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Congress Takes On Credit Ratings

Ex-Moody's Analyst Says Inflated Ratings Continue; 'Moral Responsibility'

By SERENA NG and AARON LUCCHETTI

Throughout the financial crisis, major credit-ratings firms were criticized for their overly rosy ratings of complex debt securities, which deteriorated soon after and led to billions of dollars of investor losses.

Despite months of regulatory scrutiny and some internal changes at the firms, a recently departed Moody's Corp. analyst says inflated ratings are still being issued. He has taken his concerns to congressional investigators.

The analyst, Eric Kolchinsky, said Moody's Investors Service gave a high rating to a complicated debt security in January 2009 knowing that it was planning to downgrade assets that backed the securities. Within months, the securities were put on review for a downgrade.

Eric Kolchinsky, shown on Friday, said he raised concerns with Moody's officials in July. Moody's said he wouldn't cooperate with an investigation.

"Moody's issued an opinion which was known to be wrong," Mr. Kolchinsky wrote in a July letter to the rating firm's chief compliance officer, a copy of which was reviewed by The Wall Street Journal. In the letter, Mr. Kolchinsky cited other instances in which he believes inflated ratings were given to securities.

A Moody's spokesman says the firm "takes any allegations of misconduct very seriously." The spokesman said Mr. Kolchinsky "refused to cooperate with an investigation" into the issues he raised and was suspended for this refusal, with pay.

The spokesman declined to comment on the January rating that Mr. Kolchinsky questioned because a review of the matter "is in progress." Before he resigned, Mr. Kolchinsky was a managing director in a nonratings unit and wasn't involved in ratings of the securities in question. He was previously a Moody's ratings analyst for six years and had experience with complex securities.

On Thursday, Mr. Kolchinsky is scheduled to testify on ratings-firm reform before the House Committee on Oversight and Government Reform, with panelists including a lawyer representing rival ratings firm Standard & Poor's, owned by McGraw-Hill Cos. Mr. Kolchinsky talked

to congressional investigators after his suspension and says they invited him to testify.

Mr. Kolchinsky's allegations come amid a debate on Wall Street and in Washington over the role and influence of credit ratings, and whether recent reforms are sufficient to prevent a repeat of past missteps. Last week, the Securities and Exchange Commission passed rules to improve disclosures from ratings firms and reduce conflicts of interest.

Mr. Kolchinsky raised his concerns with Moody's officials in July but says his superiors didn't treat his complaint seriously enough. The 38-year-old, who had worked at Moody's for eight years, was suspended in early September and left the company two weeks later. In December, according to internal memos reviewed by Mr. Kolchinsky, Moody's executives approved changes to their ratings methodology that they expected to lead to the downgrades of many securities backed by corporate loans. The notes issued in January were tied to those types of securities, but Moody's analysts still gave the deal a high rating.

At issue in Mr. Kolchinsky's internal complaint with Moody's is what ratings firms should do when they are planning to downgrade securities that were the building blocks for other rated products. These securities can go bad weeks or months before the impact registers on the product itself.

That could become a growing issue now that Wall Street bankers are again bundling assets into securities that can be sold to investors or pledged as collateral for short-term loans from central banks.

Between 2000 and 2007, Mr. Kolchinsky worked in the ratings group, rising to oversee credit ratings of mortgage-linked securities known as collateralized debt obligations, some of the hardest-hit investments during the credit crisis. Mr. Kolchinsky said he feels "some moral responsibility for the poor CDO ratings" issued under his watch.

"I was part of the process that did all this damage, and I feel I should try to do something now to make sure it doesn't happen again," he says.

Mr. Kolchinsky previously raised concerns with senior Moody's officials about high ratings given to new CDOs in September 2007. Moody's soon after adjusted its ratings approach, says Gary Witt, a former Moody's managing director who helped Mr. Kolchinsky raise his concerns at the time.

In October 2007, Mr. Kolchinsky was told there was no role for him because the CDO ratings group was downsizing. He joined Moody's Analytics, a separate unit.

A year later, Mr. Kolchinsky filed an internal complaint with Moody's,

citing "retaliation" against him. A Moody's spokesman says that the firm "has a strict nonretaliation policy" and that Mr. Kolchinsky "has made an evolving series of claims of misconduct within the company and we have conducted multiple separate reviews." In each case, Moody's "found that his claims were unsupported," the spokesman said. Mr. Kolchinsky says he believes Moody's didn't do a thorough investigation.

In July, Mr. Kolchinsky raised questions about the rating on notes issued by Nine Grade Funding II Ltd., an investment vehicle arranged by Guggenheim Capital Markets, a unit of Guggenheim Partners LLC.

The notes were backed by slices of securities known as collateralized loan obligations, which were in turn backed by corporate loans. In October 2008, Moody's gave Nine Grade a Baa2 rating.

In mid-December, Moody's analysts and managers had come to the conclusion that the bulk of CLOs would be downgraded to reflect new default assumptions, according to internal memos viewed by Mr. Kolchinsky. One December email he reviewed said those rated double-A and below were likely to be downgraded by three to six "notches."

In January, Nine Grade issued more notes. Moody's confirmed the deal's ratings and gave some newly issued notes the same Baa2.

In February, Moody's announced its CLO methodology changes. By April, ratings of all the CLOs held by Nine Grade had been cut or put on watch for downgrade, according to Moody's data Mr. Kolchinsky says he reviewed. In May, Nine Grade was put on review for a downgrade. Mr. Kolchinsky says in his letter that Nine Grade was determined within Moody's to be worthy of just Caa1, deep in "junk" territory and eight notches below its public rating of Baa2.

Nine Grade's managers avoided the ratings cut by switching out some of the downgraded assets for higher-rated assets. A Guggenheim spokesman said the firm arranged the Nine Grade transaction for an investor in October 2008, but wasn't involved in subsequent changes to the deal.

Meanwhile, Moody's investigated Mr. Kolchinsky's concerns. On Sept. 3, a Moody's human-resources officer asked Mr. Kolchinsky to meet that day with an external lawyer retained by Moody's to discuss his July letter. He declined, saying he had spoken to that lawyer on the phone the previous week and that his 13-page letter contained everything he knew. Moody's suspended Mr. Kolchinsky because of his refusal. He left the firm 13 days later.

Write to Serena Ng at serena.ng@wsj.com and Aaron Lucchetti at aaron.lucchetti@wsj.com

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