**OPENING STATEMENT OF**
**CONGRESSMAN PAUL E. KANJORSKI**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES**

# HEARING ON THE ROLE OF CREDIT RATING AGENCIES IN THE STRUCTURED FINANCE MARKET

**THURSDAY, SEPTEMBER 27, 2007**

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We meet this afternoon to examine a complex but familiar issue: the performance and oversight of credit rating agencies. Today's hearing also furthers our investigations into the recent credit crunch that occurred in our capital markets and focuses on the role of credit rating agencies in engineering and grading structured finance products.

A strong, robust free market for trading debt securities relies on the independent assessments of financial strength provided by credit raters – entities like Moody's, Fitch, and Standard and Poor's. When a company or a debt instrument blows up in our capital markets, critics will often raise concerns about the failures of the rating agencies to warn investors, as was the case after WorldCom's bankruptcy, Enron's insolvency, New York City's debt crisis, Washington Public Power Supply System's default, and Orange County's collapse. In recent weeks, many marketplace observers have once again criticized the accuracy of credit rating agencies in anticipating problems with debt instruments like mortgage-backed securities and collateralized debt obligations, or CDOs.

As part of the Sarbanes-Oxley Act, Congress required the Securities and Exchange Commission to study the performance of rating agencies. Congress then used this report to inform its debates about how best to register and oversee the work of Nationally Recognized Statistical Rating Organizations. Ultimately, we approved the final version of the Credit Rating Agency Reform Act on the House floor exactly one year ago today and it became law a short while later.

Throughout those debates, I and my fellow House Democrats insisted that the new legislation contain quality controls, which the final version did. The new law therefore permits the Commission to hold the rating agencies accountable for producing credible and reliable ratings and for following their internal policies. It also allows the Commission to prohibit or mitigate conflicts of interest. It further provides the Commission with the power to examine the financial wherewithal and management structures of approved credit raters.

Additionally, we have seen tremendous growth in our structured finance markets in recent years. For example, the global sales of CDOs tripled between 2004 and 2006 to stand at $503 billion. These CDOs, a financial instrument first engineered by Drexel Burnham and Lambert, have also grown increasingly complex. Because history has a way of repeating itself, I am not surprised that the ghosts created by Drexel are with us today.

To help investors cut through the complexity of CDOs, the major rating agencies have expanded their services to evaluate these products in terms of their likelihood for defaults. Their investment-grade stamp of approval helped to provide credibility for the CDOs that had the toxic waste of liar's loans and problematic subprime products buried deep within a deal. In return, the rating agencies also made great sums of money from issuers.

To me, it appears that none of the parties that put together or purchased these faulty home loans, packaged them into mortgage-backed securities, and then divided these securities into tranches and repackaged them into CDOs, CDOs-squared, and CDOs-cubed had any skin in the game. In the end, it was the final investor left with this hot potato of subprime debt and significant losses. In my view, the rating agencies helped to create this Lake Wobegon-like environment in which all the ratings were strong, the junk bonds good looking, and the subprime mortgages above average. In reality, however, we now know that they were not.

That said, the conundrum faced by the rating agencies is much like the conundrum faced by Fannie Mae and Freddie Mac. Even though the securities issued by the two government-sponsored enterprises explicitly indicate that they are not backed by the full faith and credit of the United States, many investors believe otherwise. Similarly, even though ratings agencies only calculate the likelihood of default, many investors believe that these grades measure the financial strength of the underlying instrument.

Past cases of criticism about the failure of the ratings agencies to detect defaults generally focused on a single issuance or issuer. In this most recent case, however, these financial failures seem to have been much more pervasive. They occurred across a class of financial products. As a result, I am very concerned about systemic failures within the rating agencies themselves and the potential for systemic failure within our global capital markets. I hope to explore these issues today.

As we proceed on these matters, I also want to assure everyone that I have not yet reached any conclusions. That said, we may ultimately decide that we need to revisit last year's law and improve upon the quality controls adopted within it. Some of the policy options that we could consider include requiring more disclosures for rating agencies like those required of auditors, instituting rotations in raters like auditors, altering the methods by which raters receive compensation, mandating simultaneous disclosure of non-public information to all Commission-registered raters, improving the transparency of underlying debt products, and forcing a delay in allowing complex products like CDOs to come to market so as to allow a deal to season in its performance.

In closing, I look forward to a lively debate today. We have an excellent panel of witnesses with experience in credit ratings, valuation, hedge funds, and the securitization process. They also have a variety of views. We will likely learn much from them.

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