REMARKS OF
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Good morning. I always appreciate the opportunity to address an audience as knowledgeable about the capital markets as this one, particularly when I get to choose the topic. It is only partly coincidental that I've chosen to talk to Standard & Poor's Management Forum about the role of the rating agencies in derivatives markets, because I think this is an issue that has important implications not just for the rating agencies themselves, but also for public investors. It also is an issue that is important to regulators' understanding of the ways in which the derivatives markets function and the degree of comfort we take in their integrity and security.

Although reliance on ratings certainly is not a peculiarly American phenomenon, rating agencies seem to occupy a more significant role in U.S. markets than in some others, perhaps because of a broader investor base and a corresponding need for greater intermediation in credit evaluation. The importance of rating agencies in U.S. markets also may be ascribed to the fact that, on the whole, they have performed with a high level of professionalism and objectivity. The relative independence of American rating agencies is an important part of their success. In contrast, in other countries, rating agencies, where they exist, in some cases may employ analysts who are borrowed from rated entities, or face other actual or potential conflicts. In my work with emerging securities markets, one of the issues most frequently raised is how can we attract U.S. rating agencies to our country and what level of oversight should be provided? There is clearly growing recognition throughout the world that rating agencies are integral to the efficient functioning of capital markets.

The term "derivatives" as you know covers a large universe. In addition to established exchange-traded futures, options, and other instruments, derivatives include the wide array of swaps, OTC options, forwards, and hybrid instruments that have exploded in volume and variety over the last decade. For convenience, I am using the term generically to refer to the entire universe, although I readily acknowledge that the different categories present very different issues of valuation, volatility, and credit exposure.

Rating agencies, of course, have been involved in the derivatives markets long before the advent of more esoteric over-the-counter instruments and the creation of specialized derivatives dealers. Traditionally, analysis of derivatives activity has been part of an overall assessment of the credit strength of industrial end-users, or part of the overall dealer activities conducted by banks and other institutions. More recently, ratings have been critical to the success of structured financings and mortgage-backed debt. The rating of these instruments has required a sophisticated understanding of the effect of fluctuations in interest rates, prepayments, and other market risk factors on credit quality. In addition, the rating of mutual funds has required a careful analysis of the level and purposes of derivatives activity conducted by those funds.

More recently, the growth of OTC derivatives activity has caused a new sensitivity to credit quality. This sensitivity has been heightened by the introduction of the BIS risk-based capital standards for banks, among other factors.

The growth of derivative transactions in the municipal market points up the ways in which rating agencies are being challenged, perhaps as never before, to sort out the effect of market fluctuations and other factors on creditworthiness. The rating of general obligation or revenue bonds supported by a predictable revenue source or tax base is a relatively simple, or at least more readily comprehensible, endeavor. In contrast, for one example, the increasing issuance by municipalities of floating rate instruments coupled with swaps designed to limit the issuer's interest rate risk raises new analytical difficulties. If the municipal issuer's ability to meet its payment obligations is materially dependent on the swap counterparty's meeting its obligation on the swap, the creditworthiness of the counterparty becomes a consideration. In addition, rating agencies must look at, among other factors, the extent to which the swap terms, both duration and interest rate formula, match those of the municipal securities.

The importance of rating agency analysis in municipal derivatives and other municipal securities is heightened by the lack of a ready, reliable source of secondary market disclosure concerning municipal issuers that investors could use to make an independent informed decision. Further, smaller institutional and retail investors may lack the wherewithal to undertake an independent analysis. Accordingly, ratings may gain added significance to the extent that derivatives such as inverse floaters begin to be marketed to retail investors. Moreover, because these instruments often entail significant market risk, it is important that retail investors understand that an investment grade rating speaks only to the ability of the issuer to make required payments and not to the market rate volatility of the instrument.

Another area in which rating agencies have played an increasingly important role involves the creation by some of the major investment banks of credit-enhanced derivative product companies, or "DPCs," designed to deal exclusively in certain over-the-counter derivatives. DPCs are distinguishable from other more established subsidiaries of highly rated insurance companies and other institutions, which may choose for various reasons to conduct this business through affiliates. DPCs exist expressly for the purpose of obtaining a rating higher than that of their parent and thereby gaining access to the market, or to a desired sector of the market. As in the municipal area, the importance of the rating agency as a proxy for investors in conducting credit analysis is paramount because of a lack of publicly available information concerning these unregulated entities.

The task of rating a DPC therefore requires close scrutiny of every aspect of its business and the amount and form of capital required to operate it. In looking at credit exposures to counterparties, the rating agencies must examine the concentration of exposure to individual counterparties, how credit limits are established, the firm's ability quickly to aggregate exposures to a single party across product lines, and how it accounts for future credit fluctuations.

Independent of counterparty credit, the rating of DPCs requires extensive analysis of market risk. Because DPCs deal solely in OTC products, market volatility is not cushioned by the benefits of exchange liquidity and transparency. In terms of market risk, the agency must examine not only the validity and reliability of the risk model that is used, but also what period of historical experience is used to test the model, the assumptions made about future liquidity, and the extent to which mark to market values can be aggregated, both geographically and across products.

Assuming that all credit and market risk factors are accounted for, the risk inherent in operating complex derivatives books must be examined. It is important to carefully review compliance and accounting functions, the hedging strategies employed, the adequacy of internal controls, the separation of trading and back-office functions, and perhaps most important, the degree of management understanding and oversight of risk parameters.

Nor can legal risks be ignored, particularly in the aftermath of the Hammersmith and Fulham case. In this context, rating agencies must look not only at risks that pertain to enforceability and netting, but also at the degree of legal separation between the parent and DPC subsidiary as a protection of the subsidiary from claims of the parent's creditors.

Once this extensive initial review, which extends for a period of many months, has been conducted, and assuming the desired rating has been provided, the rating agency must conduct a level of ongoing review that is not typical in other areas of its business. Daily exposures must be monitored extensively. The agencies generally have required weekly reports by an independent auditor, and any proposed changes in risk policies or parameters obviously would require more intensive review.

The task as I have described it appears formidable, and so it is. I do not mean to suggest that the task is beyond the reach of the agencies that have undertaken it. The agencies draw on substantial expertise gained from earlier experience with derivatives in evaluating all the factors I have mentioned and others, and they appear to have gone about the task with appropriate caution and skepticism. I think there are, however, certain inherent limitations on the predictive ability of any group of people, no matter how bright and experienced, where so many interdependent risk elements are scrambled together.

One limitation I've already alluded to involves "model risk," or the potential that computer programs may not accurately reflect past experience or account for future volatility. In particular, there is a synergistic concern -- that the application of models to discrete types of derivative products may not accurately measure the portfolio effect resulting from a large and varied derivatives book. This concern applies both to the entire risk assumed by individual firms as well as the systemic risk involved in a market-wide portfolio. The portfolio insurance experience of 1987 and, more recently, the significant losses sustained by some firms in the mortgage-backed market should remind us that the whole risk is often larger than, or at least different from, the sum of its parts.

Another inherent limitation on ratings generally derives from reliance on what I'll call "soft" factors, such as management's level of sophistication and its overall attitude toward the risks that are being undertaken, and these factors are particularly important in the evaluation of DPCs. Another factor that falls in this category is the ability of management and traders to master the learning curve involved in the introduction of new products. I certainly do not mean to imply any criticism of the ability of derivatives traders or their supervisors, but rather to acknowledge that the safety of any trading operation ultimately is in the hands not of computers but of humans. Especially with respect to dynamic hedging strategies, the potential for human error cannot be ignored and is hard to estimate, particularly when the added stress of the inevitable market-wide disturbance is factored in.

I would like to devote my remaining time to discussing the nature of the functions being performed by rating agencies in the derivatives markets and the implications as I see them from a regulatory perspective. The agencies' traditional function, that of information provider, is especially important because of the disparity among investors in these markets in terms of access to credit information and the means to evaluate it. Although the use of OTC derivatives has remained almost exclusively the province of institutional investors, we often are reminded that there are wide differences in experience and sophistication among institutions.

In fact, large and frequent users generally use ratings only to confirm their independent counterparty credit evaluations. Others may rely much more heavily on ratings, in part perhaps because dealers understandably are not inclined to share proprietary information concerning their derivatives books, and most customers may lack the resources to conduct an independent evaluation. This problem is complicated, of course, by the lack of clearly defined accounting conventions. The Working Group of the Bank for International Settlements in its October 1992 report on Recent Developments in International Interbank Relations (BIS Study) came to the following conclusion: "The difficulties involved in a full and independent assessment of credit risk have led a number of market participants to rely more heavily on externally provided credit ratings in their decisions as to which firms are creditworthy counterparties for financial contracting."

Certain potential collateral effects stemming from a heavy reliance by end-users on ratings also should be considered. For example, it is now commonplace for the contractual terms of swap and other agreements to tie termination or the addition of collateral to a ratings downgrade. There is the potential that similar agreements could contribute to a liquidity crisis to the extent that multiple terminations and requests for additional collateral occur at the same time.

Other functions being performed in the derivatives arena by ratings agencies are less traditional. With the advent of DPCs, the agencies may for the first time have begun to perform a de facto gatekeeper function by determining which firms gain entrance to the market and how they will operate. Although this perhaps is not a function that the agencies intentionally have assumed, the lack of a regulatory apparatus means that market participants must turn elsewhere for comfort on the integrity of the counterparties they deal with, and it is natural that they should rely more heavily on the rating agencies for that comfort than they might otherwise.

The extent to which this role continues depends in part on whether many participants continue to demand from their counterparties top-tier ratings. From a regulatory perspective, a decreased sensitivity by investors to credit would not be seen as a welcome development. In addition, the DPC phenomenon may turn out to be limited. At this point, only three rated DPCs have rolled off the assembly line, and it may be that for many firms the spreads to be earned in this competitive market won't justify the capital and start-up costs required. In addition, some participants may accept the AAA rating of a large money center bank more readily than that of a credit-enhanced entity. So I think it really is too early to tell whether the DPC becomes the model everyone wants to own, or instead becomes the Edsel of the securities world.

Other events that could change the rating agencies' role include universal acceptance of bilateral netting and the introduction of multilateral netting and clearing arrangements for OTC derivatives. Unfortunately, that day is not yet at hand -- among other difficulties, the derivatives industry first must clear the obstacle to clearing arrangements contained in the CFTC exemptive release on swaps, and appropriate standards for admission to and the operation of a clearinghouse would have to be established.

However the derivatives markets evolve, there are sure to be implications for regulatory oversight, not only of those markets but also the rating agencies themselves. With respect to the DPCs, it has been suggested in one recent article that the control and responsibility exercised by the agencies is tantamount to that of a regulator. Outside the context of the DPCs, the increasing volume and complexity of products causes participants to rely more heavily on rating agencies for assurance that major dealers do not assume imprudent or unknown risks.

I don't believe that the agencies themselves voluntarily have taken on a quasi-regulatory role -- I suspect that they would be the first to disavow such a role. Certainly the focus of regulators is much broader. In particular, it is a unique regulatory function to look for signs of systemic stress and risk. For example, the SEC is particularly attuned to the potential for "spillover" effects of derivatives trading to the cash markets. Another concern involves the potential for concentration of dealer activity among a relatively few major firms to provoke a liquidity crisis in the event of a default by one of those firms. A downgrading of one of these firms, even absent a default, could have the same effect.

Another important issue concerns the effect of product development and increase in volume on credit analysis by market participants. The BIS Study expressed concern that improvement in the ability of market participants to keep track of and manage credit risk does not appear to have kept pace with the increase in the growth and complexity of their exposures. This concern will only grow as the trend to increasing volume and complexity continues, and we have no reason to think it will not. As the derivatives markets evolve, regulators are continually tracking the effect of that evolution on all of these "big picture" issues.

The regulatory role in the derivatives markets is itself evolving. The Commission has adopted risk assessment rules, which went into effect this year, providing for periodic reports on the market activities of broker-dealer affiliates. Among other useful purposes, these reports will give us a clearer picture of the extent to which derivatives activity is being segregated outside regulated firms and the amount of activity, both in terms of notional and replacement cost exposure. Because we have only recently started receiving these reports, I won't attempt to draw any definitive conclusions, but it is fair to say that the information we have received confirms our general impression that derivatives activity by broker-dealers and their affiliates is large and growing and is rather heavily concentrated.

It also remains to be seen whether some of the activity that has moved to the DPCs or other affiliates will migrate back to the regulated entities. The Commission recently issued a concept release concerning alternatives to the current net capital treatment for over-the-counter derivatives. Our focus is not on mandating the route through which derivatives business can be conducted but rather on fashioning rules that accurately account for the true risk posed by these products. At the same time, we want to be sure that dealers operating in the U.S. conduct their securities activities through regulated broker-dealers. In addition, in considering alternative capital treatment, we should remember that ratings cannot serve as an effective substitute for strong capital standards.

As for the rating agencies themselves, I am on record as favoring legislation that would permit a regulatory definition of "nationally recognized statistical rating organization" (NRSRO), and that would provide for registration and transparent standard for recognition and minimal regulatory oversight of registered agencies. As you know, ratings are used as benchmarks for various securities regulatory criteria -- their incorporation in the haircut requirements for broker-dealers and in the classification of permissible investments for money market funds are two of the more prominent examples. And in fact, a de facto type of regulation already exists in the form of the criteria employed to qualify for designation as an NRSRO through the no-action process. The issue then is whether, in light of increasing requests by additional agencies for this recognition, regulation under express authority and with clearly defined standards is appropriate.

In my view, oversight could help to ensure that the rules that incorporate rating criteria continue to enhance the financial safety and soundness of regulated entities, promote investor protection, and further market liquidity and efficiency. I would suggest that it also could help to ensure that the well-deserved high reputation of established rating agencies is maintained. I would like to see the staff prepare a concept release to seek comment on this question.

It should be clear that this issue really is independent of the role of the agencies in derivatives markets, but I think the importance of that role may buttress the case. I can't predict whether this is a position that the Commission ultimately will adopt, and I also think we ought to be careful that overregulation does not hinder the flexibility of rating agencies to serve market demand. They perform a vital function, and nothing I've said should serve to detract from what I think is an admirable record.

However that issue is resolved, I trust that the SEC and other regulators can continue to draw on the knowledge and experience of the rating agencies, wherever it is appropriate and useful to do so, in fulfilling our role. Particularly in the derivatives markets, where new trends can emerge practically overnight, it is imperative that we maintain a continuing dialogue. And because of the vital role that the rating agencies play in all the capital markets, we have a keen interest in their continued success.

Thank you for your attention.