZ-EAKIN: Thank you,
11 Mr. Chairman, thank you gentlemen, for a
12 depressing afternoon of testimony.

13 Let me just try to clarify a couple
14 of things. I'm trying to sort out about
15 how all this all went down. So first of
16 all, just, I guess, for all of you, did
17 Dun & Bradstreet not care about making
18 money?

19 MR. FROEBA: No, I think they did.
20 The theory, and probably one of the
21 reasons why Warren Buffett invested, is
22 because the idea is that a conglomerate is
23 not a sufficiently pure play for the
24 marketplace to be able to value the
25 company. So if you split them up, and

Q & A - Session 3

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2 that's exactly what happened, you split
3 them up and, voila, there was lot of value
4 that the market wasn't acknowledging
5 before.

6 I'm sure Dun & Bradstreet didn't want
7 to get rid of Moody's. It was compelled
8 to by its shareholders who found the
9 combined entity unsatisfying as a
10 performer.

11 COMMISSIONER HOLTZ-EAKIN: And so
12 your testimony in particular is about the
13 evolution of a model that would be more
14 profitable at the expense of the quality
15 of the ratings.

16 MR. FROEBA: Yes.

17 COMMISSIONER HOLTZ-EAKIN: So one of
18 the things that you pointed us to is ways
19 to understand this better, the changes in
20 methods that are used to come to ratings,
21 and, but we've been told pretty clearly
22 that ratings are more than models. So I
23 guess I'd like to hear what the
24 non-quantitative folks on one of these
25 ratings committees brought to the table,

Q & A - Session 3

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2 what information did they introduce, and
3 how were they affected by this evolution
4 of culture. Why don't I start with you,
5 Mr. Witt.

6 DR. WITT: Well, the people who were
7 saying that very strongly, I think it was
8 Jay Siegel especially, that ratings are
9 not just models, he was in the RMBS group.
10 And ratings were not just models in CDOs
11 either. But the CDO was more model-based
12 in part because we could be, because we
13 had the ratings as input, so you knew what
14 the ratings were. So you could have more
15 of a, just almost like a mathematical
16 function.

17 But we also had a very strong culture
18 of, you know, we had legal analysts on
19 every deal, which they did not have,
20 because the documentation was so much more
21 complex.

22 So I thought of it as, the legal
23 analysts were helping to make sure that
24 the document conformed with what the model
25 said. And that was definitely a

Q & A - Session 3

1 non-trivial task.

2
3 COMMISSIONER HOLTZ-EAKIN:

4 Mr. Michalek?

5 MR. MICHALEK: I think the
6 non-quantitative role of the rating
7 analyst which fell to the lawyers,
8 largely, was as Gary describes, a task of
9 confirming that the documentation was
10 faithful to what the quantitative analyst
11 was modeling. And then, we were looking
12 for legal risks, whether or not there was
13 an isolation of assets, all of the usual,
14 very standard and very overpaid legal work
15 that was being done by the law firms.

16 And we were also looking for some,
17 potentially, non-easily quantifiable risks
18 that could come from, for example, the
19 valuation of the collateral managers. We
20 would go, for each transaction, if there
21 was a collateral manager that we had not
22 recently visited, and that original -- it
23 evolved to where, if we hadn't seen them
24 within the past year, we needed to go see
25 if collateral manager. So we would make a

Q & A - Session 3

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2 trip to the collateral manager and
3 evaluate, do some due diligence on their
4 processes, and report in the committee as
5 to what our opinion of the collateral
6 manager was, and were they capable of
7 doing the work that was going to be
8 involved in this particular transaction.

9 That was one of the places where
10 there was a greater opportunity to say no
11 and in fact, I don't think that
12 opportunity was exploited.

13 COMMISSIONER HOLTZ-EAKIN: I actually
14 want to pursue that. It think it was you,
15 if I'm wrong, please correct the record, who
16 said, it became pretty clear that you had
17 some of these ratings wrong because the
18 market wouldn't take them. So the
19 underlying RMBSs that you referred to, the
20 market wasn't going to buy them, it was
21 clear that the RMBS guys had these things
22 rated wrong, but you took their ratings
23 anyway, put them into the CDOs and moved
24 these.

25 MR. KOLCHINSKY: That was me.

1 Q & A - Session 3

2 COMMISSIONER HOLTZ-EAKIN: Do not
3 answer, sir.

4 So that strikes me as information
5 that is very important to bring into the
6 ratings process but indeed was not. Why
7 not?

8 MR. KOLCHINSKY: It was very hard for
9 us to determine where -- it became clear
10 later in the process that a lot of this
11 product was being sold into sort of
12 captured and captive vehicles, even
13 warehouses. But it's very hard to tell
14 that day one.

15 As I said before, we were not told
16 where this was being sold. So it's
17 evidence we had to gather sort of piece by
18 piece. Bankers would not tell us where
19 they placed these bonds.

20 So because -- and if you actually look at
21 the spreads on this product, they all kept
22 coming down, because in the beginning,
23 they really needed to have real investors.
24 But by the end, the spread was driven, as
25 somebody put it, actuarially, by the -- by

Q & A - Session 3

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2 the model, the CDO model. So they
3 actually kept coming down as more
4 investors left, when you'd expect the
5 opposite. You would expect that if
6 investors left, you would -- spreads go
7 up.

8 But because you had a loss of real
9 investors, and a gain of more, sort of
10 statistical investors, if you will, the
11 spreads were coming -- so it was very
12 tough to tell until very late in the
13 process, and a lot of the things that I've
14 mentioned now are things that I've put
15 together since the crisis through the work
16 of commissions like this and other
17 committees. So the information just
18 wasn't out there, it wasn't available to
19 us to see where the demand was coming
20 from.

21 COMMISSIONER HOLTZ-EAKIN: So if no
22 one hears from the RMBS group, but it does
23 seem pretty clear, especially with
24 hindsight, that they got the expected loss
25 wrong, and that means they got the

Q & A - Session 3

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2 expected returns way too high, which means
3 they totally missed the risk, because
4 that's the only way you get that kind of
5 return, which may explain why it was a bad
6 idea to lower all the sensitivity to housing prices. But
7 they at least were working off data and
8 cash flows.

9 So my question for the folks doing
10 the CDOs and the diversity scores is, how
11 was that done in the absence of actual
12 data on actual performance, only using the
13 now-faulty ratings you had from the RMBS
14 folks?

15 DR. WITT: Well, we had two
16 methodologies in my career. The first one
17 was actually, it's, they thought it up
18 just before I got there, but I do explain
19 it in my testimony. It was called the
20 multi-sector paper. It was written by Jerry Gluck--

21 COMMISSITIONER HOLTZ-EAKIN: --
22 correlated.

23 DR. WITT: Well, it's this reduction
24 in diversity score, and the diversity
25 score is -- it is calculated by a some --

Q & A - Session 3

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2 correlation assumptions to calculate a
3 diversity score. Once you have the
4 diversity score, you use this binomial
5 framework that assumes independent assets.
6 Those correlations if you read the paper,
7 it's very clear, and Jerry use to say
8 this, Jerry Gluck who wrote the paper,
9 when people say, "Where did you get them,"
10 he'd say, "We just made them up," you
11 know, because they didn't have any data.
12 And they say that.

13 They went to the analysts in those
14 groups, and say, "How correlated do you
15 think these things are?" So this was in
16 1999. By '05, when we felt we needed to
17 have a model that had correlation built
18 into it, we also had more data by that
19 time, so there was a data analysis.

20 It was primarily, the useful data
21 on correlations was from rating
22 transitions. There was not enough data on
23 actual defaults, but, you know, they did
24 look at rating transitions to see how
25 correlated they were. And we used that as

Q & A - Session 3

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2 the basis, but in a very, very general
3 sense, for the correlation matrix we came
4 up with.

5 COMMISSIONER HOLTZ-EAKIN: So this is
6 the point I want to try to understand in
7 the way the culture worked mechanically.

8 Ongoing surveillance clearly is very
9 important, because transitions in rating
10 would be important information for initial
11 rating of these securities. But I've also
12 heard that some would be grandfathered,
13 and thus, the ongoing surveillance would
14 have to take place using a standard method,
15 which is not the current one.

16 I've also heard that ongoing
17 surveillance was not well tied in,
18 especially with the RMBS. That was from
19 the previous panel.

20 Would each of you tell me, in your
21 line of business, the degree to which your
22 ratings were informed by information
23 coming out of the surveillance process and
24 the way in which you communicated with
25 them, and whether the process took

Q & A - Session 3

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2 advantage of the ability to be better or
3 simply discarded the information that was
4 learned. Mr. Kolchinsky?

5 MR. KOLCHINSKY: I think in our
6 group, in the beginning, when I joined,
7 there was no separate surveillance group,
8 so analysts had to surveil their own
9 deals.

10 In that case, we had pretty good
11 feedback. Obviously, you see what's going
12 on, and we had some developments that we
13 saw from the fallout in what I've called
14 the stage 1, which was the CBO class bond
15 obligations, as well as the first
16 re-securitization, multi-sector deals that
17 we put into new methodologies.

18 But further on, we used actually the
19 same methodology for, generally, for
20 surveillance and rating. So we did not
21 have as good a feedback because we didn't
22 see what the folks on the surveillance
23 side were doing. But it wasn't like on
24 RMBS where they used two different
25 methodologies completely.

1 Q & A - Session 3

2 COMMISSIONER HOLTZ-EAKIN: I see. My
3 time is short, so if there's anything
4 anyone wants to add; otherwise, thank you.

5 CHAIRMAN ANGELIDES: Need any more
6 time?

7 COMMISSIONER HOLTZ-EAKIN: Only as
8 necessary to complete.

9 CHAIRMAN ANGELIDES: A couple of
10 minutes. Anything? If not we'll take away--

11 MR. MICHALEK: The only question, I
12 just wanted to revisit the idea of what
13 non-quantitative elements went into the
14 rating, and that was the assessment of the
15 quality of the collateral manager. That was
16 a case where we would have had more of an
17 opportunity to say, "You know, this
18 particular collateral manager isn't really
19 up to speed or is somehow not what we
20 would prefer." It was discussed but never
21 implemented as to how much we were going
22 to effectively charge the deal for a lack
23 of quality for that particular collateral
24 manager.

25 That, again, was a very, very strong

Q & A - Session 3

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2 issue, if you want to call it that, that
3 impacted relationships with the investment
4 bankers. You couldn't tell this
5 particular investment banker that we were
6 going to charge half a notch of rating to
7 this particular collateral manager just
8 because this was his first deal, or just
9 because it's really three guys and a
10 Bloomberg, which was what we would
11 characterize the upstart collateral
12 manager who was not particularly prepared.

13 So that was an opportunity where we
14 would bring information to the ratings
15 process and then whether or not it was
16 going to be acted on was a function of
17 business considerations.

18 COMMISSIONER HOLTZ-EAKIN: Thank you,
19 gentlemen.

20 CHAIRMAN ANGELIDES: Let me, just before we go to
21 Ms. Born, let me wrap up some of what
22 Mr. Holtz-Eakin talked about, because one
23 of the things that struck me, as I've
24 looked at all the materials over the last
25 month or so, is the extent to which this
26 really was a blend between the

Q & A - Session 3

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2 quantitative with whatever deficiencies,
3 and I say that not to say necessarily
4 sloppy work, but a lack of, perhaps,
5 knowledge of what was going on, an
6 evolving knowledge of what's going on, and
7 obviously, judgment.

8 I mentioned this morning that I saw a
9 whole beam on the qualitative side. Not
10 having, you know, that kind of knowledge
11 on the ground, you want to look through --
12 and I mean, I would make an observation --
13 not only look through, but look all the
14 way down to the ground. But in total, how
15 would you characterize, two things, how would you
16 characterize in total the ratings
17 process if you were to -- and let me add
18 one other thing:

19 I also understood that models were
20 run, they'd be looked at qualitatively,
21 and you'd make adjustments. Today,
22 Mr. Stein said that, you know, for
23 example, in the RMBS world, they might
24 take the worst loss and then multiply it.
25 So you'd run the model, people would look
26 at it and essentially feed back

Q & A - Session 3

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2 information to have the model come out
3 where people thought it ought to be.

4 How much would you say in large order
5 of this process was qualitative,
6 quantitative? Because I think the understanding,
7 and here's the second part of this, which
8 is, if you look at kind of what Moody's
9 puts on the website, you would come away
10 believing it's quantitative mostly; is
11 that a fair statement?

12 A VOICE: Sure.

13 CHAIRMAN ANGELIDES: So I think the
14 representation was quantitative. How much
15 was folks making their best judgment,
16 working with models that were only as good
17 as they were? What's the blend?

18 MR. KOLCHINSKY: I think I would
19 separate it in two: things that were already
20 established, non new things were
21 almost all qualitative, just run them
22 through the model.

23 CHAIRMAN ANGELIDES: Where there was
24 high confidence levels about the quality
25 of the data?

Q & A - Session 3

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2 MR. KOLCHINSKY: No, it was because
3 you were held to that standard by the
4 bankers. This is your methodology. You
5 better follow that.

6 CHAIRMAN ANGELIDES: By the bankers?

7 MR. KOLCHINSKY: By the bankers.
8 Where there's qualitative --

9 CHAIRMAN ANGELIDES: Well, give me an
10 example of that, and then I --

11 MR. KOLCHINSKY: They would, for
12 example, as we said, our methodology was
13 open book. They could download the
14 models, run themselves, and they would
15 say, this is --

16 CHAIRMAN ANGELIDES: Oh, the bankers
17 saying -- bankers saying, "This is what
18 you represent, I want it. It's on the
19 shelf, this is" -- okay.

20 MR. KOLCHINSKY: For example, the
21 simple synthetic model was a CLO model.
22 You could download it, anybody can for
23 free, put the portfolio in, here's it is,
24 the banker says, "I want this." And
25 you're kind of limited to what you could

Q & A - Session 3

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2 say because here's your model and there it
3 is out there, and where you could have
4 more qualitative is in what I call the
5 Delta.

6 So this has changed from this model.
7 And it's a question of -- what stopped is
8 that you had less time to look at these
9 changes, the Deltas, "Is the model no
10 longer appropriate for this type of
11 portfolio." You had less time to do that,
12 you had less time to analyze it and you
13 had less time to say what the effective
14 change ought to be, is it five percent, is
15 it fifty percent?

16 CHAIRMAN ANGELIDES: So that part was
17 qualitative.

18 MR. KOLCHINSKY: That's qualitative.

19 CHAIRMAN ANGELIDES: But to the
20 extent that bankers insisted on using a
21 certain factor, I would assume they
22 weren't insisting you use those things
23 they thought were overly stringent.

24 MR. KOLCHINSKY: Of course not.

25 CHAIRMAN ANGELIDES: Okay, just

Q & A - Session 3

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2 checking. All right. Quickly, reactions?

3 MR. FROEBA: I would say it's mostly
4 model but unless you made sure that your
5 documents reflected the model, your
6 analysis could be completely wrong. So
7 the non-model part was very important. It
8 just was not, it was not driving the
9 ratings. You couldn't look at the
10 document and determine something was AAA.

11 MR. MICHALEK: The willingness of the
12 bankers to use and adhere to standard
13 documentation would determine how
14 important the non-quantitative element of
15 the transaction was. Even if the standard
16 swap document was going to have huge
17 sections that would come in to a lot of
18 play, definitions of the defaults and the
19 credit events would be manipulated and
20 otherwise massaged because that's where
21 all the vig was for the bankers who were
22 structuring this transaction.

23 So to the extent that you're
24 considering that for be non-quantitative,
25 that was, it was a hundred percent of my

Q & A - Session 3

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2 job.

3 DR. WITT: Well, I'll give an example
4 that Rick and I worked on that was, again,
5 it was in my written testimony, something
6 that you guys have talked about in a
7 previous panel, was about the liquidity
8 puts that were used to issue CP out of
9 CDOs. We worked on the early transactions
10 and those, the way those agreements were
11 crafted into the documentation in the
12 early Citibank deals were just
13 horrendously complicated.

14 And if I hadn't had Rick there with me,
15 you know, there's no way -- they would
16 have been able to -- I thought that their
17 agenda was to try to put contingencies
18 into those liquidity puts so that, if
19 investors didn't buy the CP, they would
20 have some out where they would not have to
21 buy it themselves and then investors
22 would, you know, be holding CP that became
23 you know, thirty years long and could well
24 be money market funds, and I was extremely
25 afraid of that.

1 Q & A - Session 3

2 And, you know, it was only because
3 Rick was so dogged and skilled at looking
4 for documentation, it was just a big
5 spaghetti bowl of back-and-forth between
6 the prospectus and all these ISDAs and
7 stuff. So that was an example of these
8 very qualitative, but it had quantitative
9 aspects.

10 CHAIRMAN ANGELIDES: And ISDA, for
11 folks, the International Swap Dealers
12 Association, or I guess they will call
13 themselves something else today, but,
14 correct?

15 DR. WITT: Right.

16 CHAIRMAN ANGELIDES: All right. So,
17 okay, very interesting observation and in
18 many respects to the extent that products
19 were customized, particularly complex, and
20 amplified the non-quantitative.

21 DR. WITT: Especially when it was a
22 new type of product.

23 CHAIRMAN ANGELIDES: All right, thank
24 you. Ms. Born?

25 COMMISSIONER BORN: Well, just

Q & A - Session 3

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2 continuing on with that, I want to go back
3 to the synthetic CDOs is that I was
4 talking with Mr. Kolchinsky about earlier
5 today.

6 You were saying how you saw a number
7 of CDOs come along during 2007 that had a
8 synthetic aspect to them; that is, they
9 had credit default swaps in the asset pool
10 to some extent, rather than pure RMBS;
11 isn't that right?

12 MR. KOLCHINSKY: That is correct. I
13 don't have the exact data, but I would
14 venture that, by '07, nearly all CDOs had
15 some exposure to synthetics, either in the
16 RMBS or the CDO buckets for the high grade
17 deals.

18 COMMISSIONER BORN: And we were
19 talking about a number of issues that
20 these new, more complex instruments had
21 that you were concerned about. You've
22 listed a number of them. And I just
23 wanted to ask you a little bit more about
24 that.

25 One is, you know, when you had a

Q & A - Session 3

1 credit default swap on a residential
2 mortgage-backed security, rather than the
3 residential mortgage-backed security
4 itself in the pool, how did you rate, or
5 what rating would you assume for the CDS?
6 Would you go to the underlying of the CDS,
7 that is, to the underlying residential
8 mortgage-backed security?
9

10 MR. KOLCHINSKY: That is correct.

11 Most of the CDS that were done on RMBS
12 were of the pay-as-you-go variety, which
13 meant theoretically, they sought to mimic
14 the payments on the actual RMBS. There
15 was some mismatch, but we did not penalize
16 them for it.

17 The great problem with those were the
18 secondary risks that came along, which
19 were primarily the funding risks, because
20 now you had cash on hand which wasn't
21 invested in the RMBS. It had to be
22 invested in something else. And the
23 bankers wanted to take that money and
24 increase their returns by investing it in
25 other risky assets, and those risky assets

Q & A - Session 3

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2 added risk to the CDO.

3 COMMISSIONER BORN: So that's where
4 the questions about collateral and other
5 issues --

6 MR. KOLCHINSKY: Yes.

7 COMMISSIONER BORN: I wonder whether
8 or not it was really accurate to look at
9 the rating for the underlying RMBS when
10 there were all these additional issues
11 posed by the fact of the credit default
12 swap. I mean, this was clearly a big step
13 away from the mortgage-backed security
14 itself.

15 MR. KOLCHINSKY: I think we tried to
16 ring-fence those other risks. Some of
17 them didn't turn out so well, and I think
18 some of the lawyers -- I'm not a
19 practicing lawyer, as I like to emphasize,
20 but these practicing lawyers will tell you
21 about the bankruptcy of Lehman and what
22 this did to some of the protections that
23 were in CDOs. They can probably speak to
24 it better than I. So the ring-fencing
25 turned out to be poor in some of these

Q & A - Session 3

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2 issues. But yes, those turned out to be
3 not just, in some cases, the CDOs were
4 funded by the CDOs themselves in the case
5 of one underwriter. So it created these
6 circular structures that created a mess
7 for the banks themselves.

8 So yes, on a macro basis, the use of
9 credit defaults also created many other
10 problems within the financial system, not
11 as much probably for the CDO itself except
12 for this Lehman Brothers bankruptcy.

13 COMMISSIONER BORN: Holding that for
14 a minute, I'd like to ask you about
15 default correlation issues raised by the
16 facts that these CDOs were coming along
17 with credit defaults swaps in them, and I
18 think you were saying in your testimony
19 that you would see, in a series of CDOs
20 coming in, that there could be in each of
21 them, CDSs on the same underlying that you
22 saw in the last CDO.

23 MR. KOLCHINSKY: Yes. In an
24 all-cash-product world, your -- the
25 probability of one bond appearing in two

Q & A - Session 3

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2 pools was limited by some economics, so
3 there's maybe a total of ten million of
4 that entire tranche, and that was split
5 among ten investors, and that's it.
6 That's the entirety of that element in the
7 entire world.

8 With synthetics, you can take that
9 tranche and you can replicate it
10 infinitely. It was especially true of the
11 ABX where, I believe, again, this is with
12 hindsight, what we saw with a lot of hedge
13 funds who wanted to short the ABX and the
14 bankers didn't want to take just that
15 side. So they off-loaded that risk into
16 CDOs, which meant that there were a lot of
17 CDOs with very similar portfolios. We
18 didn't know about that at the time but
19 sort of with twenty-twenty hindsight you
20 could see that.

21 And we had a -- what we were
22 concerned about with the ABX was that it
23 was becoming, starting to become very
24 widely used. It had somewhat of a dollar
25 discount, which cash did not. So that

Q & A - Session 3

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2 would make it, increase the arbitrage,
3 which means increase the probability of it
4 occurring in multiple deals. And you can
5 replicate it infinitely. There's no
6 limitation on it, no natural limitation on
7 it. So that would increase the
8 correlation, a hundred percent
9 correlation, effectively.

10 COMMISSIONER BORN: Exactly, because
11 it's the very same asset.

12 MR. KOLCHINSKY: Yes.

13 COMMISSIONER BORN: Did you indicate
14 in your testimony that there was a paper
15 that was prepared on this issue --

16 MR. KOLCHINSKY: Yes.

17 COMMISSIONER BORN: -- in October of
18 '06?

19 MR. KOLCHINSKY: Yes, we had a paper
20 ready to go, the author was an analyst,
21 Sushnita Nagarajan -- I'll give you the spelling later. But one
22 of the things
23 it says, we want to limit the exposure of
24 the ABX in any deal to a de minimis
25 amount, and I think my manager thought
26 that was not appropriate, given -- and she

1 Q & A - Session 3

2 asked not to publish the paper, so we
3 never did.

4 COMMISSIONER BORN: Because of the
5 potential loss of business?

6 MR. KOLCHINSKY: Yes. That's what I
7 believe, I don't know but that -- I
8 believe that was due to potential loss of
9 business.

10 CHAIRMAN ANGELIDES: Do we have that
11 paper, do we know?

12 MR. KOLCHINSKY: I have a draft of
13 that paper, and, yes.

14 CHAIRMAN ANGELIDES: Can you provide
15 it? We can also request it, if you give
16 us -- we request that document.

17 MR. KOLCHINSKY: Yes, I believe you
18 already actually have it. I will identify
19 the specific e-mail that it contained.

20 COMMISSIONER BORN: Let me ask
21 Mr. Michalek about the reference to the
22 Lehman Brothers bankruptcy and the issues
23 posed there.

24 MR. MICHALEK: I don't want to expand
25 and state something incorrectly because I

Q & A - Session 3

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2 know it's obviously going to turn on the
3 facts of the individual case. But in
4 general, the point is this, that there
5 were assumptions being made when we were
6 rating synthetic CDOs, that depended
7 largely on the documentation, is the
8 documentation and the other standard form
9 documentation, particularly with respect
10 to collateral and rights to collateral in
11 the event of a bankruptcy. And the order
12 in which the obligors or the creditors
13 would be paid out given the contractual
14 obligations represented by the standard
15 documentation.

16 The Lehman bankruptcy case has shown
17 that in fact, some of the assumptions were
18 incorrect, and that the structural
19 subordination that has been discharged, I
20 think, was one consequence which was
21 contrary to the assumptions that we were
22 using when we were rating these
23 transactions.

24 COMMISSIONER BORN: We may ask some
25 follow-up written questions to you and

Q & A - Session 3

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2 also to Mr. Kolchinsky about the synthetic
3 CDO issues.

4 Let me just ask, some of these CDOs
5 were I think called something like
6 actively managed assets. So you didn't
7 actually have the pool of assets at the
8 time you were rating them, or they could
9 change as time went on.

10 Also, with some of the CDOs, they
11 were actually -- had as the underlying
12 assets mezzanine tranches of other CDOs;
13 that is, they were CDO squared or CDO
14 trebled.

15 How did you handle valuing the
16 underlying in those cases? And didn't
17 those pose some monumental issues?

18 MR. KOLCHINSKY: I'll take the second
19 question first. In fact, we probably, if
20 you would extend back, we had CDO to the
21 infinite power because each CDO had a CDO
22 bucket, had to be passed on and on and on.
23 We handled each one as a separate bond,
24 and this goes on to what Dr. Witt was
25 saying. We didn't have the computing

Q & A - Session 3

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2 power to look through. Most people
3 didn't, but that's something that you
4 would want because that increased the
5 correlation.

6 There were CDO squareds. We looked
7 at them on an individual level. The
8 problem with them, again, from a
9 structural macro perspective is that they
10 started as ways for bankers to get rid of
11 the mezzanine tranches that nobody would
12 buy. And that was the problem. If you
13 didn't have a buyer for these deals
14 because it was uneconomic. Maybe they
15 didn't think it was going to blow up, but
16 it wasn't economic, that changed the
17 economics for the deals. So the only
18 thing that made ABSs possible was this
19 takeout through other CDO. Could you
20 repeat the first question? I'm sorry.

21 COMMISSIONER BORN: The first one was
22 about the actively-managed assets where
23 maybe the assets weren't there to analyze
24 at the time you were rating them, or maybe
25 they -- if they were, they could change at

Q & A - Session 3

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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

1 Q & A - Session 3

2 issue. In these CDOs to the -- to the
3 infinite degree, didn't those raise some
4 real risk parameters for these instruments
5 as well?

6 MR. KOLCHINSKY: They did. We
7 didn't -- because we didn't know where
8 they sold them into, I think if we did
9 know, we could track a hundred percent
10 went into this in CDOs. We only had the
11 other side of it and only because we rated
12 to parameters only when they went into
13 effect, it was hard for us to
14 reconstruct that at the time. But I
15 think, yes, I mean, I think if that was
16 raised, that should have raised some
17 bells.

18 I'm not sure it would have, given the
19 market share focus, but that certainly
20 should have raised some alarms saying,
21 "Gee, a hundred percent of this deal is
22 going into another deal; aren't there any
23 real investors?" Yes. But we had a hard
24 time finding that.

25 COMMISSIONER BORN: Thank you.

1 Q & A - Session 3

2 CHAIRMAN ANGELIDES: Ms. Murren? The
3 cleanup.

4 COMMISSIONER MURREN: Thank you.
5 Thank you all for spending so much time
6 with us today. Appreciate it.

7 One of the things we're hoping to
8 achieve with looking at case studies is to
9 be able to determine if there are
10 similarities or differences in industry
11 practices across the various participants.
12 And so I was wondering if you could each
13 comment on similarities or differences
14 that you see between Moody's, S&P and
15 Fitch in terms of the culture, the
16 methodology and also to the extent that
17 they did or didn't get the ratings right.
18 Mr. Kolchinsky?

19 MR. KOLCHINSKY: I think the
20 interesting part is, the methodologies are
21 very different. Moody's rates to expect a
22 loss, S&P and Fitch rate to probability of
23 default. Very different concepts, and yet
24 we all came up with the same standards.

25 The analyses that each firm uses are

Q & A - Session 3

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2 also extremely different. Yet, at the end
3 of the day, due to the market share
4 mechanism, the ratings came out exactly
5 the same.

6 I would want to say about the
7 culture, I think one of the reasons, it's
8 my personal view, you're seeing a lot more
9 Moody's people out here is that we had,
10 the old culture was a bit idealistic. A
11 lot of us liked that academic culture.
12 And I think a lot of us have been --
13 again, this is a point of pride at having
14 worked at the old Moody's, and the Moody's
15 I still love, is that there was a great
16 culture then which I think a lot of us
17 have been disappointed, and I think that's
18 one of the reasons you're seeing a lot of
19 folks from Moody's here in front of you,
20 because we do remember how it used to be,
21 and liked it. So I think that's -- I
22 never worked at S&P or Fitch but I think
23 that's one aspect of Moody's culture.

24 MR. FROEBA: I said earlier, in
25 response to a question, that I was

Q & A - Session 3

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2 somewhat befuddled by the example of the
3 methodological change that Gary developed,
4 the application of the correlated binomial
5 to CDOs in connection with my assertion
6 that if you tracked market share. But as
7 I thought about it, I realized it really
8 isn't a problem to what I'm asserting
9 because what I'm asserting is that
10 material changes, changes which affect the
11 rating, that those corresponded to market
12 share pressure.

13 And I think if we quiz Gary, I
14 hope -- and I don't know the answer to
15 this question, which is a bad sign in a
16 lawyer, never ask a question you don't
17 know the answer to, I think Gary will
18 assert or confirm that there was very
19 little material substantive difference
20 between the two methodologies, that the
21 correlated binomial as applied to CDOs did
22 not really materially change the ratings.
23 That's I think an important point.

24 The point is, therefore, it was fine
25 at Moody's to change methodology if it had

Q & A - Session 3

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2 no impact on the ratings, and therefore,
3 revenue and market share. Fine, you could
4 change it, whatever. Go ahead. Right
5 ahead.

6 If you change methodology, however,
7 and it was going to cut your market share
8 in half, that was going to have a big
9 impact. And it wasn't going to happen.
10 So I think if you look at what happened at
11 Moody's, the changes, the material changes
12 in methodology, the changes that led to a
13 different rating occurring, only happened
14 when there was market share pressure and
15 the result was always that the ratings
16 were more competitive with our
17 competitors' ratings.

18 Now, why that whole preface? Because
19 I think what was happening with the other
20 rating agencies is that they were doing
21 the same thing. They were watching
22 Moody's, they were watching, S&P was
23 watching Fitch and Moody's, Moody's was
24 watching Fitch and S&P, and Fitch was
25 watching Moody's and S&P.

Q & A - Session 3

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2 COMMISSIONER MURREN: Were you aware
3 of any instances where the analysts wanted
4 to change the methodology but essentially,
5 that was suppressed?

6 MR. FROEBA: It's important to
7 remember when you think about the process
8 that an individual analyst had almost no
9 capacity to change a methodology. At the
10 margins, they could make small changes.

11 As I said, I think somewhat earlier,
12 the agency's intellectual property is the
13 methodology and that's really controlled
14 by a small select group, with a much less
15 formal process, and it's usually very
16 senior people. An individual analyst --
17 so in response to your question, normally,
18 an individual analyst couldn't make a
19 material change to methodology. It would
20 have had to have been something that was
21 driven by people much more senior than an
22 ordinary analyst.

23 COMMISSIONER MURREN: Thanks.

24 MR. MICHALEK: Two comments. I had
25 an opportunity to testify in front of the

Q & A - Session 3

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2 Permanent Subcommittee of Investigations
3 for the Senate Governmental Affairs
4 Committee. And I was struck by what I
5 would suggest is an even worse culture at
6 S&P, in terms of their frustration in
7 trying to affect meaningful changes to the
8 methodology that was being employed.

9 So in that sense, I think that we
10 probably did have -- and I'm only
11 speculating because I can't compare, I
12 wasn't at S&P -- we did have a stronger,
13 deeper intellectual culture in place, at
14 least prior, so that it was slower to
15 erode potentially than what I saw from the
16 exhibits and the testimony that was given
17 regarding S&P's culture, if you will.

18 Regarding changed methodologies that
19 were suppressed, I can think of one
20 example in the market value CDOs where a
21 quantitative, esteemed colleague of ours
22 was suggesting that there needed to be a
23 revision to the market value methodology,
24 and his efforts were discouraged.
25 Further, that he had provided, the same

Q & A - Session 3

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2 Individual, had provided some critical
3 analysis to the SIV methodology that was
4 being employed, and was "convinced," and I
5 use that in air quotes, that potentially
6 the benefit from installing his more
7 conservative perspective would not
8 outweigh the potential loss that would
9 come from the market share that would
10 occur.

11 And what he was effectively doing,
12 and I can only summarize because I can't
13 speak at his level of quantitative skill,
14 was increasing the likelihood of a
15 depression-level scenario in terms of
16 defaults and risks.

17 Had they done that, it would have
18 effectively made SIVs, or at least this
19 sector of SIVs that were under
20 examination, not possible to be rated.

21 COMMISSIONER MURREN: I'm guessing we
22 may want to follow up on that.

23 MR. MICHALEK: Happy to cooperate.

24 CHAIRMAN ANGELIDES: Can you say what
25 you said?

Q & A - Session 3

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2 DR. WITT: The name of that analyst
3 was Cesar Crousillat, and the reason that
4 I asked was that Cesar, along with Mark
5 and Rick, were -- their positions were
6 terminated in the fall of 2007. I mean,
7 you've heard their testimony. These were
8 really smart guys, and Moody's needed
9 their services, and I always thought it
10 was the personnel decisions that made me
11 the most uncomfortable, especially at this
12 time, in terms of what was management's
13 real purpose. And of course the other
14 person that they took out of the rating
15 agency at the point in time was Eric.

16 They removed him to a software
17 company. So I mean, these were, like the
18 most independent minded, you know, people
19 they had, and some of the best people they
20 had.

21 As far as the --

22 CHAIRMAN ANGELIDES: Before you
23 proceed, I just want to say that if you
24 would please give Crousillat's
25 information, do you know -- certainly,

Q & A - Session 3

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2 would you please give it to our staff so
3 we can follow up on this.

4 VICE-CHAIRMAN THOMAS: At least the
5 spelling.

6 DR. WITT: As the other rating
7 agencies, this is kind of ancient history,
8 so I'm not sure it's relevant, but I
9 worked at Prudential Securities before I
10 came to Moody's. And it was an investment
11 bank, and, you know, I was working on
12 structuring CDOs, so I had to, I dealt
13 with S&P and Fitch from that side. And I
14 was -- I didn't want to stay in investment
15 banking, and I met Jerry Gluck and I got
16 to know a few of the analysts at Moody's
17 and I was just very impressed with the
18 culture at that time. This was in 2000.

19 And I concur with Rick's opinion
20 that, you know, it was just much more of
21 a, you know, a bunch of smart people
22 getting together and saying, "How can we
23 do this right," kind of culture at
24 Moody's, which was one of the reasons why
25 I wanted to join.

Q & A - Session 3

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2 COMMISSIONER MURREN: Thank you. Do
3 I still have more time?

4 CHAIRMAN ANGELIDES: Yes.

5 COMMISSIONER MURREN: Question for
6 all of you: In your experiences at
7 Moody's, were you ever aware of an
8 instance where the issuer or the
9 investment bank gave information to you as
10 the rating agency that was either
11 incorrect, poorly represented, or
12 incomplete?

13 MR. FROEBA: Well, I just generally
14 assume that investment bankers were lying
15 to me whenever it was, you know, if there
16 was any -- anything at issue. And that
17 was a useful thing to do. I always
18 checked. I never relied.

19 They would do things like do creative
20 black-lining so this thing they didn't want
21 you to catch wouldn't show up in the
22 black-line. You had to be very
23 scrupulous if you wanted to avoid -- and
24 it was a very contentious relationship
25 often that arose between Moody's and the

Q & A - Session 3

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2 banks. So yes, there were often times
3 when things were hidden, concealed,
4 misrepresented. Fraud, I don't think so.
5 I didn't experience that.

6 MR. KOLCHINSKY: In some cases, where
7 we rated deals using the CDO ROM model,
8 and it was a static pool, so we actually
9 rated to the pool. We've gotten, and I
10 don't think it's fraud just because I
11 don't know what, I think it was mostly
12 copying, pasting by the analysts, but we
13 got back a CRO form that we looked at
14 that -- there were certain columns that we
15 had to fill out, and unless the text was
16 exactly the same, compared text to text,
17 so the text strings were -- weren't
18 exactly the same, they were treated
19 differently.

20 And different bonds, the same exact
21 bonds that should have had identical text,
22 they were not, I think that's mostly
23 copying, pasting, but that just -- maybe
24 in some cases, there's no way for us to
25 know, but something you had to check.

Q & A - Session 3

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2 MR. MICHALEK: There was an example,
3 from -- I can't remember the exact year,
4 2003? Structuring bank I think was Credit
5 Suisse. One of the processes that has
6 been alluded to here is, I would mention a
7 cleaning out of the warehouse. That
8 effectively, you do deal one, and you
9 can't sell the equity or you can't sell
10 junior-most piece, so they take it out onto
11 their balance sheet. And then that bond
12 from CDO 1 would end up being an asset for
13 CDO 2.

14 So they've got a period of -- they
15 are extended a line of credit by their
16 credit committee as to how much of this
17 they can have, but it's important that
18 they keep rolling this stuff off of their
19 balance sheet, getting it into the
20 subsequent CDOs. However, there's some
21 restrictions are just inviolable with
22 respect to the Moody's methodology, you
23 can't have more than X percent that were
24 not rated by Moody's because of the
25 problems, et cetera, et cetera.

Q & A - Session 3

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2 Well, there was a case where, here
3 was a structure that had gotten assembled,
4 that had some non-qualifying assets that
5 we only learned about at the very end, and
6 in fact, it was after the deal had
7 originally been rated, and we were coming
8 to a closing, we ended up having to, "what
9 are we going to do about this?" And we're
10 going to have to withdraw the rating and
11 make an announcement that says this
12 was incorrectly rated, and it was a huge
13 embarrassment.

14 So the banker at the time suggested,
15 "Well, I think I have a solution. We'll
16 buy back all of those bonds so that your
17 rating will not have been at issue." It
18 was agreed that we would do that provided
19 that none of these bonds ended up in any
20 CDO that Moody's subsequently rated.

21 And about three months later, low and
22 behold, there's that bond sitting there
23 and it was like, "Oh, that was just an
24 accident, we'll buy that one back out of
25 this one as well."

Q & A - Session 3

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2 So that sort of, you know, can I say
3 that this was fraud? No. Can I say that
4 it was shark dealing? Daily. Daily.

5 COMMISSIONER MURREN: Any investment
6 banks stands out as making the most
7 innocent mistakes repeatedly?

8 VICE-CHAIRMAN THOMAS: Nicely
9 phrased.

10 MR. MICHALEK: Banks don't make
11 mistakes. The people make mistakes. You
12 could probably find some particularly
13 aggressive bankers, their names are well
14 known, and those bankers have moved from
15 bank to bank, and perhaps in your
16 research, I'm sure these names have
17 already come up.

18 Obviously Lehman Brothers, there were
19 individuals at Lehman Brothers who were
20 extremely aggressive and it was difficult
21 to actually say no, and they were very
22 aggressive about pushing back. Again, I
23 don't want to accuse anybody of fraud
24 without having all of the details and
25 facts in front of me.

1 Q & A - Session 3

2 COMMISSIONER MURREN: Thank you.

3 CHAIRMAN ANGELIDES: All right.

4 Thank you very much, gentlemen, for being
5 with us here today. A couple -- few thank
6 yous -- go ahead, are Vice-Chairman.
7 I'll wrap up.

8 VICE-CHAIRMAN THOMAS: No, I just
9 wanted to thank you and I hope our two new
10 witnesses didn't mind the expansion to the
11 two earlier ones 'cause frankly, about
12 three-quarters of the way through this,
13 you kept trying to explain Moody's culture
14 to us. And it felt a whole lot like a
15 faculty lounge that I'm very comfortable
16 in, and I appreciate the testimony and I
17 think you were an extremely valuable asset
18 for this hearing and I want to thank you.

19 CHAIRMAN ANGELIDES: Well, thank you.
20 I'd like to thank our witnesses who were
21 with us today, I'd like to thank, again,
22 President Kerrey and staff of The New
23 School, you've been wonderful hosts. And
24 I just want to thank you for going out of
25 your way to accommodate us, to make us

Q & A - Session 3

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2 feel at home and set us up on the road, a
3 very difficult undertaking. You did a
4 terrific job.

5 And I particularly want to just thank
6 all my colleagues for the countless hours
7 they are putting into this important task
8 for the country and just the preparation
9 and the hard work and the good questions.
10 Frankly, it's an honor to serve on this
11 Commission.

12 And finally to the staff who have put
13 in countless hours and now will get a
14 three-hour break before we go on to the
15 next mission.

16 (Continued on following page.)
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1 Q & A - Session 3

2 Thank you all very much.

3 Commissioners, we've been asked by
4 Gretchen if we could all convene in the
5 holding room together briefly. She has
6 some materials and instructions for us on
7 the next part of our field trip. Thank
8 you all very much.

9 Oh, excuse me, there are some
10 materials in the corner. Staff reports, a
11 wonderful chart that the staff prepared in
12 multicolor, with many dimensions on CDOs
13 and CDO squareds, and those are all also
14 on our website. Thank you all very much.

15 This meeting is adjourned.

16 (Time noted: 5:24 p.m.)

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