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U.S. Securities and Exchange Commission Roundtable to Examine
Oversight of Credit Rating Agencies

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Good afternoon Chairman Schapiro, SEC Commissioners and other distinguished guests. I am Jim Kaitz, President and CEO of the Association for Financial Professionals (AFP). AFP welcomes the opportunity to participate in today's roundtable to examine the oversight of credit rating agencies and to provide valuable insights and suggestions from the end-user perspective.

As the global resource and advocate for the finance profession, AFP serves over 16,000 members who manage, and safeguard the financial assets of more than 5,000 U.S. organizations. Organizations represented by our members are drawn generally from the Fortune 1000 and the largest of the middle-market companies from a wide variety of industries, including manufacturing, retail, energy, government, financial services, and technology. Many of our members are responsible for issuing short- and long-term debt and managing corporate cash, 401k and pension assets for their organizations. In these fiduciary capacities, our members are significant customers of credit rating agencies (CRAs). Acting as both issuers of debt and prudent investors, our members have a balanced view of the credit ratings process, and have a significant stake in the outcome of the reform of rating agency practices and their regulation. We appreciate the opportunity to provide additional insights and suggestions on ways to improve and reform the current ratings process.

AFP believes that a credit ratings process and investor confidence in ratings issued are vital to the efficient operation of global capital markets. It is necessary that the ratings produced by Nationally Recognized Statistical Rating Organizations (NRSRO) be sound and reliable. However, we believe that the current rating agency processes and business model is broken and was a catalyst for the sub-prime debacle and resulting financial meltdown that we are all so well aware of. A new model is needed to restore investor confidence and reestablish efficient global capital markets.

BACKGROUND

For nearly 100 years, rating agencies have been providing opinions on the creditworthiness of issuers of debt to assist investors. The Securities and Exchange Commission (SEC), banking regulators, and the Federal Government also rely on ratings from rating agencies. In 1975, the

SEC recognized Moody's, Standard & Poor's, and Fitch, the three major rating agencies in existence at that time, as the first nationally recognized statistical rating organizations (NRSRO). The SEC and other regulators use the ratings from the NRSROs to determine whether certain regulated investment portfolios, including those of mutual funds, insurance companies and banks, meet established credit quality standards. As a result, companies that hope to have their debt purchased by these portfolios must have a rating from an NRSRO. From 1975 to 1992, the SEC recognized four other rating agencies, but each of these entrants consequently merged with Fitch. The SEC did not recognize any new agencies from 1992 until April 2003, when Dominion Bond Rating Service received recognition from the SEC, becoming the fourth NRSRO. There are currently 10 NRSROs.

Some market participants have argued that the NRSROs did not adequately warn investors of the impending failure of Enron, WorldCom, Parmalat, and other companies. For example, in 2001, the rating agencies continued to rate the debt of Enron as "investment grade" days before the company filed for bankruptcy. These failures occurred despite the fact that CRAs have access to non-public information because of their exemption from Regulation Fair Disclosure (Reg FD). As a result of the corporate scandals of 2001, Congress, in the Sarbanes-Oxley Act required the SEC to conduct a study on credit rating agencies examining the role of rating agencies in evaluating debt issuers, the importance of that role to investors and any impediments to accurate appraisal by credit rating agencies. Sarbanes-Oxley also required the study to determine whether there are any barriers to entry into the credit rating market and whether there are conflicts of interest that hinder the performance of the rating agencies.

In January 2003, the SEC released the Sarbanes-Oxley-required study, which identified five major issues that the SEC stated it would examine further: information flow, potential conflicts of interest, alleged anti-competitive or unfair practices, reducing potential barriers to entry and ongoing oversight. Following the study, the SEC issued, for public comment, a concept release exploring these issues on June 4, 2003. As of this hearing, the SEC has not issued any proposed rule specific to that concept release.

In September 2002, AFP surveyed senior-level corporate practitioners and financial industry service providers on their views regarding the quality of the NRSROs' ratings, the role the SEC should take in regulating the agencies, and the impact additional competition may have on the marketplace for ratings information. In that survey, many financial professionals indicated that the ratings generated by the NRSROs were neither accurate nor timely.

In September 2004, AFP once again surveyed senior-level financial professionals regarding the accuracy and timeliness of the NRSROs' analyses and on the potential role regulators may have in promoting competition among credit rating agencies[1].

Key findings of the 2004 AFP Rating Agency Survey include:

- Eighty-seven percent of responding organizations with debt indicate that credit providers require them to obtain and maintain a rating from at least one of the four NRSROs.
- Many financial professionals believe that the ratings of their organizations are either inaccurate or are not updated on a timely basis.
- A third of corporate practitioners believe the ratings on their organization's debt are inaccurate.
- Fifty-two percent of financial professionals indicate that the cost of credit ratings has increased by at least 11 percent over the past three years, including 19 percent that indicate that costs have increased at least 25 percent over that time period.
- While many responding organizations are confident in the accuracy of the ratings they use for investments, they are less confident in the timeliness of the same ratings.
- Financial professionals believe the SEC should take a greater role in overseeing the credit rating agencies along with encouraging greater competition in the field.

Since the release of this information several years ago, AFP has consistently been in communication with our members assessing whether the situation has gotten better or worse with

[1] For complete copies of both survey results visit www.AFPOnline.org.

NRSROs and the ratings they produce. We are disappointed to report that the general frustration and lack of confidence has grown considerably and the recent disruptions in the credit markets have only exacerbated the problems that many financial professionals are experiencing.

A New Structure for Ratings Organizations

Since 2002, AFP has been a vocal advocate for the reform of the credit ratings industry. During that time, we conducted several surveys that found that both issuers of corporate/municipal debt and investors of corporate cash and pension assets believe: 1) the information provided by credit rating agencies is neither timely nor accurate, 2) the rating agencies are primarily serving the interest of their shareholders and other parties rather than investors, and 3) the SEC or some other regulatory body must increase its oversight of rating agencies and takes steps to foster greater competition in the market for credit rating information. In April of 2004, AFP and treasury associations from Europe issued the *Code of Standard Practices for Participants in the Credit Rating Process*, which preceded the *Code of Conduct Fundamentals for Credit Rating Agencies* issued by the International Organization of Securities Commissions (IOSCO). We testified before Senate and House committees on a number of occasions and submitted many comment letters to the SEC on its proposed rules relating to NRSROs.

While AFP believes that the *Credit Rating Agency Reform Act of 2006* (CRRA) and the SEC rules implementing the Act made significant strides toward removing barriers to competition the SEC had imposed, more work must be done to adequately address deficiencies with the current model in place. Unfortunately, passage of the CRRA has not led to real competition in the credit ratings market nor has it improved the ability of the two dominant rating agencies (Moody's and S&P) to produce timely and accurate ratings, while at the same time their fee structure has continued to rise. The recent market turmoil and disruptions in the credit markets provide strong empirical evidence that the rules do not go far enough – **significant reform** is necessary in order to fix this inherently broken system. The model and structure of the ratings agencies is flawed and AFP believes that changes to current rules will not adequately address these flaws.

Therefore, today AFP is proposing the following changes and enhancements to the current model for your consideration. We realize that additional work will need to be done should either of these ideas materialize into action but it is our hope that these suggestions can serve as the impetus for meaningful dialogue and deliberative action toward necessary reforming of the CRAs. AFP believes there to be two business models for the rating agencies that are worthy of further consideration: a) create a stand-alone model, where the only activities of the enterprise would be credit ratings; and b) implementing rules that direct government support of the other non-major NRSROs.

Our first suggestion is to implement a model that is similar in nature to a utility where a small, more practical and justifiable transaction fee would be instituted to support ratings organizations whose sole business purpose is to provide credible and reliable ratings. These organizations must have a single line of business that is entirely related to providing sound ratings. These new entities would be able to interact with and advise organizations being rated, but could not charge fees for providing advice, as Moody's and S&P do today. If this new type of rating agency is part of a larger company, there must not be any interaction between the parent company and the rating agency – they should be wholly separate and wholly independent of each other.

AFP believes this model is a viable way to subsidizing a rating organization that agrees to provide credible and reliable ratings as their sole business purpose. Additionally, this type of transaction fee model would have built-in price controls because it is based on a flat fee. With this stand-alone model, most of the conflicts-of-interest that the current CRAs have would be removed. The key to making this model flourish is to have it funded by the transaction fee. It is our contention that whether the fees are paid by the issuer/structurer or the investor, there are inherent biases in place. In the issuer-based model, there will always be pressure for the CRA to give the highest rating, and to maintain that rating, while in an investor/ or subscription-based model there will be pressure for the initial rating to be as low as possible, combined with a desire to protect the rating on an on-going basis. In either scenario, it is inevitable that potential conflicts exists with true credit analysis, however, we believe the stand alone model would significantly mitigate conflicts and reputation will become a more significant factor.

By creating a funding source that is independent of the issuers and investors, the focus of the CRAs will be on producing the most accurate and timely credit analysis rather than satisfying the desires of any other vested interest. Under this model, the SEC would still have to exercise vigorous oversight of the new entities to ensure that they are fulfilling their mission of providing reliable ratings, including ensuring NRSRO's are abiding by their own models and are held accountable for consistently inaccurate ratings

The other component we believe is worth exploring would be for the U.S. government to require itself and any all federal programs that require credit ratings, as well as any business that has had a capital infusion from the U.S. government, to utilize the smaller NRSROs as additional credit analysis providers. This departure from tradition by such a key market participant would encourage the development of a truly competitive environment and give credibility to new rating agencies that have not had an opportunity to establish their bona fides on the open market. Given the dominant market position that S&P and Moody's currently possess, the barriers to having one of the smaller NRSROs grow to the point of being an equal competitor seems remote. The U.S. government must break their own addiction to S&P and Moody's due to their duopolistic nature and history of poor performance. We believe others should get to take part in this industry if it is to be truly competitive. The government, including the Treasury Department, must immediately begin to use alternative NRSRO's as well as direct some ratings business to the new structures/entities rather than relying solely on those provided by S&P and Moody's. We further propose that federal agencies be required to utilize at least one non-issuer/non-subscriber service/new rating agency for all transactions with underlying assets of $50 million or more.

Though corporate America currently has the ability to utilize one of the smaller NRSROs, until these entities are viewed as being on a level playing field with the Big Two, this is unlikely to occur. Individual companies will be unwilling to spend the time, resources, and money on ratings that aren't view as being "as good as" the Big Two. If the government were to support the other

NRSROs, then with time, they would have the opportunity to grow to be worthy competitors, establish reputations, and provide needed competition in the credit rating agency world.

AFP Continues to Support Enhanced Disclosure and Transparency as well as Vigorous Enforcement of Rules to Prevent Conflict of Interest

Recently re-proposed rules require additional disclosure of the ratings histories for all outstanding ratings issued by an NRSRO. AFP fully supports increased disclosure requirements, but argue for model agnostic disclosure – it must be the same across the board for all NRSROs regardless of how they are compensated. Under our proposal, every rating organization would be required to disclose the same information about their practices, methodologies and research models. Above all, whether or not we move to a different rating agency model, the SEC must enforce strong anti-conflict of interest rules.

Recently, criticisms about the ratings process have been almost exclusively focused on the issuer-paid model. It is important to note however, that the subscriber-paid model is not devoid of potential conflicts of interest either. For example, a large subscriber, such as a mutual fund company or large financial institution, could exert influence on the ratings process and the direction of ratings for business for competitive reasons. Creating an external organization that seeks no business gains from providing sound and reliable ratings for companies alleviates many potential conflicts of interest.

AFP Opposes Unsolicited Ratings from Issuer-Paid Rating Agencies

The problem with unsolicited ratings is that they are used to generate new business. Unsolicited ratings are largely based on incomplete information that does not include all of the facts. Additionally, unsolicited ratings can also be used to punish entities that do not choose to do business with a particular NRSRO. Unsolicited ratings should only be allowed by 'new' organizations when they are trying to demonstrate their history when applying to become an NRSRO.

Immediate Action is Required

The rating agencies are an ingrained component of the investment decision process, but they have clearly failed, as a group, to provide accurate and timely information to investors over most of this current decade. Over this timeframe, market participants have been punished severely, while the Big 2 management teams and shareholders have benefited greatly from 'cranking out' ratings without performing the necessary credit review and stress testing that you require.

Over the past seven years, the AFP has posited that with increased competition and oversight, the inherent problems of having a government-structured duopoly would be corrected. Given the utter failure of the rating agencies over the past several years to identify the credit crisis, we believe it is time to try a new approach to provide investors with the information they need to make prudent investment decisions.

It has been argued that professional investment managers do not require the analysis of rating agencies. Since their core business is making investment decisions, they should have the resources in place to perform their own, robust due diligence. What we at the AFP are concerned with is corporate America's ability to make prudent investment decisions in a timely and effective fashion. Given the highly competitive global economy we operate in, most of our membership is unable to allocate resources purely for the purpose of investment credit analysis. In order to participate in the purchase of securities other than the most ultra-safe type, i.e. U.S. Treasuries, companies need to be able to rely on third-party credit analysis as a basic credit framework. If investors do not or cannot rely on credit ratings, then ratings agencies serve no purpose in our economic system.

Thank you for the opportunity to provide AFP's perspective and feedback on oversight of the credit rating agencies from the end-user perspective. We hope that our suggestions can be used as the basis for the beginning of a thoughtful dialogue on significant and effective reform of the current CRA model.