CFA
Consumer Federation of America

July 28,2003

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

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Re: File No. S7-12-03
Credit Rating Agency Concept Release

Dear Secretary Katz:

The Consumer Federation of America appreciates this opportunity to comment on issues related to the appropriate uses of credit ratings and regulation of credit rating agencies. The failure of the major credit rating agencies to provide any advance warning of problems at Enron – hardly their first such failure – and the role of ratings triggers in that company's rapid implosion have appropriately prompted renewed attention to an issue that has clearly been on the Commission's radar screen for some time. Perhaps these events will provide the impetus for reform that has previously been lacking.

The concept release offers a number of useful suggestions €or improving the process **for** recognizing credit ratings agencies as NRSROs and strengthening the regulation of these agencies. These changes, if adopted, should provide attendant improvements in the quality of ratings, a worthwhile goal in view of the growing importance of credit ratings in the financial markets. The benefits of these proposals could **be** further enhanced, in our view, if the Commission were to take the additional step of incorporating a performance rating mechanism into the process **of** determining NRSRO status.

The following comments present our views in more detail.

The Need for a Gatekeeper

It seems to be widely agreed that the importance of credit ratings to investors, regulators, and other market participants has grown significantly in recent years and is likely to continue to grow. **As** the Commission noted in its January 2003 report on this topic, ratings affect "an issuer's access to and cost of capital, the structure of financial transactions, and the ability of fiduciaries and others to make particular investments." Given that fact, there would seem to be an even greater need today for a reliable mechanism to identify legitimate or credible credit ratings than there was when the NRSRO designation was first formulated to serve that function. In deciding whether to maintain the NRSRO designation, therefore, the Commission should look beyond the narrow question of whether acceptable alternatives could be found within its own regulations and consider whether the markets and investors derive a significant value from the existence of the designation.

CFA believes that investors and the markets do benefit from a regulatory assurance that the credit ratings they rely on are credible. Eliminating that designation would, in our view, open the field to abusive practices that could pose a serious threat to market efficiency and investor well-being. Rather than eliminating the NRSRO designation, therefore, we believe the Commission would better serve investors by seeking to improve **the** functioning of this industry. This should include steps to ensure that the NRSRO designation effectively distinguishes between credible and non-credible ratings agencies, that those who receive the NRSRO recognition maintain high standards in conducting their ratings assessments, and that the Commission is able to identify and put an end to abusive and unfair practices where they exist.

Improving the Process for Recognizing NRSROs

CFA believes the Commission should formalize and add transparency to the NRSRO recognition process. The informal and opaque nature of the current process provides no assurance that criteria are consistently applied or that decisions are made in a timely fashion. Ratings agencies that might be interested in seeking recognition have little ability to assess whether they are likely to be successful and, thus, whether the investment of time and resources in seeking the recognition is a good one. This may have the effect of limiting potential competition. Formalizing the process, so that recognition occurs through affirmative commission action rather than a no action letter, clarifying the standards €or recognition, and providing a more definite time frame for Commission action should go a long way toward eliminating these problems.

As part of formalizing the recognition process, the Commission should consider adopting a limited recognition for certain types of smaller firms – that limit their ratings to a particular industry or government sector or geographical region, for example. Such an approach could allow quality smaller firms to provide "'recognized" credit ratings only in the areas where they have particular expertise. (Should they choose to expand their business model, they would have to get expanded recognition separately.) Such an approach could serve to enhance competition, particularly in under-served markets.

The threshold question the Commission asks in assessing the current NRSRO recognition criteria should be this: do they effectively distinguish between those credit rating agencies that provide credible ratings and those that do not? CFA does not have adequate data to answer that question, but we assume that the Cornmission either does have or can get that data. After all, this is a classic case where the proof is in the pudding. Have the credit ratings produced by the NRSROs consistently been more accurate than those of their non-recognized competitors? Are they more likely than non-recognized agencies to accurately predict defaults, or are they routinely taken by surprise, as they appear to have been with Enron? Have they generally been quicker than non-recognized rivals to spot emerging problems or positive changes that affect a rated entity's creditworthiness, or are they consistently late to the game? Do smaller, more specialized ratings agencies benefit from that specialization by producing more reliable ratings in the areas they cover, or do they lack the overall resources necessary to provide high quality ratings even in these more limited areas? It would seem that some sort of performance measurement that looked at historical ratings data could help to answer those questions.

This assessment would help to determine whether the criteria currently used by the Commission are effective in distinguishing between agencies that produce credible ratings and those that do not. Furthermore, should the Cornmission decide to formalize the recognition process, this sort of assessment could be incorporated into that process as an additional criterion for NRSRO recognition. Supplementing the more subjective factors currently in use, such as the ratings' acceptance among market participants, with an examination of a firm's actual track record would add credibility to the process. It might also allow agencies to receive **at** least a provisional NRSRO status if they have a record of producing high quality ratings but lack broad recognition among market participants.

Maintaining a system of performance ratings for use beyond the recognition process itself could: help alert the agency to possible deterioration in the quality of ratings at a particular agency that might warrant a review of its NRSRO status, aid issuers in selecting ratings agencies with the best track record rather than simply the widest name recognition, and otherwise lend credibility to less well known ratings agencies if their ratings perform consistently well. For such a system to work, independent performance measurement firms would need access to historical ratings data for the ratings agencies. Firms that have traditionally not provided their ratings to the public would have to do so in order to participate in a ratings system that would **be** a condition of NRSRO recognition, but only on a delayed historical basis which should not interfere with their subscriber paid business model. Furthermore, no **firm** would be required to participate unless they sought NRSRO recognition.

Imposing Regulatory Oversight on Ratings Agencies

Formalizing the recognition process should just be a first step in reforming the credit rating agencies. CFA believes the Commission should also have the authority to set standards of conduct for ratings agencies, governing such factors as how ratings are developed and communicated and how the independence and integrity of the ratings process is protected. With that standard-setting authority should come authority to monitor and evaluate the agencies, to dictate remedial actions where appropriate, and to discipline firms €or ethical violations or abusive practices. This disciplinary authority must include the ability to revoke the NRSRO recognition for particularly egregious abuses or if the rating agency fails to maintain the standards on which its recognition was conditioned. If legislation is necessary to provide the Commission with this authority, CFA would support congressional action to bring this about.

We do not believe this is an area that can be safely or effectively delegated to industry. Given the overwhelming dominance of the industry by just a few firms, those firms would likely use their dominant position In any self-regulatory body to set standards that affirm rather than reform their way of doing business and that minimize the threat of additional cornpetition. Also, as our recent experience with accounting self-regulation has demonstrated, such bodies tend to set standards that are too lenient and then enforce them loosely at best. **If** the Commission were to conclude that it is not in investors' best interests to bring this function in-house – because of the likelihood it would be underfunded, for example or represent an inefficient use ***of*** Cornmission resources – we would strongly recommend that Congress adopt the model provided by the Public Company Accounting Oversight Board and take appropriate steps to assure any such board's independence and effectiveness.

Conflicts of Interest

One area that merits further scrutiny – both in the recognition process and in on-going regulatory oversight – is how credit rating agencies manage the substantial conflicts of interest that are imbedded in the major firms' business model. There is an obvious conflict of interest when issuers pay for ratings If the Commission is successful in injecting more competition into this market, that could become an **even** more serious conflict – if firms compete for business by offering more favorable ratings or attempt to bully firms into engaging their firm with a threat of a negative rating. Realistically, we see no way to eradicate this conflict and retain widely accessible ratings. The best the Commission can hope to do is to ensure that agencies have appropriate mechanisms in place to manage the conflicts and police their conduct to ensure that conflicts are not influencing their ratings decisions.

If the firms become more financially dependent on the consulting and other advisory services they sell, that would also exacerbate those conflicts. Our experience in dealing with the audit firms suggests that it is better to address those conflicts early, before the practices become so entrenched it is politically difficult if not impossible to address them effectively. **As** it did with auditing conflicts, the Commission should examine the services that ratings agencies are offering to determine whether there are certain services that create unacceptable conflicts of interest. **If** so, it should consider banning firms from offering those services to ratings clients. The Commission should also consider setting dollar limits on the consulting services ratings agencies can sell to ratings clients to ensure that the consulting income does not pose an unacceptable conflict of interest.

Although all these issues are important, we are at least as concerned about the largely ignored conflicts that result from the role investment banks play in the selection of credit rating agencies. While a single issuer may have only a limited ability to **exert** influence on a credit rating agency, a single investment bank that effectively controls the selection process for a large number of issuers might be more able to influence ratings decisions. This relationship deserves particular scrutiny by the Commission as it develops recognition criteria and conduct standards for NRSROs. (One benefit of adopting a performance measurement scheme for ratings agencies is that it would make them publicly accountable for their bad ratings. This has the potential to offer at least a limited counterweight to the conflicts that could bias ratings decisions.)

Conclusion

Given the large and growing role of credit ratings in our financial markets, investors need some regulatory guarantee that credit ratings are developed according to reasonable standards by legitimate ratings agencies. The NRSRO recognition process can serve that function. To ensure that it does so effectively, the Commission should formalize the recognition process, incorporate performance measurement into the recognition criteria, and supplement the recognition process with a more robust program of regulatory oversight. Such an approach would likely improve the quality of credit ratings on which **the** financial markets increasingly rely.

Respectfully submitted,

Barbara Roper
Director of Investor Protection