

STATEMENT

of

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before the

U.S. SECURITIES & EXCHANGE COMMISSION

CREDIT RATING AGENCIES ROUNDTABLE

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## **Introduction**

Thank you for this opportunity to participate in the SEC Roundtable on Credit Rating Agencies. Realpoint is the most recent company to be designated by the Commission as a Nationally Recognized Statistical Rating Organization (“NRSRO”). Realpoint is designated as an NRSRO for asset-backed securities. Our market specialty is rating commercial mortgage-backed securities (“CMBS”) and that is the area on which I will focus my comments today.

I will begin by commenting favorably upon the Commission’s proposed rule amendments that are designed to improve, and increase the transparency of, the ratings process. Once implemented, a number of the new rules are expected to increase NRSRO administrative and recordkeeping burdens and costs. Moreover, Realpoint commends the Commission for its in-depth review and analysis of prevalent issuer and rating agency practices. I also commend the Commission for the highly professional and straightforward manner in which it processed our NRSRO application last year. The Commission processed our NRSRO application in approximately five months. We found the rules implementing the Credit Rating Agency Reform Act of 2006 to be straightforward and user-friendly. In our experience, in dealing with the Division of Trading and Markets, we have found the staff members to be responsive to our comments regarding proposed rule amendments and any requests for clarification under existing rules. The staff members are readily available by telephone or email, or for meetings, with respect to questions and issues posed to them.

On this panel, the participating rating agencies have been asked to address “What Went Wrong and What Corrective Steps Are the Industry Taking?” As to the first part of this question,

the Special Report on Regulatory Reform of the Congressional Oversight Panel found that the “major credit rating agencies played an important—and perhaps decisive—role in enabling (and validating) much of the behavior and decision making that now appears to have put the broader financial system at risk.”<sup>1</sup> There is a broad consensus among capital market participants and observers with the results of the Commission’s recent examination of issuer-paid ratings, namely that the ratings were not merely inaccurate, but that there were serious questions about the “integrity of the ratings process as a whole.”<sup>2</sup>

### **The Issuer-Paid Rating Agency Bidding and Selection Process**

The integrity of the ratings process is undermined by current issuer “ratings-shopping” practices. When issuers solicit a bid from a rating agency for lucrative new-issue rating work, the issuer requires the rating agency to provide preliminary ratings as part of that bidding process. Unlike corporate bonds and general obligation municipal bonds, which may be rated using publicly-available financial information, an initial issuance of structured finance bonds is rated by a rating agency selected by the issuer using information disclosed by the issuer to the rating agency. Under the issuer-paid business model for rating agencies, an issuer of structured finance bonds has complete control over the selection of the NRSROs who shall rate the new issue. Issuers of these bonds have the ability to control the ratings process of a new issue by awarding the rating contracts to rating agencies that provide favorable preliminary ratings.

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1 Special Report on Regulatory Reform of the Congressional Oversight Panel (January 29, 2009) at Page 40.

2 Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies by the Staff of the Securities and Exchange Commission (July, 2008).

For a new CMBS offering, for example, the issuer generally starts the process of selecting its issuer-paid rating agencies by providing data (property information and existing mortgage loan terms) to three selected NRSROs. These NRSROs then analyze the largest properties, and a sample of the other properties, to provide preliminary feedback regarding proposed tranches (i.e., the subordination level attachment points) for the securities to be backed by the pool. An NRSRO that provides unfavorable preliminary feedback may not be hired by the issuer. The issuer may only elect to select the NRSROs that provide favorable preliminary feedback to rate the new issue. The issuer then provides these NRSROs with the remainder of the information with which to develop the final tranches. The current practice of obtaining undisclosed preliminary ratings, coupled with the current reliance on issuer-paid credit ratings, fosters “ratings-shopping” and a lack of independence, accountability and transparency with respect to the new-issue ratings.

To increase the transparency of the issuer-paid credit ratings process, the Commission may wish to consider having the issuer’s registration and other pre-sale information include the (i) identity of each NRSRO that bid to rate the issuance and (ii) preliminary rating levels submitted in connection with the bid. This requirement would apply to all NRSROs that bid to rate an issuance and not just to those that were actually hired to rate the issuance. This requirement would serve the public interest by enhancing the transparency of the NRSRO bidding and selection processes.

## **The Issuer-Paid Rating Agency Selective Disclosure Process and the Potential Benefits from the Availability of Pre-Sale Independent Ratings**

The integrity of the ratings process is also undermined by current issuer practices for selective disclosure of credit rating information to only the issuer-hired NRSROs.

To increase the transparency of, and accountability for, issuer-paid ratings, the Commission proposes to amend its NRSRO rules to require issuers to simultaneously disclose to all NRSROs the information that the issuer provides to its solicited NRSROs to develop credit ratings.<sup>3</sup> The Commission's Fair Disclosure rules (Regulation FD) prohibit issuers from selectively disclosing material information; however, these same rules permit selective disclosure to a rating agency for the purpose of developing a credit rating that will be made publicly available. The Commission therefore also proposes to amend Regulation FD to permit: (a) disclosures by issuers to unsolicited, subscriber-paid NRSROs (without triggering the public disclosure requirement for such unsolicited ratings); and (b) such unsolicited, subscriber-paid NRSROs to deliver pre-sale reports solely to their subscribers.

By requiring issuers to simultaneously disclose to all NRSROs the information that the issuer provides to its hired NRSROs, investors will have the opportunity to receive pre-sale ratings and ratings reports from NRSROs who were not hired by, and who are thus independent of, the issuer. The Commission has previously stated that its goals include enhancing the transparency of the ratings process. Towards that goal, the Commission has previously stated its

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3 Re-Proposed Rules for Nationally Recognized Statistical Rating Organizations, Release No. 34-59343 (February 2, 2009), 74 Fed. Reg. 6485 (February 9, 2009), File No.: S7-04-09 [herein, "Re-Proposing Release"], Proposed Amendments to Rule 17g-5(a)(3)(iii)(B).

desire to level the playing field for unsolicited NRSROs to provide timely credit ratings to potential investors in a new bond issue. The Commission's proposals to require issuers to simultaneously disclose to all NRSROs the information that the issuer provides to its hired NRSROs to develop credit ratings foster the Commission's stated goals. Realpoint supports the Commission's proposals to require simultaneous disclosure to all NRSROs of the information that the issuer provides to its hired NRSROs to develop credit ratings.

To accomplish the Commission's goals in this regard, it is essential that the issuer-provided information be provided simultaneously to the NRSROs on a pre-sale basis, at the same time and in the same manner, and with the same search, access and other capabilities, as it is being made available to the issuer-paid NRSRO. The Commission has proposed, and, we agree, that, with respect to pre-sale reports for new issues, the delivery of information pursuant to this pro-competition amendment can be easily effectuated through a password-protected website.

Unsolicited NRSROs would suffer a competitive disadvantage if the information was only provided when the information was final. For new issues, to only provide final information would not afford the unsolicited NRSROs sufficient time to review and analyze pre-sale information and provide pre-sale reports and ratings for each tranche of the new issue it wishes to rate. Investors would not thereby receive the intended benefits of the amendment.

For surveillance purposes, the trustee, servicer or special servicer information must also be provided simultaneously to all NRSROs, at the same time and in the same manner, and with

the same search, access and other capabilities, as it is being made available to the issuer-paid NRSRO.

Currently, independent, unsolicited NRSROs who provide surveillance ratings for asset-backed securities must wait for, and rely on, the information provided by a trustee and the data available for purchase from real estate data aggregation companies. With respect to CMBS surveillance ratings, an unsolicited NRSRO needs access to the trustee, servicer and special servicer reports, as well as all property-level due diligence information and reports (such as operating statements, appraisals, re-appraisals and inspection reports) provided by third-party vendors to the issuers.

Operating under the subscriber-paid business model, Realpoint made its reputation as an independent provider of CMBS ratings and analysis through ongoing surveillance of the underlying real estate collateral. Realpoint's core products include in-depth, monthly ratings reports on all (over 700) current CMBS transactions, with analytical performance summaries, "watchlist" alerts and other information about a rated security or the underlying security for that security (such as property-level reports for CMBS). Realpoint's surveillance reports provide portfolio managers, analysts, broker/dealers and other market participants with forward-looking analysis of CMBS real estate securities, properties, loans and markets.

In support of the Commission goals for greater competition, transparency and accountability with respect to credit rating surveillance, Realpoint suggests that the Commission consider a requirement that any material post-issuance information provided by an issuer, trustee,

servicer or special servicer to an issuer-hired NRSRO be simultaneously disclosed to other NRSROs that issued pre-sale ratings or which are issuing surveillance ratings for that security. For example, with respect to CMBS surveillance ratings, an unsolicited NRSRO needs access to the trustee, servicer and special servicer reports, as well as all property-level due diligence information and reports (such as operating statements, appraisals, re-appraisals and inspection reports) provided by third-party vendors to the issuers.

In addition to requiring the issuer to provide its reports and information to all NRSROs, the Commission should require the trustee, servicer and special servicer to provide their reports and information to all NRSROs and the issuer's legal documentation (for example, the pooling and servicing agreement) to require the trustee, servicer and special servicer to provide their reports and information to all NRSROs. The Commission should prohibit the trustee, servicer and special servicer from providing their reports and information to the issuer-paid NRSROs unless they also provide the same reports and information to the unsolicited NRSROs. The first aspect of these suggested requirements prospectively addresses new issuances, in that future legal documentation would memorialize this requirement. The second aspect of these suggested requirements is intended to address currently-outstanding securities.

Thus, the only recipients of the information provided by issuers, trustees, servicers and special servicers would be NRSROs (both the issuer-paid and unsolicited NRSROs) and, of course, the investors.



Also essential, not only to the Commission's goals but also to preserve the viability of the securitization market, the Commission's new information disclosure rules must limit those disclosures to NRSROs. Limiting disclosure in this manner will allow the information to remain confidential and to only be used for its intended purpose of the development of credit ratings (and related research and analytical reports).

Requiring disclosure to unregulated companies (such as data aggregation companies), other than investors, would chill the securitization market. With respect to CMBS, requiring disclosure to unregulated companies would deter property owners from disclosing their rent rolls or other property-level due diligence information as well as their loan, lease and other underlying documentation. Requiring or permitting this level of disclosure would also allow an unregulated company to sell or disclose issuer-provided information to other professionals, consultants or data providers in the real estate industry. To maintain the desired level of confidentiality for the issuer-provided information, all issuer, trustee, servicer and special servicer information and reports should be disclosed to NRSROs but not to unregulated companies.

### **Revival of the Securitization Market**

The broad decline in real estate values contributed to the current financial turmoil. Commercial mortgage loan delinquency rates continue to increase and are projected to exceed historical averages over the next few years. Concurrently, billions of dollars of commercial mortgage loans are scheduled to mature over the next few years. Although many of these loans are backed by sound commercial properties, the lack of refinancing sources will lead to increases in default and foreclosure rates, further depressing commercial property values and perpetuating the current recession. Most refinancing transactions at this time are extensions of existing loans.

The lack of a market for CMBS reduces the availability of refinancing sources for commercial properties. The CMBS market is essentially at a standstill. There have been no new issuances since June 2008. Few transactions are under consideration. CMBS rate spreads (compared to other forms of debt instruments) have widened to historic highs, which makes the originate-to-distribute, or lend-for-securitization, models uneconomical. (Rating agencies do not opine on pricing or credit spreads. Credit ratings are an opinion regarding the likelihood of payment of a financial obligation in accordance with its terms.)

We share the hope that the Administration's Term Asset-Backed Securities Loan Facility (TALF) program will prove to be a catalyst for a revival of the securitization market.

With sound underwriting practices, simplified capital structures and greater transparency and informational disclosures in the credit rating processes, securitization remains a viable means to provide investment risk diversification and to foster the liquidity in the capital markets needed to circumvent worsening loan foreclosure problems.

**END**