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FCIC memo of staff interview with Jerome Fons, Moody's

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Memorandum for the Record

Jerome Fons, Independent consultant, K2 Global Partners

Attendees:

Victor Cunicelli,
Bruce McWilliams,
Tom Borgers

Good quotes:

IN 2005, did your peers say they were upset with developments in the market, such as stated income loans?

“On this high-level credit committee, we spoke about everything but the elephant sitting on the table. We spoke about mapping ratings to default rates.” In my defense, I was not in a position to know what we were rating. I didn’t have access to loan files.

These people were likely to have known:

Group MD: Michael Kanef David Teichert Linda Stefney Warren Kornfeld Pramila Gupta Jay Siegel

When I was in RMBS group, there was 12; by 2005, there were 30.

They knew they were caving into pressure from investment banks. Moody’s allowed itself to be bullied.

Evidence of bullying: Clarkson said, Butt out, you’re not good for business.

“We had a lot of training in document destruction.”

Background:

Bachelors in econ from san diego state uni,
phd at UC San Diego, in pricing high risk corporate deck
Federal Reserve Bank of Cleveland, NY Fed economist,
Chemical bank in 1989,

Moody’s career

Fall 1990: Senior Analyst, Industrial Group, part of Corporate Department

Fall of 1990, recruited to author corporate bond default study. Did default study for four years. This was marketing tool looking over various time horizon. Comparing losses with BBB to AAA

He reported to Andrew Kimball at Moodys, who now runs structure finance at Moodys. He became a vice president

1994 went to Structured Finance area. Wrote a methodology for mortgage pass through. Mainly rating prime mortgages, with a few subprime. I was part of rating team. I was advisor economist, rather than your typical analyst, which were lawyers. I was keeping track of housing market. To put in writing, for rating residential mortgage back securities. Heavy focus on quality analytics, on getting the rating right.

First CDO model created by Douglas Lucas in 1990

Managing director for structure-we had second residential mortgage passthrough model, which stayed in place until 2000, when they updated the model. Many people believed the model was costing the company market share. The new model was supposedly less conservative. We considered other scenarios. We tried to capture data from as broad a sample as we could.

The goal of the model in 1994. We used an approach that tried to capture the best that we could for loss performance. The main assumption is that the future would look like the past.

1996- 2000 East Asia banks and Regulatory affairs

2001: MD for credit policy for corp and other securities; he chaired fundamental credit committee, credit policy committee. Wrote a lot of papers; trained analysts, chair of rating symbol definitions committee.

2002: Structured Credit Committee was created, Brian Clarkson chair, Noel Kirnon was de facto chair. (I don't think that Fons was on this committee).

2005 Rated sovereign issuers

Left in August 2007, became independent consultant. Gerson Lerman Group- they cater to hedge funds and bank, by providing experts to various topics.

Octo 2009: working for Jules Kroll. Who expressed in starting rating agency, to form viable ratings firm

WAS THERE A CULTURAL CHANGE?

You're absolutely right. In the last year I was there at Moodys, 2006 WE HIRED WRITER we want to obtain **MOODY'S: THE FIRST 100 YEARS**.

He reported to Christopher Mahoney in 1996. The last month I report to Andrew Kimball.

He testified in 2008 Waxman panel: change in culture 95 to 96, or 98. It was sparked by article in Treasury and Risk Magazine. Rating the Rating Agencies. Subhead: why everyone hates Moody's. Article was a survey of corporate treasurers. The results was that Moody's was the least pleasant to work with; the analysts were difficult to work with. The culture we saw in 1990

Tom McGuire, head of corporate department; suggested that issuers were not to be catered to; a professional distance. To many people, to the owners of Moodys (Dun and Bradstreet), who had owned the company for a long time (since 1950s). There was love hate. Moody was a cash cow; dun and bradstreet was suffering.

A number of initiatives to become more friendly. Article came in 95. There was sensitivity training of analysts. In 96, there was separation from corporate department (industrial, financial institutions, structures) and Municipal group. In the early 1990's, the municipal ratings group wasn't doing so well. McKinsey came in to look at this dysfunctional organization. McGuire was fired; head of municipal group was let go. In 1996, they merged two areas. There were **Don Noe** and **Ken Pincus** were placed in charge of rating group. They promoted a whole bunch of people to managing director.

That's when Brian Clarkson became MD in charge of structured finance.

The net effect is that we became more focused on business, less a focus on rating quality. We were lulled into a bit of complacency.

Compensation: As long as we were owned by Dun and Bradstreet, no one thought we were ever going to get rich. Even to this day, cash bonus was never big part of compensation. Bonus was 20% to 30%.

In 94 to 2000, we got stock options from dun and bradstreet.

In 2000, when we went public, we got a big chunk of stock option. After then our pay was driven by stock options. In 2005-2006, I opened statement, and saw "millions" there.

Individual ranked on 1 to 5, 5 being the highest, he was 5 his whole career, until he started working for Chris who rated him a 4.

As a managing director, \$200,000 to \$300,000 as base salary. Finished at \$300,000 in 07. Bonus was \$30,000 to \$180,000.

MD's had largest

Associates, senior analysts, vice president, svp, and MD. The most the senior vice president got \$200,000.

As MD, I got the 10,000 options with ten year lives. Strike price at the market.

1996: 180,000 + 20% to 50%, also driven by firm's performance.

Goal: was there goal at beginning of rating period:

Standard evaluation form: various objectives. Some of objectives, business related, HR related, rating quality. Obviously subjective. New business development.

There was measure of issuer satisfaction: We hired Greenwich Associates. At group, not individual level.

What went wrong in RMBS market

Models not up to date. This was not a modeling error. For RMBS, there was some modeling error. But ultimately, it was focus on business and market share and they didn't care about quality of rating. Surveillance implies rating was done right in first place. Housing price started declining in late 2006. Performance deviated from historical norms by 2007.

There was clearly a resource problem at Moodys. There were not able to pay competitive wages relative to Wall Street. **Revolving door**. There was very little monitoring.

In Jan 2007. We had 500 openings. In 2007. We had 3000 analysts. Analyst population was 1200. By the end of 2007, they were going to lay off 250 people.

McDaniel presided over townhall meeting in Jan2007.

IN 2005, did your peers say they were upset with developments in the market, such as stated income loans?

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Model deviation:

I knew rating committees could deviate from output. I heard that rating committee could change. Every Rating Committee (from 2002 on) had document (Scott McClesky would know) which had to be filed with compliance department. I would look for when Rating committee was reconvened. Filed by transaction name. it may be that they wouldn't have filed form until they got the approval.

The culture in Structured Finance was that Clarkson picked people who were loyal to him. Noel Kirnon, Michael Kanaf,

I worked for Brian Clarkson in 95; he promoted me to MD; and then he fired me in Aug 07.

Evidence of bullying: I was on committee about symbols. We had pre rating. Clarkson said, Butt out, you're not good for business.

Chris, my boss, in charge of fundamental; brian in charge of structured, Andrew Kimball is told by brian Clarkson that there's no room for Jerry on the team. Brian makes Andrew fire jerry, chester murray

I have dinner with Chris Mahoney every six months. I was invited for alumni party. I have spoken to Richard Canter. Otherwise, I don't talk to anyone.

Service Quality ratings: when I was RMBS group, we would check on operational aspects. The RMBS group was supposed to investigate Service Quality ratings of issuers.

TRANSCRIPT FOR TOWN HALL MEETING IS HOUSE OVERSIGHT COMMITTEE
TRANSCRIPT FROM SEPT. 2007, **GREG BAUER** ASKED QUESTION ABOUT
MELTDOWN

“We had a lot of training in document destruction.”