Statement of

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Enhancing Competition in the Credit Rating Agency Sector

Madam Chairman and Members of the Commission, thank you for the opportunity to participate today. I am Alex Pollock, a Resident Fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI, I spent 35 years in banking, including twelve years as President and CEO of the Federal Home Loan Bank of Chicago. I have been working on the issues of the credit ratings agency sector since 2004, which included Congressional testimony during the deliberations which led to the Credit Rating Agency Reform Act of 2006.

At the beginning of 2005, I published an essay entitled, "End the Government-Sponsored Cartel in Credit Ratings." That title summarizes my views. I do think there has been progress in this direction since the 2006 Act and the SEC's implementing actions. I used to call Moody's and Standard & Poors "the other government-sponsored duopoly." The first one was of course Fannie Mae and Freddie Mac, which have since then become a government-owned duopoly. With the credit rating agencies, we can do much better, and keep moving toward a more competitive sector, with less government sponsorship.

Opinions About the Future

In his insightful 1940 book on investing, Where Are the Customers' Yachts?, Fred Schwed observed that what everybody in financial markets wants to know is the one thing that nobody can know: the future. So, he said, Wall Street invents ways to give them assurances about the future, which will make people feel confident enough to buy securities. These assurances are, of course, opinions.

For the fixed income markets, the single most important such opinions are those of the credit rating agencies on the probability that obligors will pay as called for in the debt instruments. Indeed, the rating agencies have often described themselves as being in the business of publishing opinions on credit and the risk of default.

In this I believe they are right. In the course of financial events, some such opinions will inevitably prove to have been mistaken, and some disastrously mistaken. During the twenty months since the onset of financial panic, it has become obvious to all, such as mortgage securities buyers who have lost hundreds of billions of dollars, that important credit opinions some of them relied on were wrong, to say the least. There has been heated criticism of the dominant rating agencies, and the stock prices of Moody's and McGraw Hill, S&P's parent company, are down about two-thirds since January, 2007.

Can't we somehow "assure" ratings which are "accurate" (to borrow terms from a current draft Senate bill)? Can't we guarantee having models which are right? No: Nobody—no rating agency, no regulatory agency, no modeler with however many computers—knows how to make universally correct predictions of future credit events.

So when it comes to opinions about the future, my view is: the more, the merrier. Having more credit rating competitors, especially those paid by investors, increases the chances that new insights into credit risks and how to conceptualize, analyze and measure them will be discovered. It will also reduce the economic rents granted by government sponsorship to the old cartel and paid for by everybody else.

Of course, any sources of opinions which are too often mistaken, late or uninformative will have little analytical value to investors and other credit market actors. They would not be purchased in a free market. But government sponsorship may nonetheless create for such opinions a large regulatory value, as opposed to a predictive value, as has been provocatively explored by my distinguished fellow-panelist, Frank Partnoy.

The "NRSRO" System

Since all opinions are liable to error, and since opinions based on models are liable to systemic error of vast proportions, why would the U.S. government what to enshrine certain opinions as having preferred, preferential, indeed mandatory status? It should not want to, and it should not—but it did. This was the old NRSRO system. (Even worse, of course, would be for the SEC staff to try to tell the rating agencies how to do credit ratings, thus effectively making the SEC into a monopoly rating agency.)

Under the old system, all regulated investors—banks, insurance companies, pension funds, thrifts, mutual funds, the vast majority of institutional investors—were required to use NRSRO ratings. Not least importantly, these helped determine regulatory capital requirements. Government regulation thus created a mandated demand for these favored ratings. Whether or not they had reliable predictive or informational value, i.e.

competitive market value, the market for them was guaranteed. Another distinguished fellow-panelist, Larry White, was pointing this out long before I was.

While mandating demand, the NRSRO system also restricted supply. We can't be surprised that the price went up. Thus the old system powered remarkable profits, return on investment, cash flow, and until 2007 stock prices, of the dominant rating agencies.

In considering any system, look for concentrated points of possible failure: this is the sound advice of my friend, Kenneth Gould. Because, he argues, if you create such points, sooner or later they will fail.

The old NRSRO system made the dominant rating agencies into just such a concentrated point of possible failure—which then indeed failed.

In this context, Deven Sharma, the President of S&P, has rightly said that we need to "avoid inadvertently [let alone intentionally!] encouraging investors to depend excessively on ratings, rather than treating them—as they should—as one of many inputs in decision making."

In my view, this is consistent with my "the more, the merrier" strategy. As we all know, Congress made it clear in the 2006 Act that greater competition in the credit rating agency sector was one of its key objectives.

In contrast to the progress of the SEC in this respect, the Federal Reserve has recently gone in the wrong direction. The Fed did this by inventing a new category: "major rating agencies," which means exactly the old government-sponsored cartel. As the Attorney General of Connecticut has written to the Fed, this category "has the effect of unfairly blocking other [new] NRSROs from the TALF program." He continues, "inexplicably, it rewards the very incompetence…that helped cause our current financial crisis." It certainly does continue the old NRSRO system as a concentrated point of possible failure.

<u>The Investor-Paid Model</u>

A particularly desirable form of increased competition, in the opinion of many of us, is from rating agencies paid by investors, which have a superior alignment of incentives compared to the currently dominant model. A frequent objection to competition in credit ratings is that there would be a so-called "race to the bottom." But this does not apply at all to the logic of investor-paid ratings.

The "major rating agencies," to use the Fed's term, have received much severe criticism for the potential conflict of interest represented by being employed by those who obviously wanted the lowest possible subordination for the highest ratings in structured securitizations. My idea is not to restrict their issuer-paid model, but to encourage meaningful competition between the two models. Let investors and other users of ratings decide which they prefer.

It has been suggested that ratings should include a disclosure of whether they were paid for by investors or issuers. This seems reasonable. More effective might be for all regulatory bodies whose regulations supported the government-sponsored ratings cartel, not just the SEC, to implement ways to promote the pro-competitive objective of the 2006 Act.

In my view, the SEC should ensure that all rules it adopts are consistent with encouraging competition from the investor-paid model—or at the very least, do not discourage it. A requirement, for example, that all ratings be made public makes an investor-paid model impossible in principle and would be an obvious mistake.

Are there ways to create a more robust presence for the investor-paid model? I have previously proposed that a group of major institutional investors should set up their own rating agency, capitalized and paid for by the investors, working from their point of view, and supplied with top talent and technology. This would certainly be a more direct and successful process than trying to set rating practices by regulation, and it continues to seem to me likely that the market would demonstrate a preference for the ratings of such an agency.

A successful competitor would find ways to distinguish itself by creating more valuable ratings. It might accompany ratings with calculated probabilities of default and loss-given-default; publish the values and ranges of key parameters; have superior monitoring and updating ratings over the life of securitizations; have all re-ratings based on the most current parameter values—for example, of paths of future house price appreciation or depreciation; and make ratings reflect the risk of increased opacity of structures. A dedicated, competent firm working for investors in a truly competitive market would think of many others.

In sum, greater competition in the rating agency sector remains in my opinion not only an essential, but also an achievable objective.

Thank you again for the chance to share these views.