**Testimony of Richard Cantor**

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**Moody's Investors Service**



**Before the**

**United States House of Representatives**

**Committee on Financial Services**

**Subcommittee on Oversight and Investigations**



**February 2, 2012**

Good morning Chairman Neugebauer, Representative Capuano and members of the Subcommittee.  My name is Richard Cantor, and I am the Chief Credit Officer of Moody's Investors Service ("**Moody's**").  On behalf of my colleagues, I thank you for the opportunity to participate in today's hearing and talk to you about Moody's views on the creditworthiness of MF Global Holdings Ltd. ("**MF Global**").

In my capacity as Chief Credit Officer, I lead the Credit Policy Group and chair the Credit Policy Committee, which are jointly responsible for the review and approval of rating methodologies.  The Credit Policy Group also helps develop the policies and procedures that govern the ratings process and publishes research on issuer defaults, credit losses and the performance of Moody's ratings over time.

In my statement today, I begin by addressing the nature of Moody's rating opinions and why they communicate to market participants the *relative* creditworthiness of an issuer or financial obligation.  I then describe in detail the evolution of Moody's opinions regarding the credit risk of MF Global.

In summary, for several years Moody's has viewed MF Global as one of the riskiest credits among all US banks and securities firms.  In the universe of all rated credits, MF Global was viewed as a medium credit risk, with certain speculative elements, as reflected in its Baa credit rating.  Moody's had identified MF Global's franchise and earnings as weak and its business model as being particularly reliant on customer and counterparty confidence.  In February 2011, Moody's warned the market that there was continued downward pressure on the rating and identified three metrics – earnings, leverage and risk – upon which we would evaluate the credit profile of the company in the following quarters.  In October 2011, Moody's observed that MF Global had performed poorly against all three metrics, and accordingly took appropriate negative rating action.  An erosion of confidence in MF Global quickly followed and led to an accelerating flight of customers and counterparties over the course of a few days, greatly straining the company's liquidity.  MF Global, like other securities firms that have faced a confidence crisis, actively sought a strategic alternative, such as a sale of the company.  When the last-

minute revelation of substantial missing customer assets appeared to derail an otherwise done deal, MF Global was forced to file for bankruptcy.

## I. The Relative Nature of Moody's Credit Ratings

Moody's credit ratings are forward-looking opinions that speak only to the relative credit risk of fixed income instruments: namely, their relative probability of default and the potential severity of any financial losses to creditors. Moody's credit ratings do not address any other type of risk, such as price, likelihood of prepayment or liquidity risk.[1]

A common misperception exists that credit ratings are binary – *i.e.*, "pass-fail" or "high-low" – perhaps because bonds **ultimately** behave in a binary manner: that is, either they default or they do not default. At the time that Moody's forms its credit opinion about any given bond, however, it is not yet known whether the bond will perform or default. It is simply not possible to predict the future with absolute precision. For that reason, Moody's has developed a non-binary rating system that reflects our view of the relative future credit risk of issuers and financial obligations.[2] It is not a "pass-fail" system that predicts which issuers or obligations will or will not default, or when they will default. Rather, Moody's rating system communicates an opinion about the probability of an issuer's or financial obligation's risk of default and loss **relative** to other issuers and obligations carrying higher and lower ratings.

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[1] A credit rating also is not a recommendation to buy or sell a bond. For more information on the definition of a credit rating, please refer to the Moody's Investors Service Code of Professional Conduct, which is available on moodys.com, or any Moody's rating action, each of which is also available on moodys.com.

[2] Moody's credit ratings are expressed according to a system of letters and numbers, on a scale that has 21 categories ranging from Aaa to C. The lowest expected credit loss is at the Aaa level, with a higher expected loss rate at the Aa levels, a yet higher expected loss rate at the A levels, and so on down through the rating scale. Moody's subdivides rating categories Aa, A, Baa, Ba, B and Caa with "numerical modifiers" of 1, 2 or 3. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category.

In addition to the specific rating levels assigned to an issuer or its bonds, a complete summary of Moody's credit opinion is publicly communicated through published commentary and, importantly, through Moody's rating outlooks and public rating review process. A rating outlook is expressed as positive, negative or stable, and provides an opinion regarding the likely direction of an issuer's rating over the medium term, typically 18-24 months. A negative outlook is an opinion that a downward rating action is more likely than an upward change, either as a result of a changing market environment or changes specific to the issuer. Placing a rating on review indicates that a rating is under consideration for a change in the near term. Ratings that are placed on review are said to be on Moody's "Watchlist" or "On Watch".

Moody's expects that some bonds at every level of the rating scale will default, with the forecast probability and magnitude of credit losses rising as the rating level declines. Moody's cannot predict which specific bonds within the group of bonds at a particular rating level will default. If that were possible, Moody's would have a binary credit rating system with only two rating categories: "default" and "not default". In our view, the usefulness of a rating system can be measured by the performance of the ratings over time and in the aggregate. Moody's regularly reviews the historical performance of its credit ratings and publishes its findings on its website.[3]

Moody's credit ratings are not formula-driven. In assigning our credit opinions, our analysts adhere to Moody's published credit rating methodologies. Ratings are determined by a rating committee, which is a deliberative process that

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[3]     Please refer to, for example, Moody's Special Comments entitled, "The Performance of Moody's Corporate Debt Ratings: September 2011 Quarterly Update" and "The Performance of Moody's Structured Finance Ratings: September 2011 Quarterly Update." The conceptual framework behind these performance reports is discussed in two Special Comments entitled, "Measuring The Performance of Corporate Bond Ratings," published in April 2003, and "Measuring The Performance Of Credit Ratings," published in November 2011. These documents and many other reports on ratings performance are available on www.moodys.com.

incorporates subjective human judgment. Other providers of credit opinions follow a similar rating process and use rating symbols intended to convey a meaning somewhat similar to Moody's rating symbols. Still other opinion providers use symbols with very different intended meanings, and others offer purely quantitative and market-based measures of credit risk. Moody's fully supports this diversity of opinion in the market, both in form and substance.

## II.    Moody's Credit Opinion of MF Global

By early 2008, Moody's viewed MF Global's creditworthiness as not particularly strong. It was seen as a mid-range credit with certain speculative characteristics. MF Global was one of the lowest rated credits in the US banking and securities industry.[4] This view was reflected in Moody's assignment of MF Global to the Baa rating category, which is many notches down from the highest rated credits.

In early 2009, Moody's observed a "weakening in MF Global's earnings generation ability," [5] and expected MF Global's "revenues to continue to come under pressure over the coming quarters," given the uncertainty in financial markets. Moody's therefore downgraded MF Global's credit rating to Baa2 from Baa1.

By late 2009, Moody's observed an increase in MF Global's balance sheet leverage and accordingly assigned a negative outlook to MF Global's Baa2 rating. As noted above, a rating outlook indicates the likely direction of an issuer's next rating change over the medium term. A negative outlook communicates to the market that we see downward pressure on the issuer's credit profile.

As with all rated credits, Moody's continued to monitor and evaluate the credit profile of MF Global in 2010, including in light of the appointment of Jon Corzine as Chairman and Chief Executive Officer in March of that year. In comments

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[4]    Among rated US banks and securities firms in the US at the beginning of 2011, only 15% were rated lower than MF Global in 2010.

[5]    All quotes in this section refer to Moody's publications, each of which has been furnished to the Subcommittee.

Moody's published following Mr. Corzine's appointment, we stated that the appointment held no rating implications for MF Global, and noted that the company's negative outlook continued to reflect its high leverage and weak profitability.

Early in 2011, Moody's observed MF Global's weaker profitability and high leverage relative to similarly-rated peers, and convened a rating committee to assess its credit rating. Moody's rating announcement on February 3, 2011, affirming its Baa2 credit rating and maintaining a negative outlook, identified three factors that it expected to be primary drivers in determining its next rating action. Moody's stated that MF Global would be evaluated over the following four to six quarters on its ability to:

- Generate annual pre-tax earnings in the $200 million - $300 million range;
- Achieve balance sheet leverage in the low 20x range; and
- Maintain liquidity and risk management discipline.

Two quarters later, Moody's published a Credit Opinion[6] which stated that in Moody's view, MF Global continued to face several challenges. Moody's stated that it would most likely downgrade MF Global if revenue and pre-tax profitability did not improve significantly, or if the company failed to manage risk adequately or materially increased in its risk appetite without increasing its capital.

On Friday, October 21, 2011, Moody's analytical team met with Mr. Corzine and members of his senior management team in advance of MF Global's announcement of its Fiscal Year 2012 second quarter financial results, scheduled for the following week. The information disclosed at that meeting showed that MF

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[6]     A Moody's Credit Opinion is a periodically updated stand-alone research summary designed to give the reader an overview of the rationale behind a Moody's rating, the key credit strengths and weaknesses, and the outlook for what would drive the rating up or down. Credit Opinions are typically informed by Moody's most recent rating announcement concerning the issuer, and the accumulated knowledge and judgment of the analyst or analysts assigned to the issuer.

Global was not satisfying any of the three factors that Moody's had listed in its February announcement – an important benchmark in Moody's opinion of MF Global's credit risk.

During the meeting, MF Global made clear to Moody's for the first time that MF Global's repurchase-to-maturity transactions were not client-driven transactions, but instead were purely proprietary trading positions. Moody's had understood that MF Global was expanding its principal trading activity for the primary purpose of facilitating customer transactions, as opposed to generating trading profits. That understanding was developed over time through numerous meetings and discussions with MF Global management, and a review of information provided by the company and public filings.

In Moody's view, MF Global's decision to assume large credit exposures that were not client-driven and represented a multiple of the company's outstanding common equity highlighted MF Global's increased risk appetite—in the absence of a parallel increase in capital. Moody's also was told at the meeting that MF Global expected to report a significant quarterly loss and that gross leverage had increased.

On the next business day following the analysts' meeting with the company's management (that is, Monday, October 24), Moody's downgraded MF Global's credit rating to Baa3 and placed MF Global's rating on review for a possible further downgrade. As noted above, a review communicates to the market that a rating is under consideration for a change in the near term—in this case a downward change.

Following the Moody's downgrade, MF Global brought forward its quarterly earnings announcement by two days to Tuesday, October 25, and disclosed a record quarterly loss. As MF Global's crisis accelerated over the subsequent 48 hours, Moody's observed a "heightened risk of loss of client and counterparty confidence" and downgraded MF Global's rating another two notches to Ba2 on Thursday, October 27. Moody's also kept the credit on review for potential further downgrade. Moody's continued to monitor MF Global as its counterparty and customer flight gathered pace and as the company explored various strategic options. By the

following Monday, October 31, MF Global had drawn down its entire credit facility, and the sudden and unexplained disappearance of significant customer assets appeared to derail any possibility of a sale of the company. With no options left, MF Global filed for bankruptcy and Moody's downgraded MF Global to Caa1.

## III. Conclusion

As Moody's observed in January 2009, the MF Global franchise was particularly reliant on customer and counterparty confidence. The events of late October 2011 demonstrate that MF Global lost the confidence of many customers and counterparties over the course of a few days, despite the lack of any default or other credit event occurring on its European sovereign debt positions. Moody's repeated rating actions during that brief period reflected our opinion that the company could not meet the three specific criteria that Moody's had spelled out in February 2011 with regard to earnings, leverage and risk. Moody's withdrew its ratings of MF Global altogether on November 15, 2011 after MF Global had declared bankruptcy.

Thank you again for inviting me to testify on this important matter, and I look forward to answering your questions.

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# United States House of Representatives
## Committee on Financial Services

### "TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

| 1. Name: | 2. Organization or organizations you are representing: |
|---|---|
| Richard Cantor | Moody's Investors Service |

**3. Business Address and telephone number:**

███████████████████████████████████

| 4. Have **you** received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? | 5. Have any of the **organizations you are representing** received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? |
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| ☐ Yes  ☒ No | ☐ Yes  ☒ No |

**6.** If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

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