U.S. Senate Banking Committee, Housing and Urban Affairs
"The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets"
Senator Jack Reed, RI
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Before I begin, I want to thank Chairman Dodd and Senator Shelby for their leadership on this issue. Both have expressed significant concerns about problems in the subprime mortgage market, and have raised serious questions about the role that credit rating agencies have played in this current crisis.

According to the FDIC, since the beginning of June 2007 the credit rating agencies have downgraded more than 2,400 tranches of residential mortgage-backed securities (RMBS). The recent wave of downgrades has caused some investors to lose confidence in both the integrity and reliability of these ratings. This hearing provides us with an opportunity to examine the role of the credit rating agencies in structured finance products and consider their impact on financial markets.

Back in April, I chaired a subcommittee hearing examining the role of securitization where witnesses testified that problems in the subprime area were confined to a small part of the market. Of course since then we have learned that the fallout from the subprime turmoil was and is deeper and broader than we were led to believe. As a result, it seems that securitization not only distributes risk but that it can hide it as well.

Credit rating agencies play a critical role in capital markets. The agencies can enhance or reduce investor confidence depending on the information they provide. The increasing complexity of structured products like MBS and CDOs (collateralized debt obligations) and the perceived lack of transparency in this sector appears to have made investors more dependent on the rating agencies to perform quality analysis. In that sense the agencies have become gatekeepers for the multibillion dollar structured finance industry.

Furthermore, the credit rating agencies are the only market participants who make it their primary focus to evaluate and disseminate information. And the importance of their central roles is further affirmed and supported by rules such as those used to determine pension investment guidelines and capital requirements for financial institutions. All of these factors indicate that the credit rating agencies have substantial responsibilities for providing timely and accurate information to other market participants.

With the complexity and the volume of new types of securities being created, the rating agencies are uniquely situated in the process of structuring of RMBS products through their close interaction with the issuers. These close relationships have led many to question the integrity of the process. Former SEC Chairman Arthur Levitt has said that the credit rating agencies' increasing dependence on revenues from structured finance products creates a conflict of interest that undermines their ability to provide fully independent ratings assessments. They are, in his words, "playing both coach and referee in the debt game."

Finally, Lew Raineri, the pioneer of MBS, suggested in 2006 that the mortgage backed security sector was “unfettered in its enthusiasm, and unchecked by today’s regulatory framework.” He further stated that “We have [a] quasi-gatekeeper in the rating services. And in the end, the SEC is the regulator of the capital market. [It] is the one who can touch this stuff and make a difference.”

So I am eager to hear about the SEC’s activity in this area. Last year under the leadership of Senator Shelby, Congress passed the Credit Rating Reform Act that gave SEC more regulatory and oversight authority over credit rating agencies. In June 2007, the Commission adopted implementing rules. These rules require a Nationally Recognized Statistical Rating Organization (NRSRO) to disclose a general description of its procedures and methodologies for determining credit ratings. We are interested in learning how the recently adopted rules will help address investor concerns.

And of course we want to hear from the credit rating agencies about why there were so many downgrades of RMBS in such a short period of time. We want to know: what did they fail to anticipate and what have they learned from recent events? How are they updating their models to account for changes in the market and the complexity of structured products?

I hope everyone here today recognizes the seriousness of this issue. We’ve been down this road before with respect to conflicts of interest – after Enron we addressed the relationships among corporate managers, auditors, and analysts. I worry whether there have been any lessons learned with respect to the importance of independent, objective analysis. Significant steps need to be taken, and all options are on the table.

Ultimately our goal is to strike the right balance between voluntary and regulatory actions, and in doing so to restore and enhance investor confidence in the capital markets.