MOODY'S ANALYST BREAKS SILENCE:
Says Ratings Agency Rotten To Core With Conflicts

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Raymond McDaniel, Moody's CEOA former senior analyst at Moody's has gone public with his story of how one of the country's most important rating agencies is corrupted to the core.

The analyst, William J. Harrington, worked for Moody's for 11 years, from 1999 until his resignation last year.

From 2006 to 2010, Harrington was a Senior Vice President in the derivative products group, which was responsible for producing many of the disastrous ratings Moody's issued during the housing bubble.

Harrington has made his story public in the form of a 78-page "comment" to the SEC's proposed rules about rating agency reform, which he submitted to the agency on August 8th. The comment is a scathing indictment of Moody's processes, conflicts of interests, and management, and it will likely make Harrington a star witness at any future litigation or hearings on this topic.

The primary conflict of interest at Moody's is well known: The company is paid by the same "issuers" (banks and companies) whose securities it is supposed to objectively rate. This conflict pervades every aspect of Moody's operations, Harrington says. It incentivizes everyone at the company, including analysts, to give Moody's clients the ratings they want, lest the clients fire Moody's and take their business to other ratings agencies.

Moody's analysts whose conclusions prevent Moody's clients from getting what they want, Harrington says, are viewed as "impeding deals" and, thus, harming Moody's business. These analysts are often transferred, disciplined, "harassed," or fired.

In short, **Harrington describes a culture of conflict that is so pervasive that it often renders Moody's ratings useless at best and harmful at worst.**

Harrington believes the SEC's proposed rules will make the integrity of Moody's ratings worse, not better. He also believes that Moody's recent attempts to reform itself are nothing more than a pretty-looking PR campaign.

We've included highlights of Harrington's story below. Here are some key points:

Moody's ratings often do not reflect its analysts' private conclusions. Instead, rating committees privately conclude that certain securities deserve certain ratings--but then vote with management to give the securities the higher ratings that issuer clients want.

Moody's management and "compliance" officers do everything possible to make issuer clients happy--and they view analysts who do not do the same as "troublesome." Management employs a variety of tactics to transform these troublesome analysts into "pliant corporate citizens" who have Moody's best interests at heart.

Moody's product managers participate in--and vote on--ratings decisions. These product managers are the same people who are directly responsible for keeping clients happy and growing Moody's business.

At least one senior executive lied under oath at the hearings into rating agency conduct. Another executive, who Harrington says exemplified management's emphasis on giving issuers what they wanted, skipped the hearings altogether.

Harrington's story at times reads like score-settling: The constant conflicts and pressures at Moody's clearly grated on him, especially as it became ever clearer that his only incentive not to "cave" to an issuer's every demand was his own self-respect.

But Harrington's story also makes clear just how imperative it is that the ratings-agency problem be addressed and fixed. The current system, in which the government blesses organizations as deeply conflicted as Moody's with the power to determine sanctioned bond ratings is untenable. And the SEC's proposed rule changes won't fix a thing.

Harrington's story is startling, both in its allegations and specificity. (He names many Moody's executives and describes many instances that regulators and plaintiffs will probably want to take a closer look at.)

Given this, we expected Moody's might want to say it has full confidence in its processes or denounce Harrington as a disgruntled ex-employee or something. Instead, Moody's did not return multiple calls seeking comment.

1/30

The analyst, Bill Harrington, worked at Moody's for 11 years. Most recently, he was a Senior Vice President.

> My name is William J. Harrington. I was employed by Moody's Investors Services ("Moody's) as an analyst in the Derivatives Group from June 1999 until my resignation in July 2010. In 2006, I was promoted to Senior Vice President, the highest title that one could attain while performing purely analytical tasks. I am extremely proud of my work at Moody's, which I memorialized in detailed committee memos, in Moody's methodologies and in other Moody's publications. A summary of my responsibilities at Moody's and at prior employers and a list of my publications are included in an appendix to this Comment.
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> During my 11-year tenure at Moody's, I was a lead analyst for many Derivative Product Companies ("DPCs"), for a collateralized swap program and for several Credit Derivative Product Companies ("CDPCs"). From 2006 onward, I was Team Co-Leader for these types of counterparty vehicles, collectively known as Structured Finance Operating Companies ("SFOCs").

William J. Harrington's "Comment" to the SEC, August 8, 2011.

2/30

Harrington was a member of Moody's derivative products group, which was responsible for producing some of the most disastrous ratings Moody's issued during the housing bubble

During my 11-year tenure at Moody's, I was a lead analyst for many Derivative Product Companies ("DPCs"), for a collateralized swap program and for several Credit Derivative Product Companies ("CDPCs"). From 2006 onward, I was Team Co-Leader for these types of counterparty vehicles, collectively known as Structured Finance Operating Companies ("SFOCs").

Beginning in 2003, I spearheaded the multi-year development of a methodology to treat interest-rate and currency swaps in all types of cash-flow securitizations rated worldwide by Moody's. In the U.S., these types of cash-flow securitizations include Residential Mortgage-Backed Securities ("RMBS"), Commercial Mortgage-Backed Securities ("CMBS"), Collateralized Bond Obligations ("CBOs"), Collateralized Loan Obligations ("CLOs" and, collectively with CBOs, "CDOs") and Student Loans, among others.

During the first seven years of my tenure, I was also a lead analyst for approximately 50 CDOs. Upon my promotion to Senior Vice President in spring 2006, I relinquished my responsibilities for CDOs to focus entirely on SFOCs.

In 2009 and 2010, I participated in 20+ sovereign committees as one of two required senior members from outside of the Sovereign Group. My prior experience as an International Economist at The WEFA Group served me well in this capacity.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

3/30

The primary conflict of interest at Moody's is so pervasive that employees cannot help but be affected by it. Actions that help Moody's business (making clients happy) are rewarded. Actions that hurt Moody's business are punished.

The salient conflict of interest confronting Moody's employees is that which arises simply from being employed by Moody's. This conflict of interest permeates all levels of employment, from entry-level analyst to the Chairman and Chief Executive Officer of Moody's Corporation.

However, the nature of the conflict-of-interest differs by levels of employment. An entry level analyst balances conducting her committee responsibilities with integrity while staying on sides of management. The Chairman and Chief Executive of Moody's Corporation balances preserving the independence of committee proceedings at Moody's with receiving increased remuneration as Moody's business grows. Analysts and managers at the intervening levels confront both conflicts of interest each time that they participate in a committee or evaluate an analyst.

The ongoing, unresolved conflict of interest plays out in the formation of Moody's opinions. These public opinions of Moody's are often at odds with its private opinions. In some cases, the distinction between public and private opinion is an explicit one. Much more often, the distinction between the two is unknown even to Moody's. Members of committees vote one opinion for publication and keep their private opinions to themselves. A committee member who votes differently, i.e. one who votes the same opinion for publication as she holds privately, earns her own self-respect. She also courts retaliation from management.

In either case, the public opinion fails its only purpose – a tool for external parties to categorize bonds.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

4/30

Moody's defense of its conduct during the housing bubble is laughable, Harrington says. The company knew full well what it was doing and what might happen. And it took deliberate steps to protect itself in the event the housing market crashed.

Moody's argues that RMBS committees could not have factored the collapse of real estate prices into their opinions, given that the scale of the collapse was both unprecedented and unforeseeable. This rationale is as unconvincing as it is disingenuous, for it pretends that Moody's and other financial players were not designing and operating the conveyances that carried real estate prices to unsustainable levels in the first place. A roller coaster inexorably chugs up to stomach-turning heights before it hurtles downward, and both a carnival operator and a thrill seeker understand the nature of the ride's operations.

The rationale of "who could know?" is wholly undone through even a cursory examination of the actions of Moody's and other financial players in the structured finance sector. Moody's and other financial players took care to protect their earning should the real estate bubble that they were ushering into the world subsequently collapse.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

5/30

In fact, Moody's management went so far as to ensure that the payments it received for maintaining ratings on securities would be paid BEFORE the interest and principal on those securities. And these payments were made no matter how many times the securities were downgraded. In other words, Moody's got paid even if those who bought the bonds lost their shirts.

The major financial institutions that dominate the workings of the International Swaps and Derivatives Association ("ISDA") designed template confirmations for credit default swaps on several types of structured finance. The individual templates that were introduced for the RMBS, CMBS and CDO sectors each had a credit event should the specified tranche be downgraded to Caa1 or lower. On the one hand, structured finance groups in these institutions were extracting ever poorer Moody's opinions and being rewarded for doing so. At the same time, these very same groups turned around and protected themselves against the downgrades that they foresaw for the time when the impoverished nature of Moody's opinions would inevitably become apparent.

For its part, Moody's management insisted that its quarterly monitoring fees and all other amounts owed by a structured finance issuance be paid at a very senior level in its priority of payments, ahead of payments of interest and principal to rated notes, including those rated Aaa at issuance. Moody's is paid the vast majority of its monitoring fees on structured finance issuances that it continues to rate, no matter how little remains for distribution to rated notes and no matter how far the notes have been downgraded.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

6/30

Meanwhile, Moody's management frowned on macro views that might derail the gravy train. Economist Mark Zandi of Economy.com, which Moody's acquired, told Harrington that after articulating (somewhat) cautious views on the economy, he was subjected to "personal attacks" by management.

Mark Zandi, my former colleague at The WEFA Group, related that he endured harsh criticism after Moody's Corp. acquired his economic forecasting firm in 2005. In Mark's view, some of the criticism rose to the level of "personal attacks" on him. Management was offended by his forecasts for the U.S. economy and the housing market that did not support the RMBS modeling assumption that housing prices would rise 4.00% per annum ad infinitum.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

7/30

The primary concern of Moody's management, not surprisingly, is the growth of Moody's profits. The way to grow profits is to do more business. And the way to do more business is give clients the ratings they want.

The board of Moody's Corporation, the parent of Moody's, exercises no oversight regarding analyst independence nor is there an incentive for it to do so. Moody's has recorded positive earnings in every quarter since going public in 2000. Earnings fell as the financial crisis unfolded, but they remained positive.

The lesson learned to-date by the management of Moody's and that of Moody's Corporation with respect to their roles in the financial crisis and its aftermath is that they can brazen out anything and are untouchable. Implementation of many of the Proposed Rules will be yet another validation that this is the case.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

8/30

During the housing bubble, the desire to keep clients happy resulted in Moody's managers believing that their job was to give issuers the ratings they wanted. In many cases, Harrington says, this led to Moody's issuing public ratings that were higher than the analysts' private opinions.

In the experience of the contributor, the committees that issued opinions on "CDOs" from 2005 to the middle of 2006 degenerated increasingly into "talking shops." In these instances, members felt free to discuss the negative aspects of the CDO but also felt pressure by management to overlook these aspects when voting. The contributor ceased rating CDOs in Spring 2006, but in the ensuing year discerned a further deterioration of CDO committees into what seemed to be "commiseration shops", based on the widespread demoralization that he repeatedly observed as members emerged from such committees.

Moody's management was solely responsible for the degradation of opinions formed in CDO committees from 2005 onwards and possibly earlier. From the Managing Directors of the Derivatives Group upward to the CEO of Moody's Corporation Ray McDaniel and for every intervening management level, Moody's management undercut analyst attempts to produce informed Moody's opinions regarding CDOs. The means employed by management were various, but a manager either supported the increasingly transparent mission of obliging each banker and arranger in all matters and disrupting no scheduled steps of a scheduled CDO issuance or she ceased managing. Surviving management at all levels both protected their jobs and prospered for doing so as compensation grew and payouts from annual option grants skyrocketed along with the stock price of Moody's Corporation. The stock hit a high of $75 in early 2007 from an initial level of $14 in 2000.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

9/30

Specifically, product managers in "ratings committee" meetings viewed particular ratings as a promise to a client that they were responsible for delivering. Management used many tactics to deliver on these promises.

Moody's has long tolerated the practice of managers in the Derivatives Group treating a committee opinion as a pre-determined outcome that they are personally responsible for delivering and for which their views carry primary weight. The managers are accustomed to having influenced very, very many committees over very many years, principally for CDOs but also for other asset classes. Their modes of intimidation have encompassed interrupting subordinates, grimacing while opposing views are voiced and voted, belittling both opposing views and members who voice them and inflating the impact of voting an opposing view to indicate that that view is inappropriate to even raise.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

10/30

Moody's managers participate in ratings decisions. They use many tactics to bully committee members into delivering the requested ratings, Harrington says. Some of these tactics are subtle. Some aren't.

Unfortunately, the contributor participated in numerous committees where management maneuvered for a prescribed result through intimidation of other voting members. Intimidation could be blatant, with managers belittling opposing views, interrupting while others speak, making evident that they didn't consider the

14

Comment on SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations

File Number S7-18-11

William J. Harrington

committee memo to be relevant or engaging in non-committee activities such as communicating on an electronic device until ready to speak themselves. Managers might also adopt a strictly formulaic approach and seek to have aspects of others' opinions deemed "irrelevant" to the opinion at hand or challenge a member with a possible ramification of her opinion along the lines of "with your view, you should be suggesting that the entire methodology be up for grabs and we're not here to do that.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

11/30

Sometimes, while "ratings committee" members were debating the underlying merits of ratings, Moody's managers often just tuned out and played with their BlackBerries.

When Derivatives managers were not attempting to strong-arm committees, they often ignored the proceedings entirely by losing themselves in their Blackberries. Even more destructively, the contributor was left with the strong impression that Derivatives managers were communicating surreptitiously via Blackberry with each other during committees. This destroys the very core of a committee, which is that all points are made for all to hear. An examination of the Blackberry records of managers to compare with their committee attendance would be highly instructive as to their views of their responsibilities in a committee.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

12/30

Harrington details one specific instance in which Moody's managers worked the rest of a ratings committee over until everyone capitulated and the desired rating was granted.

The 2004 committee for the initial rating of Athilon Asset Acceptance Corp. and Athilon Capital Corp. (collectively "Athilon CDPC") exhibited a full gamut of actions and reactions as management jockeyed to obtain the desired opinion. The recommended opinion met with such objection from the analyst committee members that deliberations exceeded four hours. The senior-most manager departed at the two hour point, observing that the committee was in fine hands to continue and whispering his vote to one of the two remaining managers. That indicated to one of the analysts that voting for the recommended opinion was exactly what the committee had been convened to do.

A first round of voting on a technical issue met with "no's" from the committee and these several "no's", in turn, met with glares from one of the managers who remained behind and dispirited resignation from the second manager. In the next round of voting, committee members changed their "no's" to "yes", for various reasons unrelated to the credit of Athilon CDPC. One member cited intimidation from the glaring manager and another felt misplaced sympathy for the beaten-down managers who in most other areas was trying to fight the good fight. In this instance, the committee was merely a "talking" shop, where the members developed informed opinions that they could defend robustly but held them privately and did not vote them.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

13/30

Outside of "ratings committee" meetings, Harrington says, Moody's compliance department "harasses" analysts viewed as troublesome. The definition of "troublesome," Harrington says, are analysts who don't do everything they can to help give banker (issuer) clients what they want.

The Compliance Department is also an enforcer that actively harasses analysts viewed as "troublesome", i.e. independent, and is well-experienced in doing so. Several of its prominent officers trained for the Compliance Department (and Credit Policy) by managing the issuing and monitoring of RMBS opinions. The contributor can attest to harassment meted out by the Compliance Department while employed at Moody's as well as ongoing harassment that has stopped only recently.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

14/30

One particularly aggressive (and successful) Moody's manager, Brian Clarkson, used to lurk in the halls to wait for Harrington and complain about various analysts' obstructiveness. In the summer of 2006, Harrington says, near the peak of the housing bubble, Clarkson told Harrington his personal view of the housing market, which was that no one should consider buying a second house. Meanwhile, Moody's analysts continued to use analytical models based on the premise that house prices would continue to appreciate at a minimum of 4% per year.

Brian Clarkson related his view of the real estate market to me in the summer of 2006. With respect to the primary market, Mr. Clarkson mulled that, well, the primary market would be okay. However, he was emphatic that everyone knew it was not the time to buy a second house. He then asked if he should call my partner to relate this gangbusters outlook. (Such offer immediately and emphatically declined).

William J. Harrington's "Comment" to the SEC, August 8, 2011.

15/30

When an analyst had concerns about a particular rating, the analyst's "manager" took these concerns straight to the client--the banker who wanted a particular rating on the security. This, Harrington says, led to a barrage of phone calls and meetings in which the client would try to change the analyst's mind and wear his or her resistance down.

Raising an issue to one's manager inevitably resulted in a series of phone conversations with a banker, her bosses, issuer and outside counsel on one side and the contributor and fellow analyst on the other side. The manager presided, trying to broker an agreement. Sometimes, the manager treated the views of each side as equally valid. More often, the contributor and colleague began on the defensive and stayed there throughout the call. The analysts argued their corner as effectively as possible while their manager remained silent egging on the rating team to fold.

Putting up a spirited effort before caving-in made analysts look good in the eyes of management. Opposing a banker or issuer brought only trouble from Moody's senior management. It also inevitably ensured that the parties would re-convene on the following day for a heated reprise. The banker and Derivatives manager would each be joined by still more of her managers, leaving the two members of the rating team even less leverage to maintain their position.

Holding the line on these calls required preparation and a determined state of mind. Bankers and issuers were willing to have as many calls a day as were necessary to wear a rating team down. A manager often opened the door for the analysts to let go of an issue that the same manager had presented in a group meeting as vital to implement with no compromise.

Not once in eleven years did a manager ask if the contributor was analyzing an issue with sufficient rigor. Nor did management in a single instance suggest that a harder stance should be adopted towards a banker or issuer.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

16/30

When an analyst pushed back against a banker's attempts to sway the rating, Harrington says, this resulted in complaints from Moody's managers about giving the client "a hard time..."

Court the Bankers. Embrace the Bankers. Love the Bankers. Never, Ever, Harm a Banker

Sometime in 2003-2004, Clarkson mentioned that he had heard the contributor had given a "hard time" to Geoff Witt, a Merrill Lynch banker. The contributor was lucky that the banker had been Geoff Witt," otherwise…" The contributor was surprised as the call with Mr. Witt had occurred some considerable time earlier but said nothing and kept walking.

The ABS Group of Moody's regarded Geoff Witt as among the most obnoxious of bankers, a very impressive designation given the competition.

"Giving a hard time" to Mr. Witt consisted of the contributor explaining in an extremely polite manner that a trade being proposed for Merrill Lynch Derivative Products AG was in conflict with Moody's methodology for DPCs.

The contributor was extremely careful in making his points on the conference call as he was speaking alone from his office and could not gauge the reactions of his ABS colleagues also on the call. (After the call, the ABS analysts offered that they had rolled their eyes whenever Mr. Witt spoke.)

William J. Harrington's "Comment" to the SEC, August 8, 2011.

17/30

And when more subtle pressures didn't work, Harrington says, Moody's management resorted to threats...

Management also explicitly threatened the job security of analysts who "impeded deals," as was notoriously done both collectively to the entire legal staff of the Derivatives Group and individually to certain analysts by Brian Clarkson, abetted by his managers in the Derivatives Group. These managers raised no objections to the tactics employed daily by Brian Clarkson to pressure analysts into green-lighting any and all proposals by CDO bankers and issuers. The contributor heard repeatedly from one of these managers that a manager who obstructed the CDO flow would lose her job.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

18/30

During the housing boom, Harrington says, Moody's analysts repeatedly warned Moody's management that the firm's ratings were were increasingly corrupted. Moody's management did nothing.

In one egregious instance of systematic subversion of CDO committees, Moody's management ignored the frequent reporting from two very capable Derivatives analysts who had been seconded to the RMBS rating

16

Comment on SEC Proposed Rules for Nationally Recognized Statistical Rating Organizations

File Number S7-18-11

William J. Harrington

group to help with its overwhelming deal flow. These analysts repeatedly let Derivatives managers know of the poor quality of opinions that were being churned out by the RMBS machine, opinions which managers insisted be respected in committees for CDOs of ABS. To objections that the RMBS group was known to be pumping out worthless opinions, managers would counter that to do other than respect the RMBS opinions at face value would indicate that Moody's didn't believe its own opinions.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

19/30

As the housing boom continued, and Moody's business exploded, Moody's management hired ever-more-junior analysts to rate the flood of housing securities. These analysts, Harrington says, did not have the experience or expertise to stand up to pressure and persuasion from management and issuer clients. From management's perspective, Harrington says, this was ideal.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

20/30

Basically, Harrington says, everything that Moody's management did sent the message that an analyst's job was to rubber stamp ratings that issuers' wanted. The only force pulling in the opposite direction--toward integrity--was an analyst's self-respect.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

21/30

Moody's rating process was so conflicted, Harrington concludes, that many of its CDO ratings were "corrupted at inception."

William J. Harrington's "Comment" to the SEC, August 8, 2011.

22/30

All this, Harrington says, led to ratings that were "many times more damaging than had they been merely useless."

William J. Harrington's "Comment" to the SEC, August 8, 2011.

23/30

During government hearings into ratings agency practices, Harrington says, at least one Moody's manager lied in her testimony.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

24/30

So, has Moody's reformed? Will the SEC's new "Proposed Rules" fix the ratings agency? No way, says Harrington. In fact, they'll make the situation even worse. For starters, the same Moody's senior managers who drove the firm during the housing bubble are still in charge...

William J. Harrington's "Comment" to the SEC, August 8, 2011.

27/30

In fact, Harrington says, the Proposed Rules will make the situation worse.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

28/30

The conflict of interest at Moody's is so embedded, Harrington concludes, that even if every manager were fired and replaced it would still remain.

William J. Harrington's "Comment" to the SEC, August 8, 2011.

29/30

Meanwhile, Moody's stands ready to relax newly "strict" rating criteria the moment a compelling business opportunity presents itself...

William J. Harrington's "Comment" to the SEC, August 8, 2011.

30/30