

January 27, 2012

Memorandum

To: Members, Committee on Financial Services

From: Committee Staff

Subject: Oversight and Investigations Subcommittee Hearing on “The Collapse of MF Global: Part 2”

The Oversight and Investigations Subcommittee will hold a hearing on “The Collapse of MF Global: Part 2” at 10:00 am on Thursday, February 2, 2012, in Room 2128 of the Rayburn House Office Building. This hearing will examine the role that MF Global’s risk management played in the firm’s collapse. This hearing will also examine the conduct of the credit rating agencies that evaluated MF Global’s creditworthiness. This will be a two-panel hearing with the following witnesses:

Panel I

- Mr. Michael Roseman, former Global Chief Risk Officer, MF Global Holdings Ltd.
- Mr. Michael Stockman, Global Chief Risk Officer, MF Global Holdings Ltd.

Panel II

- Mr. Craig Parmelee, Managing Director, Corporate and Government Ratings Division, Standard & Poor’s Rating Services
- Mr. Richard Cantor, Chief Credit Officer, Moody’s Investors Service
- Mr. James Gellert, President and CEO, Rapid Ratings International, Inc.

Background

On October 31, 2011, MF Global filed for bankruptcy protection in the United States Bankruptcy Court for the Southern District of New York. MF Global’s bankruptcy—the eighth largest in U.S. history—came just nine months after it was designated as a primary dealer by the Federal Reserve Bank of New York. The firm’s sudden failure was set in motion on October 24, 2011, when Moody’s downgraded MF Global because, among other things, the firm had a large exposure to European sovereign debt. That exposure resulted from an aggressive proprietary trading strategy advocated by its then chief executive officer Jon Corzine, who had hoped that the firm’s ambitious strategy would transform MF Global from a commodities merchant—a line of business with diminishing revenues—into an investment bank. The risk to MF Global from its increasing exposure to European

sovereign debt was raised as a concern by Michael Roseman, the firm's Chief Risk Officer, as early as September 2010. Notwithstanding Mr. Roseman's concerns, MF Global had amassed about \$6.3 billion of European bonds by the time it collapsed.

MF Global's Internal Risk Management

Michael Roseman was MF Global's Chief Risk Officer from 2008 through early 2011. Mr. Roseman was hired to remedy deficiencies in MF Global's risk management and to create an Enterprise Risk Management system. Standard & Poor's found that Mr. Roseman "generally succeeded in addressing these governance and control issues," and raised its evaluation of MF Global's risk management system from "weak" to "adequate." Although Mr. Roseman was MF Global's Chief Risk Officer, it was MF Global's board of directors that determined the firm's business strategy and set the "risk appetite" within which the firm would operate. Nonetheless, Mr. Roseman worked closely with MF Global's senior management and its board of directors as the firm considered increasing the volume of repurchase-to-maturity ("RTM") transactions it entered into. These RTM transactions were collateralized by European sovereign debt, thus increasing MF Global's exposure to the risk that European governments might default on their obligations.

From June 2010 and into 2011, MF Global increased its positions in European-backed RTMs. Mr. Roseman expressed concern over the firm's expanding RTM portfolio. In June 2010, MF Global's management team determined that a \$1 billion position in European-backed RTMs did not exceed MF Global's risk appetite, although Roseman was "cautious" about the trade. By the end of August or early September 2010, the firm's RTM position had risen to between \$1.5 billion and \$2.5 billion, and Mr. Roseman began to "question the trade based on liquidity risk concerns relative to the company's approved risk appetite." Mr. Roseman met with then-CEO Jon Corzine, and they agreed to consult MF Global's board of directors. In mid-September, the board of directors decided to move forward with the accumulation of European-backed RTMs, which approached approximately \$4 billion by late October. At that time, the firm's exposure caused Mr. Roseman to become "very concerned."¹ Mr. Roseman met with Mr. Corzine again, then with the executive committee of the board of directors, and finally with the full board of directors. The board of directors approved position limits of about \$4.5 billion and agreed to "revisit" the positions in February or March of 2011. At the end of January 2011, MF Global told Mr. Roseman that Michael Stockman would replace him as chief risk officer. At that time, Mr. Roseman "disengaged" himself from his responsibilities as chief risk officer and focused on transitioning authority to Mr. Stockman.

In a March 1, 2011 memo to MF Global's board of directors, Mr. Stockman supported an increase in the firm's European-backed RTM positions from \$4.75 billion to \$5.8 billion until March 31, 2011, at which time the limit would decrease to \$5 billion. Mr. Roseman wrote that the "European sovereign trade is a unique opportunity in the capital markets to earn reasonable to high reward to risk returns relative to other available strategies." When MF Global collapsed, its position in European-backed RTMs was approximately \$6.3 billion.

The Credit Ratings Agencies and MF Global

¹ In a phone interview with Committee staff, Mr. Roseman said that he was uncomfortable with a European-backed RTM position greater than \$2 billion, and that he believed that MF Global's RTM position should not exceed \$4 billion.

Moody's and Standard & Poor's lowered their ratings of MF Global over the three years that preceded MF Global's failure. At the beginning of 2008, Moody's rated MF Global "A3," which meant that in Moody's opinion, MF Global's debt obligations were "upper-medium grade" and "subject to low credit risk." Moody's downgraded MF Global in February 2008, and it downgraded MF Global again in January 2009. From January 2009 until October 24, 2011, Moody's rated MF Global "Baa2," which reflected Moody's opinion that MF Global's debt obligations were "medium grade," and that MF Global's debt obligation might have possessed "certain speculative characteristics." On October 24, Moody's assigned a rating of "Baa3"—one notch above "junk" status—because it did not expect MF Global to meet "the financial targets that Moody's had previously specified were required for it to maintain a Baa2 rating." Moody's also cited its concerns about MF Global's exposure to European sovereign debt and MF Global's regulatory capital shortfall resulting from that exposure. Moody's highlighted MF Global's "increased risk appetite" and "questions about the firm's risk governance." Three days later, on October 27, Moody's downgraded MF Global to "Ba2," meaning that Moody's believed that MF Global's debt obligations were "subject to substantial credit risk."

Standard & Poor's ratings of MF Global followed a similar trajectory. In February 2008, Standard & Poor's downgraded MF Global from BBB+ to BBB. In November 2010, Standard & Poor's downgraded its MF Global rating to BBB-, a rating that MF Global retained through October 2011.² In October 2011, Standard & Poor's noted that "continued volatility in the capital markets and low interest rates could further harm MF Global's ability to generate capital" and highlighted that MF Global's exposure to European-backed RTMs was "very high compared to the company's loss absorbing capital base." Five days later, on October 31, 2011, Standard & Poor's gave MF Global the lowest-possible rating: D.

Although Moody's and Standard & Poor's flagged MF Global's exposure to European sovereign debt in October 2011, neither rating agency appears to have raised that exposure as a factor in their ratings of MF Global's creditworthiness before then, even though MF Global had disclosed its exposure in its 10-K filed in May 2011.³ In response to an inquiry from Committee Staff, Moody's stated that it had developed a "collective understanding"—through "numerous" meetings and discussions with MF Global's management, as well as from its review of public filings and information provided by MF Global—that MF Global was expanding its principal trading activity "for the primary purpose of facilitating customer transactions." Moody's reported that presentations provided to it by MF Global's management did not reflect significant increases in the firm's risk profile until October 21, 2011. At that time, according to Moody's, MF Global personnel—including then-CEO Jon Corzine—informed Moody's that its European-backed RTMs were "purely proprietary trading positions," rather than "client-driven transactions from which MF Global had protected itself with appropriate hedging."

² Standard & Poor's BBB- rating, which it assigned to MF Global almost a year before it collapsed, corresponds to the Baa3 rating that Moody's assigned to MF Global on October 24, 2011.

³ Moody's reviewed the May 20, 2011 10-K "on or around the date of its filing." In a letter to the Committee on Financial Services, Standard & Poor's did not state when its analysts first reviewed the 10-K filing.

In a letter to the Financial Services Committee, Standard & Poor's did not state whether it believed that MF Global's RTM portfolio resulted from client-driven transactions or proprietary trading. Without specifying when it reviewed MF Global's 10-K or when it became aware of MF Global's exposure to European sovereign debt, Standard & Poor's noted that it "understands that the RTM portfolio consisted of sovereign bonds with short maturity exposure, funded through scheduled maturity in 2012." Standard & Poor's also stated that it did not receive any information from MF Global about its RTM portfolio—outside of the firm's public disclosures—until August 31, 2011, when MF Global informed Standard & Poor's that its regulator had required it to set aside additional capital against its European-backed RTM positions. On October 20, 2011, Standard & Poor's met with MF Global to discuss the firm's upcoming earnings report, strategic plan, and RTM portfolio.

MF Global collapsed soon after Moody's downgraded it and Standard & Poor's issued a warning that it was considering downgrading it. MF Global's collapse cannot fairly be said to have resulted from the ratings downgrades in October 2011. But the abruptness of the downgrades and the suddenness of MF Global's collapse raise questions about why the credit rating agencies did not consider MF Global's exposure to European sovereign debt until late October, given that MF Global had disclosed its European-backed RTM holdings as early as May 2011. By way of contrast, the Financial Industry Regulatory Authority immediately identified MF Global's exposure to European sovereign debt as a concern during a routine review of MF Global's audited financial statements that were filed with FINRA on May 31, 2011.⁴

⁴ Testimony of Mr. Richard Ketchum, President, Chairman and Chief Executive Officer, Financial Industry Regulatory Authority, *The Collapse of MF Global*, Hearing Before the House Comm. on Financial Services, Subcomm. on Oversight and Investigations (December 15, 2011), available at <http://financialservices.house.gov/UploadedFiles/121511ketchum.pdf> .