United States Securities and Exchange Commission

Roundtable to Examine
Oversight of Credit Rating Agencies

April 15, 2009

Statement of
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DBRS appreciates the opportunity to participate in this timely discussion regarding the oversight of credit rating agencies. A great deal has happened in this area over the past two years. Not only did the Commission create an entirely new regulatory regime for credit rating agencies, as directed by the Credit Rating Agency Reform Act of 2006 ("Rating Agency Act"), but it also fortified that regime with a second set of rules that took effect just last week, and it has a third set of rules out for comment. In view of all this activity, DBRS believes that it is important to take stock of what has been accomplished, to see where we are now, and to identify what, if anything, is left to do.

Overview of DBRS

DBRS is a Toronto-based credit rating agency established in 1976 and still privately owned by its founders. With a U.S. affiliate located in New York and Chicago, DBRS analyzes and rates a wide variety of issuers and instruments, including financial institutions, insurance companies, corporate issuers, issuers of government and municipal securities and various structured transactions. The firm currently maintains ratings on more than 43,000 securities in approximately 35 countries around the globe. DBRS operates on an "issuer-pay" model, which means that our ratings are available to the public free of charge.

In 2003, DBRS became the first non-U.S. based credit rating agency to be designated as an NRSRO. It currently is registered as an NRSRO under the Rating Agency Act, and is also recognized as External Credit Assessment Institution (ECAI) in the U.S., Canada, Switzerland and the European Union.

Identifying Problems in the Credit Rating Agency Industry

The first question presented to this panel is, "What went wrong in the credit rating agency industry?" In addressing this question, DBRS believes that it is important to distinguish between ratings of corporate issuers, financial institutions, insurance companies and government securities issuers (collectively, "corporate ratings") on the one hand, and ratings in the structured finance market on the other. There is no evidence of a systemic problem in the corporate ratings market. On the contrary, publicly available data demonstrates that with very few exceptions, these ratings have performed extremely well over time.

This has not been the experience with structured finance ratings. While the underlying causes of the unsatisfactory performance of these ratings will undoubtedly be the subject of study for years to come, one thing is clear: Market concentration in the credit rating industry exacerbated the turmoil in the structured finance market, because changes in the assumptions underlying the rating models of the largest agencies led to rapid and dramatic ratings downgrades over a very short period of time. DBRS believes that increasing competition in the credit rating agency industry will minimize the risk of future problems of this type.

Corrective Steps Taken by the Industry

The need to enhance the quality, integrity and transparency of credit ratings has not gone unnoticed by the rating agencies. Over the past few years, the NRSROs have worked diligently with the Commission and other standard-setting bodies like the

International Organization of Securities Commissions (IOSCO) to identify and implement a host of reforms.

At DBRS, we have adopted a wide range of internal controls designed to eliminate conflicts of interest wherever possible, and to disclose and manage those conflicts that cannot be eliminated. DBRS also has adopted a Business Code of Conduct in accordance with the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. In addition to displaying its credit ratings, DBRS' public Web site also discloses the firm's ratings policies and methodologies as well as extensive information about how its ratings have performed over time. As a result of the most recent set of NRSRO rules, DBRS will soon be making additional information about its ratings history available in a user-friendly, searchable format that will allow investors to compare DBRS' ratings to those of its competitors.

DBRS is committed to ensuring the objectivity and integrity of its ratings and the transparency of its operations. We believe that this is the only way to restore the market's confidence in the credit rating industry.

Next Steps

Because the Commission's NRSRO rulemaking is so recent, DBRS believes that the best course is to monitor the rules' effectiveness before pursuing further regulatory measures. In particular, the Commission should examine the impact of its rules in three inter-related areas: conflicts of interest, competition and transparency.

Conflicts of Interest

Virtually all business endeavors entail at least the potential for conflicts of interest, and credit rating agencies are certainly no exception. Firms operating on an issuer-pay model have an incentive to produce ratings favorable to the issuers who hire them, while firms operating on a subscriber-pay model have an incentive to please their largest customers, who may also have a stake in how an issuer or instrument is rated. Rather than adopting an unrealistic, zero-tolerance policy towards conflicts, DBRS endorses the approach the Commission has followed thus far. Conflicts should be eliminated wherever possible (and some conflicts should be prohibited outright) and the remaining conflicts should be disclosed to the public and managed in a transparent and verifiable fashion.

In this regard, DBRS believes that requiring NRSROs to establish and abide by transparent ratings procedures and methodologies; implement and enforce codes of conduct; and publish useful information about the performance of their ratings over time will go a long way to minimizing or eliminating the harmful ramifications of conflicts of interest in the credit rating industry.

On the other hand, DBRS does not believe, as some have suggested, that the Commission should become involved in the process of hiring NRSROs. In addition to the moral hazard this would create for the government, such an approach would present insurmountable practical problems. For example, if the Commission were to select NRSROs on a rotating or random basis, ratings may wind up being produced by agencies that lack the resources or expertise to produce them. Assigning ratings based on historic market share would perpetuate the existing market concentration and thwart the development of healthy competition. And picking NRSROs based on past performance would preclude the entry of new rating agencies into the industry.

Competition

As indicated above, DBRS believes that an open, competitive marketplace for rating agencies is critical to the stability and long-term efficiency of the capital markets. On the whole, the Commission's approach to regulating NRSROs has been even-handed and conducive to competition. However, DBRS does have two concerns in this area.

First, the Commission has begun to impose unequal regulatory burdens on issuer-pay and subscriber-pay NRSROs. In particular, the Commission recently adopted a rule requiring issuer-pay NRSROs to publish ratings history information in order to provide users of credit ratings, investors and other market participants with the raw data they need to compare how NRSROs initially rated an obligor or security and how they adjusted those ratings over time. The SEC did not impose a similar requirement on subscriber-pay NRSROs, because they protested that any public disclosure of their ratings, even with a substantial time delay, would be antithetical to their business model. The Commission now proposes to perpetuate this disparate treatment by adding another disclosure requirement for issuer-pay NRSROs only.

There has been much debate about the relative quality and reliability of ratings determined under the issuer-pay and subscriber-pay business models. Questions also have been raised as to whether the conflicts of interest faced by rating agencies who are paid by issuers are more pronounced than the conflicts faced by rating agencies who are paid by subscribers.

This debate cannot be resolved so long as investors and other market participants are unable to verify the ratings accuracy claims made by subscriber-based ratings providers. Anecdotal discussions by subscriber-pay NRSROs of "where they got it right" are no substitute for an objective, independent analysis of the universe of their ratings. Although DBRS appreciates the need to protect the commercial value of subscriber-pay NRSROs' real-time ratings, DBRS believes that absolving such NRSROs from all transparency obligations is not in the best interests of investors or the capital markets.

DBRS' second concern relates to the cumulative burden imposed on rating agencies by the NRSRO regulatory regime. Although the incremental cost of any one requirement may seem reasonable, the costs of complying with the entire NRSRO rule book are quite high. At some point, these costs could drive smaller firms from the market and could inhibit new entrants. Rules that require the complete separation of functions within a rating agency could have a similarly chilling effect on competition, by imposing insupportable burdens on small firms.

DBRS urges the Commission to keep these practical concerns in mind as it assesses the need for further rulemaking in this area.

Transparency

As the foregoing discussion demonstrates, shining light on rating agencies' operations, methodologies and performance history is the best way to curb conflicts of interest and foster competition. This is especially true in the structured finance arena.

In this regard, DBRS urges the Commission to assess whether the most recent NRSRO rules succeed in discouraging ratings shopping, and whether the rules give investors a greater voice in the selection of which agency(ies) are used to rate structured products. DBRS believes that providing investors with the information they need to assess the quality and integrity of the ratings issued by all NRSROs will empower them to demand the honesty and reliability that the capital markets deserve.

Conclusion

DBRS looks forward to continuing to work with the Commission and others in restoring market confidence in the credit rating industry.