DEFINITION OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION – PROPOSED RULE S7-04-05

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GENERAL COMMENTS

(1) The proposed NRSRO criteria are anti-competitive and would make it very difficult, if not impossible, for a new rating firm to meet the criteria. If existing rating firms do not receive NRSRO status in the near future, they will likely be forced out of business due to the increasing importance of NRSRO status and therefore, potential competition will cease to exist. New firms generally bring innovation and competition to the industry, but with the three largest rating firms dominating the industry, users of these rating services will continue to pay high prices, receive infrequent rating changes and poor credit evaluations.

(2) The SEC NRSRO proposal favors the rating of large firms, which can afford to pay the large sums for their ratings. The proposed criteria may significantly limit credit ratings of smaller firms, which are rated free by some rating companies. These rating agencies earn revenue by charging for their rating services and if ratings are required to be provided "free", the service revenue would not be available to fund such ratings and the companies will cease issuing credit ratings for small companies.

(3) The conditions that the SEC is imposing on new NRSRO companies should be applied to all NRSRO companies for fairness purposes.

PUBLICLY AVAILABLE CREDIT RATINGS

Comment: The SEC needs to clearly define what "credit ratings" should be made available to the public, especially those at no cost. On page 25 of the SEC proposal, it states the term "NRSRO" <u>primarily relates to credit ratings on specific securities or obligations.</u> The word "primarily" could be considered vague and we suggest it be more clearly defined. Is the term "credit ratings" for; (1) new issue ratings that will be traded on public exchanges, (2) new issue securities that are private placements or (3) credit ratings issued on the financial condition of institutions used for credit extension and risk management?

LACE Financial does not have a problem of providing "free" ratings on new issues of publicly traded securities since we would charge the securities' placement agents to derive such ratings.

To require LACE Financial to provide "free" credit ratings on the financial condition of all the institutions we rate such as banks, savings and loans, credit unions, and bank holding companies will require us to drop this service on approximately 20,000 institutions, since we do not charge these institutions for their ratings. The idea that you could shift the rating cost by charging rating fees to these institutions will not work. The only institutions that would want to pay the fees are those that are well rated and in most cases larger institutions. Most institutions would not want to be rated and LACE Financial would not be able to rate the full universe. Providing credit ratings free for financial institutions is analogous to providing credit ratings to individuals. In our case, companies like Wal*Mart, General Motors, ChevronTexaco, JP Morgan Chase, MasterCard, and other large corporations are concerned about the financial condition of banks they may have deposits with or are receiving letters of credit. We would assume these companies would be very dissatisfied if we were forced out of this business. Many, if not all of these institutions prefer our services because we do not charge for credit ratings and they feel there is a bias in exchanging a rating for money. As a public service, LACE Financial provides to public libraries a rating book four times a year that provides credit ratings on 12,000 institutions (cost of about one cent per rating). For a small financial institution to receive a credit rating from an NRSRO would cost approximately $25,000. This book saved many individual investors their savings during the late 1980's and late 1990's when 200 to 300 banks and savings and loans were failing each year (100% of the institutions were rated non-investment grade and 98% had "D" or "E" ratings at least six months prior to failure). The book, provided to only public libraries is subsidized from revenues received from services sold to larger clients. If we lose their revenues, we will have to cancel the <u>Quarterly Financial Institution Rating Service.</u>

ISSUE SPECIFIC CREDIT OPINIONS

Question: <u>Should a credit agency that does not rate specific securities or money market instruments be included in the definition of NRSRO?</u>

Answer: The answer to this question has to be yes! If existing NRSRO rating companies receive more than half of their revenue or at least a significant portion of their revenues from rating "non specific securities or money market instruments", shouldn't applicants for NRSRO status also be allowed to do the same? To deny an applicant NRSRO status based on the fact that they only rate specific securities or money market securities when this is a significant business for existing NRSRO companies is <u>anti-competitive.</u>

Question: <u>If so, under what circumstances?</u>

Answer: The rating company should have:

(1) A history of providing credible ratings not only to investors, but to credit risk managers.

(2) The rating company should be free of complaints from those they rate as well as those who use the ratings to make credit decisions. The users and those being rated should, in general, feel that the ratings are accurate and fair.
(3) The rating methodology should be consistent over time and be backed by academic research.
(4) Credit ratings issued should be accompanied by the information that is used to derive a significant portion of the rating and the date the rating was derived.
(5) Analysts should be available to discuss the rating with an investor, client, or with a person representing the institution being rated.
(6) The rating should be provided free to the institution being rated if requested.

Comment: If these criteria are imposed on an applicant for NRSRO status it should be required of all NRSRO companies in order to ensure a level playing field in the rating process.

CURRENT CREDIT OPINIONS

Question: <u>Should the Commission provide additional interpretation regarding what it means for a credit rating agency's credit ratings to be "current assessments"?</u>

Answer: Yes, the Commission should require that a date be shown for when a security is issued and for each time it is reevaluated. This information will inform an investor or risk manager, how current the credit evaluation is and whether the rating took into account certain events since it was issued. The date assigned to the rating will put market pressure on the rating agency to maintain current ratings and should provide assurance to the markets that ratings are current.

GENERAL ACCEPTANCE

For a new start up rating agency, the condition of "Wide acceptance in the market" and generally accepted in the financial markets by "predominant users of securities ratings" is an impossible achievement in the current market environment dominated by the three large NRSROs. Prohibition of issuing publicly traded securities by the SEC rules and regulations applied against non-NRSRO rating companies further hinder a non-NRSRO rating company from gaining market acceptance.

Question: <u>How would predominant users be determined?</u>

Comment: The following are some of LACE Financial's clients – are they predominant users?

Ace Companies, USA, Allianz Life Insurance, Ambac Assurance Corporation, American Share Insurance, Archer Daniels Midland, Bank of America, Bank of New York, Bank of the West, Bear, Stearns & Company, Bristol-Myers Squibb Company, Central Pension Fund, Certegy Card Services, ChevronTexaco Corporation, Cigna Corporation, Citizens Bank, CAN Insurance Company, Coca-

Cola, Credit Suisse First Boston, Crum & Forster, DC Office of Treasury, Delta Airlines, Electronic Payment Services, Farm Credit Financial, Farmer Mac, Farmers Insurance Group, Federal Home Loan Bank of Atlanta, Cincinnati, Chicago, Dallas, Des Moines and New York, Federal Home Loan Mortgage Company, Firemans Fund Insurance, FTN Financial, General Motors Corporation.

We would hope that the above users are “predominant users of securities ratings” and their use would be considered as “wide acceptance in the market”. If not, the SEC may want to delineate further, what is meant by the above terms in quotation marks. A majority of the above clients have used our services for the last ten to twenty years**.**

GENERAL ACCEPTANCE IN THE FINANCIAL MARKETS

Question: <u>How else could the Commission define the term “NRSRO” in order for users of a credit rating agency to determine whether such ratings are credible and are reasonably relied upon by the market place? Are the approaches discussed above useful for determining whether a credit rating meets the second component of the proposed definition?</u>

Answer: LACE Financial certainly agrees with the SEC’s proposal that credit ratings issued by an applicant for NRSRO status should be “credible and reasonably relied upon by the market place.” Most of our clients have used LACE Financial’s rating services for the last ten to twenty years. To determine who uses these rating services, particularly at large institutions, the SEC must obtain a list of who the users are from the NRSRO applicant and then determine from these institutions whether the applicant is a credible and reliable rating service.

Question: <u>Should the fact that a credit rating agency has many subscribers support a finding that the credit rating agency satisfies the second component?</u>

Answer: Yes, if the subscribers are major users of credit ratings, have used the credit ratings over several years, and there have not been significant complaints from the institutions being rated.

Question: <u>What types of statistical data could be relied upon to determine if a credit agency’s credit rating are relied upon by the market place?</u>

Answer: Most of the financial data LACE Financial uses is regulatory data collected by the FDIC and Federal Reserve Board. This data has standard definitions for items being reported and is extremely valuable for comparison analysis. The reports must be signed by an officer of the institution and if fraudulent reporting occurs, fines can be imposed and/or persons could risk imprisonment. The second preferred data is information filed with the SEC, however this is generally for larger companies. Statistical information that is received from companies must be audited prior to being used in the rating process and should be used very cautiously.

Question: Should the views of issuers be a relevant consideration in determining whether a credit rating agency meets the second component of the NRSRO definitions?

Answer: LACE Financial has issued over 1.2 million credit ratings and our experience leads us to believe that most companies would argue that their ratings should be higher because it is in their interest. We have assigned an "E" (our lowest rating) credit rating to two banks in Thailand, whose nonperforming assets are greater than their capital and reserves and "E" ratings have been assigned to several banks in China, which are clearly insolvent. I doubt that these companies would recommend us for NRSRO status, but our clients are very grateful for our candidness.

LIMITED COVERAGE NRSROs

Question: Should a credit rating agency that is recognized by the market place for issuing credible and reliable ratings within a limited sector or geographic area meet the NRSRO definition only for its ratings within such sector or geographic area, or more broadly?

Answer: First, it must be recognized that all rating agencies start out relatively small and usually specialize in certain types of securities, such as railroad bonds. To limit by geographic area does not make much sense since business and credit instruments are becoming more and more international. LACE Financial over the last seventeen years has rated financial institutions in 58 countries and the majority of our larger clients are multinational.

To limit ratings to a certain sector may be more manageable by the SEC but would be very anti-competitive. Existing NRSRO rating agencies would love to have the SEC restrict LACE Financial to rating only financial institutions and to restrict others to limit their growth. But upon receiving NRSRO status, we will enter the rating of municipal securities because many states (NY, large cities (NYC), counties (Orange County)) are users of our services and prefer our rating process. The SEC must realize there is tremendous market discipline for small rating companies to "get it right", credibility is everything for them and if they make a mistake, no one will use their services. Large NRSRO companies can seriously mis-rate a company and not worry about losing clients since there is nowhere for their clients to go.

Question: If a credit rating agency meets the NRSRO definition only with respect to its ratings within a particular sector or geographic area, would the NRSRO classification interfere with the credit rating agency's ability to expand its business?

Answer: No, NRSRO status will put new NRSRO companies on a level playing field with existing NRSRO companies and they should be able to expand their business as fast as they can hire and train experienced staff. LACE Financial is very reluctant to enter new rating markets without NRSRO status.

Question: We noted above that commenters mentioned that it would be difficult for limited coverage NRSROs to perform a full and accurate assessment of credit risk without a broader expertise in credit risk assessment. We request further comment on this view given our proposal to permit limited coverage.

Answer: First, the SEC proposal for limited coverage is anti-competitive and the industry needs more competition. Although I believe limited coverage is going in the wrong direction, I do believe the statement "it would be difficult for limited coverage NRSRO to provide a full and accurate assessment of credit risk without a broader expertise in credit assessment" is wrong. One should not assume that existing NRSROs get it right, i.e. WorldCom, Enron, Orange County, Daiwa and Asahi Bank. Second, one should not assume that a company like LACE Financial whose founder wrote a Ph.D dissertation on rating Bank Holding Companies, has issued 1.2 million ratings on financial institutions, whose rating methodology was adopted by the three federal bank regulators, and was rating banks, bank holding companies, and savings and loans before Moody and Standard and Poors can not accurately access credit risk. Such reasoning is absurd!

ANALYSTS' EXPERIENCE AND TRAINING

Question: The Commission requests comments on appropriate subjective (and objective) criteria that a credit rating agency should use in assessing the experience and training of an analyst to meet the proposed NRSRO definition.

Answer: To be hired by LACE Financial all analysts are required to have a minimum of a bachelor's degree in finance (no substitution). Before hiring our last two analysts, we reviewed over fifty applications and hired a person from Zurich Switzerland that had the kind of experience we were looking for to help in the rating process of securities issued by insurance companies. The second analyst had previously worked for the investment-banking department of JP Morgan Chase and had an MBA degree in Finance from the University of Chicago and was hired to work on new securities issues. Entry-level financial analysts are not allowed to rate companies until they have two years training and generally, they are senior financial analysts before they become fully involved in the rating process. Country risk ratings can only be assigned by an analyst with a PhD. The major subjective criteria we are interested in are communication skills, mainly the ability to write, to talk with senior staff at financial institutions, and the ability to work with investment bankers.

NUMBER OF RATINGS PER ANALYST

Because of the different analytical approaches, rating methodologies, the different types of securities being rated and the various types and size of issuers as well as the different abilities of financial analysts, I would suggest the SEC not set standards that deal with the number of ratings that analysts should issue within a certain time period. NRSROs, as well as LACE Financial, will charge a higher rating fee for a new issue depending on the complexity of the issue and the size and complexity of the issuer, since these generally require more analytical time than smaller issues.

Question: Should the Commission specify minimum standards for a credit rating agency's analysts to continuously monitor and assess relevant developments relating to their ratings so that users of the credit rating agency ratings can determine whether the agency meets the NRSRO definition?

Answer: LACE Financial completely re-rates all new issuers twice a year, which takes into account all relevant developments. If the SEC is going to set an industry standard, I would suggest it be at least once a year.

Question: If a credit rating agency relies primarily on quantitive models to develop credit ratings, how can a firm's ratings reflect a thorough analysis of the specific credit characteristics of a particular security?

Answer: In most cases, the majority of the analysts' time in rating a security is not used in determining the credit characteristics of the security since these are usually defined, but in determining the ability of the issuer to make interest or dividend payments as specified by the security. Quantitive models play a significant role in the rating process and are not only used by LACE Financial but by large NRSROs and investment banks. These models are used in a support role to aid the analysts to establish a credit rating or a new issue rating but never to derive a rating. It can take a hundred or more calculations to derive a single score for liquidity, asset quality, capital and earnings and the risk components of each of these four major determinants for financial soundness, including peer information, percentiles and historical comparisons. These models were developed to increase the productivity of analysts and enhance the ability to perform a better evaluation in the rating assignment. Computer models help determine the current financial condition of the issuer but the analyst must evaluate the future outlook of the issuer and its ability to meet the obligations of the security. Although a rating agency may use quantitative models extensively, they are not relied upon to establish a security rating, at least not by LACE Financial.

Question: Should the Commission require credit rating agencies to disclose the number of credit analysts they employ and the average number of issues rated or otherwise followed by those analysts?

Answer: Because of the various types of securities rated and the different characteristics of the issuers, I do not believe this information is meaningful and one cannot use it to make comparisons among rating agencies. For example, LACE Financial rated in 2004 three pools of structured trust preferred securities, raising about $768.3 million of capital. It took two senior financial analysts to perform this task plus considerable review time by senior staff and about a year's time of support staff. Included in the pools were approximately 150 issuers, all of which had to be analyzed to derive the pool rating. Is this good or bad? What is important to us is that we felt and our client felt, we did a good job and we made money in performing the tasks. Is this comparable to other NRSROs?

We are just not sure. In our opinion, what is important is the quality of the product. The proposed requirement will likely cause an increase in costs to the rating process and, in the end, will produce information that is not likely to be meaningful.

Question: Should a credit rating agency be required to test in some way the integrity of information provided directly by issuers (both public and nonpublic) through third party vendors?

Answer: Insuring the accuracy of information is a normal procedure in the rating process and is performed prior to the analysis. During the analysis, if information provided appears to be questionable, management is contacted to provide the answers. Due to the different types of information used to rate various instruments, we feel that it would be very difficult to provide guidelines for data verification and we would suggest that the SEC focus more on the integrity of the rating agency. There have been several cases where information provided by the institution being rated is old or questionable and LACE Financial has refused to issue a rating under such circumstances.

CONTACT WITH MANAGEMENT

Question: In designing and implementing systematic procedures to insure credible and reliable ratings, should a credit rating agency seeking to meet the definition of NRSRO address how and the extent to which it involves an issuer's senior management in the rating process?

Answer: We agree that for new issues of securities it is important to involve management to determine how the proceeds are going to be used, whether the company is engaged in lawsuits and if so, what the worst case outcome could be, if there are any other contingent liabilities, and the need to understand the institutions future business plans. As mentioned earlier, it is also necessary to contact management to answer the questions that arise from the analytical effort. For credit ratings, generally the answer is no because it is usually not necessary. LACE Financial issues credit ratings on all insured commercial and savings banks, all bank holding companies, all savings and loans and all federal credit unions on a quarterly basis and does not charge the institutions for their ratings. We have rated these institutions as many as eighty times since we started business in 1984 and have found that contacting management on an exceptional basis works best for the institution being rated.

There are three major points the SEC should consider when concerning contacts with management for credit ratings.

(1) LACE Financial issues approximately 20,000 credit ratings a quarter and management may not want to be contacted on such a frequent basis. Furthermore, a credit rating agency would not be able to provide credit ratings on such a frequent basis if they were required to contact management each time they issued a rating. In most cases, the ratings do not change and contact with management is not necessary. All financial institutions that were

established before 1984 have been rated eighty times by LACE Financial and we are very familiar with the institution. Generally, when we do contact management, it is on an exceptional basis and they are very appreciative for the inquiry since it normally deals with a data error, a major rating change has occured since the last quarter, and /or we may be in the process of assigning a "D" or "E" rating.

(2) The requirement to meet with management eliminates rating all institutions in a large industry. As commented on by others, the requirement to meet with management or charging for credit ratings will mean that most companies will not be interested in participating in the rating process and rating an entire industry will not be possible. Since LACE Financial needs NRSRO status <u>to effectively compete and continue to do business</u> it will have to refrain from rating smaller companies. The requirement that we will have to contact management for credit ratings will mean we will have to stop (1) providing quarterly ratings for almost all companies (2) stop rating almost all credit unions (9,000), only rate the larger bank holding companies, (stop rating 2,300 BHC's), rate the 100 larger S&L's (stop rating approximately 900) and only rate the larger 300 banks (stop rating approximately 7,000 banks). We will stop rating all title insurance companies; currently we rate the universe and do not charge to rate these companies. This is not something that LACE Financial wants to do but we will be forced to do depending on the SEC NRSRO criteria. Initially it will cost us about 60% of our revenues, drastically forcing us to change the way we do business, but the impact will be far greater for others. LACE Financial, mainly because of its analysts, is a premier rating company for medium and smaller financial institutions. By not rating these institutions, the cost of credit will likely rise for most of them and credit may not be extended to others.

(3) If the requirement to contact management causes LACE Financial to cancel its credit rating services for all financial institutions it will have a major impact on smaller financial institutions. The lack of rating material provided by LACE Financial on smaller financial institutions will affect the decision making process dealing with the extension of credit by: (1) large financial institutions (most of which are clients of ours) to smaller institutions, (2) large corporations placing deposits with financial institutions, (3) smaller financial institutions that extend credit among themselves (bankers banks most of which are clients of ours), (4) municipalities that are placing tax funds in local banks, (5) small investors who use our ratings on approximately 12,000 institutions in a service we only provide to libraries to make decisions on buying large CD's (6) large corporations that buy CD's from minority banks. Our minority bank service will be canceled since we will not be rating these institutions.

LACE Financial has built its franchise as a niche player in providing credit ratings and new issue ratings for smaller financial companies since the NRSROs were not interested in this low margin business. Hopefully the SEC will recognize that issuing credit ratings on smaller financial institutions is an important part of the credit rating industry and adjust LACE Financial's NRSRO criteria so that this portion of the industry can be maintained.

CONFLICTS OF INTEREST

LACE Financial believes the greatest conflict of interest that can arise in the rating industry is exchanging a rating for money. We feel that the majority of large corporations are over rated by the large NRSROs for this reason. However, after the Enron and WorldCom failures new large corporate ratings are approaching the true financial condition of the companies being rated. When the spot light of public opinion and congressional concern move to other issues, the problems of over rating companies in exchange for money will reoccur because it is an inherent problem in the industry. One way to help prevent this is proper disclosure, frequent ratings and placing dates on the ratings. Information used in the rating process should be shown with the rating as well as when the company was rated so that like comparisons can be made with companies in the same industry. If a company has a higher rating than its peers, but poorer financial ratios, certain questions will be raised and market discipline will help to correct the problem.

LACE Financial feels that conflicts of interest are a major problem in the industry and would want to abide by any restrictions imposed by the SEC and feel all NRSROs should be affected equally.

UNSOLICITED RATINGS

Comment: If a rating agency uses unsolicited ratings by giving a company a low rating but a higher rating if he pays a fee, this is a form of extortion and the matter should be forwarded to the Justice Department. If convicted, the rating company, no matter how large, should be banned from the industry.

MISUSE OF PUBLIC INFORMATION

Comment: LACE Financial feels that a NRSRO or an applicant for NRSRO status should have detailed disclosure procedures and these procedures should be incorporated in the training of employees. We feel that these procedures may vary by rating company depending on its line of business. For example, LACE Financial analysts are prohibited from owning bank or S&L stocks, but this procedure may not be appropriate for other rating agencies.

FINANCIAL RESOURCES

Comment: LACE Financial has been in business over 21 years, has 600 clients and rates 21,000 institutions quarterly. Not one client or any company we have rated over this period has been concerned about our financial condition (asked for our financials). LACE Financial believes that financial resources can best be evaluated by a company's staying power in the industry and its ability to deliver credible and reliable ratings over a long period of time. LACE Financial is over capitalized with a capital to assets ratio of 97%. If necessary, the majority owner of LACE Financial could double or triple the company's capital to meet new growth within ten days without borrowing. Our problem is not the lack of financial resources but the ability to grow our revenue because of the constraints of NRSRO status

STANDARD RATING SYMBOLS

Comment: For the sake of issuers of credit and new issue ratings there is need for more standardization of rating symbols among raters. Our credit ratings of A to E are consistent with other rating agencies and our new issue ratings are the same as used by Standard and Poors. We would not object to changing our rating symbols to help meet an industry standard.

STATISTICAL MODELS

Question: Should a credit rating agency that relies solely or primarily on statistical models be able to meet the proposed NRSRO definitions?

Answer: No. Analysts must be employed to review the results of the statistical models, make changes to the ratings based on emerging or current circumstances, discuss with management problems raised by the models and other concerns that may arise in the rating process. LACE Financial employs analysts that issue warnings on failing institutions, as well as releases concerning rating changes, mergers, accounting fraud, changes in country risk ratings, currency revaluations, pending financial crises, and outlooks for both the domestic and international banking industries.

As commented on earlier, statistical models are very important in assisting the rating process and are utilized by existing NRSROs and will become even more important in the future.

PROVISIONAL NRSRO

Question: Does the Commissions' proposed NRSRO definition and approach for promoting competition address the competitive concerns raised by commentators?

Companies with provisional NRSRO status would likely be considered second class NRSROs and have the same problems competing as they did without the status. We believe the Justice Department's concern that the national recognition criterion is "nearly insurmountable" is correct. We would suggest that relaxing these criteria would be best, rather than creating provisional NRSROs.

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