RiskMetrics Group

One Chase Manhattan Plaza
44th Floor
New York, NY 10005

Roundtable on Oversight of Credit Rating Agencies

U.S. Securities and Exchange Commission
April 15, 2009

RiskMetrics Group is pleased to participate in the roundtable held by the Securities and Exchange Commission on Oversight of Credit Rating Agencies and to share its views on competition issues affecting the credit rating agency industry.

Competition Issues: What are the Current Barriers to Entering the Credit Rating Agency Industry?

The ratings industry is dominated by three large agencies that hold disproportionate market power. That market power arises from informational privileges and special status of their ratings gained as a consequence of historical regulatory and market actions giving them unique standing in regulation and investment guidelines. Certain measures can be taken to promote healthy and fair competition in the long run, but we also believe that intervention will be required in the short term to break the grip of the dominant agencies and jump start competition before market forces are allowed to take over.

We start by discussing barriers to entry as well as measures to eliminate them and promote sustainable competition in the long run. We then turn our attention to some measures that regulators can take to break the current dynamics and give new entrants the opportunity to compete with the incumbents.

There are four main types of barriers to entering the credit rating business: the first are regulatory barriers to entry and in particular the requirement to be in business for three years before applying for registration as an NRSRO, the second is the lack of equal access to information by all NRSROs that is necessary to produce high quality ratings, the third is inadequate transparency and disclosure by rating agencies, and the fourth refers to negative competitive dynamics reinforced by the combination of NRSRO status and issuer paid ratings. Each one of those barriers can be addressed by changes in regulation. We express our views on these important issues and outline potential solutions below:

1. <u>Regulatory barriers to register as a NRSRO</u>

The objectives of regulation should be to promote robust rating methodologies, address misaligned incentives, address information asymmetries, ensure that rating agencies adequately manage conflicts of interest, set minimum standards of transparency and disclosure for rating agencies, and prevent anticompetitive behavior. These objectives should be directly linked to the criteria required to obtain registration. There are four broad categories of criteria that can be used to determine whether a credit rating agency is suitable to be registered as an NRSRO: 1) the rating process (i.e., overall governance and organizational structure, adequate resources and qualifications of staff, management of conflicts, documentation of methodology, systematic application of methodology, quality control, etc.), 2) ratings methodology, 3) ex-post performance of the ratings regardless of how they were estimated, and 4) market acceptance (e.g., reputation, number of clients, etc.)

In our opinion, regulators should stay away from directly regulating ratings methodology because it creates moral hazard for the regulators, stifles innovation, and potentially encourages ratings convergence. In addition, regulators should not require measures of market acceptance as prerequisites for registration because they are subjective, difficult to define, and ultimately prevent competition since it is difficult to be accepted by the market when you are not allowed to compete on an equal footing. Instead, regulators should focus on the quality of the ratings process and ex-post ratings performance as the key criteria for registration. However, we strongly believe that new entrants should not be required to wait three years before they can compete as an NRSRO. To that end, we propose a phased approach where initial registration for new NRSROs is based on a review of the rating agency's governance and organizational structure, management of conflict, compliance with disclosure and transparency requirements, documentation of ratings methodologies, and the systematic application of those methodologies. As new NRSROs build track records they should also be subject to performance requirements on their historical ratings in order to maintain their registration.

Finally, we encourage the SEC to make the requirements, the process, and the timeframe to obtain registration as clear as possible to encourage potential new players to enter the space.

2. <u>Unequal access to information</u>

New entrants to the credit rating industry need to gain credibility before they can compete with the established NRSROs. However, it is virtually impossible for new entrants to challenge the incumbents without access to non-public information that is critical to assign a credible rating and demonstrate the quality of their work. It is our view that all NRSROs should have equal access to information from issuers, arrangers, underwriters, and any other parties disclosing non-public information to NRSROs being retained to rate a product. This principle should apply to all asset classes and types of ratings, but is particularly important for structured products given their complexity and the amount of information required to assess their credit risk.

We fully support the SEC's proposed changes to Rule 17g-5 mandating the hired NRSRO to alert other NRSROs when they start rating a new security and the arranger to provide all other NRSROs with all the information being provided to the hired NRSRO on a real-time basis whether it is used for initial ratings or ongoing surveillance. We believe it is important to make this information available not only for new deals, but also for legacy/outstanding deals to NRSROs wishing to rate those securities.

It is critical that the information provided by the arranger is complete and includes all the details on the collateral pool, the structure of the security, as well as detailed information on the credit enhancement and liquidity providers. Examples of the information required are trustee reports, offering documentation, waterfall documentation, loan tapes, and financial statements of the SPV among other documents. It is also critical that the information is available through the same medium and in the same format in which it was provided to the hired NRSRO (preferably on a machine readable electronic format.) The SEC should not tolerate any attempts by arrangers to technically comply with the rules while limiting the usefulness of the data to other NRSROs (e.g., the hired NRSRO receives a clean tab delimited file while other NRSROs have to sift through a massive amount of data to find important information.)

Finally, to achieve a true level playing field, it is important to extend the proposed disclosure requirements to all classes of credit ratings. This can be achieved by setting up an electronic data room where all the information provided to the hired NRSROs could be uploaded and viewed by other NRSROs.

3. <u>Lack of Transparency</u>

We believe the existing structure of the ratings market is not conducive to competition based on the quality and performance of ratings. In particular, market participants do not have access to sufficient information to compare ratings produced by the various NRSROs.

The most valuable asset of a rating agency is its credibility. In order to build credibility based on the quality of their work, rating agencies should be given the opportunity to prove and differentiate themselves from their competitors by comparing their relative performance and the information they provide to investors. Rating agencies should provide to regulators, issuers, investors, academics, other NRSROs, and the general public sufficient information to scrutinize the quality of their work. We view aggregate information and performance reports currently published by NRSROs as insufficient to perform an in-depth study of their ratings. Access to the raw data would allow market participants to engage in an informed and critical dialogue on the absolute and relative performance of the various rating agencies. With that in mind, we fully support the SEC's proposed changes to Rule 17g-2 requiring the public disclosure of credit rating histories for all outstanding issuer-paid credit ratings issued by an NRSRO on or after June 26, 2007. In our opinion, the requirement should be extended to investor-paid credit ratings issued by NRSROs. Since the proposal allows NRSROs to delay by as much as 12 months the disclosure of a rating action the impact on investor-paid revenues is likely to be small.

In addition, we encourage the SEC to consider rules requiring the disclosure of additional information including the assumptions used in the ratings process, as well as scenarios describing how the ratings would change if the original assumptions were wrong.

4. <u>Negative competitive dynamics reinforced by the NRSRO status and issuer paid ratings</u>

The NRSRO status supports the perception that ratings from various NRSROs are of similar quality and creates the wrong incentives in competitive situations. NRSRO's ratings are often viewed as interchangeable from a quality point of view due to the perceived official status of the registered rating agencies. That perception provides an incentive for issuers to hire rating agencies that provide higher ratings, require less information from issuers, or disclose less information to investors. The problem of ratings shopping by issuers is the most important example of this behavior. Some observers have called for the elimination of the NRSRO status, but another option to solve this problem is to increase transparency regarding shadow ratings. In particular, we recommend dealing with ratings shopping by mandating NRSROs to publicly disclose all shadow ratings that are not made public by the issuer. This is particularly important for structured products where the complexity of the assets would naturally lead to a more diverse set of opinions on their credit risk.

By streamlining the registration procedures and enforcing minimum performance standards, mandating equal access to information for all NRSROs, and mandating more transparency and disclosure by NRSROs, regulators can promote a competitive marketplace where new qualified entrants can quickly obtain registration and acquire the information needed to produce quality ratings, investors have sufficient information to assess NRSROs and demand the highest quality ratings from issuers, and issuers have incentives to seek the ratings of the best NRSROs instead of those that provide them with ancillary benefits. It is important to recognize that it could take a long time for these changes to make an impact on competition. That delay can have the effect of discouraging new players to enter the market. We now discuss ways in which regulators can accelerate competition.

Jump starting competition

In our view, the current market dynamics have to change before true competitive market forces can take over. We are afraid that it would be difficult for new entrants to compete against entrenched players even in the absence of the structural barriers mentioned above.

There are two ways to break the current vicious cycle. The first is to tackle directly the combination of the misalignment of incentives in the issuer-paid model and the mandated use of ratings in regulation. To do that regulators can either mandate a business model where investors decide which ratings are used (regardless of who pays for them) or completely eliminate references to NRSROs ratings in regulation. If regulators do not tackle this problem directly they could end up in a situation where they have to explicitly opine on the quality of ratings to make agencies accountable for their work since issuers do not have an incentive to do it and investors cannot directly influence rating agencies. This will require regulators to establish minimum ratings performance criteria and apply disciplinary measures to those agencies that do not satisfy the criteria.

If regulators want to spur competition without mandating a change in business model or the use of ratings in regulation, they will have to directly intervene to give new entrants an opportunity to thrive given the current market dynamics. To that end, we would propose two ideas that can be used to kick start competition. The first would require issuers to obtain a rating from a new entrant for every new issue. This measure would only apply to issuer-paid ratings and would require an issuer to obtain a rating from an NRSRO other than the existing dominant agencies. This measure could be put in force for some period of time (e.g., three to five years) before letting the market decide freely which ratings to use. This will reduce the disadvantage that new entrants have as a result of the special standing currently enjoyed by the dominant players. The second idea would require issuers to rotate rating agencies every three years. In other words, an issuer would not be allowed to use the same rating agency for a period longer than three years, at which point they would have to use a different rating agency for at least three years. This is analogous to the rotation policy implemented for financial auditors. We understand that some will view these measures as interventionist, but we believe that regulatory intervention is justified since competition in the ratings industry is in the public interest