

REFORMING CREDIT RATING AGENCIES

HEARING
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES
OF THE
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U.S. HOUSE OF REPRESENTATIVES
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REFORMING CREDIT RATING AGENCIES

Wednesday, September 30, 2009

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS,
INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:10 p.m., in room 2128, Rayburn House Office Building, Hon. Paul E. Kanjorski [chairman of the subcommittee] presiding.

Members present: Representatives Kanjorski, Sherman, Scott, Perlmutter, Donnelly, Carson, Speier, Foster, Kilroy, Kosmas; Garrett, Castle, Manzullo, Royce, Hensarling, Posey, and Jenkins.

Ex officio present: Representative Bachus.

Also present: Representative Green.

Chairman KANJORSKI. This hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises will come to order pursuant to agreement with the ranking member. Opening statements today will be limited to 15 minutes on each side. Without objection, all members' opening statements will be made a part of the record.

Today we meet to discuss one of the most important issues Congress will address as part of our overhaul of financial regulations: The reform of credit rating agencies. This issue has already generated much debate.

Credit rating agencies play an integral part in our markets. Even though they operate as independent firms, they hold quasi regulatory powers. Investors around the world also heed their words, or the letters, as the case may be.

These entities also greatly contributed to our current economic problems by inappropriately issuing triple A ratings for mortgage-backed securities and other complex financial instruments that later failed spectacularly. These agencies further used the same faulty assumptions as so many others that real estate prices would never go down. They were wrong.

Perhaps most troubling, these agencies failed to learn more about the quality of the products they rated. Investors have come to rely on the judgment of credit rating agencies, and it now appears that rating agencies with their, "Ask me no questions, I will tell you no lies" approach betrayed not only that trust, but also the special status under our laws.

To correct these problems, I have worked to draft legislation that achieves a balance between improving the regulatory oversight of

credit rating agencies, while also creating incentives for investors to recognize that “caveat emptor” is still the ultimate rule for any financial transaction. Today’s hearing is therefore on a discussion draft that aims to reform and regulate these gatekeepers to our markets using these two principles as guides.

This summer, the Administration released a promising proposal to reform rating agency regulation. I have incorporated many useful provisions from that document into my discussion draft, including reforms aimed at enhancing the oversight of the rating agencies by the Securities and Exchange Commission and requiring new disclosures about how issuers pay rating agencies.

Under the reforms, rating agencies will remain independent. The Commission will not opine on the methods used for determining ratings, but it will ensure that rating agencies follow their internal procedures. The changes additionally require new duties for compliance officers at each rating agency to monitor and manage the many conflicts of interest inherent in this industry.

We must however go further. My draft therefore includes the sensible proposals to promote accountability through liability as first suggested by my friend, Senator Jack Reed.

One of the most repeated complaints I heard in my district is that no one has been held accountable for the credit crisis. While the Justice Department belatedly works to take legal action against wrongdoers who caused this economic meltdown, going forward I believe that all responsibility parties, including the rating agencies, should be held accountable for their actions, good or bad.

We can promote accountability in credit ratings through the threat of liability. While these legal reforms are an important change from current law, I want to assure everyone that I am committed to working to refine them as we move through the legislative process.

To get at the tremendous conflicts of interest created by the issuer pay model, I have also proposed a new idea: making the rating agencies responsible for each others’ ratings through collective liability. This reform will hopefully incent participants in this oligopoly to police one another and release reliable high-quality ratings. This reform, however, is not the only way to fix this problem, and I am open to other ways to achieve this objective.

My discussion draft further includes many other new reforms, like a duty for supervisors to manage the work of their subordinates, and the establishment of boards with independent directors. Many of us also share the policy goal of diminishing the reliance on credit ratings. I wish we could just snap our fingers and take away the countless references to credit ratings in laws and regulations. While I have proposed in this discussion draft the elimination in Federal statutes of all credit rating agency references, I have serious concerns about the unintended consequences of this plan.

In sum, this is the start of a process. I want to thank my cosponsors, Representatives Cleaver, Kilroy, and Kosmas, for joining me in producing this bill. Going forward, I am optimistic that many more Members—from both sides of the aisle—will join me as we find the best ways to reform the regulation of these gatekeepers to our markets.

I now recognize the gentleman from New Jersey, Ranking Member Garrett, for 5 minutes for his opening statement.

Mr. GARRETT. I thank the chairman and the members of the subcommittee for holding this important hearing today. I also thank the chairman for all of his hard work and that of his staff as well that they put into this discussion draft. I must begin by saying I am a little disappointed, as I am sure the chairman is, that we couldn't find 100 percent complete bipartisan consensus on all portions of this proposed release, but I do sit here today and pledge to continue to work with the chairman moving forward in hopes that we can eventually reach a place where we both are able to support the eventual final legislation.

One of the provisions, as the chairman just indicated, he has some concerns with deals with the national recognized statistical rating organizations, the NRSROs and removal of them from the statute. I approached this debate on the credit rating agencies reform with the belief that the two most fundamental problems with our rating system are overreliance on ratings and a lack of investors' due diligence. Investors have become increasingly all too often solely reliant on the use of these ratings in determining the safety and soundness of any investment. In literally hundreds of Federal and State government statutes and regulations, there are specific requirements mandating certain grades from the approved agencies is this formal requirement that provides an implicit stamp of approval to investors. So when an investor sees that the government is requiring a specific grade to make a safe investment, it reinforces the belief that any investment obtaining such a grade is basically safe. I know that the SEC has a similar concern as I do. So 2 weeks ago, the SEC announced it is removing references to the NRSROs in several of the regulations and studying other areas to determine where else they can be removed.

And so I applaud the SEC for their actions and I urge them to continue their work. I believe that Congress should follow suit and reexamine all the areas where statute mandates the ratings of NRSROs. Credit ratings are only one piece of the puzzle in determining creditworthiness. Investors must be encouraged to do proper due diligence as well in evaluating issuer credit quality.

Another way in which I believe we can help increase investor due diligence that this bill does touch on but does not go far enough is to increase disclosure through information by the issuer. When dealing with equity securities, investors have all the public information about the company because of the annual and quarterly filing requirements. So I believe that we should require the similar situation with debt securities. The issuer of debt securities should disclose the information contained in the offering more broadly so that investors have the ability themselves to delve in deeper into the submitted transaction.

While there may be other things included in the proposal that I do support, like increased disclosure and better oversight, there are a couple of provisions that I have a little concern with. The provisions that I am most troubled by center around the question of liability. Unlike many of my friends across the aisle, I do not believe that the solution to some of these problems is more lawsuits. In the discussion draft, there is a provision to institute a collective liabil-

ity among the NRSROs. And I must say, I am concerned about the practicality of this provision, not to mention the constitutionality as well. I don't see what positive can be obtained by holding all the NRSROs accountable for the actions of just one.

The main thrust of the 2006 Reform Act was to increase competition between credit rating agencies. Now, I know that the chairman voted for final passage of that Act in 2006, notwithstanding his previously stated belief that there might be a natural oligopoly as he indicated within the credit rating industry. If we institute a sharing of financial legal liability however between all the NRSROs, I cannot think of any bigger impediment to new entries into the marketplace. The second area of concern regarding legal liability is the language in Section 4 to lower the pleading standards for lawsuits against the rating agencies. By making the rating agencies subject to suits whenever they are "unreasonable," you are essentially lowering the bar from fraud to negligence. The practical effect of lowering the pleading standard will be a dramatic increase in cases being filed and eventually going to court.

So I don't believe that having more lawsuits brought against rating agencies is a really constructive way to improve the rating process. As Chairman Frank so often noted during the Bush Administration, that he did not realize that he was here to defend President Bush and his policies whenever there is an argument on the Floor of the House with regard to them, likewise, I must say I did not realize it would fall upon me to defend President Obama's efforts in this context as well, because the Obama Administration has submitted an extensive credit rating agency reform proposal and increasing legal liability and was nowhere to be found in his proposal.

Also, a recent ruling by a Federal court judge debunks the myth that it is impossible to get the credit rating agencies into the courtroom. So we should see how that case plays out before we overreact in committee. I have another concern as well, basically the increased liability. And so while I support the SEC providing better oversight of the NRSROs, I am worried that too much SEC involvement with ratings further implies a government sign-off on the ratings themselves. At what point during the SEC examination process to review whether rating agencies are following their methodologies does the SEC start prescribing specific methodologies for the NRSROs to follow? In my opinion, this would only further the belief that government is doing the rating themselves.

Also, the requirement for differentiation of ratings from structured products is a concern. All structured products are not the same. And giving them the same connotation implies that they are. The SEC has already once considered this idea and they frankly dismissed it after an overwhelming number of investors voiced their concerns. So in conclusion, I think we all agree that significant reforms for the credit rating agencies are much needed. And I, quite frankly, do wholeheartedly applaud the chairman for his hard work and again of his staff. And I do look forward to working closely with him and the members of his staff and other members from both sides of the aisle as we move forward on this extremely important issue. With that, I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Garrett. We now recognize the gentleman from California, Mr. Sherman, for 3 minutes.

Mr. SHERMAN. Thank you. Nothing is more responsible for the fact that we are in this situation than the credit rating agencies giving AAA to Alt-A and otherwise giving outrageously high ratings to very bad mortgage-backed securities. Smart people in these credit rating agencies discovered that if they could devise a model based on the idea that home prices would never go down, then they could please the issuer, get the big fee, and avoid a liability. And so just sticking to your own model is insufficient since devising an issuer pleasing model is the key to get more business. We either have to remove the incentive the credit rating agencies have to please the issuer, or we have to counterbalance that incentive with the fear of liability.

The best way to defend the status quo, to defend a system of pleasing the issuer, and getting the big fee and avoiding liability is to just tell people, don't rely on the credit rating agencies, let them do whatever they want, and we will put a little cigarette warning on the bottom of the rating agency. This is a clever way to defend the status quo. Blame the investor for relying on the rating. How is my mother supposed to know which corporate bond to invest in if she wants a super safe bond? She either has to rely on the agency or hire a team of financial analysts to work for her. Which is a better system? And then we are told, well, invest in mutual funds. How are you supposed to determine which of two funds is safer if you want to invest in the corporate bond fund? The one that averages a AA rating or the one that averages an AAA rating or is my mother going to have to hire a team of financial experts to tell her which mutual fund is necessary?

Rates are necessary. That is why people rely upon them. No matter what we say, people will continue to rely on them, so we have to make them reliable. One way to do that—as the chairman points out—is to counterbalance the risk that they will give to liberal—and a rating with the threat of liability. Another is to remove the incentive to give too liberal an A rating by eliminating the program where the issuer picks the credit rating agency. That is like having the home team pick the umpire and that is why I will have a legislative proposal.

I look forward to working with the chairman on it, perhaps including it in his bill. I will have the work on it done next week to say that we should select the credit rating agency for the issuer at random from among the qualified umpires. That is how the American League does it. That is how the National League does it. Where would Major League Baseball be if the home team picked the umpire? The other way to do it is to have instant replay and make the umpire liable if he is calling too many balls that were really strikes. That might be effective as well. But the current system has failed. I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Sherman. We will now recognize the gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. Just for unanimous consent to issue a statement from the Commercial Mortgage Security Association on this—regarding this hearing on reforming credit rating agencies.

Chairman KANJORSKI. Are there any objections? Without objection, it is so ordered. Next, we will hear from the gentleman from Delaware, Mr. Castle, for 2½ minutes.

Mr. CASTLE. Thank you, Mr. Chairman. Credit rating agencies are meant to provide a valued service to investors by giving them an informed judgment on the risk of certain bonds. As we know, subprime and other mortgages were fragmented into pieces and bundled into mortgage-backed securities and then rated. Investors relied heavily on the rating agency models to assess the risk of these investments before making a purchase decision. Yet when AAA mortgage-backed securities began to fail, it became evident there was a problem with the system. As the housing bubble burst, I grew increasingly concerned with this issue, as did my colleague, Mr. Ackerman from New York. In July 2008, again, this Congress in the form of H.R. 1181, introduced legislation that directs the SEC to establish a process by which asset-backed instruments can be deemed eligible for nationally recognized statistical rating organizations, NRSRO ratings. Under this bill, eligible investments must consist of securities whose future performances can be recently predicted, such as those with established track records or homogenous structures. The SEC would have the authority to strip nationally recognized statistical rating organizations of their NRSRO designation if the rating agency fails to comply with provisions set forth in the legislation. I am pleased that we are continuing debate on credit rating agency reform.

Although I believe it is clear that action must be taken, I believe we must do more to set guidance on the eligibility for investment for NRSRO designation to avoid falling into the same problems we currently face. I look forward to working with my colleagues to ensure adequate reform moving forward. Just one further comment beyond my talking points here, and that is the question I will have of the methodology of paying for your services. That was raised a little bit by Mr. Sherman, I think. And I think it is a matter of legitimate concern, that if the entities are asking you to rate a product or paying you, does that influence all the way this comes out or not and are investors shortchanged for some reason or another? I don't have a solution to that. I am just interested in your comments on that as we go forward. I yield back the balance of my time.

Mr. SHERMAN. Will the gentleman yield? My concern is not who pays the umpire, but who selects the umpire.

Mr. CASTLE. If the wrong team pays the umpire, regardless of who selects him, that could be an issue too. So maybe we have to combine the two concerns. I understand where you are coming from. I would be happy to try to work with you on it. I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Castle. We will now hear from the gentleman from Indiana, Mr. Carson, for 2 minutes.

Mr. CARSON. Thank you, Mr. Chairman, for holding this important hearing today. We all agree that reform is necessary in the credit rating industry. This has become all too evident in the ongoing financial crisis. However, I believe that as we work to make the industry more independent and objective, we cannot ignore the industry's relation to systemic risk. Credit rating agencies can in-

crease systemic risk through unanticipated and abrupt downgrades. Such rating crises can lead to large market losses, fire sales and liquidity shortages. In this financial crisis, we have seen many recent examples of this. Defaults of subprime loans have led to abrupt and unanticipated rating downgrades of a number of rated securities, insurers, and bond insurers. These downgrades in turn led to larger market losses for investors. Although conflicts of interest and informational issues are key to understanding why such rating crises occur, it is critical to identify the different facets of risks in the ratings market and how it can lead to systemic crises and how to measure and manage them. We need to better assess the nature and extent of the use of credit ratings in financial markets as well as their potential impact on our long-term financial stability.

It is clear that such an assessment will require a global approach that includes both micro and macro level analysis and includes all market participants. I look forward to this opportunity to discuss these issues with the distinguished panel, and I yield back my time.

Chairman KANJORSKI. Thank you very much, Mr. Carson. We will now hear from the gentleman from California, Mr. Royce, for 3 minutes.

Mr. ROYCE. Thank you, Mr. Chairman. As we dissect the proliferation of the exotic mortgages throughout our financial sector, it is hard to overlook the role played by the ratings issued by the various rating agencies. Certainly there were flaws in the actual ratings. In January of 2008, there were 12 AAA rated companies in the world. At that time, there were also 64,000 structured finance instruments like collateralized debt obligations holding that AAA rating.

Further, many of those products were based on nothing more than junk mortgages. Of the \$3.2 trillion of subprime mortgage securities issued, 75 percent were awarded AAA ratings. But the rating agencies missing the mark when assessing the potential risk associated with these products was not the core problem. I believe the major failure over the years was the blind reliance on the rating agencies by investors, financial institutions, and by the Federal Government. In many respects, the government has institutionalized these failed ratings. Looking back, this overreliance was as misguided as the ratings being issued by the NRSROs.

Going forward, nothing will replace due diligence by investors and institutions and regulators. Alternative risk indicators must supplant what was previously an oligopoly by the NRSROs. I think a more competitive market with alternatives to the NRSROs ratings is the most effective alternative. And, for instance, I would raise the issue that many economists for some time have advocated for mandating large institutions to issue subordinated debt. Credit default swap spreads have also been used as an alternative to agency ratings. I look forward to discussing the draft legislation issued by the chairman as well as other potential reforms with my colleagues here today and hearing from these witnesses and I thank you, Mr. Chairman. And I think in retrospect, Mr. Chairman, had we never codified under law some of the references to rating agencies that essentially put government behind the rating agencies there might have been more due diligence. Going forward,

I hope we learn from that. Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman KANJORSKI. We will now hear from the gentleman from Illinois, Mr. Foster, for 2 minutes.

Mr. FOSTER. Thank you. And I would like to thank Chairman Kanjorski for convening this hearing today to discuss the important topic of how best to reform the credit rating agencies. While I applaud the general thrust of this bill, and I think it signals advanced improvement over today's regulatory environment, there are at least two major areas where I think the bill could be improved. The first major problem that we are wrestling with is the conflicts of interest inherent in the issuer pays business model for the rating agencies. I believe that the best model for going forward is to mimic the way that we handle similar conflicts and oversight of accounting and maybe modeled on the public company accounting oversight board, PCAOB.

An oversight board like the PCAOB would be constituted largely or dominantly by users of credit ratings and would have teeth. Specifically, it would have powers to set standards and mandate disclosures, conduct spot checks and investigations, impose civil fines, ban firms and individuals from the credit rating industry. I believe that the PCAOB has been a necessary and sufficient entity to restore the credibility of the accounting industry in the post-Enron area. So the question I will be asking is what, if anything, might be the downside of instituting a similar oversight board for the credit rating industry. The second major problem that I see is the nonuniformity and nonquantitative nature of the language in which the ratings are reported by the CRAs. While the draft bill mandates the CRAs use generally recognized models when arriving at their ratings, I believe that greater detail under various well-defined market conditions would be very beneficial to investors.

Specifically, I would emphasize the desirability of, first, standardization of ratings terminology so that all firms report ratings using identical terms. Second, industrywide standardization of stress conditions under which the ratings are evaluated. Thirdly, unambiguous quantitative correspondence between the ratings and the default probabilities under standardized conditions of economic stress. And fourth, standardization of terminology across asset classes so that, for example, a given rating applied to a municipal bond and a corporate bond will have the identical default probability under identical market stress conditions. One specific proposal that I would like to see investigated are what might be called ABZ ratings at a glance in which the three digits of a rating, instead of just being things that are made up, correspond to default probabilities under three different, well-defined levels of market stress.

So the first digit, for example, could represent the default probability under normal market stress, the second digit under severe market stress and the third digit represents the default probability under extreme market stress. A 50 percent asset price drop, 10 percent increase in unemployment and so on. So a rating, if this style of ratings had been applied, then the ratings that would be assigned to an intermediary tranche of a mortgage pool, for example,

might hold up well under normal market conditions and then collapse at times of stress would be ABZ.

And had this sort of language been applied to the ratings of mortgage-backed securities, then the right questions would have been asked and there would have been no way that AAA ratings would have been so freely disbursed. I thank the chairman for convening this hearing and I look forward to working with him to strengthen this critical legislation. I yield back.

Chairman KANJORSKI. Thank you very much, Mr. Foster. And now we will hear from the gentleman from Texas, Mr. Hensarling, for 3 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman. Clearly, there were a number of causes of our Nation's economic turmoil, and most had their genesis in flawed public policy. Particularly with respect to the affordable housing mission of the government-sponsored enterprises, Fannie Mae and Freddie Mac, a story we know all too well. Now to state the obvious, the three major credit rating agencies badly missed the national housing bubble. That does not necessarily make them duplicitous, and it doesn't necessarily make them incompetent. It just makes them wrong—very, very wrong. It is also a painful and expensive reminder that there is no substitute for some modicum of investor due diligence and personal responsibility.

Now there is a sincere bipartisan desire for credit rating agency reform in this committee. Unfortunately, I believe the draft that is before us now falls short. There are a number of good provisions in the draft, in Chairman Kanjorski's draft, including essentially removing the NRSRO designation from current statute in regulation. Unfortunately, the bill also includes provisions that will allow new liability exposure, including joint liability for the rating agencies. I feel that these sections will actually increase barriers to entry into the rating market and make it more difficult to have competition. An increase in lawsuits will become, I believe, an insurmountable barrier to competition. The joint liability provision especially troubles me. To make every rating agency potentially liable for the ratings of other agencies, I don't see the parallel anywhere else in our body of law. I heard someone say that is a little like making Ford liable for a defective car manufactured by GM and then not giving Ford a chance to defend themselves.

No nation can sue its way into economic recovery and financial stability. Increasing the agencies' liability does not get at the root of the problem, which is the de facto government stamp of approval behind the rating agency's work product. That is indeed where we need to go. People assume wrongly that the government stamp of approval meant accurate ratings. Congress took a good step with the Credit Rating Agency Reform Act, but it was too little too late. Again, there is a vitally important lesson we have all learned about implied government backing. And so I want to compliment the chairman and the ranking member for having a bill before us that would essentially terminate the NRSRO designation. But unless we eliminate all barriers to entry, I am fearful that it is all for naught. And with that, Mr. Chairman, I yield back the balance of my time.

Chairman KANJORSKI. Thank you very much, Mr. Hensarling. Now, we will hear from the gentlelady from Ohio, Ms. Kilroy, for 2 minutes.

Ms. KILROY. Thank you, Mr. Chairman. Thank you for your leadership on this issue and for the opportunity to work with you and the task force on this very important issue. Credit rating agencies occupy a unique and powerful position within the global markets and reforming this industry is a critical part of strengthening our financial regulatory system. Like many of my House colleagues, I have firsthand experience with the role credit rating agencies play as gatekeepers to the financial markets. Before coming to this House, I served for 8 years as a Franklin County commissioner and also for 8 years on the Columbus board of education representing constituents of central Ohio and as a county commissioner, worked very hard to make our county fiscally responsible and to maintain our double, AAA rating.

It is a rating that we worked hard to keep because we thought it had meaning and value, that it represented a seal of approval and that it would save our taxpayers their hard-earned money. Of course, as you know, the rise of credit rating agencies as financial gatekeepers began when the Securities and Exchange Commission in 1975 in what probably seemed like a benign move tied broker/dealer capital requirements to credit ratings issued by the nationally recognized statistical rating organization, a designation created and determined by the SEC.

Since then, the credit rating agencies have experienced unprecedented growth. Even when the credit rating agencies seemed to get it all wrong, they did amazingly well, posting record profits at about the same time they were downgrading billions of dollars worth of subprime offerings. And it is not just that the rating agencies seemed to miss big. But now an infamous instant message exchange has been made public, instant messaging between two Standard & Poor's officials about a mortgage-backed security deal dated April 5, 2007, which seems to suggest that credit rating agencies can make billions of dollars to provide an opinion on just about anything with little fear of penalty or recourse and that exchange one analyst stated over a colleague's objections, "We rate every deal. If it is structured by cows then we would rate it." And as recently as September 23, 2009, The Wall Street Journal reported that Moody's is still assigning inflated ratings to complicated debt securities that they still do not fully understand. I am a sponsor of this very important piece of legislation, because it is this cavalier culture made worse by a broken system that cost millions of hard-working Americans their life savings and set our Nation into the worst economic crisis since the Great Depression.

Addressing the overreliance on NRSRO ratings and Federal statutes and regulations is a good place to start. Rating agencies should be a part of the equation when making investment decisions, not the equation. That is not to say that credit rating agencies do not provide value. For thousands of small investors, rating each and every security individually would be an impossible task. The proposal directs the SEC to adopt rating symbols to help the small investor distinguish between a municipal bond issue and a collateralized debt compromised of subprime mortgages that have

been sliced and diced and repackaged into looking like a safe investment.

Finally, the proposal seeks to deal with credit rating agencies that act with malfeasance. Credit rating agencies that knowingly or recklessly failed to conduct a reasonable investigation into the very ratings they were paid to provide an assessment on should not be allowed unfettered constitutional protection. Thank you again, Mr. Chairman, for the opportunity, and I yield back.

Chairman KANJORSKI. Thank you very much, Ms. Kilroy. We will now hear from the gentleman from Georgia for 1 minute, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman. As we continue to monitor the current economic climate we are in and look towards some solutions and improvements that can be made, this hearing is quite timely as the credit rating agencies played a considerable role in what transpired and what will also impact in the future. Once a financial institution achieves the desired quality grade on a product, it pays the agency for the rating. This process is rife with conflict as I believe the agencies are acting as the market regulators, investment bankers, and as a sales force all the while claiming to be providing independent opinions.

As these organizations are extremely important to the financial world, we should realize they did have a significant role to play in where we are now. And I also want to more intently focus on finding some consensus on how to move forward. These organizations determine corporate and government lending risk and are an integral part of our financial services sector. And as such, I want to ensure that we take all issues into account, including conflicts of interest, as well as the international financial world in reforming how we rate financial products.

I am very interested to hear each of your thoughts and opinions on the recently introduced draft legislation by our chairman addressing rating agency reforms. And the requirement of disclosure revenue serving the Securities and Exchange Commission. Thank you very much, Mr. Chairman, for the time. And I look forward to this panel's discussion.

Chairman KANJORSKI. Thank you very much, Mr. Scott. And now for our last presenter, Mr. Donnelly of Indiana, for 1 minute.

Mr. DONNELLY. Thank you, Mr. Chairman. Some of the things we are going to be determining include whether it makes any sense for the very people who are trying to sell the product to be paying for the rating on it, whether we need a blind pool similar to how they do it with judges throughout this country in many places or as Mr. James Simon, whom we heard from, talked about a quasi-public utility. Whether a few pennies from each trade should go in to try to get an independent rating agencies. The fact is that this caused extraordinary damage and harm to our country and to Main Street America. In my very hometown, of South Bend, Indiana, Moody's, in fact, closed their office there. And it was done because of economic hardship, allegedly, a very, very, very profitable company, and that hardship was supposedly caused by the meltdown we had that was caused, in part, by the credit rating agencies.

So Main Street America has been extraordinarily damaged by this. And it is our job to make sure it does not happen again. Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you very much, Mr. Donnelly. We have a little bit of a dilemma. We have four votes, I understand. And of course, we have 7 panelists of 5 minutes each for a presentation. Rather than break up the presentations of the panel, I suggest we will take our recess now, go over and vote, come back, and then hear the entire panel strung together so we have a better consensus. That means you are going to have to stay. We are sorry. Okay. With no other comments, the committee stands in recess.

[recess]

Chairman KANJORSKI. The committee will reconvene. The Chair recognizes the gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman. I have a written statement for the record. So I would just like to submit it for the record.

Chairman KANJORSKI. Without objection, it is so ordered.

We are at the point now where we have to welcome the panel. Thank you for accepting the delay. That is not uncommon around here. Many of you know that because of your prior experience. First and foremost, let me say that without objection, your written statements will be made a part of the record. You will each be recognized for a 5-minute summary of your testimony.

First, we have Mr. Daniel M. Gallagher, Co-Acting Director of the Division of Trading and Markets at the United States Securities and Exchange Commission. Mr. Gallagher.

STATEMENT OF DANIEL M. GALLAGHER, CO-ACTING DIRECTOR, DIVISION OF TRADING AND MARKETS, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. GALLAGHER. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, my name is Dan Gallagher, and I am a Co-Acting Director at the Division of Trading and Markets at the Securities and Exchange Commission. Thank you for the opportunity to testify today regarding the oversight of credit rating agencies. I note at the outset that my written testimony today was approved by the Commission, but any remarks I make today, in particular on the draft bill, will be my own and may not reflect the views of the Commission.

The poor performance of highly-rated securities over the last few years has resulted in substantial investor losses and increased market turmoil. As we work to restore the health of the markets, it is vital that we take further steps to improve the integrity and the transparency of the ratings process to promote competition among rating agencies and give investors the appropriate context for evaluating ratings. The proposed legislation Chairman Kanjorski recently released for discussion contains a number of measures that could enhance the Commission's oversight program, including provisions designed to address conflicts of interest, a lack of transparency and limited accountability in the credit rating industry.

I would note that over the last few years, the Commission has been addressing a number of these issues and we welcome the opportunity to discuss these efforts. As you know, Congress provided the Commission with authority to register and oversee nationally recognized statistical rating organizations, NRSROs, in the Credit Rate Agency Reform Act of 2006.

In the summer of 2007, using our new oversight authority and in response to gradually worsening marketing conditions, the Commission staff began examination of the three largest NRSROs—Fitch, Moody's, and Standard & Poor's—to look into their policies and practices relating to ratings of structured finance products linked to aggressively underwritten mortgages. To put it bluntly, the examinations revealed a number of serious problems. In particular, the examinations raised serious questions about the NRSROs' management of conflicts of interest, internal audit processes, and due diligence activities. Findings from these initial examinations informed a second round of rule amendments which the Commission proposed in June of 2008 and adopted in February of 2009. Earlier this month, on September 17th, the Commission embarked on further rulemaking designed to promote greater accountability, foster competition, decrease the level of undue reliance on NRSROs, and empower investors to make more informed decisions.

The Commission adopted rule amendments designed to create a mechanism for NRSROs not hired to rate structured finance products to nonetheless determine and monitor credit ratings for these instruments. The goal of this rule is to make it possible for nonhired NRSROs to provide unsolicited ratings in the structured finance market just like they can in the corporate debt market. The Commission also adopted a requirement that NRSROs must disclose ratings history information for all outstanding ratings initially determined on or after June 26, 2007. This new disclosure requirement is designed to promote greater transparency of ratings, quality and increased accountability among NRSROs. The Commission also published for comment three sets of new requirements for NRSROs. The first proposal would increase accountability by requiring NRSROs to furnish the Commission with an annual compliance report describing actions taken to ensure compliance with the securities laws.

The goal of this proposal is to increase accountability by strengthening the compliance function at the NRSROs and to alert the Commission to issues that may need to be examined. The second and third proposals would increase the information NRSROs must disclose to the public about the conflict of being paid for determining credit ratings and other services. These disclosures which would include a consolidated annual report are designed to provide investors with additional information on the source and magnitude of revenue, including revenues from non-rating services that an NRSRO receives from its clients. Notably, in its recent rulemaking, the Commission also proposed rating disclosure requirements for issuers of securities. For example, the Commission proposed amendments that would require certain detailed disclosures regarding credit ratings and registration statements.

The Commission also proposed requiring the disclosure of preliminary ratings, as well as final ratings not used by an issuer so that investors would be informed when an issuer may have engaged in rating shopping. The Commission also took action to eliminate references to NRSRO credit ratings in certain of its rules and forms. This is designed to address concerns that references to NRSRO ratings and Commission rules may have contributed to an undue reliance on those ratings by market participants and the

Commission found that the removal of references either improved the rules or had no effect on them.

Finally, the Commission issued a concept release seeking comment on whether it should propose rescinding a rule that exempts NRSROs from expert liability under Section 11 of the Securities Act. Rescinding Rule 436(g), coupled with the proposal to require disclosure of credit ratings in a registration statement if a rating is used in connection with a registered offering, could cause NRSROs to be included in the liability scheme for experts set forth in Section 11. The Commission appreciates Congress' interest in this issue, and we stand ready to provide any assistance the subcommittee might need in its consideration of measures to reform the financial markets. I would be happy to answer any questions you may have. Thank you.

[The prepared statement of Mr. Gallagher can be found on page 60 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Gallagher. And now we will hear from Mr. Raymond McDaniel, chairman and chief executive officer of Moody's Corporation. Mr. McDaniel.

**STATEMENT OF RAYMOND W. McDANIEL, CHAIRMAN AND CEO,
MOODY'S CORPORATION**

Mr. McDANIEL. Thank you. Good afternoon, Chairman Kanjorski, and members of the subcommittee. I am Ray McDaniel, chairman and CEO of Moody's Corporation, the parent of Moody's Investor Service. I welcome the opportunity to contribute Moody's views to the discussion today on legislative proposals of the credit rating industry. As this subcommittee knows well, the economic downturn has exposed numerous vulnerabilities in the infrastructure of the financial system. It has also provided important lessons for credit rating agencies and other market participants.

In light of these lessons, during the past 18 months, Moody's has adopted a number of measures to enhance the quality, independence, and transparency of our credit ratings. While these steps are detailed more thoroughly in my written statement, they include changes in the following five key areas: Strengthening the analytical quality of our ratings; enhancing consistency across rating groups; bolstering measures to manage conflicts of interest; improving transparency of ratings and the ratings process; and increasing resources in key areas. We believe we have made important progress but we welcome continued efforts that would reinforce high quality ratings and improve market transparency without intruding on the independence of rating opinion content.

To that end, I would like to provide Moody's initial views on the discussion draft circulated by the committee last week. These views are based on a preliminary review of the draft and we will be happy to provide the committee with more detailed comments in the near future. Moody's supports the proposal to increase the transparency of ratings performance and methodologies. We believe such transparency will allow comparisons that can drive improvements in ratings quality across the industry. We also support enhancing regulatory oversight of the industry. Creating a dedicated SEC office for example, staffed by individuals with the necessary

expertise, could increase the focus of regulatory oversight and help protect the interests of all market participants.

We also welcome efforts to limit the use of ratings and regulation. Moody's has long believed that using ratings as a regulatory tool for oversight of regulated entities can adversely affect market behavior. It encourages overreliance on ratings as well as rating shopping and it can reduce incentives for rating agencies to compete based on the quality of ratings. While we strongly support the goal of the discussion draft to remove references to credit ratings and regulation, we also recognize the wisdom of pursuing this goal judiciously so as to not create unintended market disruptions. Moody's also supports ratings oversight by an independent board of directors. Eight of the nine directors on Moody's board are independent and, we believe, effective governance is well served by having the board provide oversight with respect to procedures and policies for the rating agencies. If, however, their role extends beyond oversight to the content of methodology, we believe the content of methodologies would suffer. This would replace the judgment of our current large body of analysts and credit policy professionals with a small body of board members who are at best part time experts in credit analysis. One provision in the discussion draft that Moody's does not support is imposing a collective liability regime on all NRSROs. Credit rating agencies currently have the same liability as any other market participant if, for example, they knowingly make false statements or issue opinions that they don't genuinely hold. We do not believe the market would be well served by changing the standard of liability in a way that would increase the ability of market participants to pursue litigation because they are unhappy with our ratings.

We believe the effect on the credit rating industries would be to wash diversity of opinion, reduce competition, negatively impact market transparency, and make rate opinions more volatile.

Finally, we strongly support efforts to address rating shopping, which is a serious concern. We believe, however, that to deter rating shopping, issuers must be required to disclose more detailed information to the market. Issuers in the structured finance market are not currently required to disclose publicly sufficient information for investors to engage in reliable analysis of the underlying assets of a securitization. We urge this subcommittee and the Congress to consider requiring that issuers in the structured finance market make disclosures similar to those required in the corporate market. Moody's strongly supports constructive reforms that can enhance confidence in the credit ratings industry and the Nation's credit markets. And we are committed to working with you to achieve that goal. I am happy to respond to any questions.

[The prepared statement of Mr. McDaniel can be found on page 109 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. McDaniel.

And now we will hear from Mr. Deven Sharma, president of Standard & Poor's. Mr. Sharma.

**STATEMENT OF DEVEN SHARMA, PRESIDENT, STANDARD &
POOR'S**

Mr. SHARMA. Chairman Kanjorski, Ranking Member Garrett, and members of the subcommittee, good afternoon. My name is Deven Sharma. I am the president of Standard & Poor's, and I am pleased to appear before you today.

Let me start by saying that at S&P, we appreciate your goal to reinvigorate the economy and job growth through stability and innovation. This is an important point in history as a regulatory reform is being considered that will shape the future of capital markets and economic growth for many years to come. Since our founding more than a century ago, we have tried to learn from experience to improve and strengthen our analytics and criteria and to review processes when appropriate. Thus in 2008, we announced a series of initiatives aimed at improving checks and balances in our organization. These measures are designed to promote the integrity of the rating process and enhance analytical quality, provide greater transparency to investors, and more effectively educate investors about ratings.

Let me assure you that these improvements are substantive and will go a long way to restoring confidence in our ratings. Another way to restore confidence in ratings is to pursue effective regulation of credit rating agencies. Although we are already subject to a broad and robust regulatory scheme, S&P shares the view that further regulation appropriately crafted can serve the goal of restoring and maintaining investor confidence. Indeed, we support many recent proposals for greater regulatory oversight and enhanced internal processes to promote integrity in the ratings process. These include increased accountability through SEC authority to oversee NRSRO and impose steep fines and other sanctions for noncompliance with SEC rules or NRSRO rules, internal procedures and to require disclosure around issues such as data quality. There are other proposed measures that would seriously disrupt the capital markets by encouraging less diversity of opinions, providing strong disincentives for analytical innovation and creating global inconsistency. One such proposal would seek to lower the threshold, legal requirements for bringing a securities fraud claim against NRSROs.

Such a measure, if enacted, would cause some NRSROs to rate only those entities and securities that are the least likely to default or be downgraded. As a result, issuers who are relatively new to the debt markets may have a difficult time getting rated and therefore greater difficulty accessing capital and contributing to economic recovery. Since small and medium enterprises as well as new technology companies, for example, green companies or broadband providers, represent critical and emerging elements in our national production and employment basis, this result could have detrimental effects on economic growth. Another proposal would subject each NRSRO to collective liability for legal judgments against any NRSRO. No NRSRO should be required to act as an insurer for its competitors. We are also concerned about a proposal providing that rating opinions shall not be deemed forward looking statements under the Federal securities laws.

This proposal ignores that the very essence of a rating is forward looking; that is, ratings speak to the likelihood that an obligor will pay back principal and interest in the future. At S&P, we have heard consistently from investors that ratings must be forward looking in order to have value. Another proposal would dictate that ratings could only measure likelihood of default. At S&P, our analysis includes additional important factors such as credit stability, which addresses whether an issuer or security would have a likelihood of experiencing large declines in credit quality in certain stressful situations. These are analytical considerations that investors have told us repeatedly that they want. Any government mandate that would dictate how NRSROs form their rating opinions and which factors they may or may not consider would deprive investors of the full breadth and diversity of NRSROs' opinions. It could also lead to undue investor reliance on rating opinions based on the perception that the government has endorsed NRSROs' methodologies and their written opinions, a result counter to the goal of recent proposals that would remove the NRSRO designation from existing laws and rules.

In sum, we agree completely with the goal of improving the integrity, quality, and transparency of credit rating analysis to better inform investors in their decisionmaking. However, we urge caution in the crafting of proposals that will result in less comprehensive and informative ratings to the detriment of investors, business enterprises large and small and the capital markets as a whole. I thank you for the opportunity to participate in this hearing and would be happy to answer any questions you may have.

[The prepared statement of Mr. Sharma can be found on page 129 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Sharma.

Next we will hear from Mr. Stephen W. Joynt, president and chief operating officer at Fitch, Incorporated. Mr. Joynt.

**STATEMENT OF STEPHEN W. JOYNT, PRESIDENT AND CEO,
FITCH, INC.**

Mr. JOYNT. Thank you, Chairman Kanjorski, and members of the subcommittee. I am pleased to appear before you on behalf of Fitch Ratings. Today's hearing marks the third time this year I have appeared before congressional panels on the topic of regulation of credit rating agencies. I have attached my written statement from August to the end of my statement. However, I would like to highlight a few brief important points in light of selected recent events.

I believe in the last several years, Fitch generated and we continue to produce a significant amount of balanced and insightful fundamental credit analysis across many asset classes and capital markets. Having said that, I have also previously acknowledged that too many of our rating opinions, particularly in some of the most impacted structured finance asset classes, did not perform as expected with too many downgrades of too many notches. I am aware that this negative result is the key factor in our discussions here today.

Improving our performance drives many of the changes that we continue to make at Fitch. Having said that, all credit rating agencies are not the same. When it comes to the issues of credit culture

and intent, I would like Fitch to be judged on its own merits. Over the last several years, media coverage of the credit rating agencies and related regulatory inquiries tend to characterize the industry as being dominated by the Big 3 agencies. Many market participants and commentators then extend the point by asserting and implying that there is no difference among the Big 3.

In the SEC's 2008 report on the rating agencies, the source document for many negative e-mails often quoted in the media, none of the negative e-mails referenced were from Fitch. That same report concluded that our internal processes were robust and that our staffing levels were appropriate and kept pace with the growth in our business. In the early stages of the credit crisis in November 2007, Fitch decided we needed to conduct a wholesale review of our CDO methodology. As a result, we imposed a moratorium on rating any new CDOs while we conducted this review. We subsequently adopted a revamped and more conservative criteria for corporate CDOs on April 30, 2008.

Since that time, we have assigned very few ratings to any corporate or other CDOs. Fitch was also early in highlighting the increasing credit risk of the financial guarantors, lowering AAA ratings, which resulted in direct public attacks against us from these monolines, followed by requests to withdraw our ratings and termination of all commercial relationships.

Fitch culture and credit practices consistently emphasize the importance of the timeliness, transparency, and integrity of our ratings and credit opinions over any revenue implications. Turning to recent regulatory developments in the United States, the SEC has introduced some final rules and proposed a series of new ones, while much progress has been made, we are disappointed that one key area has yet to be addressed: enhanced public disclosure broadly and structured for finance securities. Fitch has repeatedly suggested that the information made available to the rating agencies as parts of the rating process for securitization should be made available to all investors and the responsibility for disclosing that information should rest with issuers.

To date, the SEC continues to focus narrowly on the sharing of information only among NRSROs. Regarding the committee's recent draft of the bill, Fitch shares the general objectives of greater reliability, transparency, and accountability embodied in many of the provisions for credit rating agencies. A number of the provisions are very reasonable and consistent. We will provide comments in more detail to the members and staff in the coming days. I would like to highlight several issues that have also already been mentioned. The goal of reducing the market's reliance on ratings through reference in Federal regulation, the proposed bill removes all such references. Fitch has previously noted that ratings have been used effectively in regulations in many places as independent benchmarks, a position that has been supported by many market participants. We continue to suggest that an in-depth, case-by-case review of any removals to determine whether such course of action is appropriate.

The question of what would replace ratings also remains unanswered, or at least without a thorough understanding of the specific pros and cons or unintended consequences of the removals.

Also, a bill that mandates the removal of all references to NRSROs and all Federal statutes while significantly enhancing the Federal regulatory requirements and burden on NRSROs seems contradictory to us. I believe it would affect the increasing competition that the committee was hoping for, for the industry. We have previously commented on the concept of the mandatory registration for credit rating agencies. I noted in my testimony before the Senate Banking Committee in August that Fitch, along with the other NRSROs, is already registered and subject to explicit SEC regulatory oversight. We believe the mandatory registration concept is unnecessary. Fitch has previously stated that it supports the concept of enhanced accountability for what we do, but we continue to disagree with the notion that far greater liability or specific liability is the right way to achieve that.

Ratings are a forward looking opinion of creditworthiness, not a backward looking verification of financial statements as conducted by accountants. Creating an additional and separate liability standard solely for NRSROs as envisioned by the bill seems unprecedented and unnecessary. The bill also introduces collective liability for rating agencies. This provision would require us to share information with all other rating agencies, much of it proprietary or from third party vendors. We cannot turn that information over to other agencies. That idea also that we should be responsible for verifying other NRSROs' information and ratings seems to us quite problematic.

Finally, the bill also contains some provisions that we find to be contradictory. For example, the bill requires distinct symbology for structured finance ratings, yet also mandates that we try to use all the same ratings and approaches for all kinds of asset classes; this is confusing. And in closing, Fitch has undertaken a wide variety of initiatives to enhance the reliability and transparency of our ratings. I believe we can continue to produce a significant amount of good work with that in mind, and we are open to all improvements to the industry and our own performance. Thank you.

[The prepared statement of Mr. Joynt can be found on page 88 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Joynt.

Next, we will hear from Mr. Robert Dobilas, president and chief executive officer of RealPoint LLC. Mr. Dobilas.

**STATEMENT OF ROBERT G. DOBILAS, PRESIDENT AND CEO,
REALPOINT LLC**

Mr. DOBILAS. Thank you for the opportunity to participate in today's hearing. RealPoint successfully operates under the investor pay business model. While we issue subscriber paid ratings on around \$1 trillion worth of securities, our market specialty is CMBS, or Commercial Mortgage-Backed Securities. We are one of 5 NRSROs designated under the TALF program as an eligible rating agency for CMBS.

Last week, with strong investor support, the NAIC, or National Association of Insurance Commissioners, unanimously approved RealPoint as an acceptable rating organization for CMBS securities. We believe the credit crisis is far from over, but we believe that the SEC's recent efforts are working, at least with respect to

structured finance. New issues are creeping back into the market and spreads are contracting from their all-time highs of a year ago. Investor confidence is starting to return. This momentum needs to be sustained. One way to sustain it is to give investors choices in regards to their selection of rating agencies.

It would be a mistake to legislate smaller NRSROs out of business and force investors to rely only on a few large NRSROs for ratings. We support the SEC's most recent announced changes and believe any rating agency reform should be consistent with those policies. The discussion draft may be intended to reform the larger NRSRO but its measures may eliminate the smaller ones. Legislation that creates barriers to entry in practical levels of liability or increased internal costs for smaller NRSROs furthers the interests of the larger ones.

The proposal to make all NRSROs jointly liable for an unsatisfied civil judgment against another is impractical. No one company should be forced to guarantee a competitors obligation. A company should not have to risk responsibility for a liability over which it has no control. The proposal to reduce first amendment protections for credit rating agencies is anti-competitive and further enhances the existing oligopoly structure. A small company cannot guarantee trillions of dollars of rated securities, merely because it provided a forward looking independent opinion regarding their performance. The proposal to require publication of ratings and rating actions without a timeline will put subscriber based NRSROs out of business.

The SEC has already announced rules requiring public disclosure of ratings and rating actions with the specified time lag. That protects the interests of subscriber-based NRSROs. The proposal to require every agency to review and improve every other NRSRO's work is impractical. Not every agency rates every class of security. This requirement would increase the cost of ratings and thereby reduce investor yields. This requirement appears to include analytics and proprietary information developed by an NRSRO and date of purchase by that NRSRO, towards the goal of improved ratings and competitive advantages. This requirement would therefore reduce incentives to improve proprietary rating methodologies. The proposed requirements for independent directors and compliance officers may work for large, publicly-traded companies, but would require small companies to incur significant costs who had board members with a skill set and depth of knowledge necessary to fully understand and improve analytical models and methodologies and may expose those board members to a level of liability.

The one-year prohibition on performing ratings for an issuer that hired a former analyst would increase the cost to attract and retain talented analysts. Rating agency employees who may also wish to seek corporate work will not be willing to impair their right to do so without increased compensation. The proposal to require credit ratings symbols that distinguish classes of securities is not in our experience desired by the capital markets. Investors want to know that AAA means AAA, not where one class is a real AAA whereas another represents a lower version of AAA. As we have attempted to show with various examples, the discussion draft and other well-intentioned remedial proposals have a common flaw, namely their

proposals are aimed at two entirely different types of companies with entirely different business models.

If Congress applies a multitude of new rules, regulations, and procedure controls to NRSROs which disadvantage smaller companies, the result is to punish the innocent and stifle the progress we have made to date. In our view, the better remedy is to specifically address the two fundamental problems, market concentration and rating shopping. Competition can be further enhanced across the broader range of public offerings and—by having securities, at least in part, rated coequally by subscriber-based rating agencies. No meaningful change can take place while three agencies control over 95 percent of the market. Thank you for the opportunity to appear at this hearing. I look forward to responding to any questions you may have.

[The prepared statement of Mr. Dobilas can be found on page 48 of the appendix.]

Chairman KANJORSKI. Thank you very much.

Next, we will hear from Mr. James H. Gellert, President and chief executive officer of Rapid Ratings International, Incorporated. Mr. Gellert.

**STATEMENT OF JAMES H. GELLERT, CHAIRMAN AND CEO,
RAPID RATINGS INTERNATIONAL, INC.**

Mr. GELLERT. Thank you. On behalf of my colleagues at Rapid Ratings, I would like to thank Chairman Kanjorski, Ranking Member Garrett, and the members of the subcommittee for inviting me to provide testimony today. As the only non-NRSRO on this panel, we appreciate your invitation all the more as we and companies like us have what we believe is a critical voice in these debates. As with the new subscriber-paid NRSROs, we represent the potential for meaningful change to the status quo if we are not inadvertently hindered by the consequences of legislation and regulation along the way. Ours is a subscriber-paid firm. We utilize a proprietary software based system to rate the financial health of thousands of public and private companies quarterly. We use only financial statements, no market inputs, no analysts and have no contact in the ratings process with issuers, bankers or advisors. We have not applied for the NRSRO status. As I have testified to the SEC and the Senate in recent months, there are still too many deterrents for me to recommend to our shareholders that the designation enhances value as opposed to puts it at risk.

That said, we believe that reform in our industry is necessary and time is of the essence for restoring credibility. However, we caution that some initiatives may have significant and counter-productive consequences. In short, we do not believe it is advisable to create more legislation for legislation sake. Although we did not necessarily agree with all of the elements of the Credit Rating Agency Reform Act of 2006. Its intent of appropriate to promote competition to transform this industry. Some say the Act has not had enough time to mature and others that it wasn't sufficient.

Nevertheless, the Act is still the basis for constructive change and the SEC's recent initiatives have made good progress in adding reform and oversight to the prior legislation. These improvements have set a better stage for competition than we have had in years.

The Commission has also been receptive to input from industry players. When recently faced with criticism about reading disclosure rules, adverse effect on subscriber paid firms, the SEC created different standards for issuer paid and subscriber paid NRSROs.

This showed admirable flexibility and not applying a one-size-fits-all model to new rules. We encourage the subcommittee to be guided by this flexibility.

The subcommittee's discussion draft joins a crowded field of rating agency reform initiatives currently underway. There are positive developments in the collection of initiatives, but even these do not yet go far enough, and the negative ones forge entirely new and unfortunately disturbing paths.

Competition is key to transform this industry. But competition for competition's sake is not the answer. Competition that effects change will enhance the credibility of the ratings process. The new subscriber-based rating agencies are the best hope for achieving these goals but are the ones put most at risk by the discussion draft. For new players to want to register NRSRO status must have value and not carry massive compliance costs and legal liability. New players will want the designation if they see it as a business asset, not as a series of contingent liabilities.

In order to achieve this, legislation must foster the following goals: accuracy in ratings; innovation in business models and rating methodology; encouraging, not discouraging, new players; equivalent disclosure of structured product information; and recognition that many initiatives tacitly support the status quo oligopoly.

Sadly, the trend toward greater and more complex legislation and regulation will repel and not attract competition and, hence, preserve the status quo, the very problem you were hopefully trying to solve.

In particular, the emphasize on liability I believe is being overdone. Should negligence and malfeasance be rooted out? Yes. Should a one-size-fits-all legal framework be enacted to punish all players jointly, irrespective of whether they have sinned in the past? No.

A few specific notes on liability. Joint liability is a great disincentive to NRSRO status. In fact, it is simply a nonstarter for a potential applicant. Why would one want to be an NRSRO, joining a group dominated by three players who have an iceberg of lawsuits looming on their horizon? That would be like swimming towards the Titanic.

Equivalent disclosure. The equivalent disclosure of data used in formulating a ratings decision among NRSROs is a boon to competition. If the perspective NRSRO sees the ability to expand into a new asset class of ratings, for instance, CDOs and CLOs, there is a material benefit to the designation. Moreover, expanding this disclosure to outstanding issues is critical. Likely no greater initiative could be taken to kick-start liquidity revival in structured products.

Mandatory registration. Under current law, ratings firms have the option to apply for NRSRO status. Requiring registration while the hard and soft costs of being an NRSRO are currently unquantifiable is a major hurdle to new players and is likely a

complete disincentive to the de novo firm. Add this to joint liability and the potential costs to a new player are astronomical.

Removal of ratings, references, and regulations. In general, we are very supportive of removing references and regulations because they protect the status quo dominance of the ratings oligopoly.

I will conclude with the issue of conflicts of interest.

Central to the issuer-paid rating agencies argument for defending their conflicted business model is that the subscriber-paid rating agencies also conflicted, suggesting that a modified version of the status quo is the only real alternative. This is a red herring. Let's not miss the irony of these issuer-paid agencies shifting public attention away from their committed sins to the uncommitted sins of very small competitors paid by investors who are seeking protection from fiduciary irresponsibility.

To address all of these issues, legislation and regulations must be flexible and not require a one-size-fits-all straitjacket, recalling that subscriber-based rating agencies are the future solution to the current problems, while issuer-paid rating agencies were the cause.

Thank you very much.

[The prepared statement of Mr. Gellert can be found on page 76 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Gellert.

Now, we will finally hear from Mr. Kurt Schacht, managing director of CFA Institute Centre for Financial Market Integrity. Mr. Schacht.

**STATEMENT OF KURT N. SCHACHT, MANAGING DIRECTOR,
CFA INSTITUTE CENTRE FOR FINANCIAL MARKET INTEGRITY**

Mr. SCHACHT. Thank you, Chairman Kanjorski, and thank you, subcommittee members, for having CFA here to provide you some background and perspective that I think is not otherwise represented here, which is the perspective of investors and users of these products. So we are happy to have our 95,000-member organization help with some of that perspective.

We have been commenting on these various aspects of credit rating agency reform for the last couple of years. In my written testimony, I reference some of those occasions. And as we have commented before, I think there is a lot of confusion on the investor side about just what is going on, whether we are regulating, whether we are removing reference; and there is a good deal of confusion on what is the role of CRAs going forward, what should it be, and what can be trusted in this process. So we are hopeful that this discussion draft moves it along closer to some answers.

I will concentrate my verbal testimony this afternoon on the five questions that you asked us in the invitation.

Regarding the discussion draft, we very much support the efforts there to provide additional transparency of the process. I think, most importantly, we support the efforts to better align that process and activity with the interest of investors, very basic, very important concepts.

There are sections where we have new Commission rules on conflicts of interest. Section 5 is excellent. The look-back reviews that you have there with respect to employees going to work for firms that they have rated are excellent, and the new rules on public dis-

closure of both ratings performance and methodologies we think are very strong.

We are very concerned about a couple of things, the proposed detail of the legislation on setting director pay for credit rating agencies as well as setting by statute the roles and responsibilities of directors. We think that it is rather unusual to see that in statute, as does the some 13 different subsections that you have in place related to the dos and don'ts, shoulds and shouldn'ts for compliance officers. That seems to be something that should be left to general principals and articulated by the regulators as they implement this.

Regarding the liability question, you have heard a lot about that today. I don't have to recast that.

Earlier this year, we help set up an Investors Working Group, which put together a very comprehensive report on a lot of pieces of regulatory reform related to the crisis, and that is all part of our written testimony. I hope you have a chance to take a look at it. It is comprised of very senior, very well-known investors, former regulators, and experts.

This group was clear that they felt that NRSROs should not be essentially exempt from civil liabilities under section 11 of the 1933 Act for issuer-paid ratings. We could not find one instance where a credit rating agency has ever been held liable for any sort of money damages at all in this area for their doing things in the normal course of their ratings practice. And so claims have been brought, but almost all have failed. The Investors Working Group felt that this change would make credit rating agencies much more diligent about the process and much more accountable for negligent practices.

I won't comment on the freedom of speech issue. The first amendment stuff, we are not experts on that, of course, but just to say we are happy and glad to leave that to you to referee. That will be an interesting discussion.

In any event, the group felt that they needed to have increased liability. I think we feel that section 4, the standards for private actions on page 31 of your consult, moves us in that direction, moves us closer.

This morning, I think you heard this discussion about doing something that would give reason for these firms to turn down business, bad business; and I think that is probably the one area where we should focus.

I won't say anything more about section 3. I don't think anybody likes that idea, maybe with the exception of the plaintiff's bar.

On the issue of the issuer-paid model, there will always be an actual conflict of interest. In the research and opinions where there is an issuer-paid model, the best we can do is to mitigate that conflict. I think that is what this discussion draft does. It is what the SEC has been focused on, it is what other stakeholders in this debate have been focusing on, trying to mitigate those conflicts of interest.

In the Investors Working Group report that you have, there are further suggestions related to the fee area, that fees earned for rating should vest over time, that the amount of fees paid, they should be based on the performance of the ratings over the course of the

credit performance of the bond. And I think you get to that in your section 5(f) on page 13.

There are many other discussions going on about the somebody-else-pays model. We have not—this Investors Working Group nor our organization has really focused much on these other approaches, preferring instead to focus on, if we are going to have an issuer-paid model, how do you mitigate those risks?

Finally, on the issue of removal and unintended consequences, we found this issue to be the trickiest of the lot. There has much been said and already done, as you know, globally on the removal of the references, but it still appears everywhere. We are talking about putting back references through this discussion draft, and it continues to appear throughout private contract.

We are not sure what happens if you remove it all. We are not sure what happens to the pace and the efficiency of financial markets. What the Investors Working Group and CFA have focused on is looking at this from the standpoint of the investor, and what we do is we scold investors for the blind reliance and the very bad habits that this credit rating process has developed across many institutions and that is using credit rating agencies as really a substitute for their own analysis and due diligence.

Now, I think unless you are fully asleep at the switch, investors should be on full alert that the ratings are not government-sanctioned, that the quality and validity and the accuracy are not examined or otherwise approved by the government. We seem to be moving in that direction with the discussion draft.

The Investors Working Group reasons that maybe further removal and ultimately elimination of those references would further drop that reliance. We just did a survey in the last couple of days, and our member survey came back that 54 percent of the members would like to see us move towards full elimination of those references.

I will stop there. Thank you very much.

[The prepared statement of Mr. Schacht can be found on page 124 of the appendix.]

Chairman KANJORSKI. Thank you very much, Mr. Schacht.

I will start the questions simply because, to a large extent, some of the issues that you raised are issues that I put into the draft.

First and foremost, the explanation of the conflict of interest—inherent conflict of interest with issuer pays. I find it being exceptional. I cannot think of many examples and certainly few good examples, but recently in a discussion with a United States Senator, I suggested that I discovered the methodology by which we could cut a significant cost out of our budget in the United States. If we removed any expenses allowed in the budget for the payment of judiciary and that we would pay the judiciary by having the attorneys for the winning litigants stand the expenses of the judges' salaries and expenses.

And, of course, as I say that, I see some of the people in the room smile and smirk. Nobody would even remotely suggest that would be a reasonably acceptable standard in justice. And yet, if you really analyze what I just said to you, it is exactly what you are doing in the rating agency business.

Now you may be holier than nuns or cleaner than popes, but I doubt that at all times there have not been compromises in the situation—or else there would not be shopping around. Many of the witnesses here talked about shopping. Now why would you shop for something if you were not trying to buy a little preference in a rating from your potential rater? I think we have to concede it is there.

Now the next question is, can you remove it? And I have come to the conclusion obviously this did not come about because somebody envisioned just let's do it. It is obvious that the other methodology, user pay, was not working too well or sufficiently to support a rating agency, a business. So my attempt was to find some compromise that would allow users to pay but increase their liability—or issuers to pay but increase their liability if there is knowing wrongful acts on their part.

And then, secondly, encouraging a mechanism to find exposure. What better than to have your competitors examine the same figures and information and having them do a reasonably good job of oversight? Because if they miss it or do not do it, if they do not report actions to the regulator, that will raise questions on the validity of the rating. They ultimately could become sanctioned.

Now where we pulled that out, quite frankly, is by analogy from the insurance industry. We basically do that in the insurance industry, right now, in catastrophic disaster areas.

If an insurance company is insuring against hurricanes in Florida, you could make a fortune. Go down and cut any ratings in half, and everybody in Florida will flock to your house, pay you the premium, and you can have the major proportion of business in Florida. Then what you want to do cleverly is get out of town before the hurricane arrives, and if you do that, you will make a fortune. The problem is that we have had people do that and stay in town and not be able to pay those damages that resulted from the hurricane.

So in order to prevent that irresponsible levying of rates, insurance rates, they started pooling. Basically, that is what pooling is all about. It says, look, if the one that wrote the policy underrated the proper premium to pay for the damage, or made some fundamental errors, or did not make any errors at all but just because of circumstances was unable to pay, the insured should not be the responsible party taking all of the loss. Instead, that loss will be shifted to a pool created by an assessment of all the other underwriters in the area.

Now, I do not think that is the best thing in the world; and, as a result, we have not even structured the language to accomplish this idea.

What I am trying to encourage is outside-of-the-box thinking. We obviously have a major problem of conflict of interest. We obviously have rating agencies that are being shopped. We obviously have had horrible results in the last several years with rating agencies missing many of the securitized areas by giving them rates of triple A when in no way should they have had triple A.

I do want to point out that an insurance company came to me very recently with a study in their industry; and that industry in the United States is almost wiped out. And the reason being they

showed me that their competitors were buying securitized mortgages. It got so bad in 2007 that 15 percent of the mortgages included in the pools had never made the first installment of the mortgage. There was a default by 15 percent in the first installment due to the mortgages that were included in the pool.

Now I do not know whether due diligence is being used. I do not know whether proper study measures are being used. But when you are including mortgages and marketing them, the securities based on those mortgages, as triple A when the installments of 15 percent of the mortgages are missed in the first instance, somebody is wrong and somebody is lax.

And to some of the testimony here, it seemed to me that you are saying, well, sorry, we missed it, or the most important thing is we have competition.

Competition is good and cures things, if competition really works. Has anybody suggested the competition that is there now is working? And if it is not working, what are your suggestions of competition and how we get it to work, other than just putting more people into the field when there are only 3 doing 95 percent of the work.

I see that my time has expired, so I will pass on my comments and questions and hopefully get to the next round.

I will now recognize the gentleman from New Jersey, the ranking member, Mr. Garrett.

Mr. GARRETT. I am going to defer first to—

Chairman KANJORSKI. I am sorry. Mr. Bachus.

Mr. BACHUS. That is okay.

Mr. Chairman, can we have about 8 minutes on each side? I know you took about 8 minutes, if that is all right. There is a limited number of members.

Chairman KANJORSKI. Just do not act like rating agencies.

Mr. BACHUS. And I would maybe start my time after I ask this question.

Chairman KANJORSKI. Well, no, I think we should certainly give you 8 minutes. For you, Mr. Ranking Member, we will give you 10 minutes, if you want.

Mr. BACHUS. Thank you. I know the timekeeper heard that, too.

My first question is, we have heard a scenario where an issuer gets a rating from one of the rating agencies and that rating is not disclosed. Then they go to a second rating agency, and they share that rating and say, can you do better? Obviously, that could lead to some skewed ratings.

I would ask Mr. McDaniel and Mr. Sharma, does that happen?

Mr. MCDANIEL. Congressman, the issue of rating shopping, as we said in—at least as I said in our prepared remarks, is indeed a serious issue. It is not, however, an issue that I think is driven by the business model and payment. It is an issue that is driven by lack of information.

Mr. BACHUS. What I am saying, Mr. McDaniel, are there cases where someone goes to, say, S&P and then they come to you. They haven't disclosed that rating. And they come to you and say, I would like to you do another rating. And then you give a different rating and say it is higher. Then they choose which one to disclose. Does that happen?

Mr. MCDANIEL. Yes, I believe that does; and that is why I believe it is a serious issue.

Mr. BACHUS. And you would agree—and, Mr. Sharma, do you agree that has happened in the past?

Mr. SHARMA. Yes, Congressman, it does happen; and the solution around putting more transparency as to where the issuers have gone and who they have selected and why they selected, such transparency will bring everything up.

Mr. BACHUS. Would either one of you gentleman object to saying that if you go to a second agency, you disclose both ratings?

Mr. SHARMA. The issuers and we could be asked to disclose.

Mr. BACHUS. Mr. McDaniel.

Mr. MCDANIEL. I think the objective is a good objective. I think that it would be difficult to make work. Because I think that, to the extent the marketplace does not want to have ratings disclosed, they would simply work around that. They would ask hypothetical scenarios.

Mr. BACHUS. What if you gave a preliminary rating and you were under legal obligation to disclose that? Do you think you could work around that?

Mr. MCDANIEL. To the extent that we give a preliminary rating and are required to disclose that, we certainly would. I think they would—to the extent that they are trying to avoid having that happen, I think they would try to avoid having a preliminary—

Mr. BACHUS. Oh, I can bet you they will try to avoid it.

Mr. Gallagher, is that a problem and are you going to address that at the SEC?

Mr. GALLAGHER. Congressman, thank you.

This is actually something that the Commission has taken action on. In our September 17th meeting, the Commission proposed rules geared specifically to issuers, going right to the primary actor in the scenario that you outlined and proposing rules that would require, as you say, under penalty of law that they disclose whether they are rating shopping, whether they are seeking either preliminary or other ratings.

Mr. BACHUS. Mr. McDaniel, I think he has been quite candid; and I compliment you for that, Mr. McDaniel.

There are ways to get around it. And even if, say, Mr. McDaniel doesn't or Mr. Sharma, someone may try to; and I would ask you to maybe even consult with them on ways not to get around it.

Mr. Joynt and others, if you would maybe share with the industry. Because they know better than anybody else how to get around it and could tell you how to build a safer system.

Mr. Gallagher in his testimony said that analysts were sometimes involved in the discussions concerning fees. That to me appears—and he said in his testimony that is a serious conflict of interest. Mr. McDaniel, do you agree that that appears to be a conflict of interest, at the very least?

Mr. MCDANIEL. The involvement of analysts in fee discussions I do think is inappropriate. We do not permit that.

Mr. BACHUS. Mr. Sharma, do you permit that? Going forward, will you permit that?

Mr. SHARMA. Mr. Congressman, we have had long-standing policies not to allow analysts involved in any commercial activities, and we recently even reinforced that.

Mr. BACHUS. And, Mr. Joynt, I assume you all are already doing that.

Mr. JOYNT. That is correct.

Mr. BACHUS. I appreciate all of you saying that.

And even I think when you share e-mails, if they see the e-mail traffic about those discussions, I think that you need a safeguard there. Mr. Gallagher mentioned that, and I thought that was very appropriate.

Mr. GALLAGHER. Congressman, I will just jump in and say that we actually have a rule that is exactly on point with this issue prohibiting that conflict.

Mr. BACHUS. Is that a new rule or something you have had in the past?

Mr. GALLAGHER. Since we have gotten the statutory authority.

Mr. BACHUS. Thank you.

Mr. Joynt, you mentioned there are certain things you do, internal controls, that in the past that maybe S&P and Moody's didn't have. What are some of those that you would like to elaborate on?

Mr. JOYNT. First of all, I don't want to sound holier than thou, as the chairman pointed out.

Mr. BACHUS. Oh, we welcome those kind of testimonies.

Mr. JOYNT. But I do think it is important that, over a long period of time, we have tried to build a culture of credit orientation. And there has always been a conflict—we have talked about that—between being paid by issuers and how we have to have completely independent credit rating processes with analysts who think independently and ratings that are done by committee. And so we have to have at the forefront of our mind the fact that the ratings are entirely independent.

There have been many instances—I am sure other agencies have examples as well—where the consequence of taking difficult ratings decisions, like downgrading companies, or structured financings has resulted in financial impact. And I was only pointing out that I think that we have—I have examples of those, and I could cite more, where we feel the impact of that rating decision, notwithstanding the fact this rating decision would change our financial results, because of the independence of the credit judgments.

Mr. BACHUS. I actually have seen some articles that the Senator confirmed that you have suffered from that.

Mr. JOYNT. Thank you.

Mr. BACHUS. Let me ask Mr. McDaniel—well, actually, let me shift gears and say to Chairman Kanjorski, if I could, this idea of joint and severable liability, as I understand it, even rating agencies that didn't participate in the ratings could be found liable. Is that any of you gentlemen's understanding?

Mr. Gellert, would you comment on that?

Mr. GELLERT. Yes, that is my understanding. To my read or at least the intention of the clause in the draft is exactly that, that any NRSRO—just to clarify, not anyone who is providing ratings or credit research services independently but an actual NRSRO would have a joint liability if a problem was found and a suit was

pursued against one, that all would share if collection was not available.

Mr. BACHUS. That sounds—the asbestos legislation, I think, was one of the worst things that has ever passed this Congress, where you had innocent companies who did nothing wrong and yet they were—in many cases, they actually had to file bankruptcy, not because of anything they did. And I would hope the Congress would not—that is something the Congress has tried to straighten out for 30 or 40 years and, regrettably, has resulted in some of the greatest inequities in our judicial system.

I used to be both a plaintiff and a defense lawyer, and I almost consider that practice un-American. It is certainly the opposite of justice. I would hope that we can work with Chairman Kanjorski on that particular issue, because I don't think that is what most Americans would call justice.

Mr. Gallagher, what do you consider—are there some actions you think have been taken that will go a long way to assuring us that what has happened in the past won't happen again? I think that ought to be our main motivation here.

There certainly is enough blame to go around for what happened last year, and I think the credit rating agencies were a significant contributor to that. But I think our motive ought to be stopping in the future, and I think they have acknowledged that.

Mr. GALLAGHER. Thank you, Congressman.

Since the Commission got statutory authority to oversee the rating agencies in 2006, this is an area in which we have been very active, there have been several sessions of rulemaking, the last of which, as I mentioned earlier, was 2 weeks ago. The rules address a whole number of issues: conflicts of interest in particular; accountability; transparency. And we are just now starting to see the net effect of some of those rules.

And so I would say it is an area where we have taken a lot of steps. We are not resting on our laurels. We are looking constantly to see where there are existing regulatory gaps, and where we can do something better, more efficiently. I won't promise that we are done by any means, but I think we have taken a lot of steps, and we would like to see what the net effects of those rules are.

Mr. BACHUS. Thank you very much.

Thank you very much, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Bachus.

Mr. Donnelly for 5 minutes.

Mr. DONNELLY. Mr. Joynt, let me ask you this: What would be the problem if purchasers paid for the credit rating agency's work instead of issuers?

Mr. JOYNT. There is no problem with that. The reason why the industry developed with an issuer pay model was cited earlier. Going back to the mid-1970's, after the Penn Central bankruptcy, the Wall Street community had gotten together and suggested that a much stronger, independent rating agency business was needed, better funded to do better analysis; and they wanted all the ratings to be publicly available to all investors. And so that was the germination of the issuer pay model, it was to get the ratings out freely and broadly and disseminated to everyone and to fund a much more vibrant and better ratings business.

I think that has been accomplished. But there is nothing wrong. If there could be developed a way to have all the investors pay enough to fund a well-structured and good credit ratings business, that would be a good solution, also.

Mr. DONNELLY. Is there a concern, for instance, that on an issue that the purchasers would not be able to properly fund your work?

Mr. JOYNT. I think that is the case, yes. Investors are willing to be subscribers to our research and our ratings, but the amount of compensation for that is restricted.

Mr. DONNELLY. Let me ask you this, Mr. McDaniel. In the legal profession, when you go to court, you don't get to pick your judge, for obvious reasons. There is conflict of interest. Can we use a blind pool system with credit rating agencies as well so you don't get to, in advance when you bring out an issue, pick the organization you want to work with?

Mr. MCDANIEL. I think to the extent that issuers are going to rating agencies, they are doing so, at least in the traditional context, in order to meet investor demand. That is a model we would call a demand pool model. The issuers would certainly like to make choices that would be most favorable to themselves, but at the end of the day their securities must satisfy the investor demand for independent, high-quality opinions.

It is one of the reasons why we are supportive of a reduction or elimination of the use of ratings and regulation. Because I think that traditional system is a healthier system, frankly, and would return more of the demand for ratings to the investor choice, as expressed through who the issuer reaches—reaches out to with its rating requests.

Mr. DONNELLY. Mr. Dobilas, let me ask you this. What would you think of a blind pool system?

Mr. DOBILAS. You know, I am glad you mentioned that. Because, just listening to everyone's ideas and brainstorming out of the box, I think you have to remove competition from the new issue side. I think what you want to do is what is best for the investor. That is really what a rating agency was designed to do. I think we lost sight of that several years ago when we switched to an issuer-paid system. Ninety-five percent market share for three companies is a lot, and nothing is going to change without a meaningful change.

So what I was thinking is—I would agree with you. I think if you, again, in the investor's best interest, sort of promoted the subscription-based model but had a blind pool on the new issue side, you would encourage the three companies next to me to focus more on investor-paid models, while at the same time breaking up the oligopoly at the new issue site.

It is really quite simple. Their revenue would have to be derived from somewhere else besides rating shopping and where else would they get that revenue? They would focus on building investor-based products and tools and analysis that promote all the values you are looking at promoting and selling those directly to investors, and investors will pay for that.

Mr. DONNELLY. And I know I don't have to tell you folks, but the critical nature of what you do—in my State, the damage caused to our economy was breathtaking, with company after company unable to obtain credit because of the collapse of credit markets. And

there is a deep anger in our area toward Wall Street, toward the work done there, that what you did there caused our families to lose jobs.

And that is the perspective that we have in middle America, is that—was this done by rating agencies alone? No. But the work that was done caused so much damage that we had moms and dads going home at the end of a day—I represent the recreational vehicle area, the auto area—that they went home and lost their jobs because the credit markets had been destroyed. And so we had a lot of skin in the game.

I guess the question I will ask you is, short of the liability discussions that we have had, what skin in the game do you have or should you have or what can we put in there to make sure that your work isn't done for one of the investment banks but is done for accuracy and the American people so that they have some sense of confidence in what you are doing? I mean, what consequence is there to you? The consequence to us is our companies are destroyed and our jobs are lost.

Mr. Sharma, would you be willing to help out here?

Mr. SHARMA. Mr. Congressman, first of all, our focus is on the investors, as to what we can do for the investors. And the investors ultimately make a choice. They, in fact, even if we are in the regulations, investors influence who the issuers select as a rating agency. If they are not satisfied with it, they are not going to invest in the securities that the issuers issue. And that is something that the investors always have that choice.

Second, we are accountable. We are accountable through the regulatory process to SEC. If you don't comply with the policies and procedures, they have provisions to penalize us and even shut us down. Second, we are also accountable through the private litigation. If we don't follow policies and procedures and there is fraud, then there is security fraud laws that we are liable against.

Third, we are scrutinized by the market everyday. We make our criteria around which we rate public. We make our basis around which we do the rating actions public. And if people disagree with us, they speak up; and we hear that very loud and clear. We do feel ourselves very accountable in many ways.

Mr. DONNELLY. One last question. We heard from a number of folks in regards to the conflict of interest piece.

One successful investor said, run it like a private utility—like a utility, where there is a couple of pennies paid on every trade or that there is a pool of funds available to then fund—that it remains private, but the funding comes from that pool instead of directly from an issuer.

And would anybody like to take a whack at that as to what you think?

Mr. Gellert, we will throw you in the bucket, too.

Mr. GELLERT. Sure, why not?

I think it is one model that is worth exploring, like investor-owned rating agencies are worth exploring. I think the devil is in the details when you talk about a public utility model, because you really have to dive deep into what the value is, what investors are going to believe is value being created by an entirely new entity.

We face it. I am sure RealPoint faces it. We all face it as newer entrants into the market, that we have to establish credibility over an extended period of time. The market doesn't immediately grant us the benefit of the doubt and say everything that you do is fantastic. So it would take quite some time, and I don't you could turn this industry on a dime.

I would then suggest that a public utility model or a government-owned model, particularly in the context of the joint liability and other liability issues that we are talking, would be extremely problematic and probably not welcomed.

Mr. DONNELLY. The reason it is all so important is the extraordinary repercussions that come when we miss the mark in the rating system. So—

Mr. DOBILAS. I would like to add to that.

I think part of the reason why we missed the mark was because surveillance of the securities was so poor or it just didn't exist, and that is part of the reason why a subscriber-paid model works so well. Because if we get a rating wrong we lose a subscriber. That is the penalty. It is almost like we are almost 100 percent self-insured. Because we will go out of business if we made the mistakes that, again, few firms have made in the past.

And, also, by focusing on surveillance, you really look at things on a monthly basis, as opposed to an annual basis. I think that is a big reason, too, why we saw so many mass downgrades when we did see those downgrades. And why it affected your home State so much. Because all at once it was too much for the economy to absorb. If these things would have happened more gradual over time, I think the effect would have been less traumatic.

Mr. DONNELLY. Thank you very much.

Thank you, Mr. Chairman.

Chairman KANJORSKI. Thank you, Mr. Donnelly, and we will now hear from the gentleman from Illinois, Mr. Manzullo.

Mr. MANZULLO. Thank you, Mr. Chairman, for calling this hearing.

Let me ask a question. Can the issuer-pays and the investor-pays models for rating coexist in the marketplace? Mr. Gellert or Mr. Dobilas?

Mr. DOBILAS. I will take a crack at this.

I don't think they can. I honestly think you have to confront the problem. And when the issuer chooses who does the initial rating, I think that is a big problem, and you will have rating shopping take place.

I think the mitigating factor which the SEC sort of put a rule in place that really helps out is the fact that subscription-paid agencies or any agency can focus on producing the same report at the same time and trying to sell that. The question is, are investors going to be willing to pay for that?

Historically, they have not. Historically, they are used to getting this information for free and may go back to their old ways by just relying on those issuer-paid ratings.

That is why I think the idea of a rotating structure where all the agencies would then focus on making their money for the benefit of investors by providing—

Mr. MANZULLO. But even if you had that, you have three large credit rating agencies, and that is not much of a pool. You are going to pull one out of three. And eventually, let's say there is some mischief on the part of one of them, then an investor out there or issuers say, well, I reject that rating, and then go back to the pool again. And then you are down to two and then down to one. What have you accomplished at that point?

Mr. DOBILAS. But the good news is there are more than three now. There are 10 registered NRSROs. And what you want to do is encourage more companies to apply for the NRSRO.

Mr. MANZULLO. What about one of the big three, do you want to respond to my question?

Mr. JOYNT. I think one point I would like to make is most of what we are talking about seems to be surrounding structured finance and the transactions rated there.

Mr. MANZULLO. Except for the problem ones.

Mr. JOYNT. In fact, the rating agencies rate corporations and municipal entities. So I just ask you to bear in mind that the question about whether we select ratings or not, Fitch has been added as a third rating to almost all corporations that we rated over the last 10 or 15 years. They didn't select to drop someone else and add us. We have been added because they respected our research. It wasn't a competition in that kind of way.

So in public finance, I don't believe there is any other rating agency among the newer entrants that is in position to rate any public finance entities.

Mr. MANZULLO. Mr. Joynt, let's say in 1 year your company had a sales of, let's say, \$100. How much of that \$100 would be represented by structured products? Just generally.

Mr. JOYNT. Fifty percent.

Mr. MANZULLO. Fifteen?

Mr. JOYNT. Fifty, "5-0."

Mr. MANZULLO. So it is about half the product.

An issuer wants to sell a product, can he effectively sell that product if he does not have a rating at the same time that he makes the offering to the public—a rating that goes along with the product?

Mr. JOYNT. If it is a public offering, typically they would ask for at least for two ratings.

Mr. MANZULLO. And investors demand that?

Mr. JOYNT. Many investors, regulated or not regulated, would expect to see at least two different rating opinions on public securities that are offered, yes.

Mr. MANZULLO. So even though there is obviously a built-in conflict of interest with the issuer paying for the ratings, there is no effective way around that?

Mr. JOYNT. Over time, investors have been comfortable and confident that management of the conflict of interest has been done appropriately.

Mr. MANZULLO. Anybody else want to respond to that? Mr. Gellert.

Mr. GELLERT. I think this is more about market norms than it is about anything else. I think your typical corporate issuer knows that, generally speaking, to get the best pricing on your bond deal

you need to ensure that there will be the most liquidity potential in the secondary market for that bond; and you will always have the most potential liquidity if you have S&P and Moody's ratings on it and then, more recently, Fitch's.

Mr. MANZULLO. Okay. Let me ask this question. Perhaps it goes to the heart of the collapse.

Many of us find it incomprehensible that, in the rating of these mortgage-backed securities, the people doing the rating simply failed to realize that mortgages that were given to people who could not make the first payment were somehow tainted and could end up poisoning the whole.

We are just—I don't know it got missed. When Members of this Congress were saying that credit was too easy and other groups said, no, it is not; and then everything went along—yes, sir.

Mr. DOBILAS. I think the answer is simple. Just like in the commercial real estate market, it was missed because the models that were rating these securities were developed for issuers, not for investors. You know, over the last 5 years—

Mr. MANZULLO. They were developed for issuers but not for investors.

Mr. DOBILAS. Yes, to get the deal. Over the last 5 years, we have seen a deterioration of credit standards across-the-board on an individual loan level. Commercial real estate, which was a fairly conservative industry, again, 5 years ago, we have seen the deterioration of credit standards. The rating agencies rating those deals should have been the mitigating factor to that, should have been the advanced warning signal to investors that, hey, something is going on; deals are getting riskier.

But that didn't happen, and I blame rating shopping for that. They wanted to be on the deals. They didn't want to take a stance. And I think you have to confront that. You have to put an end to that.

Mr. MANZULLO. Mr. Chairman, my time is up, but it is up to you. If you want to—

Mr. DONNELLY. [presiding] If you would like to take an extra 2 minutes, that would be fine.

Mr. MANZULLO. I appreciate that.

Mr. Gellert, then I want to hear from one of the big three, a response to fairness. If you would like to respond to it. Mr. Gellert and the—

Mr. GELLERT. I think one of the key issues here as well is the availability of information to rate the products, particularly in the structured product market. The equivalent disclosure initiatives that the SEC has undertaken and that are picked up in the draft bill I think are key.

Because one rating agency that would be—one of the traditional three may very well have a model that was geared for something other than what it was used for or not. I am not speculating. But I can say, if there are more opinions out there and there are more of us who are interested in rating those products as well, we have the ability to do the due diligence that they currently are not doing, but only if we have access to the information that is underlying those securities. And that is the mortgage information underlying residential mortgage bond CDOs and a whole slew of others, par-

ticularly collateralized loan obligations, things that right now we do not have access to.

And one of the absolute keys as we move forward is not just being able to get access to that information on the new issue basis but it is on the existing securities outstanding that are on people's books. Before we can provide value on new issuance, we need to be able to benchmark that new issuance against what people are already holding. That means we have to have ubiquitous access to information for all securities.

Mr. MANZULLO. Did anybody want to—Mr. McDaniel?

Thank you, Mr. Chairman, for giving us the extra time.

Yes, sir?

Mr. MCDANIEL. I just wanted to again reinforce our support for the availability of information. I think that is just absolutely crucial, information available to the investing public and to rating agencies which are not selected to rate a security by an issuer. If that information is available to all of us, as well as to investors, we have the ability to act as a check and balance on each other and the institutional investment community has the ability to act as a check and balance on the analysis of rating agencies. I think that if we have one solution to the rating shopping and competition problems that are being raised, that is the solution.

Mr. MANZULLO. Thank you, Mr. Chairman.

Mr. DONNELLY. The gentelady from California.

Ms. SPEIER. Thank you, Mr. Chairman; and thank you, gentlemen, for being here today.

In my experience back home in the district, what I hear more than anything is just outrage about the fact that no one has really been held responsible. And so I guess my first question—and my questions are going to be all around accountability.

My first question is to each you at the credit rating agencies. You had rated AIG and Lehman Brothers as triple A, double A minutes before they were collapsing. After they did fail, did you take any action against those analysts who had rated them? Did you fire them? Did you suspend them? Did you take any action against those who had put that kind of remarkable grade on products that were junk?

Mr. McDaniel?

Mr. MCDANIEL. No, we did not fire any of the analysts involved in either AIG or Lehman. Lehman did not have a double A rating or a triple A rating. It had a single A rating. And an important part of our analysis was based on a review of governmental support that had been applied to Bear Stearns earlier in the year. Frankly, an important part of our analysis was that a line had been drawn under the number five firm in the market and that number four would likely be supported as well.

Additionally, AIG—

Ms. SPEIER. But that is not analysis. That is an opinion. That is not—I mean, I could have that kind of an opinion, and I am not an analyst. How can you possibly make that kind of a decision based on an opinion when you have millions of people relying on that?

Mr. MCDANIEL. Our opinion applies to whether we believe an instrument will pay or will not pay.

Ms. SPEIER. That was a political determination that you made, Mr. McDaniel.

Mr. MCDANIEL. A very important component of that analysis is whether we believe there would be external support in the event of distress; and that analysis is relevant to financial institutions, to governmental entities—

Ms. SPEIER. Thank you. Mr. Sharma?

Mr. SHARMA. Congresswoman, financial institutions are very—

Ms. SPEIER. If you could just answer the questions, because I have a series, and I have a limited amount of time.

Mr. SHARMA. No, we did not fire anyone.

Ms. SPEIER. No one got fired. No one got their hand slapped.

Mr. SHARMA. Congresswoman, ratings had been downgraded over time for both of those institutions.

Ms. SPEIER. AIG was still double A on the 14th or 13th. I mean, it was—

Mr. SHARMA. We had been changing the rating over a period of time. And financial institutions are very confidence sensitive. So, in Lehman's case, not only were they trying to raise capital and they were about to raise capital and when they weakened they had declared bankruptcy. And once there is a run on an institution, then it is very hard—as you have also experienced in California, when these institutions have a run on them, it is very hard to manage that and process, because it is very confidence sensitive.

Ms. SPEIER. All right. Mr. Joynt?

Mr. JOYNT. No, no analysts were fired.

I would say our lead analysts in those cases, as well as the analysts who participated in the committees, are disappointed, surprised, went back and reflected on, well, how do we reach our conclusion? There are committee deliberations. It is not just one person who decides. I think we have done a lot of thoughtful soul searching about how do we perceive this going forward, how do we think about our analysis.

Ms. SPEIER. What are your opinions on consulting services? Do you do consulting services in addition to doing the issuing for a single client? I know you have done it historically. Are you continuing to do that?

Mr. MCDANIEL. We do not offer any consulting in the rating agency. We offer some professional services in the form of credit training and risk management, risk measurement tools in the Moody's analytic business, which is another company owned by Moody's Corporation.

Ms. SPEIER. And there is no sharing of information?

Mr. MCDANIEL. That is correct.

Ms. SPEIER. Mr. Sharma?

Mr. SHARMA. We do not offer any consulting services. We have, in fact, reinforced the policies and added more checks and balances that there is none of that even activity happening—

Ms. SPEIER. Mr. Joynt?

Mr. JOYNT. Any kind of advisory services have been housed in a separate company from the rating agency, yes.

Ms. SPEIER. Mr. Dobilas?

Mr. DOBILAS. No, we don't provide consulting services.

Ms. SPEIER. Mr. Gellert?

Mr. GELLERT. No, we do not.

Ms. SPEIER. There is a regulation FD that the agencies contend that the exemption is needed in order to fully evaluate credit risk. Most notoriously, even though Enron made nonpublic credit rating agency presentations, information about the risk described in those presentations was not reflected in Enron's credit ratings. So my question is, if we are talking about accountability, if we are talking about greater disclosure, why should you be eligible for this exemption from regulation FD?

Mr. MCDANIEL. We operated for 90 years before regulation FD became effective. I think we were able to do a very fine job during that period, and I think we would be able to operate without regulation FD exemption now.

Ms. SPEIER. Thank you.

Mr. Sharma?

Mr. SHARMA. Ratings are forward looking, and information that allows us—that gives us more insight as to the future helps us to make better decisions.

Ms. SPEIER. Mr. Joynt?

Mr. JOYNT. I would agree. I think that regulation was passed to allow issuers to more freely communicate with rating agencies so they can make better decisions.

Ms. SPEIER. But we have lots of examples where it wasn't used in that way. So the question is, is it going to hurt your business if we get rid of that exemption?

Mr. JOYNT. I believe we could continue to offer educated opinions.

Ms. SPEIER. I see that my time has expired. Could I be offered one more—

Mr. DONNELLY. One more minute.

Ms. SPEIER. Thank you.

I just want to get to this liability issue, this private right of action. As I understand it, you only want to be sued if you knowingly make a false statement. Now that is akin to a doctor only being sued when he knowingly leaves sponges in a body during a surgery. And we all know that is just not the case.

For most professionals in this country, you can be sued for negligence. You can be sued for gross negligence. And most professionals don't have this huge benefit that you have, which basically allows you to not be sued by anyone unless you knowingly make false statements.

I am going to read to you one little section here, and I want you to tell me whether or not you could live with this kind of a standard:

“Knowingly or recklessly failed either to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk or to obtain reasonable verification of such factual elements from other sources that it considered to be competent and were independent of the issuer and underwriter.”

Ms. SPEIER. So it is a different standard.

Mr. MCDANIEL. I am interpreting perhaps correctly, perhaps incorrectly, the section that you just read to subject NRSROs to the same liability under Section 10(b) of the 1934 Act for knowing or

reckless actions as other market participants would be. While no CEO wants to volunteer for more liability for their firm, that does not sound like an unreasonable standard to me.

Ms. SPEIER. Thank you.

Mr. SHARMA. I think my point—

Mr. DONNELLY. [presiding]. I am sorry. Time is up. The ranking member from New Jersey.

Mr. GARRETT. Thank you. And I thank the panel for your testimony. Before I begin, I guess I would echo the words actually during part of your comments, Mr. Donnelly, with regard to how middle America views much of what has transpired over the last 9 or 12 months, having that real dilemma of trying to find responsibility out there in the midsts of all the doom and the gloom on the economic crisis morass that we are in and unfortunately just not being able to see what Congress is apportioning that liability and just who the responsible parties are.

That is the quagmire that we are in at this point in time. The forest is this piece of legislation. I just want to go through some particular points on this. I guess I will start from right to left or maybe in between to throw you all off. Mr. Schacht, you I believe stated in your testimony that with regard to the legislation, that maybe some of it might just be too specific and some should be left to the regulators to imply. I guess some parts with the compensation, but also dealings with the duties of the compliance officer. Can you just spend a brief period of time—isn't that the responsibility of us to get into that detail? Because obviously the regulators haven't been doing that task in the past.

Mr. SCHACHT. Well, I think somebody needs to do it. That is for sure. I think the question is whether it needs to be committed to statute or whether we as I said—whether we just articulate the general principle behind this and we leave to the functional regulator to implement the various standards associated with that. Our view was that it is best left at the functional regulator level.

Mr. GARRETT. Thanks. And Mr. Gellert, on another point, your firm is not registered as an NRSRO?

Mr. GELLERT. That is correct.

Mr. GARRETT. And in a few seconds, since we are all on time, why is that? Why was that decision made?

Mr. GELLERT. It has basically been for the last number of years, watching the evolution of the regulatory and legislative debate around how to control the NRSROs and finding that there has been too much uncertainty as the dust hasn't settled and new ideas and concepts continue to come up and that now there is an increased focus on litigation liability and there is a significant amount of risk involved, and we don't see it so far that the advantages outweigh the negatives.

Mr. GARRETT. Okay. Now, one of the provisions that is in this legislation is a proposal to remove the imprimatur of the government approval by statute and regulation by removing that designation. Anyone can answer this question. What are the downsides if we implement that? Even if we did so over an appropriate period of time, recognizing that the SEC is already taking some actions and going through the review process and picking a few out here and there. But if we just put a date certain and said going forward

for purposes of this, in a reasonable period of time, what would be the downside particularly on the—as far as the investors' perspective and would there be something you could look to and say oh, my goodness, pension funds are all the sudden going to have a calamity in there or something like that that I am missing? Some are nodding your head, but—

Mr. DOBILAS. I could take a stab at that to start with. I think there is a downside. I think the NRSRO being a regulated entity serves its purpose as a benchmark for investors. I think removing the NRSRO is going to create a lot of problems for investors. They do depend on that minimum benchmark. It gives them comfort in their decisions. But first and foremost is the data issue. A lot of these securities are public-private securities. A lot of information like rent rolls, financial statements—

Mr. GARRETT. We are not suggesting that you couldn't do that, that institutions still could not make that choice to actually go out and say we want to have an AAA rated by one of the Big 3 and that is the way our town, county or State or government is going to do it. It is just that we are no longer going to have the stamp on it saying that you have to do that, that it is up to the investors or the institutions.

Mr. DOBILAS. Yes. And again my point is having that stamp does encourage a certain bare minimum, a certain competency. Are you going to go into broker/dealers and see if they have the competency to put the securities together and really subject yourselves to that kind of regulation or is the rating agency—again, could that be a regulated entity where again it is a bare minimum competency of risk?

Mr. GARRETT. From the other rating agencies, do you have a problem with that?

Mr. JOYNT. A couple of thoughts. I think the money market fund industries' response to the idea that the ratings would be withdrawn from—I don't know the exact SEC rules, but—2(a)(7)—sorry—is still being openly dialogued about. But they were concerned about having no minimum standards. So new entrants into that business were likely to take extraordinary risks and sort of blemish the reputation or the minimum standard of the larger or more general population of money funds. So whether there is a substitute or not for that, it is a good example of the sort of benchmarks in place and it is a constructive one, even if it is not a full solution. People should be doing their own analysis. But it is perceived as constructive.

Mr. GARRETT. That is something—I will let you answer, Mr. Sharma.

Mr. SHARMA. Thank you. Ranking Member, we have never asked for a designation like the NRSRO. So whatever the policymakers—you and SEC and the investors make a conclusion was the best interest of the investors, we would work with that and we would be very comfortable with that, to go in that direction.

Mr. GARRETT. And if you did rank the removal, wouldn't it be—I guess your sense on the money market funds, what have you. But then the onus would be on them to either select the concurrent process that they are doing now, or I guess the SEC would take a look to see whether they have established their own internal

mechanisms for making sure that they are making the proper investment decisions in those situations. And I thought that would be sort of what we are all ultimately striving for because there is this question mark remaining out here, despite the best intentions. Comments? The liability side and again with regard to this legislation, who sees that as many of you mentioned this before, who sees as far as changing the liability standards as we have here as a significant impediment to entry into the field and whether it would change the volatility of the ratings? Those are two separate questions.

Mr. GELLERT. Everyone is looking at me. It is clearly an impediment, it is clearly a disincentive to enter the space, and without question, it further solidifies the market share that the three largest players have, without a doubt. I cannot speak for the other NRSROs that are smaller and outside of that Big 3, but without a question, it does. The more you have entrenched—the more you have entrenched oligopoly and less competition, the more likely it is that you will have stable ratings. But they won't necessarily be accurate ratings because they won't necessarily have the competitive and innovation—

Mr. GARRETT. Let me flip it around. Does anybody see that it would not be an impediment to—no. What about for you guys, as far as insuring yourself, you have two provisions in here, the liability as far as the pleading section on one hand and you have the joint and several liability section there. Would you be able to go out into the insurance market to insure yourself? How will you intend to do that if either one or both of those get through? Which insurance companies want to insure you now I guess?

Mr. DOBILAS. I can tell you being a smaller NRSRO that we are down to a very limited choices of insurance companies that will even insure us based upon the recent events of what is happening with the lawsuits against some of the other NRSROs. If that were to pass, we would most likely remove ourselves from the NRSRO playing field.

Mr. GARRETT. How about the big 3?

Mr. MCDANIEL. I cannot imagine being able to obtain a satisfactory level of insurance when, in fact, the insurer is being asked to insure an entire industry over which the individual firms do not have any control over each other in terms of their opinions. And I have to at least ask the question whether this might have the unintended consequence of reducing quality because to the extent that competitors do not have any control over each other and one of them is performing to a lower standard level, there is really not much reason to form of a higher standard level because one is going to be liable for the lowest common denominator.

Mr. GARRETT. So it might be actually a race to the bottom?

Mr. MCDANIEL. That would be a question I think should be considered more carefully in thinking about this, yes.

Mr. GARRETT. Okay. And does anybody have an answer on the volatility aspect as far as the ratings?

Mr. SHARMA. The only thing, Mr. Ranking Member, is that it would treat rating agencies at a different standard than all of the market participants and as a consequence sort of we will have to become more—we will have to look at the ratings at the lower end

of the rating categories because they are generally more volatile. And that will restrict access to capital from companies that are coming into the market or new and emerging companies and technologies.

Mr. GARRETT. I think there is another aspect, but I see my time is up, and I appreciate it.

Mr. DONNELLY. Thank you. I know the ranking member has a few more questions. And first Ms. Speier, if you would like a couple more minutes. Okay. Ranking member.

Mr. BACHUS. Thank you. One thing Mr. Gallagher says in his testimony is that the rating agencies relied on information provided to them by the sponsor of the RMVSs for instance. But let us just broaden that. Any time you rely on the company you are rating for information and you have to do that—I mean, there has to be a certain level of—you have to rely on them for the accuracy. Many times when you relied on them, it turned out that information in hindsight was not correct. Have you—is there less of a reliance—and I would ask the Big 3 rating agencies? Have you made any changes there? Or what were the problems there?

Mr. JOYNT. So it was and is our expectation that issuers and their representative investment bankers in putting together financings would be doing due diligence on any of the information they were presenting in order to put together to finance and market it and sell it.

So we certainly would be relying on that information just like we rely on public financial statements audited by accounting firms when we rate IBM and General Motors and other companies.

So having said that, of course, we are way more cautious now in thinking about that issue. So—and we are not in a position to go do that kind of due diligence ourselves on individual mortgage loans or auto securities and other things. So we have taken the position that if we are uncomfortable with the amount of information and the quality of information we are getting, then we are unwilling to rate.

Mr. BACHUS. Okay. That is a reasonable answer. Mr. Sharma?

Mr. SHARMA. Mr. Ranking Member, similarly as you said very appropriately, that this is a whole market share with different participants and we have to rely on different market participants sort of fulfilling their accountabilities. So we do depend on the issuers and the arrangers to give us good quality data. But we also do adjust our criteria to sort of reflect the data that we are getting in our decision making. And if we are not comfortable, we also do not rate it many times.

Mr. BACHUS. Mr. McDaniel?

Mr. MCDANIEL. Just add to these comments that, again, I think a cure is to make the information that goes to rating agencies available through the prospectus offering process to the investing public. I think subjecting that information to the standard of Federal securities filings would certainly help with the voracity and completeness of that information.

Mr. BACHUS. I would agree with you there. Are you all doing—is that—Mr. Gallagher, can you update us on—

Mr. GALLAGHER. Yes. I think the chairman or some of my colleagues have spoken publicly recently about an initiative underway

at the Commission to pursue further disclosure by issuers of all of the relevant underlying information we are talking about. On September 17th, the Commission took final action on the rule that Mr. Dobilas has mentioned earlier which provides that this information be provided to the other NRSROs, but taking the next step and moving to the public is under consideration.

Mr. DONNELLY. Thank you very much. The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

Before we adjourn, the following written statements will be made part of the record of this hearing: Egan-Jones Ratings Company; Assured Guarantee U.S. Holdings; Mortgage Bankers Association; and Commercial Mortgage Securities Association. Without objection, it is so ordered. The panel is dismissed and this hearing is adjourned.

[Whereupon, at 5:14 p.m., the hearing was adjourned.]

A P P E N D I X

September 30, 2009

**Statement of
Ranking Member Spencer Bachus
Capital Markets Subcommittee Hearing on
"Reforming Credit Rating Agencies"**

Wednesday, September 30, 2009

Thank you Mr. Chairman for convening this afternoon's hearing to review the impact of your discussion draft entitled the "Enhanced Accountability and Transparency in Credit Rating Agencies Act."

The global financial crisis exposed the significant risk posed by inaccurate credit rating agency risk assessments, and effective corrective action must address these shortcomings. There is an obvious need for increased transparency and accountability in the credit rating process. But above all, Congress must reinforce the importance of investor due diligence.

For the second time this decade, the Financial Services Committee is considering legislation to improve the oversight of credit rating agencies. Chairman Kanjorski's discussion draft and the House Republican Regulatory Reform Plan both eliminate references to credit ratings in Federal statutes so that the rating agencies will no longer operate as a government-sanctioned oligopoly. There is general agreement that the government's "Good Housekeeping" seal of approval on the rating agencies and their products contributed significantly to a mispricing of risk and a subsequent collapse in market confidence.

Other provisions in the Chairman's draft—including those establishing a new liability standard governing lawsuits against rating agencies—are potentially problematic and warrant careful study by this Committee before proceeding further. Federal securities laws already allow the rating agencies to be sued in the event of fraud. The establishment of a new liability standard could discourage new entrants into this

marketplace and further entrench the dominant rating agencies. No one believes that the rating agencies capably performed their job, but solving the rating agency problem requires investors to independently assess a product's creditworthiness while not giving rise to a flood of costly litigation.

Mr. Chairman, let me be clear, ratings should be one component of an investor's analysis whether to buy a debt instrument for their portfolio, but they should not be the *only* component. Investors must be incentivized to perform their own due diligence and assessment of risk or suffer the consequences. As we once again attempt to reform the regulation and oversight of rating agencies, addressing the perverse incentives created by the current system and restoring a sense of market discipline to our credit markets should be our highest priority.

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STATEMENT

of

ROBERT G. DOBILAS,

PRESIDENT & CEO,

REALPOINT LLC

at the

HEARING

on

ENHANCED ACCOUNTABILITY AND TRANSPARENCY IN CREDIT RATINGS

before the

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT
SPONSORED ENTERPRISES

of the

FINANCIAL SERVICES COMMITTEE

U.S. HOUSE OF REPRESENTATIVES

September 30, 2009

Washington, DC

Thank you for the opportunity to participate in this hearing. You have previously indicated that the Congress should “no longer pursue only modest modifications in regulating this problematic industry.”¹ As one of the relatively accurate rating agencies, and with a business model very different than the other companies represented at this hearing, we agree with your assessment of the need for major changes in the *status quo*; however, we believe that this change should be accomplished by decisively and immediately addressing past abuses of the system by the larger NRSROs while simultaneously avoiding measures that (i) support their business models and control of the ratings business, (ii) restrict competitors and limit their growth with barriers to entry with impractical levels of liability and increased internal costs, and (iii) delay necessary action and thereby create uncertainty in the capital markets.

By way of background, Realpoint is the most recent company to be designated by the SEC as a Nationally Recognized Statistical Rating Organization (NRSRO). We were designated for asset-backed securities where our specialty is rating commercial mortgage-backed securities (CMBS). Realpoint is one of the five companies designated by the Federal Reserve Board as an eligible rating agency for these types of securities being issued under the Term Asset-Backed Securities Loan Facility (TALF), and, last week, we were added to the list of Approved Rating Organizations by the National Association of Insurance Commissioners.

The credit rating industry suffers from two fundamental problems. First, it is highly concentrated with two companies controlling 80 percent of the market and third company accounting for the next 15 percent. Second, market share has traditionally been maintained

¹ *Hearing on Approaches to Improving Credit Rating Agency Regulations*, 111th Cong. 1st Sess. (May 19, 2009).

by the restricted flow of information from the issuers and arrangers of debt offerings, which I have previously described in testimony before this Subcommittee. Essentially, these companies have been able to garner business without really having to compete on terms of either price or quality. In this situation, investors and the broader public interest are going to suffer as has indeed been the case.

Fortunately, companies like Realpoint have emerged in recent years using the subscriber-based business model where our revenues are primarily derived from investors, portfolio managers, analysts, broker/dealers and other market participants who pay on a quarterly or other recurring basis for our services. In this context, if we do not produce accurate, timely and independent ratings, we would lose our subscribers.

Under the currently dominant issuer-paid model, the record shows that the larger companies maintain market share despite poor ratings performance. Almost ten years ago, for example, the major rating agencies were assessing the debt of Enron, WorldCom, and Global Crossing at investment grade practically to the point at which these companies filed for bankruptcy. Yet, in the ensuing years, the profits of these same rating agencies rose and their market share remained unchanged. More importantly, there is no indication that the well-publicized failures of the major rating companies in asset-backed financing has resulted in any meaningful changes in industry practices or structure.

MARKET PROGRESS IN 2009

The credit crisis is far from over but we believe that the SEC's recent efforts are working, at least with respect to structured finance. New issues are creeping back into the

market. As with the increased levels of confidence that are visible in other areas of the economy, investor confidence in CMBS is starting to return. This momentum needs to be sustained. One way to sustain it is to give investors choices in regard to their selection of rating agencies. It would be a mistake to legislate smaller NRSROs out of existence and force investors to rely on only a few, large NRSROs for ratings. A positive course of action at this time would be to allow the SEC to implement its most recently-announced changes.

Partly due to the SEC's actions, the structured finance market shows positive trends. Exhibit 1 hereto tracks changes in spreads for super-senior AAA CMBS from July 7, 2006 to September 25, 2009. CMBS spreads are currently 500-600 bp over swaps, well below their all-time highs of 900 and 1,100 bp over swaps from November 2008 through April 2009.² Current spread levels would be further reduced by the elimination of uncertainty in the market over whether changes other than those most recently announced by the SEC will be implemented.

Another positive development in the structured finance market, and in the markets generally, is the ability of REITs to de-leverage their assets. In 2009, REITs have been able to both reduce their near-term debt maturities, and raise capital through the equity markets.

² From November 2008 through April 2009, CMBS spreads were at an all-time high, ranging between 900 and 1,100 bp over swaps. In May 2009, when the Fed announced that TALF would be extended to legacy CMBS, spreads tightened to about 600 bp over swaps. Unfortunately, spreads rose, by approximately 230 bp, on the news that Standard & Poor's was changing its ratings methodology and would downgrade 90 percent of super-senior AAA bonds from deals issued in 2007. When S&P softened its stance, some of the effect of its original announcement was mitigated. In June, the introduction of Re-REMICs further tightened spreads. Re-REMICs take AAA bonds with 30 percent subordination and structure them into two classes, one with a 50 percent subordination level. The added credit support drives demand from conservative investors. Since then, Spreads remain volatile in a range of 500-600 bp over swaps.

JOINT LIABILITY

We are very concerned about the proposal to make all NRSROs “jointly liable” for a civil judgment if the agency being sued is unable to satisfy the judgment. This is an unprecedented concept with respect to the inter-relationship of competing companies and it is particularly inappropriate for smaller companies like Realpoint to be guarantors for our multi-billion dollar competitors.

A related proposal essentially would require every agency to review and approve every other NRSRO’s work. To do so, each agency would need to be an expert in every field and every methodology. Not only could we not afford to assume this liability, it would almost certainly result in the elimination of our current E&O policy.

FIRST AMENDMENT

The Discussion Draft seeks to reduce the First Amendment protections traditionally accorded to rating agencies by liberalizing “procedural” thresholds for private-sector litigation. In our view, this focus on First Amendment or “freedom of speech” defenses which have traditionally been accorded by the courts to credit ratings is counterproductive. At Realpoint, we offer and provide our research and best opinions regarding the likelihood of payment of a financial obligation, but we cannot be a financial guarantor on the \$780 billion of CMBS we have rated. Whether or not the larger companies could manage that risk is for them to determine, but, in our view, the removal of the industry’s liability protections is anti-competitive and would further support the existing oligopoly structure.

As the Committee is aware, various courts, State Attorneys General and other parties including the SEC are revisiting these legal concepts and it is clear that some changes are in the works. In a major development, a federal judge in New York has ruled preliminarily that this longstanding defense was inapplicable in a case being brought against a rating agency by the Abu Dhabi Commercial Bank.³ Another relevant case was initiated by one of the nation's preeminent pension funds.⁴

We see no reason that the judicial process should be short-circuited by congressional action particularly in light of the fact that many of the pending cases are in the early stages at the trial courts. Moreover, while securities litigation has worked well for the plaintiffs bar, individual investors receive next to nothing from these cases and there is no conclusive evidence that there has been any significant deterrent effect. In the medical field as well, over half of malpractice expenses go to lawyers and administrative costs according to a 2006 study in the New England Journal of Medicine. Additional resort to the courts for effective remedy resolution is not what we need in the business community.

RATINGS SHOPPING

The Discussion Draft also seeks to redress ratings shopping by having the SEC adopt rules requiring issuers to disclose preliminary credit ratings from NRSROs on structured products as well as other forms of corporate debt. While attractive in concept, it is hard to see how such a requirement would be effectuated in practice since the early flow of

³ *Abu Dhabi Commercial Bank v. Morgan Stanley*, No. CGC-08-7508 (NYSD).

⁴ See, e.g., *California Public Employees' Retirement System v. Moody's Corp.*, No. CGC-09-490241 (Cal. Superior Ct. July 9, 2009).

information between the debt issuer/arranger and the credit rating agency is informal and primarily telephonic. Thus, any form of preliminary “trigger” would be difficult to prescribe and easy to avoid.

The Treasury Department has taken a strong position against “ratings shopping” through its support of legislation requiring that issuers and arrangers of credit provide all NRSROs with the same offering data so ratings can be prepared regardless of whether or not a specific NRSRO is hired on the transaction. On September 17th, the SEC adopted this concept by requiring any issuer or other sponsor of a structured security seeking a credit rating from an NRSRO to disclose the same financial information given to its solicited NRSRO to all other NRSROs designated to offer ratings for that particular type of security.⁵ We deem this to be one of the most important reforms undertaken by the government in response to the credit crisis. The public benefits of having independent and qualified credit ratings, rather than just the two selected and paid by the parties selling the securities, are immediate and manifest.

OTHER ISSUES

We support the provision of the Discussion Draft requiring that each credit rating issued to the public include a disclosure of the fees billed to the obligor for the credit rating. Consideration should also be given to comparable disclosure for the regulated entities such as banks, insurance companies, mutual funds, pension funds and investment advisors insofar as the external ratings they use for federal and/or state regulatory purposes, i.e., whether or not

⁵ SEC Press Release 2009-200 (September 17, 2009).

the ratings being relied upon were independent or paid out of the proceeds of the debt issuance.

The one-year prohibition on performing ratings for any issuer that has hired a former analyst at an NRSRO would significantly raise the costs of acquiring talented individuals since anyone who worked at an NRSRO would in effect be banned from working for an issuer for at least one year. Many individuals begin working at rating agencies for the training and experience provided with a view toward preparing for corporate work. Even people not planning this should be very hesitant to place this type of limitation on their career. Mobility is a keynote in the modern workplace and these types of limitations have the effect of hurting everyone's recruiting capacity vis-à-vis other financial services businesses.

The Discussion Draft would require all NRSROs to "publicly disclose information on initial ratings and subsequent changes to such ratings." These reports are to be made "freely publicly available" on websites and in written form when requested. Without a substantial time lag, this requirement is antithetical to the subscriber-based business model since selling this information is how we produce our revenues. Realpoint and other companies like it are able to produce independent and reliable bond-rating analysis because certain investors are willing to pay for it and these subscribers rightly believe that the information for which they are paying is not made freely available to others. Not only would disclosure requirements of this type undermine competition from the subscriber-paid companies, but some have argued that the mandate to make proprietary information freely available to the public may constitute a form of government taking.

The new requirements for independent directors and a Compliance Officer demarcated from ratings, marketing and other corporate functions may work for large, publicly-traded companies, but would penalize small companies seeking to expand their market presence. At Realpoint, we would certainly have to hire at least one new compliance officer due to these limitations on the person's other responsibilities.

The concept of the Compliance Officer reporting directly to the Board of Directors and having the Board approve analytical models methodologies are impractical for companies like Realpoint which employs approximately 50 individuals and has a board consisting of company officials and our start-up partners.

The Discussion Draft mandates that the SEC require NRSROs to adopt and use credit rating symbols that "distinguish" among structured products, non-structured products, corporate offerings and municipal offerings. Our experience it to the contrary; investors want to know that AAA means AAA, not whether one asset class is a real AAA whereas another asset structure represents a lower version of AAA.

CONCLUSION

As we have attempted to show with these various examples, the Discussion Draft and other well-intended remedial proposals have a common flaw, namely that the resolutions are aimed at two entirely different types of companies, with entirely different business models. Moreover, the market performance of Realpoint has been much more successful than the record of our larger competitors. For these reasons, our company is starting to gain some market traction. However, if the Congress applies a multitude of new rules, regulations and procedural controls on NRSROs which inevitably and disproportionately disadvantage

smaller companies, the result is to punish the innocent and stifle the progress we have made to date.

In our view, the better remedy is to specifically address the two fundamental problems identified at the outset of my testimony: market concentration and ratings shopping. For example, one proposal which was suggested recently by Senator Charles Schumer (D-NY) which would require every 10th credit rating issued by an NRSRO have its second rating generated from a separate independent agency designated by the SEC.⁶ As can be seen, the effect of this proposal would both diversify the market and limit the ability of issuers to steer business to preferred rating agencies.

At a minimum, we would suggest that the Congress follow the example used in the Sarbanes Oxley Act and apply the proposed new rules on internal controls and certifications on NRSROs which are publicly traded companies. Alternatively, the proposed remedies should be directed more precisely at the potential conflict that arises from the major rating agencies being paid exclusively by the issuers of the securities.

Mr. Chairman and Members of the Subcommittee, the SEC has taken an important step in this direction in mandating that the issuers' pre-sale and ongoing information on structured asset offerings be made available to all qualified rating agencies. However, this is only a first step. Competition can be further enhanced across the broader range of public offerings and by having securities, at least in part, rated co-equally by subscriber-based rating agencies.

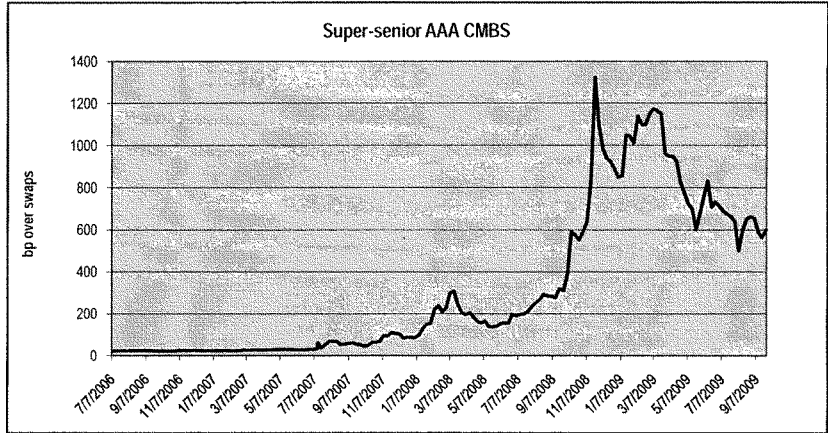
⁶ Press Release: *Schumer Proposes New Backup Rating System to Keep Conflict-Riddled Credit Rating Firms Honest* (August 5, 2009).

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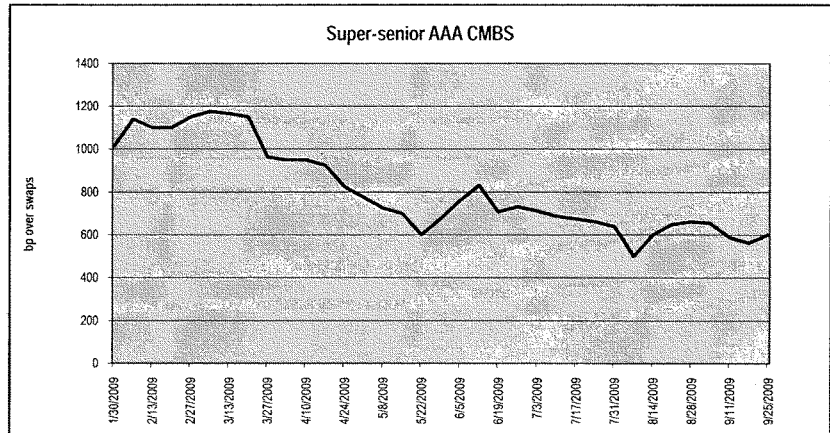
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Thank you for the opportunity to appear at this hearing and I look forward to responding to any questions you may have.

Exhibit 1



Source: Commercial Real Estate Direct



**Testimony: “Reforming Credit Rating Agencies”
by Daniel M. Gallagher**

Co-Acting Director, Division of Trading and Markets
United States Securities and Exchange Commission

**Before the United States House of Representatives
Committee on Financial Services and Subcommittee
on Capital Markets, Insurance and
Government-Sponsored Enterprises**

September 30, 2009

Introduction

Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee:

My name is Dan Gallagher, and I am the Co-Acting Director of the Division of Trading and Markets at the Securities and Exchange Commission (“Commission”). Thank you for the opportunity to testify before you today on behalf of the Commission regarding the oversight of credit rating agencies.

The Commission shares the Subcommittee’s concerns about the role credit rating agencies played in the dislocation of the credit markets. Poor performance by highly rated securities resulted in substantial investor losses and market turmoil which severely damaged the financial markets. As we work to restore the health of the markets, it is vital that we take further steps to improve the integrity and transparency of the ratings process, promote competition among rating agencies, and give investors the appropriate context for evaluating ratings.

To this end, the Commission has been active in its rulemaking and oversight with respect to credit rating agencies registered as nationally recognized statistical rating organizations (“NRSROs”). Congress provided the Commission authority to register and oversee NRSROs in

the Credit Rating Agency Reform Act of 2006 (“Rating Agency Act”). In keeping with this charge, the Commission has adopted a number of rules to date, and earlier this month embarked on new rulemaking designed to (1) promote greater accountability, (2) foster competition, (3) decrease the level of undue reliance on NRSROs, and (4) empower investors to make more informed decisions. The Commission appreciates the opportunity to discuss these new rules and rule proposals, as well as background on the NRSRO oversight program, findings during staff examinations of NRSROs and other actions the agency has taken since Congress enacted the Rating Agency Act.

Initiation of NRSRO Oversight Program

In September 2006, Congress enacted the Rating Agency Act, which mandated that the Commission establish a registration and oversight program for NRSROs. The Rating Agency Act’s over-arching goal, as stated in its legislative history, was to “improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition in the credit rating industry.”

In June 2007, the Commission adopted six rules and an application form (“Form NRSRO”). The rules, which are described in more detail in the attached Appendix, require NRSROs to make public disclosures about, among other things, ratings performance statistics, ratings methodologies, conflicts of interest, and analyst experience. The rules also require recordkeeping and annual reporting, as well as procedures to prevent the misuse of material nonpublic information and to manage conflicts of interest. In addition, the rules include prohibitions against certain conflicts and engaging in unfair, coercive or abusive practices.

In September 2007, the first seven credit rating agencies were registered with the Commission as NRSROs. Subsequently, three additional credit rating agencies have registered.

2008 In-Depth Staff Examination of NRSROs

At the end of 2007, the Commission staff began an examination of the three largest NRSROs that were most active in rating structured finance products linked to aggressively underwritten mortgages. These examinations of Fitch Ratings, Moody's Investor Services, and Standard & Poor's Ratings Services reviewed their policies and practices related to rating subprime residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") linked to subprime RMBSs.

The period reviewed by the examination generally covered January 2004 through July 2008. The firms under examination had become subject to regulation as NRSROs when they registered with the Commission in September 2007. All three NRSROs agreed to undertake remedial actions as a result of the examinations. The staff published a summary of their findings and observations in July 2008.¹

Staff Examination Findings and Recommendations

The staff examinations of the three NRSROs revealed a number of troubling results. In particular, the examinations raised serious questions about the NRSROs' management of conflicts of interest, internal audit processes and due diligence activities.

¹ See <http://www.sec.gov/news/studies/2008/craexamination070808.pdf>.

Management of Conflicts of Interest

Each of the examined NRSROs prepares the majority of its ratings under the “issuer pays” model, in which the arranger or other entity that issues the security also is seeking the rating and pays the NRSRO for the rating. While each NRSRO had policies and procedures restricting analysts from participating in fee discussions with issuers, the policies and procedures at each of the firms still allowed key participants in the ratings process to participate in fee discussions. In fact the examiners found that analysts appeared to be aware, when rating an issuer, of the firm’s business interest in securing the rating of the deal; that there did not appear to be any internal effort to shield analysts from emails and other communications that discussed fees and revenues from the issuers; and that in some instances, analysts were involved in fee discussions for a rating. In addition, the NRSROs did not appear to take steps to prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria. Accordingly, the staff recommended that each NRSRO consider and implement steps that would insulate or prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria.

The examiners also observed that each NRSRO had adopted policies prohibiting employees from owning any security that was subject to a credit rating by a team on which the employee was a member. However, the NRSROs varied in how rigorously they monitored or prevented prohibited transactions, including personal trading by their employees, from occurring. As a result of its findings, the staff recommended that each NRSRO conduct a review of its policies and procedures for managing the securities ownership conflict of interest to determine

whether these policies are reasonably designed to ensure that employees' personal trading is appropriate and complies with the requirements of NRSRO regulations.

Internal Audits

The examiners found that the internal audits of the ratings processes of two NRSROs appeared to be inadequate. At one NRSRO, the internal audits of its RMBS and CDO groups constituted a one-page checklist limited in scope to evaluate the completeness of deal files. That NRSRO provided only four examples where the reviewer forwarded findings to management and no examples of any management response. The examination of another NRSRO's internal audits of its RMBS and CDO groups uncovered numerous shortcomings, including the failure of management to formally review/validate derivative models prior to posting for general use. As a consequence of these findings, the staff recommended that two of the NRSROs review whether their internal audit functions are adequate and whether they provide for proper management follow-up.

Due Diligence Practices

The staff found that the NRSROs did not engage in any due diligence or otherwise seek to verify the accuracy or quality of the loan data underlying the RMBS pools they rated during the review period. The NRSROs each relied on the information provided to them by the sponsor of the RMBS.

NRSROs were not required to verify the information contained in RMBS loan portfolios presented to it for rating. Additionally, NRSROs were not required to insist that the issuer

perform due diligence, nor were they required to obtain reports concerning the level of due diligence performed by issuers. Notwithstanding the lack of regulatory requirement to do so, all the NRSROs implemented, or announced that they would implement, measures designed to improve the integrity and accuracy of the loan data they receive on underlying RMBS pools.

Ongoing NRSRO Examination Program

Since issuing the July 2008 staff examination report, the Commission has been monitoring the examined NRSROs as they continue to address the examination findings. In addition, the Commission is conducting a number of other ongoing NRSRO examinations. To bolster our examination program, the Commission recently allocated resources for a branch of examiners dedicated specifically to NRSRO oversight. Once fully staffed, this branch will focus its expertise on conducting routine, special and cause examinations of the NRSROs to review their activities for compliance with the securities laws and rules.

Commission Rulemaking – Strengthening Oversight of NRSROs

The preliminary staff findings from the examinations of NRSROs informed a round of NRSRO rule amendments, which the Commission adopted in February 2009 and which are described in more detail in the attached Appendix. The Commission also proposed additional measures designed to further address, in part, these issues. Earlier this month, on September 17th, the Commission embarked on further rulemaking designed to (1) promote greater accountability, (2) foster competition, (3) decrease the level of undue reliance on NRSROs, and (4) empower investors to make more informed decisions.

Fostering Competition

Creating a Mechanism to Provide All NRSROs with Access to the Same Information to Rate Structured Finance Products. The Commission adopted amendments to Rule 17g-5 that are designed to create a mechanism for NRSROs not hired to rate structured finance products to nonetheless determine and monitor credit ratings for these instruments. To this end, the new amendments require an NRSRO that is hired by an issuer, sponsor, or underwriter (“arranger”) to determine an initial credit rating for a structured finance product to disclose on a password-protected Internet web site that it is in the process of determining such a credit rating and the location where information provided by the arranger to determine and monitor the credit rating can be located. The hired NRSRO must make this information available to any other NRSRO that provides it with a copy of a certain certification. The hired NRSRO also is required to obtain representations from the arranger that, among other things, the arranger will provide the same information to the non-hired NRSROs. The goal of this rule is to make it possible for non-hired NRSROs to provide unsolicited ratings in the structured finance market just like they are able to do in the corporate debt market where there is access to information needed to determine and monitor credit ratings.

Empowering Investors to Make More Informed Decisions

At the September 17th meeting, the Commission also adopted new rules to strengthen its registration and oversight program for NRSROs by providing investors with more information to make informed decisions.

Disclosing History of Ratings Activity. One rule augments the current requirement for an NRSRO to disclose ratings history information for a random sample of 10 percent of its outstanding issuer-paid credit ratings. Under the new requirement, an NRSRO must disclose, on a delayed basis, ratings history information in a downloadable format for *all* credit ratings initially determined on or after June 26, 2007, regardless of whether they were paid for by the issuer. This new disclosure requirement is designed to foster greater transparency of ratings quality and accountability among NRSROs, by making it easier for persons to analyze the actual performance of credit ratings. In addition, the ratings history information will generate “raw data” that market observers can use to statistically analyze performance across NRSROs.

Providing More Information on Conflicts of Interest. The Commission also proposed amendments to the instructions for Exhibit 6 to Form NRSRO to require a credit rating agency applying for NRSRO status to publicly disclose: (1) the percentage of the net revenue attributable to the 20 largest users of credit rating services of the NRSRO; and (2) the percentage of the net revenue of the NRSRO attributable to other services and products of the NRSRO.

Providing Additional Information about the Magnitude of Conflicts. The Commission proposed the creation of a new rule – Rule 17g-7 – that would require an NRSRO to make publicly available on its Internet website a consolidated report that shows three pieces of information with respect to each person that paid the NRSRO to issue or maintain a credit rating. Specifically, the NRSRO would be required to indicate in the report for each such person (1) the percent of the net revenue attributable to the person earned by the NRSRO for providing services and products other than credit rating services; (2) the relative standing of the person (top 10

percent, top 25 percent, top 50 percent, bottom 50 percent, or bottom 25 percent) in terms of the amount of net revenue earned by the NRSRO attributable to that person; and (3) identify all outstanding credit ratings paid for by the person.

The second and third proposals are designed to provide investors with additional information on the source and magnitude of revenues an NRSRO receives from its clients. Creating greater transparency about the revenues generated could provide increased information to assist investors and other users of credit ratings in assessing the potential risks to the NRSRO's objectivity. In particular, an NRSRO's disclosure of information about revenues received from major clients and revenues attributable to ancillary services would allow users of credit ratings to have more information about the dimensions of the conflict arising from NRSROs being paid to determine credit ratings as well as the conflict of offering other services to persons who pay for credit ratings. The former would also provide investors and other users of credit ratings more specific information about the extent to which NRSRO revenues are from a concentrated group of clients.

Highlighting Rating Shopping and Other Key Information. The Commission proposed amendments to its rules regarding how credit ratings are disclosed by issuers in connection with registered offerings. First, the Commission proposed amendments that would require that if a registrant, selling security holder, underwriter or other member of a selling group uses a credit rating in connection with a registered offering, certain detailed disclosures regarding the credit rating must be made in the registration statement for the offering. The proposed amendments

would require disclosure of general information about the credit rating, including all material scope limitations of the credit rating and any related published designation, such as non-credit payment risks, assigned by the rating organization with respect to the security. In addition, in order to highlight potential conflicts of interest, the proposed rule would require disclosure identifying the party who is paying for the credit rating. If any additional non-rating services have been provided by the credit rating agency to the registrant over a specified period of time, disclosure of the services and the aggregate fees paid for those services would be required. The Commission also proposed requiring the disclosure of preliminary ratings, as well as final ratings not used by a registrant, so that investors will be informed when a registrant may have engaged in ratings shopping.

In addition, the Commission proposed amendments to forms under the Securities Exchange Act of 1934 to provide investors with updated information regarding credit ratings by requiring disclosure of changes to previously disclosed credit ratings. Under the proposed amendments, a change to a credit rating, including when a rating has been withdrawn or is no longer being updated, would be required to be disclosed within four business days pursuant to a new item in Form 8-K.

Decreasing Level of Undue Reliance on NRSROs

Removing References to NRSRO Credit Ratings in Rules and Forms. The Commission also eliminated references to NRSRO credit ratings in certain of its rules and forms. Specifically, the Commission adopted amendments that removed references in Rules 5b-3 and 10f-3 under the Investment Company Act and Regulation ATS and related forms under the

Securities Exchange Act. The Commission believes that the references to credit ratings in these rules and forms are no longer warranted as serving their intended purposes. The amendments are designed to address concerns that references to NRSRO ratings in Commission rules may have contributed to an undue reliance on those ratings by market participants. The Commission also reopened the comment period on amendments that would eliminate references to NRSROs in other rules and forms under the Exchange Act, the Investment Company Act, the Investment Advisers Act, and the Securities Act. The Commission is seeking additional comment to determine, among other things, whether the use of NRSRO ratings in these additional rules and forms poses any danger of undue reliance on NRSRO ratings by investors and the viability of alternative external or objective measures of credit risk that could be substituted for ratings by an NRSRO.

Promoting Greater Accountability

Expert Liability. The Commission also issued a concept release seeking comment on whether the Commission should propose rescinding Rule 436(g) of the Securities Act of 1933. Currently, Rule 436(g) exempts NRSROs from “expert” liability under Section 11 of the Securities Act. Rescinding Rule 436(g), coupled with a proposal to require disclosure of credit ratings in a registration statement if a rating is used in connection with a registered offering, would cause NRSROs to be included in the liability scheme for experts set forth in Section 11. If the Commission rescinded Rule 436(g), an issuer that includes a credit rating issued by an NRSRO in a registration statement would be required to file the consent of the rating agency

with its registration statement, and the rating agency would be subject to potential Securities Act liability.

Reporting on Compliance Reviews. The Commission also proposed amending Rule 17g-3 to require an NRSRO to furnish the Commission with an additional annual report containing a description of the steps taken by the firm's designated compliance officer during the most recently ended fiscal year to: (1) administer the policies and procedures that are required to be established pursuant the Exchange Act (e.g., the policies to manage conflicts of interest); and (2) ensure compliance with securities laws and regulations. Specifically, the proposed amendments would require the compliance officer to report: (1) a description of any compliance reviews of operations of the NRSRO; (2) the number of material compliance matters found during the reviews of the operations of the NRSRO and a brief description of each such finding; (3) a description of any remediation measures implemented to address material compliance matters found during the reviews; and (4) a description of the persons within the NRSRO who were advised of the results of the reviews. The goal of this proposal is to strengthen the compliance function at the NRSROs and to alert the Commission to issues that may need to be followed-up through an examination.

International Initiatives

The Commission staff also has undertaken a number of international credit rating agency initiatives in an effort to promote greater international cooperation in this area. I currently chair Standing Committee 6 of the Technical Committee of the International Organization of Securities Commissions ("IOSCO"). This committee, comprised of supervisors from

jurisdictions in Europe, Asia and the Americas, has two primary responsibilities: (1) to consider regulatory and policy initiatives concerning credit rating agencies in order to promote greater cross-border regulatory alignment; and (2) to facilitate dialogue between securities regulators and the credit rating industry. The Commission is also actively providing technical advice to our foreign counterparts, including assisting the Committee of European Securities Regulators ("CESR") with its mandate by the EU Commission regarding regulation of credit rating agencies.

Conclusion

In conclusion, I want to emphasize that the Commission is committed to administering a comprehensive and effective oversight program for NRSROs. I believe this commitment is reflected in the multiple rulemakings and examinations undertaken by the Commission since being granted authority in September 2006. We appreciate Congress' interest in this issue and the Commission is happy to provide any assistance the Subcommittee might need in its consideration of measures to reform the financial markets. I would be happy to answer any questions you might have. Thank you.

Prior Commission Rulemaking for NRSROs

The first round of post-Rating Agency Act rulemaking established the Commission's rating agency oversight program. Specifically, in June 2007 the Commission adopted six rules (Rules 17g-1, 17g-2, 17g-3, 17g-4, 17g-5 and 17g-6) and an application and ongoing disclosure form ("Form NRSRO").

Rule 17g-1, among other things, requires an NRSRO to disclose information about the: (1) firm's ratings performance statistics (e.g., default and transition statistics); (2) firm's methodologies for determining credit ratings; (3) firm's policies for preventing the misuse of material non-public information; (4) firm's organizational structure; (5) firm's code of ethics; (6) conflicts of interest inherent in the firm's activities; (7) firm's policies for managing conflicts of interest; (8) general qualifications of the firm's credit analysts; and (9) identification and qualifications of the firm's designated compliance officer.

Rule 17g-2, among other things, requires an NRSRO to make and retain certain financial records; document the identities of the credit analysts who determine a rating action and persons who approve the rating action; document the identities of issuers that have paid for ratings and the ratings determined for them; and document all ratings methodologies. NRSROs also are required to retain records such as compliance and internal audit reports, marketing materials, and communications (e.g., emails) relating to determining ratings actions.

Rule 17g-3, among other things, requires an NRSRO, on a confidential basis, to furnish the SEC with annual reports that include: (1) audited financial statements; (2) an unaudited report of revenues received from the different types of rating services offered by the NRSRO; (3) an unaudited report of the aggregate and median compensation of the NRSRO's credit analysts; and (4) an unaudited report of the 20 largest clients of the NRSRO as determined by revenues received.

Rule 17g-4, among other things, requires an NRSRO to establish, maintain and enforce procedures reasonably designed to prevent the inappropriate dissemination of material, non-public information received during the rating process; the trading of securities while in possession of material, non-public information; and the selective disclosure of a pending ratings decision.

Rule 17g-5, among other things, requires an NRSRO to disclose and manage each conflict of interest resulting from its business activities, including from the issuer-pay and the subscriber-pay models. It also prohibits an NRSRO from having the following conflicts: (1) receiving more than 10% of its annual revenues from a single client; (2) having an analyst rate or approve the rating for a security the analyst owns; (3) rating an affiliate; and (4) having an analyst rate or approve the rating for a security of a company where the analyst is a director or officer of the company.

Rule 17g-6, among other things, prohibits an NRSRO from engaging in certain practices that are unfair, coercive or abusive. Such practices include: (1) conditioning a rating on the rated

person buying another service of the NRSRO; (2) deviating or threatening to deviate from established methodologies for determining credit ratings because an issuer did not agree to pay for the rating; (3) modifying or threatening to modify a rating because the issuer does not agree to continue to pay for the rating; and (4) employing a methodology for rating structured finance products that discounts or “notches,” for anticompetitive purposes, the ratings of other NRSROs for assets underlying the structured finance product.

In response to the role played by NRSROs in the credit market turmoil and informed by the Commission staff’s first round of NRSRO examinations, the Commission adopted a second round of rules in February 2009. Most of the new requirements specifically target the rating process for structured finance products. The new rules require the following, among other things:

- **Enhanced performance statistics.** The Commission amended Form NRSRO to require an NRSRO to provide greater specificity – to achieve better comparability – as to how performance statistics are generated. In particular, NRSROs are now required to provide default and transition statistics over 1, 3, and 10 year time periods (as opposed to the previously prescribed generic “short, medium, and long” time frames). Further, an NRSRO is required to generate these performance statistics for each class of credit ratings for which the NRSRO is registered.
- **Enhanced disclosure of ratings methodologies.** The Commission amended Form NRSRO to require more detailed disclosures concerning the procedures and methodologies an NRSRO uses to determine credit ratings. Specifically, the NRSRO must disclose (as applicable):
 - whether and, if so, how, information about verification performed on assets underlying or referenced by a structured finance product is relied on in determining the rating;
 - whether and, if so, how, assessments as to the quality of originators of assets underlying or referenced by a structured finance product factor into the determination of credit ratings; and
 - with respect to rating surveillance, how frequently credit ratings are reviewed, whether different models are used for surveillance, and whether changes to initial rating or surveillance models are applied retroactively to existing ratings.
- **Record of model deviation.** The Commission amended Rule 17g-2 to add a new recordkeeping requirement relating to the use of models in rating structured finance products. Specifically, if a quantitative model was a substantial component in the process of determining a credit rating for a structured finance product, the NRSRO is required to make a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued.
- **Record of ratings history.** The Commission amended Rule 17g-2 to add a new

recordkeeping requirement to allow examiners to track the history of all current ratings. Specifically, for each outstanding credit rating, an NRSRO is required to make a record showing all rating actions and the date of such actions from the initial credit rating to the current credit rating identified by the name of the rated security or obligor and, if applicable, the CUSIP of the rated security or the Central Index Key (“CIK”) number of the rated obligor. In addition, NRSROs with 500 or more issuer-paid credit ratings in a credit rating class must publicly disclose on a six-month delayed basis the ratings histories for a random sample of 10% of the current credit ratings in that class.

- **Written complaints.** The Commission amended Rule 17g-2 to add a new recordkeeping requirement to allow examiners to review how an NRSRO handles complaints about credit analysts from, for example, issuers or underwriters of structured products. Specifically, an NRSRO is required to retain any written communications received from persons not associated with the NRSRO (e.g., individuals that are not employees) that contain complaints about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating.
- **Rating actions report.** The Commission amended Rule 17g-3 to add a new financial report that must be furnished to the SEC annually. The report is designed to alert the SEC about the number of rating actions (upgrades, downgrades, placements on watch or withdrawals) taken by an NRSRO during the fiscal year in each class of credit rating for which the NRSRO is registered.
- **Prohibited conflict – recommendations.** The Commission amended Rule 17g-5 to add a new conflict prohibition to prohibit an NRSRO from making recommendations to issuers and others about how to obtain desired ratings. Specifically, the rule prohibits an NRSRO from issuing or maintaining a credit rating where the NRSRO or an affiliate made recommendations to an issuer, obligor or arranger about how to structure the rated entity or security.
- **Prohibited conflict – fee discussions.** The Commission amended Rule 17g-5 to add a new conflict prohibition to prevent credit analysts and the persons who establish ratings methodologies from participating in fee discussions with issuers and others who pay for ratings. Specifically, the rule prohibits an NRSRO from issuing or maintaining a credit rating where the fee paid to the NRSRO to determine or maintain the credit rating was negotiated, discussed or arranged by a person within the NRSRO with responsibility for determining or approving the credit rating or for developing or approving procedures or methodologies used for determining credit ratings.
- **Prohibited conflict – gifts.** The Commission amended Rule 17g-5 to add a new conflict prohibition designed to prevent credit analysts from being influenced by gifts from issuers and others who pay for ratings. Specifically, the rule prohibits an NRSRO from determining or maintaining a credit rating where a credit analyst who determined the rating or approved the rating received a gift from the person paying for the rating.

Testimony Concerning:
“Transforming Credit Rating Agencies”

James H. Gellert
Chairman and CEO
Rapid Ratings International, Inc.

Before the
United States House of Representatives

Committee on Financial Services and
Subcommittee on Capital Markets, Insurance, and Government
Sponsored Enterprises

September 30, 2009

On behalf of my colleagues at Rapid Ratings International, Inc. ("Rapid Ratings"), I would like to thank Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee for inviting me to provide testimony on the critical subject of Transforming Credit Rating Agencies.

Rapid Ratings has been making submissions on these important matters since October 2003 and most recently at the Senate Banking Committee Hearings¹ in August of this year and in April at the SEC roundtable.²

As the only company on this panel that is not a Nationally Recognized Statistical Rating Organization ("NRSRO"), we appreciate your invitation all the more as we, and companies like us, have what we believe is a critical voice in these debates. As with the new, subscriber-paid NRSROs, we are small compared to the Big Three agencies, but we represent the future of competition in the ratings business. As such, we signify the potential for meaningful change to the status quo if we are not inadvertently hindered by the unintended consequences of legislation and regulation along the way. Getting it right now is critical. The consequences will be with us for years.

Rapid Ratings is a subscriber-paid firm. We utilize a proprietary, software-based system to rate the financial health of thousands of public and private companies and financial institutions quarterly. We use only financial statements, no market inputs, no analysts, and have no contact in the rating process with issuers, bankers or advisors. Our ratings far outperform the traditional issuer-paid rating agencies in innumerable cases and also typically outperform the prevalent market-based default probability models.

We have not applied for the NRSRO status and have no immediate plans to do so. As I have testified to the SEC and to the Senate in the recent months, there are still too many deterrents for me to recommend to our shareholders that the designation enhances value as

¹ *Testimony concerning proposals to enhance the regulation of credit rating agencies*, James H. Gellert, Chairman and CEO, Rapid Ratings International, Inc., before the Committee on Banking, Housing and Urban Affairs, United States Senate, August 5, 2009

² SEC Roundtable to Examine Oversight of Credit Rating Agencies Washington D.C., April 15, 2009

Competition in the Credit Rating Industry: Are we asking the right questions and getting the right answers? James H. Gellert, President and CEO and Dr. Patrick James Caragata, Founder and Executive Vice Chairman, Rapid Ratings International Inc.

opposed to putting it at risk. Being an NRSRO in the current environment (and particularly under the Subcommittee's Discussion Draft if enacted as written) means exposing my company to far more uncertainty and risk than the designation offers in reward. As you consider the value of competition in the NRSRO world, you can use Rapid Ratings as a live case – it currently looks too fraught with risk for us to become an NRSRO.

That said we believe that reform in our industry is necessary and time is of the essence for restoring credibility. However, we caution that some initiatives may have significant, and counter-productive, unintended consequences.

In short, we do not believe it is advisable to create more legislation for legislation's sake. The most recent legislation in this industry was the Credit Rating Agency Reform Act of 2006. Although we did not necessarily agree with all elements of the Act, the sentiment was appropriate – promote competition as a central tenet to transforming this industry. Some say the Act has not had enough time to mature and others that it wasn't sufficient. In either case, the subprime crises occurred and the issuer-paid rating agencies played a central role.

Nevertheless, the SEC's recent initiatives have made significant progress in adding reform and oversight to the prior legislation. The Commission is working towards curbing the more egregious conflicts of interest by issuer-paid agencies such as ratings shopping, reducing investor reliance on the NRSROs by removing references in some regulations, and providing for equivalent disclosure of structured product data. These qualitative improvements all set a better stage for competition than we've had in years.

The Commission has also been receptive to input from industry players. When recently faced with criticism about proposed rules mandating NRSROs to publicly disclose ratings actions, the SEC split issuer-paid and subscriber-paid firms' rules regarding a time embargo on ratings actions disclosure to 1 year and 2 years, respectively. This showed, dare I say, admirable flexibility in not applying a "one-size-fits-all" model to new rules. We encourage the Subcommittee to be guided by this flexibility and to acknowledge that nuance is required now, not blanket new legislation. Why is this important? Because subscriber-based rating agencies did not help create the sub-prime crisis and we represent the best hope for more competition and greater ratings accuracy in the market.

This Subcommittee's Discussion Draft joins a crowded field of rating agency reform initiatives currently underway. New rules voted on by the SEC on September 17 and new rules out for comment, the Treasury Department's rule recommendations announced on July 21st and Senator Read's Rating and Accountability Act announced on May 19th are some of the highlights. The competition of ideas is valuable but there is a risk of throwing into the mix random or unproven proposals whose consequences will deter competition, undermine business models and fail to resolve the accuracy, timeliness and conflict of interest problems.

There are some common themes: address conflicts of interest of the issuer-paid agencies through greater disclosure, increase oversight of all NRSROs, increase liability, increase access to information used in ratings by other firms, and decrease references to NRSROs in regulations.

For sure, there are positive developments in the collection of initiatives. But even the positive developments do not yet go far enough, and the negative ones forge entirely new, disturbing paths. We have two initial concerns.

First, nobody seems inclined to end the conflicted issuer-paid model itself. Absent this, the market's best bet for rating agency market transformation is to have regulators and law makers embrace the need, and value, of competition. Competition is key to evolving and reforming this industry. But, competition for competition's sake is not the answer. Competition that effects change through innovation, greater ratings accuracy, more timely and objective warnings, and the establishment of viable alternatives to the status quo will enhance the credibility of, and public confidence in, the ratings process. The subscriber-based rating agencies are the best hope for achieving these goals. Legislators need to ensure that the unintended consequences of current proposals (discussed below) do not undermine those goals.

Second, for new players to want the NRSRO designation, NRSRO status must have value and not carry massive compliance costs and legal liability. Conversely, new players will want the designation if they see a business advantage that outweighs the costs. The straightforward equation means that we as non-NRSROs must be enticed by value and by seeing the designation as a business asset, not as a series of contingent liabilities.

In order to achieve this, the legislation must prioritize and foster the following goals:

- Accuracy in ratings
- Innovation in business models and in ratings methodology
- Competition by encouraging not discouraging new players
- Equivalent disclosure and transparency of information so new firms can rate products on unsolicited bases
- Recognition that many initiatives on the table explicitly or tacitly support the status quo oligopoly.

Sadly, the trend towards greater and more complex legislation and regulation will repel not attract competition and hence preserve the status quo dominance of the ratings oligopoly -- the very problem you are hopefully trying to resolve. In particular, the emphasis on liability is being overdone. Should negligence and malfeasance be rooted out through heightened regulatory oversight and consequences? Yes. Should a one-size-fits-all legal framework be enacted to punish all players jointly irrespective of whether they've sinned in the past? No.

Liability

Joint Liability: The Joint Liability language in the Discussion Draft is the greatest disincentive to NRSRO status of any proposal that has preceded it. It is simply a non-starter for a potential NRSRO applicant. Why would one want to become an NRSRO joining a group dominated by three players with an iceberg of lawsuits looming on their horizon? That would be like swimming *towards* the Titanic.

First Amendment: We understand the Big Three's use of the First Amendment as a first level of protection against suits. Their thinking is that the frivolous suits are best caught in this net and it saves them the trouble and expense of having to fight everyone on an individual basis. Given strong litigious tendencies in the US, there is merit for all ratings firms to have this level of protection. The risk is that ratings opinion will be stifled and capital markets liquidity will pay the price.

Ultimately, we believe that NRSROs should be held accountable for compliance with their internal procedures, as monitored by the SEC, and with SEC regulations for disclosure, compliance, etc. We do believe strongly that ratings are opinions and not recommendations and

should not be construed as investment advice. We are conscious of an irony as well. Subscription-paid ratings firms enter into subscription contracts with subscribers. These agreements state clearly that ratings are opinions and not recommendations and our users indemnify us in this regard. This protection of both the firm and the subscriber can be achieved because we have the commercial relationship directly with the user of the ratings. With issuer-paid agencies and with subscriber-paid firms, as public disclosure of ratings actions is indeed mandated (the SEC's new rule requiring disclosure of ratings actions, albeit with a 2-year embargo for subscriber-paid firms), anyone (understanding the distinction between opinion and investment advice or not) can have access to these ratings and use them properly or not. The public disclosure of ratings ironically creates more chance for misunderstanding of the nature of ratings and their misuse as opinions and increases the potential liability for the rating agency. Worse still, under the new plan investors will receive free historical ratings and yet, under the proposed liability provision, be entitled to sue any or all rating agencies if they incur losses. This is completely counterproductive.

Equivalent Disclosure

Although comments on this topic were not specifically solicited, it is a critical one to positive evolution in this industry and warrants discussion. The Discussion Draft addresses this issue to some extent, but the recent SEC rules enacted this month are likely the most significant development in improving the ratings business. The equivalent disclosure of data used in formulating a ratings decision among NRSROs is a boon to competition. The SEC has also put out a concept release soliciting comment about whether the disclosure program can be expanded to include existing issues (as opposed to just new issues).

If a prospective NRSRO sees the ability to expand into a new asset class of ratings (e.g. CDOs, CLOs³), there is a material benefit to the designation. Moreover, expanding this disclosure to outstanding issues, and potentially even allowing the institutional investor community access to the data, would be truly significant. Likely no greater initiative could be taken to kick start a liquidity revival in structured products.

³ For an insightful commentary on this issue please see comments recently submitted to the SEC by Glenn Reynolds, CEO of CreditSights. <http://www.sec.gov/comments/s7-04-09/s70409-64.pdf>

Mandatory Registration

We understand that a prior version of the Discussion Draft contained a provision for mandatory registration of ratings firms as NRSROs. We commend the Subcommittee on its removal and hope that indeed it will not return post discussion. In fact, combined with the Joint Liability provision, it would pair to be the most destructive force against competition and would only serve to solidify the Big Three firms' market position.

Forcing NRSRO registration on all companies issuing ratings will force compliance costs on new CRAs, thus erecting further barriers, potentially force small CRAs out of business and deter potential new capital sources entering this industry, all thereby undermining the growth of innovative and more accurate ratings technology. The potentially vast number of firms captured by this sweeping net would not only confuse users of ratings, but also potentially hundreds of new agencies would be designated that would not have qualified as NRSROs under the Credit Rating Agency Reform Act of 2006. All of these would fuel the use of the largest brand names, and solidify regulatory protection of S&P, Moody's and Fitch.

Mandatory registration was a central element to the Treasury proposal as part of the Investor Protection Act of 2009. We found it to be the most short-sighted proposal that has emerged from any front in this current wave of legislative initiatives. It is also counter to one of the significant elements (though not one without its critics) of the Credit Rating Agency Reform Act (CRARA) of 2006, the requirement that new applicants be in business for three years prior to applying as an NRSRO.

There are a number of significant problems with this initiative:

- Currently, rating firms have the option to apply for NRSRO status or not. As with Rapid Ratings, some choose not to apply for any one of a number of reasons. *Requiring registration, while the hard and soft costs and risks of being an NRSRO are currently unquantifiable as the landscape is changing, is a major hurdle to newer players and is likely a complete disincentive to the de novo firm, as qualified and competent as they may be.* Add to this the Joint Liability provision in the Discussion Draft and then the potential costs to a new player are astronomical.

- If the current Treasury proposal language is enacted and interpreted literally, it could be forcing the disclosure of proprietary intellectual property.

Rapid Ratings utilizes a proprietary intellectual property that we do not disclose. We give valuable insights into the methodology but we do not provide certain elements of our process to the public. We recognize that some potential subscribers could choose not to do business with us for this reason, but we have not encountered one yet. If we are required to disclose that methodology into the public domain, we will lose a significant competitive advantage and our ability to continue in business will be seriously threatened. Nevertheless, this disclosure is a business decision to protect an asset of the company and is not something we or others like us should have to disclose by fiat. The protection of property rights is an essential component of any strategy for introducing effective competition.

For new players considering entering the ratings business, in concept a good development if they bring something additive to the industry, this IP disclosure might be a prohibitive hurdle. Detering new players is, of course, another way of protecting the current ones.

If joining the ranks of the NRSROs is something a company like Rapid Ratings may elect to do, as under the CRARA of 2006, a high "cost" of being an NRSRO is something we can calculate and decide on based on a risk-reward scenario, once the legislative dust has settled. If we are required to register AND forced to disclose our intellectual property AND had Joint Liability, that is a very serious problem.

Mandatory registration, we understand, was contemplated for the CRARA of 2006 and ultimately dropped. Where would one draw the line on defining rating agencies? Certainly the definition could be interpreted as incorporating every independent research business, Sell-Side research division, select institutional investors, brokers, etc. One purpose of the various qualifications required in the CRARA of 2006 was to ensure that NRSROs were "nationally recognized," or had at least a modicum of credentials for the job. With mandatory registration, the market could be flooded with NRSROs, devaluing the designation by definition. Further, institutional investors will not have the patience to sort through the products and ratings of

potentially hundreds of new players. The certain outcome of this would be institutional investors' flocking to the names they know best already: S&P, Moody's and Fitch.

Another result of this initiative is that only new players with massive balance sheets will be interested in entering the ratings business. Innovation typically comes from smaller players. If the Treasury's proposed scenario is realized, the small players will avoid entering and the market will lose something it desperately needs – innovation. And with innovation comes increased accuracy. Inadvertently, mandatory registration will further solidify the S&P, Moody's and Fitch oligopoly.

Removal of Ratings References in Regulations

In general, we are very supportive of removing references in regulations because they protect the status quo dominance of the ratings oligopoly. Certainly, some of the regulations need to be looked at more carefully to assess the implications of such a move. But, in concept, the most effective way to reduce over-reliance on ratings in regulations is to start by sending a clear message that they will come out over a period of time. We believe the recent SEC moves in this regard, and the relevant elements of the Discussion Draft, are both positive signs of this intent.

Ratings Symbology

The Discussion Draft mandates the SEC to require NRSROs to "distinguish" among structures, corporate, municipal bonds, etc. We believe this is a counterproductive initiative. The problem is not that investors did not know they were buying structured products (in theory corrected by having a new ratings symbol that alerts them); they either knew and were happy to get the higher yield on a highly rated product and/or did not understand the risk of what they were buying (often because products were too complicated) but were allowed to buy the security BECAUSE it was rated. The problem, in the current regulatory effort, is about the "accuracy" of the ratings, not their symbology. No institutional investor bought a structured bond thinking it was a plain vanilla instrument. What the market needs is to have risks of securities rated on a common basis, to provide an adequate apples-to-apples perspective on investment risks. We do not need yet

another confusing ratings scale or it will be arbitrated by players (agencies or otherwise) who wish to obscure the relativity of instruments.

Conflicts of Interest

Central to the issuer-paid rating agencies' argument for defending their conflicted business model is that the subscriber-paid rating agency business model is also conflicted, suggesting that a modified version of the status quo is the only real alternative. Business as usual and ratings rules inertia are their target goals, and they are succeeding. S&P, Moody's and Fitch, are paid by companies (vanilla bonds, commercial paper, etc) and conduit vehicles (structured products) to provide ratings on securities. The communication, consulting, collaboration and ratings shopping that have long underpinned this relationship between issuer and agency is inarguably a conflict of interest. This does not mean that every rating is tainted or designed in some way to mislead the public. As demonstrated last year by an SEC investigation and in the House Oversight Committee hearings, this conflict is too often a practical hindrance to truthful and objective execution of their obvious fiduciary duty. The infamous S&P email correspondence that said that a security "could be structured by cows and we would rate it" to maintain market share and the CEO of Moody's statement that sometimes they "drank the Kool-Aid" of issuers and bankers representing them, are evidence enough of this claim.

S&P, Moody's and other defenders of the conflicted issuer-paid model have continually proffered the argument that the primary alternative, subscriber-paid agencies are also conflicted. The argument is that one of these firms will be unduly influenced by a phantom, substantial investor client that has investment positions the agency will wish to support and release ratings that grind the subscriber's ax, lest the agency risk losing that subscriber's business. In comments to the SEC Roundtable to Examine Oversight of Credit Rating Agencies in April, of which Rapid Ratings was an invited participant, S&P and Moody's heads commented, respectively, "every business model has positive and negative aspects" and "conflicts are inherent and must be properly managed for any model." Regarding the new Treasury initiatives, Michael Barr, Assistant Treasury Secretary for financial institutions, was reported on July 22nd as justifying the decision not to heed calls for a fundamental overhaul because "there were

conflicts inherent in alternative models too.” Assuming the report is accurate, the scales of justice in this case are not balanced if this is the logical foundation for new legislation.

People interested in rating agency reform need to see very clearly into the irony of this situation – the issuer-paid agencies are drawing an analogy between their daily business model and the potential for a subscriber-paid agency to falsify a rating to benefit a paying customer, an act of fraud and fiduciary malfeasance. There is no evidence or claim we know of that any subscriber-paid agency has ever actually overridden their ratings to benefit a subscriber. In Rapid Ratings’ case it would be impossible because all of our ratings are generated by computer algorithms based on empirical and published financial statements (not assumptions and projections) and no analyst opinions are involved. Could other subscriber-paid rating agencies be conflicted? There is a remote chance, but it is highly unlikely; even the mere suspicion that this occurred would be the agency’s death knell. The issuer-paid agencies have little substance with which to defend their own model (which, importantly, they switched to from the subscription model in the 1970s because, amongst other reasons, it is more profitable) and, therefore, are attempting to rely on the shaky argument that their competition is also conflicted. So it is clear that their strategy is that the best defense is an offense. If government wishes to perpetuate the issuer-paid business model, so be it. But, let’s not miss the irony of the issuer-paid agencies’ shifting public attention away from their committed sins to the uncommitted sins of very small competitors paid by investors who are seeking protection from fiduciary irresponsibility. Let’s have no illusions about why we are here. There are problems that need to be resolved and they did not arise from subscriber-based rating agencies.

Conclusion

Rapid Ratings is one competitor in the ratings business. We have brought innovation to the space and automation that makes us the most scalable player in the industry. Our ratings accuracy typically surpasses the Big Three and often leads credit default swaps and share price movements of companies. Soon we will be rating more industrial companies than any of the Big Three, and we do all of this without getting paid by issuers,

For us to compete against the current agencies, as an NRSRO, we need to see that the designation has value that outweighs the risks. We believe over-legislating the industry will

increase the risks rather than improve the principal goals we see necessary to increasing competition.

Recalling the principal goals:

1. Accuracy in ratings
2. Innovation in business models and in ratings methodology
3. Competition by encouraging not discouraging new players
4. Equivalent disclosure and transparency of information so new firms can rate products on unsolicited bases
5. Recognition that many initiatives on the table explicitly or tacitly support the status quo oligopoly.

Introducing joint liability will smother competition and undermine goals (1), (2) and (3) while supporting the status quo dominance of the ratings oligopoly. Mandatory registration would do the same. Removal of ratings references in regulations will support goals (1), (2), (3) and weaken the ratings oligopoly. Goal (4), equivalent disclosure and transparency on structured products for new and existing deals, supports (1), (2) and (3). Introducing new ratings symbology for structured products will create confusion and strengthen the status quo. Proposed changes to conflict of interest rules will have only a modest effect because these conflicts are driven by the issuer-paid business model itself which is protected under current and proposed regulations.

Legislation and regulations must be flexible and not require a one-size fits all straight-jacket, recalling that subscriber-based rating agencies are the future solution of the current problems while issuer-paid rating agencies were the cause.

Thank you for inviting me to present these thoughts.

FitchRatings

**Prepared Statement of Stephen W. Joynt
President and Chief Executive Officer
Fitch, Inc.
before a hearing of the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
on
“Reforming Credit Rating Agencies”
September 30, 2009**

Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee, I am pleased to appear before you on behalf of Fitch Ratings.

Congress and the Administration continue to examine a range of important and challenging issues and proposals related to the comprehensive reform of our financial regulatory system. Credit rating agencies are a part of this larger system, but an important part, and I appreciate the opportunity to share my perspectives with you.

Today’s hearing marks the third time this year that I have appeared before Congressional panels on the topic of regulation of credit rating agencies. I have attached my written statement from August to the end of my statement. However, I would like to highlight briefly a few important points in light of selected recent events.

I believe that in the last several years Fitch generated – and we continue to produce – a significant amount of balanced and insightful fundamental credit analysis across many asset classes and capital markets. Having said that, I have also previously acknowledged that too many of our rating opinions – particularly in some of the most impacted structured finance asset classes – did not perform as expected, with too many downgrades of too many notches. I am aware that this negative result is the key factor in our discussions here today. Improving our performance drives many of the changes we continue to make at Fitch.

All credit rating agencies are not the same. When it comes to the issues of credit culture and intent, I would like Fitch to be judged on its own merits. Over the last several years, media coverage of the credit rating agencies, and related regulatory inquiries, tend to characterize the industry as being “dominated by the big three” agencies. Many market participants and commentators then extend the point by asserting or implying that there is no difference among the “big three.” In the SEC’s 2008 report on the rating agencies – the source document for certain negative emails often quoted in the media – none of the negative emails referenced were from Fitch. That same report also concluded that our internal audit processes were robust and that our staffing levels were appropriate and kept pace with the growth in our business.

Recent allegations that pertain to another NRSRO are specific to that NRSRO, and it is neither possible nor appropriate for me to comment on the specifics of that situation.

Please do not extrapolate those specific claims to Fitch's practices. At the early stages of the credit crisis in November 2007, Fitch decided that we needed to conduct a wholesale review of our CDO methodology. As a result, we imposed a moratorium on rating new CDOs while we conducted this review. We subsequently adopted revamped and more conservative criteria for corporate CDOs on April 30, 2008. Since that time we have assigned ratings to only three corporate CDO transactions. Fitch was also early in highlighting the increasing credit risk of the financial guarantors, lowering AAA ratings, which resulted in direct and public attacks against us from certain monolines, followed by requests to withdraw the ratings and the termination of commercial relationships. Fitch credit decisions can result in revenue changes. Fitch culture and credit practices consistently emphasize the importance of the timeliness, transparency, and integrity of our ratings and credit opinions over any revenue implications.

Turning to recent regulatory developments, in the U.S. the SEC has introduced some final rules and proposed a series of new ones. The E.U. recently enacted rules that will result in over 40 separate reforms. Similar efforts are under way in the other major regulated markets as well. Fitch has already made significant progress in adopting new or revised policies and procedures to comply with the spirit and letter of the new rules.

While much progress has been made, we are disappointed that one key area has yet to be addressed: enhanced public disclosure in structured finance securities. Fitch has repeatedly suggested that the information made available to the rating agencies as part of the rating process for securitization be made available to all investors, and that the responsibility for disclosing that should rest with the issuers. To date the SEC continues to focus narrowly on sharing the

information only among NRSROs. I believe that presents untenable conflicts for “investor paid” NRSROs who by their nature will selectively disseminate to their subscribers.

The Committee recently released a draft bill – the “Enhanced Accountability and Transparency in Rating Agencies Act.” Fitch shares the general objectives of greater reliability, transparency and accountability for credit rating agencies. A number of the provisions in the bill appear reasonable and consistent. While we will provide comments that are more detailed to the Members and staff in the coming days, I would like to highlight several key issues.

With a goal of reducing the market’s reliance on ratings through their references in federal regulations, the proposed bill removes all such references. Fitch has previously noted that ratings have been used effectively in regulations in many places as independent benchmarks – a position that has been supported by many market participants -- and we continue to suggest an in depth case-by-case review of any removal to determine whether such a course of action is appropriate. The question of what would replace ratings also remains unanswered – or at least without a thorough understanding of the specific pros and cons, and unintended consequences.

A bill that mandates the removal of any references to NRSRO in all federal statutes, while significantly enhancing the federal regulatory requirements and burden on NRSROs, is seemingly contradictory. What rational rating agency would continue to be a part of the NRSRO system if there is no compelling reason to do so, yet be willing to incur the significant costs and enhanced liability associated with it? In terms of competition and new entrants, what firm not currently recognized as an NRSRO would ever apply for the designation?

We have previously commented on the concept of mandatory registration for credit rating agencies. As I noted in my testimony before the Senate Banking Committee in August, Fitch, along with the other recognized NRSROs, is already registered and subject to explicit SEC regulatory oversight. We believe the mandatory registration concept is unnecessary and unwarranted and is not consistent with basic free speech principles.

While we are happy to provide the Committee with a more detailed legal analysis, in summary we believe that a mandatory registration provision would make it illegal for rating agencies to publish opinions about the creditworthiness of issuers or securities, which are matters of public concern, without first registering with the government. Such a registration requirement as applied to rating agencies would restrict rating agencies from engaging in their publishing activities and would constitute an impermissible prior restraint upon the exercise of free speech.¹

Fitch has previously stated that while it supports the concept of enhanced accountability for what we do, we continue to disagree with the notion that greater liability is the right way to achieve that. A rating is a forward-looking opinion of creditworthiness – not a backward-looking verification of financial statements as conducted by accountants. We continue to believe that

¹ See *Lowe v. SEC*, 472 U.S. 181, 211-236 (U.S. 1985) (J. White concurring) (the Investment Advisers Act may not constitutionally be applied to prevent the publisher of an investment newsletter whose registration under the Act was revoked from publishing); *Taucher v. Born*, 53 F. Supp.2d 464 (D.D.C. 1999) (a publisher of books, newsletters, websites, containing analysis and advice on commodities could not be required to register under the Commodity Exchange Act citing *Lowe*); See also Written Statement of Eugene Volokh, Gary T. Schwartz Professor of Law, University of California, Los Angeles, School of Law before Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Committee on Financial Services at *Approaches to Improving Credit Rating Agency Regulation*, May 19, 2009 at pages 9-10 available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/volokh.pdf.

there is a misperception regarding rating agencies and liability. Rating agencies are already liable under current securities law just as other entities are – accountants, lawyers, corporate officers, etc. – to the extent that an agency intentionally or recklessly makes a material misstatement or omission in connection with the purchase or sale of a security. Creating an additional and separate liability standard solely for NRSROs as envisioned by the bill is unprecedented and unnecessary.

The bill also introduces the concept of collective liability for rating agencies. This provision would require us to share the information we create and use in developing a rating opinion with all other NRSROs. Much of the information is our own (reflecting our own proprietary intellectual property) or from third-party information vendors with whom we have contracted and do not have redistribution agreements. We cannot turn that over to every other agency. The idea that we should be responsible for verifying other NRSROs' information and be liable for the actions of another rating agency even if we did not rate the bond is very problematic.

My previous testimony has addressed the topic of managing conflicts of interest associated with the issuer-pays model, and I refer you to those statements.

Finally, the bill also contains a number of provisions that, while we think we understand the intent behind them, appear to be redundant, contradictory or overly formulaic. For example, the bill requires distinct symbology for structured finance, yet also mandates that we use the same ratings and approaches for all asset classes.

In closing, Fitch has undertaken a wide variety of initiatives to enhance the reliability and transparency of our ratings and research, and to manage better any conflicts of interest. I believe we continue to produce a significant amount of good and balanced fundamental credit analysis that is appreciated by market participants. That said, I recognize there is always more that we can do, and we are willing to continue to work with you to identify and implement reasonable and balanced steps to enhance the market's confidence in credit ratings and rating agencies.

Appendix:

Prepared Statement of Stephen W. Joynt before a hearing of the Committee on Banking, Housing, and Urban Affairs, United States Senate on August 5, 2009

[Statement attached.]

FitchRatings

**Statement of Stephen W. Joynt
President and Chief Executive Officer
Fitch Ratings
before a hearing of the
United States Senate
Committee on Banking, Housing, and Urban Affairs
on**

Examining Proposals to Enhance the Regulation of Credit Rating Agencies

August 5, 2009

While overall macro-economic conditions remain difficult, it seems the period of the most intense market stress has passed. This is due to both a variety of government initiatives here and abroad aimed at restoring financial market stability as well actions taken by companies individually to shore up their balance sheets and reduce risk. Having said that, important sectors in the fixed income markets remain effectively closed and certain sectors, such as commercial mortgage-backed securities, are experiencing greater performance strain on their underlying assets.

During this time, the focus of Fitch Ratings has been on implementing a broad and deep range of initiatives that enhance the reliability and transparency of our rating opinions and related analytics. More specifically, our primary focus is on vigorously reviewing our analytical approaches and changing ratings to reflect the current risk profile of securities we rate. In many cases, that continues to generate a significant number of downgrades in structured securities, but

also affects other sectors, such as banks and insurance. We are releasing our updated ratings and research transparently and publicly and we are communicating directly with the market the latest information and analysis we have.

In parallel, we have been introducing a range of new policies and procedures – and updating existing ones – to reflect the evolving regulatory frameworks within which credit rating agencies operate globally.

In each of these areas, we have been as transparent as possible and broadly engaged with a wide range of market participants, including policy makers and regulators. We are happy to expand upon any of these topics.

That said, the primary focus of today’s hearing is to examine proposals to enhance the regulation of credit rating agencies, or “where do we go from here.” Clearly, credit rating agencies continue to be a topic of interest in the market and in the regulatory communities. Senator Reed has introduced a bill this year – the “Rating Accountability and Transparency Enhancement Act of 2009.” The House Financial Services Committee held a hearing in May 2009 on topics similar to today’s hearing. The SEC has issued new rules and considered many important questions in its roundtable discussion in April. Most recently the Treasury sent legislation to Congress that reflected the Administration’s perspectives on credit rating agency reform. Outside of the U.S., the EU recently enacted a registration and oversight system and related rules for credit rating agencies. Other nations are considering similar measures.

As this Committee considers these topics, we would like to offer our perspective on several important issues. The bodies referenced above have touched on many of these themes in their proposals and discussions. Let me reiterate that Fitch is committed to engaging on all of these matters in a thoughtful, balanced, constructive and non-self serving manner. At the same time, some perceptions and proposals continue to circulate that warrant further consideration, clarification, or in some cases “reality checking.”

Managing Conflicts of Interest. The majority of Fitch’s revenues are fees paid by issuers for assigning and maintaining ratings. This is supplemented by fees paid by a variety of market participants for research subscriptions. The primary benefit of this model is that it enables Fitch to be in a position to offer analytical coverage on every asset class in every capital market – and to make our rating opinions freely available to the market in real-time, thus enabling the market to freely and fully assess the quality of our work. Fitch has long acknowledged the potential conflicts of being an issuer-paid rating agency. Fitch believes that the potential conflicts of interest in the “issuer pays” model have been, and continue to be, effectively managed through a broad range of policies, procedures and organizational structures aimed at reinforcing the objectivity, integrity and independence of its credit ratings, combined with enhanced and ongoing regulatory oversight. In recent months, Fitch has introduced new policies, and revised many existing ones, focused on these issues. A few examples of our relevant policies and procedures are below:

- Business development is separated from credit analysis, to keep each group focused on its core task.
- Employees involved in the assignment of the resulting ratings do not handle fees discussions for an issuer or transaction.
- No analyst or group of analysts is directly compensated on the revenues related to their ratings.
- Rating analysts are prohibited from advising issuers and underwriters on structuring transactions and focus solely on developing and communicating our opinion on the credit fundamentals associated with a given structure.
- Ratings are determined using a committee structure, not by a single analyst. These committees include a mandatory independent member.
- Cross-group committees and an independent internal review function review all ratings criteria.
- Fitch has introduced the new role of group credit officer in each of its rating groups.
- Fitch has established and enforces a Code of Conduct (consistent with IOSCO's and updated in February 2009) and ancillary policies to specifically address potential conflicts.
- Fitch has relocated all of its non-rating operations into a separate division, Fitch Solutions, which operates behind a firewall.

No payment model would be completely immune to conflicts of interest, whether from investors, issuers, governments or regulators. An "investor pays" model also contains direct conflicts,

given that most major investors have a vested financial interest in the level of ratings and many are rated entities. A move to a complete “investor pays” model, by definition making the ratings a subscription product, could also remove ratings from the public domain. This would conflict with investor and policymakers’ call for ratings to be broadly available, thereby allowing the market to openly judge ratings performance.

Disclosure of Ratings Methodologies. The definitions for all of Fitch’s ratings and rating scales are regularly reviewed and updated, publicly disclosed and freely available on our website. The most recent update to our ratings definitions is set forth in a March 2009 report entitled “Definitions of Ratings and Other Scales.” In addition, the criteria that details Fitch’s analytical approach to rating issues and issuers in every region and asset class are also regularly reviewed and updated, and freely available on our website on a centralized “criteria homepage.” In select cases where Fitch is considering what it believes to be a material shift in our thinking regarding our analytical approach to a given sector, we normally release our thinking to the market as an “exposure draft.” In such a case, we solicit feedback from market participants and engage in transparent discussions about our approach – such as one-on-one meetings, webcasts and conference calls – and we have done so repeatedly in the last few years. In addition, the processes we follow internally in developing and approving such methodology updates are also fully codified, consistent with SEC and IOSCO rules, and freely available. Finally, we develop and publish an enormous number of rating commentaries (over 15,000 in 2008) and research reports that summarize our opinions on issues, issuers and market sectors as part of our efforts to ensure the market is aware of our perspective. Those in the market that allege that our ratings are a “black box” must not be fully aware of the information we make available, or they do not

fully appreciate the concept that the rating itself is not a simplistic mathematical output, but rather a committee decision based on a range of quantitative and qualitative factors. For every rating action we take, we publish the corresponding rationale and make that freely available to the market. We do not believe that everyone will agree with all of our opinions, but we are committed to ensuring the market has the opportunity to discuss them.

Issuer Disclosure and Due Diligence in Structured Finance. Some market participants, in reviewing the performance of ratings in structured finance markets, have noted that limits on the amount of information that is disclosed to the market by issuers and underwriters has made the market over-reliant on rating agencies for analysis and evaluation of structured securities. The argument follows that the market would benefit if additional information on structured securities (such as asset specific data on residential and commercial mortgage backed securities) were made broadly and readily available to investors, thereby enabling them to have access to the same information that mandated rating agencies have in developing and maintaining our rating opinions. Fitch fully supports the concept of greater disclosure of such information. A related benefit of additional issuer disclosure is that it addresses the issue of ratings shopping. Greater disclosure would enable non-mandated NRSROs to issue ratings on structured securities if they so choose, thus providing the market with greater variety of opinion and an important check on any perceived “ratings inflation.” We also believe that responsibility for disclosing such information should rest fully with the issuers and the underwriters, *not* with rating agencies. Quite simply, it is their information on their transactions, so they should disclose it.

Furthermore, Fitch notes that the disclosure of additional information is of questionable value if the accuracy and reliability of the information is suspect. That goes to the issue of due diligence. While rating agencies have taken a number of steps to increase our assessments of the quality of the information we are provided in assigning our ratings, including adopting policies that state that we will not rate issues if we deem the quality of the information to be insufficient, due diligence is a specific and defined legal concept. Due diligence is not currently, nor should be, the responsibility of credit rating agencies. Consistent with existing securities laws, the burden of due diligence belongs on issuers and underwriters. In that regard, we support the concept that issuers and underwriters ought to be required to conduct rigorous due diligence on the underlying assets that comprise asset backed and mortgage backed securities offered or sold in the U.S. Fitch believes Congress should consider amending the securities law to require such due diligence on underlying assets for all ABS and MBS securities offered or sold in the US, whether or not the securities are registered under Section 5 or sold pursuant to an exemption from such registration. Congress ought not to hold rating agencies responsible for such due diligence or for requiring that others do it. Rather, Congress should mandate that the SEC enact rules to require issuers and underwriters to perform such due diligence – make public the findings – and enforce the rules they enact.

Regulation and Transparency. Stated simply and clearly, Fitch supports fair and balanced oversight and registration of credit rating agencies and believes the market will benefit from globally consistent rules for credit rating agencies that foster transparency, disclosure of ratings and methodologies and management of conflicts of interest.

The dialogue on changes to rating agency regulation continues to follow two primary – and not necessarily consistent – themes. The first is the imposition of additional rules and regulations that are manifested in a range of new or enhanced policies and procedures. This has been the primary thrust of recent SEC rulemaking and of the recently passed EU rules. Fitch is or will be fully compliant with these new rules.

At the same time, a number of commentators have spoken on the topic of the market's perceived over-reliance on credit ratings. To a certain extent, we agree with this premise, in so far as some market participants clearly used ratings as a substitute for – as opposed to a complement to – their own fundamental credit analysis. One proposed remedy for this is to eliminate the use of ratings in regulation or to eliminate the NRSRO concept altogether. While deceptively simple, we believe this proposal warrants several comments. Ratings have been used constructively in many places in regulation, as they are an important common benchmark. From a regulatory point of view, the question of what would be used in place of credit ratings is rarely answered satisfactorily. Simply having regulators “do it themselves” has a range of practical implications and unintended consequences. As does the notion of allowing regulated financial entities to assess the credit risk of the securities completely on their own without reference to any independent external risk benchmarks. In many cases, if you eliminate the use of “NRSRO” ratings in regulation, company and industry participants will likely develop or maintain their own guidelines and use credit ratings anyway. We believe they will default to the largest “brand name” rating agencies (Moody's and S&P), which is not a positive if one of your objectives is increasing competition and thereby fostering a better work product. Note that the SEC proposed a variation on this theme in 2008 with respect to money market funds and their use of ratings but

chose not to move forward, in part based on significant feedback supporting the use of ratings in money market regulations from the fund industry itself. Some have suggested replacing ratings with market prices for debt – either bond spreads or CDS spreads. While these may reflect the market’s sense of price at a given point, recall from the events of the last two years that not all securities are liquid, that bid-ask spreads can widen materially in times of stress and that market prices by definition are inherently more volatile than a fundamentally driven credit rating. However, if one is serious about eliminating ratings in regulation, we suggest you transition to elimination over an intermediate time frame with careful consideration of each regulation, rather than wholesale elimination. A better solution is continued recognition and oversight of NRSROs with the goal of improving the performance and usefulness of ratings.

Speaking of competition and regulation, the SEC also has approved a wide range of new NRSROs. Some are established with global reach, resources and coverage, while others are focused geographically or by sector, have modest resources, and/or coverage and ratings history that are more limited. Given the divergent profiles, it is quite a challenge to consider the issues we are discussing today. For example, we do not believe the definitions and meanings of ratings are all the same among NRSROs, let alone the levels of the ratings themselves. We also believe it is significant that a verifiable record of performance is not publicly available from all NRSROs and that not all ratings are publicly available in real-time. Specifically, the market benefits from the differences of opinion as expressed by the different ratings assigned by credit rating agencies. Usually, the initial rating assigned by Fitch will be proven reliable. The same is of course true of any other agency. However, if some NRSROs need not disclose all of their ratings, that dynamic merely allows them to “cherry-pick” the selected ratings where they believe they were “first” or

“better” without the obligation to provide the information that enables the market to fully compare and contrast the opinions and performance of the NRSROs based on *all* of their ratings. If a goal is improvement of the reliability of credit ratings through increased competition and transparency, we believe all oversight requirements should be applied consistently and equally to all NRSROs.

A final point on regulation: The Treasury’s proposal includes the concept of mandatory registration for credit rating agencies. Fitch, along with the other recognized NRSROs, is already registered and subject to explicit SEC regulatory oversight. We believe the mandatory registration concept is unnecessary and unwarranted and is not consistent with basic free speech principals.¹

Accountability and Liability. While we understand and agree with the notion that we should be accountable for what we do, we disagree with the idea that the imposition of greater liability will achieve that. Some of the discussion on liability is based on misperceptions, and those points are noted below. More fundamentally, we struggle with the notion of what it is that we should be held liable for. Specifically, a credit rating is an opinion about future events – the likelihood that an issue or issuer will meet its credit obligations as they come due. Imposing a specific liability standard for failing to accurately predict the future in every case strikes us as an unwise approach.

¹ See Written Statement of Eugene Volokh, Gary T. Schwartz Professor of Law, University of California, Los Angeles, School of Law before Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Committee on Financial Services at *Approaches to Improving Credit Rating Agency Regulation*, May 19, 2009 at pages 9-10 available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/volokh.pdf (“Professor Volokh Statement”).

The first misconception is that rating agencies are free from liability and hide behind the First Amendment to shield them from legitimate securities law liability. Rating agencies may be held liable for securities fraud just as any person or entity may be (including accountants, lawyers, officers, directors and securities analysts) to the extent that a rating agency intentionally or recklessly makes a material misstatement or omission in connection with the purchase or sale of a security. Of course, a plaintiff must prove securities fraud against a rating agency just as against any other defendant. The reality of U.S. securities law is that any plaintiff may make a claim against a rating agency under the antifraud provisions of the securities law, just as they can against accountants, lawyers, officers, directors and securities analysts, but they must prove their claims to the standard required under the securities law.

Some also have criticized rating agencies for what they perceive as taking undue advantage of the First Amendment and its protection of free speech. We believe this is an overblown argument that fails to acknowledge key facts about the nature of ratings. We publish all of our ratings, accompanied by detailed published commentary about the companies and securities we rate. Fitch's ratings are available free to anyone who has access to the Internet. The companies and securities we rate are of significant interest to investors of all types and other parties interested in the securities and the capital markets. Hundreds of investors, fiduciaries, government entities and other interested parties subscribe to our published commentary and thousands access our website daily. We believe Fitch enjoys the same free-speech rights as any other person or entity to comment on matters of public interest and to "make informed, thoughtful predictions about the future. That is no different from what newspapers or scholars

do."² We further believe that the manner in which we are paid and the nature of the securities we rate do not affect the essence of what we do or the free-speech rights we enjoy in connection with our work.³

A second misconception centers on where the responsibility for full and complete disclosure about companies and securities, and appropriate due diligence to ensure the accuracy and adequacy thereof, should be placed. As discussed above, these obligations are today, and have been since the enactment of the earliest U.S. securities law, the sole responsibility of issuers, their officers and directors and underwriters. The obligation to enforce these responsibilities falls squarely on the shoulders of the Securities and Exchange Commission and the courts.

Some have proposed that rating agencies should be liable not merely for material misstatement, but for the investigation of rated securities and the verification of information. In one proposed bill, rating agencies would be liable for knowingly or recklessly failing to conduct such investigation or verification, which will cause rating agencies to be judged by whether, in hindsight, they could have reasonably done more. Because a plaintiff could base a claim on "you had to have known more could be done," the effect is negligence based private rights of action. Even a requirement to plead with particularity might not be at all protective in this context. In hindsight, it will always look like a rating agency could have reasonably foreseen future problems with different assumptions and stress testing.

² Nathan Koppel, "Credit Raters Plead the First; Will It Fly?" *The Wall Street Journal*, April 21, 2009, C1 (quoting Professor Eugene Volokh).

³ See Professor Volokh Statement at pages 2-3.

While we believe some proposals are ill advised, Fitch has been and will continue to be constructively engaged with policy makers and regulators as they consider important ideas and questions about the oversight of credit rating agencies. Fitch has taken a number of important analytical and procedural steps already and we acknowledge there is more to do. We remain committed to enhancing the reliability and transparency of our ratings, and welcome all worthwhile ideas that aim to help us achieve that.

**Testimony of Raymond W. McDaniel
Chairman and Chief Executive Officer
Moody's Corporation**

**before the
United States House of Representatives
Subcommittee on Capital Markets, Insurance and
Government-Sponsored Enterprises**

September 30, 2009

I. INTRODUCTION

Good afternoon, Chairman Kanjorski, Congressman Garrett and Members of the Subcommittee. I am Ray McDaniel, Chairman and Chief Executive Officer of Moody's Corporation ("MCO"), the parent of Moody's Investors Service. On behalf of Moody's, I would like to thank the Subcommittee for inviting me to contribute our views to the legislative discussions under way in Congress regarding the credit rating agency ("CRA") industry. Moody's supports examination of our industry that encourages best practices and the integrity of the products and services we provide.

The current economic downturn has exposed vulnerabilities in the infrastructure of the financial system. Important lessons for CRAs and other market participants have emerged from the rapid and dramatic changes. In response, we have undertaken a number of initiatives to enhance the quality, independence and transparency of our ratings.¹ These enhancements build on Moody's existing practices and processes through which we continually seek to ensure the integrity and credibility of our ratings. We also have been working to adapt, as needed, our policies, systems and organization to implement rules adopted by the Securities and Exchange Commission ("SEC") for nationally recognized statistical rating organizations ("NRSROs").

We welcome reform efforts that are likely to reinforce high quality ratings and improve market transparency without intruding on the independence of rating opinion content. We believe that some of the reform proposals – such as increasing transparency in the ratings process or reducing the use of credit ratings in regulation – likely will have a positive impact. We remain concerned, however, that other proposed measures, while well-intentioned, do not address the more fundamental vulnerabilities in credit markets and ultimately could, if implemented, reduce transparency and the availability of diverse, independent opinions. We also believe policymakers should review the weaknesses that exist in the structured finance market – in particular, the need for greater transparency and disclosure by issuers to the investing public of information about transaction structures and asset pools.

Moody's is committed to maintaining a productive dialogue with this Subcommittee, the entire Congress, the SEC and other regulators and market participants about the necessary steps to restore confidence in our industry and the U.S. financial system.

II. MOODY'S EFFORTS TO ADVANCE THE QUALITY, TRANSPARENCY AND INDEPENDENCE OF CREDIT RATINGS

The various contributors to the recent market crisis are by now well-chronicled, starting with the performance of U.S. sub-prime home mortgages and then of mortgage-backed and related securities originated primarily in 2006 and early 2007. Moreover, it is now clear that significant, latent vulnerabilities had been developing in the infrastructure of the global financial markets, and that once exposed, these weaknesses could, and

¹ See our update to *Strengthening Analytical Quality and Transparency*, which we began publishing in August 2008 and continue to update. It is available on moodys.com.

would, have severe and reverberating consequences.²

Moody's has addressed in previous legislative and regulatory hearings the steps we took prior to and during the financial crisis to watch, warn and react.³ Like other market participants, however, we did not fully anticipate the magnitude and speed of the deterioration in mortgage quality or the suddenness of the transition to restrictive lending. We were far from alone in that regard, but we believe that we should be the leading edge for predictive opinions about future credit risks, and we have learned important lessons from that experience.

Efforts to Restore Confidence

The past two years have reminded all market participants how rapidly and dramatically markets can change. Throughout this period, Moody's has – in an effort to enhance accountability – reached out to market participants and policymakers globally for feedback regarding the utility of our ratings and ratings system. Based on the feedback we have received and our own deliberations, Moody's has adopted a wide range of measures to enhance the quality, independence and transparency of our credit ratings, including the following:

- 1) **Strengthening the analytical quality of our ratings:** including creating permanent, internal methodology review and model verification and validation processes; continuing the separation of personnel involved in initial rating assignments and surveillance; reinforcing the independence of the Credit Policy function; implementing methodological modifications; enhancing our existing professional training program; and formalizing model error discovery procedures.
- 2) **Enhancing consistency across rating groups:** including incorporating common macro-economic scenarios in rating committees; broadening cross-disciplinary rating committee participation; and improving surveillance coordination across rating groups.
- 3) **Reinforcing measures to avoid conflicts of interest:** including codifying the existing prohibition against analysts providing recommendations or advice on structuring securities; prohibiting fee discussions by ratings managers as well as analysts (who were already subject to such a prohibition); changing rating committee composition to enhance independence and objectivity; conducting "look-back" reviews when analysts leave to join organizations with potential conflicts; revising our Securities Trading Policy; retaining and reviewing complaints about analysts made by third parties; reinforcing independence and objectivity through analyst compensation policies; and adopting a stricter prohibition on Moody's analysts receiving gifts (to supplement our existing Moody's Corporation policy on this matter).

² Some of these weaknesses include exceptional leverage and business models that relied on secondary markets for liquidity of complex instruments in periods of stress; the interaction of asset valuation and capital; insufficient risk management practices; interlinked market participants; and limited transparency.

³ For example, see, April 15, 2009 Statement of Raymond W. McDaniel before the United States Securities and Exchange Commission, which is available on moodys.com.

- 4) **Improving the transparency of ratings and the ratings process:** including enhancing disclosures on incremental changes to methodologies; publishing detailed summaries of our methodologies for rating U.S. RMBS and CDOs; enhancing the review of loan originators in U.S. RMBS transactions and asking issuers for stronger representations and warranties relating to those transactions; providing additional information on structured finance ratings (V Scores, Parameter Sensitivity analysis, loss expectation and cash flow analysis, and key statistics and assumptions); enhancing disclosures regarding attributes and limitations of credit ratings in each rating announcement; pursuing efforts to discourage rating shopping; beginning to publish key statistics and default assumptions for all new structured finance ratings and for surveillance rating actions in major asset classes (including information relating to underlying pool losses); and creating a structured finance “Quick Check” Report which seeks to inform the market of our latest opinions, summaries of rating activities, methodology changes and ratings transition summaries and other key information.
- 5) **Increasing resources in key areas:** including strengthening the global leadership of the rating surveillance function; increasing the number of rating surveillance analysts; increasing the Credit Policy group’s staff; conducting a comprehensive review of our staffing model; and continuing to build out our Compliance function.

While we believe that we have made good progress with respect to augmenting the analytical framework and credibility of our ratings, we are committed to continuing to strive to enhance our policies and procedures even further.

III. PRELIMINARY COMMENTS ON DISCUSSION DRAFT OF HOUSE BILL “ACCOUNTABILITY AND TRANSPARENCY IN RATING AGENCIES ACT”

Moody’s supports reform proposals that can help restore the credibility of CRAs and help return confidence to structured finance markets. Policymakers, market participants, commentators and the CRAs themselves have offered a number of reform proposals that we believe could be constructive, if properly crafted and implemented.

In that regard, we are pleased to provide our preliminary views on the recently circulated discussion draft – “Accountability and Transparency in Rating Agencies Act” (the “**Discussion Draft**”). We will provide more detailed comments as we are able to more thoroughly analyze the Discussion Draft. We believe that it introduces a number of proposed changes in law and regulatory oversight of NRSROs that could further the objectives of accountability and transparency among CRAs. At the same time, however, we believe it also includes some areas that have the potential, if adopted in their current form, to undermine the very attributes of credit ratings that market participants and authorities value. While our remarks are preliminary, we hope that they will serve as a meaningful contribution to the discussion in Congress about the future regulation of the credit rating industry.

1. **Enhanced Transparency**

Moody's supports the efforts in the Discussion Draft to increase the transparency of our ratings performance and ratings methodologies and believes that such disclosures can benefit the credit markets. In our view, ratings quality can improve when market participants are able to compare the performance of ratings. As outlined above, in response to the credit crisis, we have increased the transparency of our methodologies and their risk characteristics. We support legislative efforts to continue such initiatives by requiring increased disclosures in the industry relating to information such as the assumptions used in ratings, the potential limitations of ratings, the information reviewed in the rating process and the potential volatility of the rating.

Further, we believe it may be appropriate to disclose some data, such as fees received from each rated entity, to regulatory entities. Disclosure of this data more broadly, however, may both undermine efforts to maintain analyst objectivity (Moody's currently prohibits analysts and managers from engaging in discussions regarding fees with issuers) and could also inadvertently raise antitrust issues.

2. **Increased Regulatory Oversight**

Moody's generally supports provisions in the Discussion Draft that would enhance oversight of all NRSROs. For example, Moody's supports language in the Discussion Draft that would establish an office within the SEC to oversee the credit rating industry. We believe that creating a dedicated office staffed by individuals with expertise in our industry will increase the focus of regulatory oversight and ensure that the interests of all market participants are well protected.

Moody's also supports language clarifying the ability of the SEC to apply fines or sanctions to NRSROs that fail to meet regulatory requirements - which we believe helps to promote accountability for CRAs.

We also welcome language requiring all NRSROs to establish governance procedures to appropriately manage conflicts of interest. While our Company already has such a policy in place, this requirement will help restore confidence in our industry by ensuring that all NRSROs are subject to enhanced regulatory oversight.

3. **Removal of statutory references to credit ratings from regulation**

Moody's has long been concerned about the regulatory use of ratings.⁴ In light of the rapid and dramatic market changes in the last two years, we have reevaluated and reinforced our belief on the use of such ratings. Specifically, we believe that the use of ratings as a regulatory tool for oversight of regulated entities can adversely affect the behavior of market participants, encourage both over-reliance on ratings and rating shopping and reduce incentives to compete based on the quality of ratings. We therefore

⁴ See, for example, Moody's Investors Service September 5, 2008 Comment Letter to the SEC re: References to Ratings of Nationally Recognized Statistical Rating Organizations - Files S7-17-08, S7-18-08 and S7-19-08; Moody's Investors Service July 28, 2003 Comment Letter to the SEC re: File No. S7-12-03, Concept Release: Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws; Moody's Investors Service March 2000 Response to the Consultative Paper Issued By the Basel Committee on Bank Supervision - "A New Capital Adequacy Framework"; June 1995 Speech by Moody's Former Executive Vice President Before a Forum of International Regulatory Authorities Entitled "Ratings in Regulation - A Petition to the Gorillas".

strongly support the goal of the Discussion Draft to remove references to credit ratings in regulation. We also recognize, however, that in light of current market conditions, eliminating or reducing NRSRO ratings-based criteria should be pursued judiciously as financial markets continue to show signs of weakness. We are happy to work with Congress in developing a plan for the judicious and efficient removal of ratings.

4. Governance

Moody's supports the concept of oversight by an independent board of directors. Eight of the nine directors on Moody's Board are independent directors, as defined by the NYSE. We also support having the board provide oversight with respect to procedures and policies. From a governance point of view, we believe it can be healthy for boards to have such input and that our board members have the appropriate skill set to succeed at this type of oversight. We believe that a separate committee of independent directors within the board may be the best way to accomplish this goal. Audit Committees may serve as a good model for forming a committee charged with the oversight of rating policies and procedures.

Moody's does not believe, however, that it is appropriate for the Board to provide oversight with respect to the content of our methodologies. We are concerned with the prospect of replacing the judgment of a large body of full-time experts in credit analysis with, at best, a small body of part-time experts in credit analysis. We question how taking this mandate away from our Credit Policy Group and giving it to our Board would strengthen the quality of our ratings.

5. Liability

Moody's is opposed to provisions in the Discussion Draft that would impose a collective liability regime on all NRSROs.

As a general matter, Moody's would caution against the unintended consequences of introducing measures that could increase CRAs' exposure to litigation and liability. To begin with, there is simply no truth to the popular notion that CRAs are somehow "immune" from liability. No less than any other market participants, CRAs have potential liability, for example, if they knowingly make false statements, engage in fraudulent conduct, or issue opinions that they do not genuinely hold. Moody's and other NRSROs are in fact being sued as we speak in numerous cases in federal and state courts around the country. So, under the existing law, there is already substantial accountability.

Courts agree, however, that, given the specter of unlimited liability, and the public interest in having independent rating opinions, CRAs should not be subject to potential liability simply because some disagree with an assigned rating, or because of honest errors of judgment. Furthermore, measures that would attempt to create new standards of liability could have a negative impact on markets. It is a CRA's task to make unbiased and often unpopular observations, and it is in the nature of the business that our opinions about the future (which are not statements of fact) are often not welcomed – not by the issuers, underwriters, or current holders of the issuer's securities. At any time, therefore, some market participants are likely to be unhappy with, and eager to contest, what they perceive as the "rightness" of a particular rating.

Thus, any change in the legal regime that exposes CRAs to greater liability is likely to result in a significant increase in threatened and actual litigation, much of it driven by mere disagreement with rating opinions. (Historically, litigation pursued against CRAs has come from issuers. This indicates that pressure created by a new liability standard will likely come again from issuers who would threaten litigation in an attempt to coerce CRAs into issuing higher ratings or refrain from taking a negative rating action.) This could lead CRAs to avoid publishing controversial opinions, and issue ratings that tend to conform to market sentiment. This would clearly be an unintended and undesirable consequence of any reform recommendations as it would quash diversity of opinions and, in turn, negatively impact transparency in the markets. In addition, to the extent that CRAs would increasingly move in lock-step with the market, rating opinions would be more volatile and pro-cyclical. If ratings continue to be used in the U.S. regulatory framework, such pro-cyclical behavior could have an adverse impact on U.S. capital markets.

Finally, measures that would attempt to create new standards of liability for CRAs could lead to a greater risk of over-reliance on ratings by investors. This stems from the fact that investors may be tempted to hold the view that if a CRA is subject to heightened standards of liability and publishes an opinion in such an environment, a CRA would be expected to have considered all elements of risk for an investor, leaving the investor with a misguided comfort that a CRA's opinion on credit risk addresses all the risk elements (e.g., foreign exchange risk and currency devaluations) relevant to that investor, not just the creditworthiness about which our ratings are designed to provide an opinion.

With respect to the First Amendment issues raised by the liability provisions, I have asked our First Amendment counsel, who include Professor Laurence Tribe and Tom Goldstein, to prepare a Whitepaper that we would be happy to share with the Subcommittee.

6. Issuer Disclosure of Preliminary Ratings

Rating shopping, in structured finance as well as other credit markets, is a harmful practice engaged in by some issuers and/or subscribers. The problem exists regardless of whether issuers or subscribers pay for ratings and stems from issuers' control of the information needed to analyze an obligation and assign a rating. It occurs in situations where those paying for credit ratings do not feel constrained to seek the best quality rating by, among other things, market disciplinary forces. Opaque markets can facilitate rating shopping by limiting the ability of CRAs, other analysts and investors to: (1) assess independently the creditworthiness of issuers; and/or (2) express opinions to compete with issuer-paid or subscriber-paid ratings.

We do not believe, however, that the disclosure of preliminary ratings will in any meaningful manner deter rating shopping. As issuers become aware that preliminary ratings will be required to be disclosed, issuers will simply "shop" one stage earlier in the process. Issuers could (i) present "what if" scenarios to CRAs, thereby avoiding any trigger for disclosure; or (ii) completely bypass CRAs that are perceived to have a more conservative methodological approach. This will result in an environment where the more conservative CRAs are not provided with an opportunity to provide their credit

opinion to the market, thus leaving the market worse-off in considering only favorable preliminary and final credit ratings.

The answer to rating shopping, we believe, lies more in the solution we propose under Section IV below – that is, encouraging issuers to make more detailed information as well as ongoing performance data available to the general public at issuance.

IV. IMPROVING DISCLOSURE IN THE STRUCTURED FINANCE MARKET – A CRITICAL ELEMENT MISSING FROM THE CURRENT PROPOSALS

Similar to the analysis of corporate securities, analyzing and monitoring structured finance products is a data-intensive process. Consequently, we believe that one of the most significant steps that can be taken to restore confidence in the structured finance market is to improve the availability and quantity of underlying information for structured securities within the regulatory framework. For the reasons set out below, we hope that regulators and policymakers will adopt a more forceful, legislative approach in encouraging issuers to address the information quality problems in the structured finance market.

Unlike in the corporate market, where investors and other market participants can reasonably develop their own informed opinions based on publicly available information, in the structured finance market, there is insufficient public information to do so. Disclosure requirements for publicly offered securities do not require the public dissemination of sufficient information about the structure or underlying assets of a securitization to make reliable analysis possible. Indeed, under this limited information disclosure model, CRAs must ask for additional information to analyze and rate securities.

In the absence of sufficient data, investors are unable to conduct their own analysis and develop their own independent views about potential or existing investments. Furthermore, CRAs are practically unable to offer unsolicited ratings and research, which has the effect of restricting information available to investors and increasing the potential for rating shopping by issuers. Finally, since they are not subject to a similar degree of public scrutiny as corporate issuers, structured finance issuers may feel less responsibility for the quality of information related to their securitized products.

To address these problems in the structured finance market, Moody's believes that a legislative amendment to the Securities Act of 1933 and the Securities Exchange Act of 1934 (collectively, the "**Securities Legislation**") mandating that the SEC update the structured finance disclosure regime for all offers and sales of asset-backed securities ("**ABS**") by, as appropriate, amending existing rules and regulations (e.g., Regulation AB and Rule 144A) or adopting new rules and regulations, is necessary.⁵ We recommend that the legislation outline the main categories of information that the issuer, sponsor or

⁵ The SEC is moving in the right direction and has announced that it will adopt a final rule that will require an NRSRO – that is paid by an arranger to rate a structured finance product – to disclose to other NRSROs that it is in the process of determining such a credit rating. The rule will also require the NRSRO to obtain a representation from the arranger that the arranger will provide the same information to other NRSROs seeking to rate the product. We believe that this rule should be a first step in amending the structured finance disclosure regime so that all investors have access to this information.

underwriter should disclose to investors eligible to invest in the securities in question and make available to the public. We also recommend that the Securities Legislation be amended to direct the SEC to develop requirements for issuers of ABS to disclose:

- in periodic and annual reports, updates to and material changes in the information required to have been disclosed at the time of the ABS' offer and sale;
- information about events that may take place after issuance of the securities and that are relevant to an assessment of the risks associated with buying or holding such securities, such as information regarding the performance of the underlying assets, breaches of material agreements relating to the securities and fulfilled repurchase requests; and
- any other type of information that the SEC determines, after consultation with the market, is needed to maintain a transparent structured finance market and provide investors with sufficient information to conduct a thorough analysis of the principal investment risks of the securities.

In the U.S., a significant secondary market where privately placed securities are traded among qualified purchasers (such as institutional investors) has developed for some types of structured finance securities. In addition, some types of structured finance securities that are issued under private placements are often tailored to meet the needs of specific investors and originators involved in the transaction. This tailoring process can contribute to a structured finance security's complexity. As a result, secondary market purchasers of privately placed structured finance securities can find it challenging to obtain sufficient information to make informed investment decisions. In such circumstances, they might be inclined to over-rely on credit ratings to assess risks other than credit risks. For these reasons, we recommend that information about ABS should continue to be made available generally to the market for so long as the ABS may be traded, offered, sold, purchased or otherwise transferred.

While Moody's is committed to implementing various initiatives to address shortcomings in this sector, we also believe that confidence in structured finance markets will not be restored unless the mandatory disclosure regime for structured finance products is enhanced and updated. In our view, updating the disclosure regime will yield three principal benefits:

- **Giving investors access to more information would reduce the risk of over-reliance on credit ratings.** Such access also would have the effect of enhancing investors' ability to meaningfully assess the work of CRAs.
- **Embedding enhanced information requirements in offering and ongoing performance documents intended for investors likely will improve the information about structures and assets.** This approach, which is analogous to the approach taken in corporate debt markets, aligns responsibility for information quality with the party who: (i) has the greatest control over the information in the first place; and (ii) will gain the benefit from access to the securities markets.
- **Making more information available to investors will broaden the range of opinions and analysis available, including from all CRAs.** If sufficient information is made available to investors, then it necessarily is available to those

CRAs not selected to rate a securitization. As a result, CRAs (as well as a host of other market commentators) would be in a position to offer ratings and research, which would broaden the range of information available to investors.

V. CRA BUSINESS MODEL

Some market observers remain skeptical that meaningful rating quality improvements can be achieved within the context of the issuer-pays model and some current reform proposals seek for this topic to be researched in greater depth over the next few years with a report due to policymakers on a preferred model for rating agency compensation. They maintain that the potential conflict of interest inherent in the issuer-pays model is fundamentally unmanageable. In fact, all CRA business models (investor-pays, government pays and issuer pays) have embedded conflicts that need to be properly managed. Furthermore, the greater analytical resources and the free public availability of ratings under the issuer pays model have demonstrable benefits in terms of rating quality.

During its history, Moody's has operated both under an issuer-pays model and, before that, under an investor pays model. Historical performance recorded under both models does not support the assertion that the potential conflict of interest in the issuer-pays model is unmanageable.

In fact Moody's research shows (as detailed more fully in Appendix A) that with respect to ratings on companies the issuer-pays model which Moody's has used since the early 1970s is actually associated with higher accuracy ratios,⁶ lower investment-grade loss rates, and higher downgrade rates⁷ than the investor-pays model it used prior to that time. All together, the data suggests that Moody's ratings on companies have become more accurate and less "issuer-friendly" over time. Moreover, these findings are consistent with academic studies and our own research, which have observed that our corporate rating criteria, as measured by standard credit-related accounting ratios, appear to have become more "conservative" over time.⁸

Potential Conflicts of Interest in the Investor-Pays Model

Some market participants have suggested that an investor-pays business model would have fewer potential conflicts than an issuer-pays model. We believe this presumption ignores the sources and drivers of potential conflicts of interest in the ratings business as well as the significant public policy benefits associated with the issuer-pays model.

⁶ See, "Measuring the Performance of Corporate Bond Ratings," April 2003. Accuracy ratios measure the ability of ratings to differentiate between issuers that default and those that do not default. The accuracy ratio lies between minus one and positive one, similar to a correlation statistic, and can be converted to a percentage. If all defaulters were initially assigned the lowest rating category, the accuracy ratio would approach one. If all defaulters were distributed randomly throughout the population without regard to ratings, the accuracy ratio would be zero. And, if all defaulters were initially assigned the highest rating category, the accuracy ratio would approach minus one.

⁷ *Ibid.*, discusses these benchmarks of ratings performance.

⁸ See, for example, Blume, M.E., F. Lim & A.C. MacKinlay (1998), "The Declining Credit Quality of U.S. Corporate Debt: Myth or Reality?" *Journal of Finance* 53.4, and "Maintaining Consistent Corporate Ratings Over Time," *Moody's Special Comment*, August 2008.

- **First, investors can be just as motivated as issuers to influence ratings.** In practice, the term “investors” is a short-hand description for any subscriber to a rating service and describes a variety of parties with vested interests in the credit ratings of securities including:
 - **Short sellers:** (for example, hedge funds that take a significant short position on a particular company): as subscribers under an investor-pays model, they may be highly motivated to encourage a negative rating action.
 - **Long investors:** similar to their short counterparts, long investors understandably are interested in the outcome of rating actions. Before they purchase a security, they may prefer to have ratings maintained or raised rather than lowered to avoid, for example, valuation markdowns or forced sales.
 - **Governments:** governments, often faced with competing financial market and social policy objectives, may seek to have ratings “protect” nationally, systemically or politically important issuers such as large industrial employers, banks or governments themselves. This is particularly an issue in instances where governments have stepped in to provide systemic support to such institutions, i.e., when the prudential regulator also becomes an investor.
- **Second, there is often no clear distinction between investors and issuers.** Investors frequently are entities that are also issuers, such as banks, insurance companies and governments.
- **Third, shifting “who pays” will not prevent issuers from using other financial means to try to influence ratings.** Entities seeking to influence rating actions can and have attempted to do so by challenging CRAs through commercial mechanisms unrelated to fees, such as litigation to coerce higher ratings.

Put simply, numerous parties – including investors and issuers – may want ratings assigned and maintained in a manner that is most beneficial to their interests, and those interests often may conflict with the goal of a CRA to issue an objective rating.

Given that the investor-pays business model also embeds potential conflicts, a secondary question arises. Does one business model offer superior, offsetting public policy benefits over the other? The principal benefit in the issuer-pays model is that it allows all rating actions to be released to the general public simultaneously and at no cost to investors. Larger, wealthier parties do not have an advantage over smaller rivals. The investor-pays model, however, does not allow for the public and broad disclosure of ratings. Rather, the model involves selective disclosure of information via subscription. The basis of the model, therefore, is to charge fees in return for selective access to information for those who can afford the subscription fees.

A Deal-Pays Model May Eliminate Competition

An alternative business model has been discussed in the public debate, variously referred to as a “deal-pays” or “bond surcharge” model. The principal perceived attraction of such a model is that it would automate the fee payment process by imposing some sort of surcharge on debt issuance that is thereafter allocated among CRAs. The

deal-pay model appears to “fix” the two shortcomings of the investor-pay model, in that (like the issuer-pay model) it delivers a public rating available to all for free; and, it can generate fees that can be calibrated to fund higher quality analysis.

Leaving aside the complexities of the mechanism by which the model could be made operational,⁹ the meaningful distinctions between the deal-pays model and the issuer-pays or subscriber-pays models are: a) who picks the rating agency – the government, institutional investors, or issuers; b) by what criteria is the rating agency chosen; and c) at what price is the rating agency paid? Whatever the mechanism for selecting the rating agencies, the nature of competition is changed. Rather than each rating agency competing for investors and issuers on a one-by-one basis, each CRA will seek to convince a single agent (whether a board of investors, the government, or a board of issuers) to pick the CRA for the next transaction or set of transactions. This power will lead to a similar conflict of interest as that which already exists in the other models. In fact, it may result in “lobbying” activities and greater risk of error, because it is substituting the decision of one entity (the sole decision-maker), for the decisions of many (the market).

Consequently, the deal-pays model is unique only if it ultimately allocates fees differently than the other two models, that is by determination of interested parties – whether issuers, investors or governments. To achieve that would require some form of non-judgment-based fee allocation (for example, rotational, pro rata or lottery system), with the consequence, and perhaps the goal, of eliminating competition – under a theory that if “competition” could be eliminated, so too could “conflict”. However, the elimination of competition would also likely eliminate the incentive for ratings agencies to strive to produce better quality ratings. Perhaps the negative influences of competition would be redressed, but if fees are guaranteed (or, conversely, not achievable) regardless of the quality of a CRA’s opinions, the incentive for CRAs to innovate, update and adapt methodologies to changing market conditions – i.e., to enhance ratings performance – is removed.

Moody’s has always believed that healthy competition in the CRA industry is crucial. It is the mechanism through which each participating CRA is motivated to improve. The answer is not as simple as “more competition is good and less competition is bad”; the opposite may also be true depending on circumstances. The critical question is what form of competition is being encouraged? Are rules and regulations (or the market) structurally encouraging competition for the most flattering ratings? Are they encouraging competition based on the most predictive ratings? Or are they encouraging something else entirely?

⁹ This approach introduces intriguing complexities. How will the fees be apportioned? Will fees be equally divided between all CRAs? Will CRAs be paid and therefore authorized to assign ratings on a rotation basis? Will distribution of fees be based on an arbitrary lottery system? In addition, who will be responsible for distribution of the fees? It is conceivable that whoever is authorized to distribute the fees will be similarly conflicted as those entities discussed in the models above, which would negate the underlying purpose of instituting a surcharge model. More importantly still, which CRAs will be eligible to receive such fees? Obviously, if divided only among registered CRAs, or a sub-set of registered CRAs, such a system would leave others at an extreme competitive disadvantage and create significant regulatory barriers.

We believe that the public interest is served by trying to answer the question of “how can the system encourage high quality ratings” not simply “who should pay for ratings?”

VI. CONCLUSION

Moody’s has always believed that critical examination of the CRA industry and its role in the broader market is a healthy process that can encourage best practices, support the integrity of our products and services, and allow our industry to adapt to the evolving expectations of market participants. Many necessary actions can and have been taken by Moody’s and at the industry level, and policymakers at the domestic and international levels have proposed a host of constructive reform measures for our industry and credit markets generally. Moody’s wholeheartedly supports constructive reform measures and we are firmly committed to meeting the highest standards of integrity in our rating practices, quality in our rating methodologies and analysis, and transparency in our rating actions and rating performance metrics.

I am happy to respond to any questions.

APPENDIX A

The Evolution of the Issuer-Pays Model

For over fifty years, Moody's operated under the investor-pays model before shifting to the issuer-pays model in the early 1970s. The change was made in response to several market trends, including increasing interest by investors for more in-depth and timely analysis. This more rigorous and more costly analysis could not be sustained by the fees charged to subscribers. As investors were seeking this higher quality analysis, advances in reproduction and distribution technologies were simultaneously increasing the "free rider" problem among users of ratings. This made it even more difficult to raise the required revenue from subscribers.

Moody's therefore adopted a new business model – shifting from one supported by investor fees to one based on fees from issuers – which had the impact of allowing Moody's to increase the depth and quality of its analysis. In so doing, Moody's made its ratings available to the entire public, rather than just paying subscribers. The resulting increase in revenue allowed individual rating analysts to focus on fewer credits in greater depth. At the same time, analysts were able to increase the frequency of informational meetings with both issuers and investors, allowing for a more measured approach to ratings transition as new information was incorporated into the rating on a more timely basis.

Comparing Performance: Issuer-Pays Period vs. the Investor-Pays Period Shows Higher Accuracy During the Issuer-Pays Period

This change in our business model in the early 1970s provides insight as to whether ratings quality likely would benefit from a shift away from the issuer-pays model today. In particular, we have looked into whether, after a change in our business model, our ratings performance deteriorated and whether there was any statistical evidence to suggest that Moody's analysts began to cater more directly to the interests of issuers at the expense of investors.

Performance of Corporate Finance Ratings

With respect to ratings on companies, as is shown in the table below, Moody's research demonstrates that the issuer-pays era is actually associated with higher accuracy ratios,¹⁰ lower investment-grade loss rates, and higher downgrade rates.¹¹ All together, the data suggests that Moody's ratings have become more accurate and less "issuer-friendly" over time.¹² Moreover, these findings are consistent with academic studies and

¹⁰ See, "Measuring the Performance of Corporate Bond Ratings," April 2003. Accuracy ratios measure the ability of ratings to differentiate between issuers that default and those that do not default. The accuracy ratio lies between minus one and positive one, similar to a correlation statistic, and can be converted to a percentage. If all defaulters were initially assigned the lowest rating category, the accuracy ratio would approach one. If all defaulters were distributed randomly throughout the population without regard to ratings, the accuracy ratio would be zero. And, if all defaulters were initially assigned the highest rating category, the accuracy ratio would approach minus one.

¹¹ *Ibid.*, discusses these benchmarks of ratings performance.

¹² Moody's has conducted similar research for structured finance dating from 1993-2008 (as far back as we maintain default and loss data on securitizations), but with two important limitations. First, securitization did not exist during the 1920-1970 period, so the issuer-pays vs. investor-pays comparison available for corporate ratings is not

our own research, which have observed that our corporate rating criteria, as measured by standard credit-related accounting ratios, appear to have become more “conservative” over time.¹³

While this “before and after” comparison is by no means a definitive test, it indicates that a move from an investor-pays model to an issuer-pays model does not necessarily lead to deterioration in credit standards and rating inflation as some have suggested. Indeed, it suggests that the issuer-pays model is coincident with, and may lead to higher overall ratings quality.

Comparing Corporate Rating Performance Over Time

	Investor-Pays ERA 1920-1970	Issuer Pays ERA 1971-2008	Difference
Simple averages across monthly cohorts			
1-Year Accuracy Ratio	67%	83%	16%
5-Year Accuracy Ratio	63%	68%	6%
1-Year Investment Grade Loss Rate	0.13%	0.03%	-0.1%
5-Year Investment Grade Loss Rate	1.35%	0.11%	-1.24%
Broad Rating Downgrade Rate (12 month)	5.6%	6.3%	0.7%
Weighted average, by number of issuers			
1-Year Accuracy Ratio	62%	83%	21%
5-Year Accuracy Ratio	54%	71%	17%
1-Year Investment Grade Loss Rate	0.17%	0.04%	-0.13%
5-Year Investment Grade Loss Rate	2.08%	0.13%	-1.95%
Broad Rating Downgrade Rate (12 month)	7.8%	6.6%	-1.2%

One reason that overall ratings quality may have improved is that the quality of the analysis, itself, may have improved. With the advent of the issuer-pay model, the number of credits followed by individual rating analysts declined, the frequency of informational meetings with issuers and investors increased, investments in better technological tools increased, and the frequency of rating changes all rose over time. A second reason behind the improvement in our ratings performance during this time period may be the considerable increase in both the quantity and quality of corporate issuer-disclosure and reporting.

available for structured finance. Second, the current measurement period for structured finance through mid-2008 does not capture the full impact of the current downturn on expected losses for outstanding structured finance securities. Nonetheless, for completeness we include the following table:

Structured Finance Performance Statistics (1993–2008H1)		
	Simple averages across monthly cohorts	Weighted average, by number of issuers
1-Year Accuracy Ratio	90%	76%
5-Year Accuracy Ratio	88%	84%
1-Year Investment Grade Loss Rate	0.18%	0.42%
5-Year Investment Grade Loss Rate	0.54%	0.73%
Broad Rating Downgrade Rate (12 month)	1.9%	3.4%

¹³ See, for example, Blume, M.E., F. Lim & A.C. MacKinlay (1998), “The Declining Credit Quality of U.S. Corporate Debt: Myth or Reality?” *Journal of Finance* 53.4, and “Maintaining Consistent Corporate Ratings Over Time,” *Moody’s Special Comment*, August 2008.

Enhanced Accountability and Transparency in Rating Agencies Act
Response to the Discussion Draft

U.S. House of Representatives
Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises
B-304 Rayburn Office Building Washington, DC

September 30, 2009

STATEMENT OF KURT N. SCHACHT, JD, CFA
MANAGING DIRECTOR
CFA INSTITUTE CENTRE FOR FINANCIAL MARKET INTEGRITY

INTRODUCTION

I am Kurt Schacht and I am the Managing Director of the CFA Institute Centre for Financial Market Integrity. I would like to thank the Committee for inviting our organization to testify today about credit rating issues. For those of you not familiar with our organization, CFA Institute is a non-profit professional membership organization with a mission of leading the investment profession globally by setting the highest standards of ethics, education, and professional excellence. CFA Institute is most widely recognized as the organization that administers the CFA examination and awards the CFA designation, a designation held by nearly 88,000 investment professionals worldwide.

The CFA Institute Centre, which is part of CFA Institute, represents the views of investment professionals, including portfolio managers, investment analysts and advisors located in more than 130 countries worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end-users remains of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for our members and the global investment community at large through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct*.

Over the past two years, the CFA Institute Centre has responded to six domestic and international regulatory consultations, and conducted two surveys of our 100,000 members on various aspects of this debate. Our responses to these consultations have discussed, among other things, the role and responsibilities of the credit rating firms, the NRSRO process, and conflicts of interest inherent in the issuer-paid model.

Before I focus on specific areas, I would like to comment briefly on the September 25th House Discussion Draft. In general, we support many aspects of this Discussion Draft.

We certainly support calls to increase transparency, manage conflicts of interest inherent in the current issuer-pay model, and provide the SEC with strong oversight authority. The objectives this Bill seeks to achieve go far in aligning investor interests with the work of ratings agencies.

We are concerned, however, about the degree of detail presented in this Discussion Draft, finding many instances where there is an effort to legislate what is more typically (and we believe more appropriately, in this case) left to the regulatory agency to implement. For example, we question provisions to set the compensation structures for the Board and the nine subsections detailing duties of the compliance officer. Instead, we encourage a reworking of this Bill that identifies and sets objectives, and imbues the functional regulatory agency with authority to implement the details of those objectives.

Now, I would like to focus my testimony on three matters. First, I want to focus on changes that need to be made to the business models of credit rating agencies in order to better protect investor interests. Second, I will discuss the perceptions of our professional membership on the validity of, level of reliance on, and government reforms efforts to date, related to credit ratings and raters. And finally, I will touch on the problematic custom of investors' and investment firms' blind reliance on the ratings. Users have a responsibility, too.

COMMENTS

Protection of Investor Interests

Regarding the credit-rating process, users are most concerned about the conflicted nature of ratings. The CRAs did a poor job of handling the crisis and acknowledging that their role was significant in convincing many investors, who would not have otherwise invested, to buy into a mix of exotic and complex instruments that were rated triple-A. While much of this CRA activity is still under investigation, there is convincing information that firms did an inadequate job of performing their due diligence. This includes little investigation of underlying mortgage portfolios, weak testing of default risks in a booming housing market, their inability to objectively and knowledgeably rate many of these brand new structured products, and that the lure of a high and sustained flow of fee income related to the manufacture, rating, and sale of mortgage paper impaired their judgment and process. In case after case, ratings were issued on collateralized and other structured instruments—ratings that were based on very limited performance data for the underlying collateral. Often there was little or no prior record of default experience or track record of performance for such instruments. All of these factors led to an extremely conflicted, low-quality product and service in the view of many. In an environment where government has required these ratings and/or certified the raters, this is unacceptable and should never be permitted to happen again.

Earlier this year, we, in cooperation with the Council of Institutional Investors, created the Investors Working Group which brought together an august panel of investors, investor advocates, and former regulators to consider these and other matters relating to financial market regulatory reform from the investor's perspective. Co-chaired by former

SEC chairmen Arthur Levitt and William Donaldson, this group considered the substantial role credit rating agencies played in the U.S. market turmoil and recommended changes for a more comprehensive and rigorous government regulatory model, complete with conflict protections and consequences for improper process and behavior. These include the following:

1. **Congress and the Administration should consider ways to encourage alternatives to the predominant issuer-pays NRSRO business model.**

The IWG suggested that the fees earned by the NRSROs should vest over a period of time equal to the average duration of the bonds. Fees should vest based on the performance of the original ratings and changes to those ratings over time relative to the credit performance of the bonds. Credit rating agencies that continue to operate under the issuer-paid model should be subject to the strictest regulation.

2. **Congress and the Administration should bolster the SEC's position as a strong, independent overseer of NRSROs.**

The SEC's authority to regulate rating agency practices, disclosures, and conflicts of interest should be expanded and strengthened. The SEC should also be empowered to coordinate the reduction of reliance on ratings.

3. **NRSROs should be required to manage and disclose conflicts of interest.**

As an immediate step, the IWG recommended that NRSROs should be required to create an executive-level compliance officer position. More complete, prominent, and consistent disclosures of conflicts of interest are also needed. And credit raters should disclose the name of any client that generates more than 10 percent of the firm's revenues.

4. **NRSROs should be held to a higher standard of accountability.**

The IWG recommended that Congress eliminate the effective exemption from liability provided to credit rating agencies under Section 11 of the Securities Act of 1933 for ratings paid for by the issuer or offering participants. This change would make rating agencies more diligent about the ratings process and, ultimately, more accountable for sloppy performance.

The IWG also believes that NRSROs should not rate products for which they lack sufficient information and expertise to assess. Credit rating agencies should only rate instruments for which they have adequate information and should be legally vulnerable if they do otherwise. This would effectively limit their ability to offer ratings for certain products. For example, rating agencies should be restricted from rating any product that has a structure dependent on market pricing.

Finally, the IWG said NRSROs should not be permitted to rate any product where they cannot disclose the specifics of the underlying assets. The IWG also recommended that credit rating agencies be restricted from taking the metrics and methodology for one class of investment to rate another class without compelling evidence of comparability.

5. Reliance on NRSRO ratings should be greatly reduced by statutory and regulatory amendments. Market participants should reduce their dependence on ratings in making investment decisions.

Many statutes and rules that require certain investors to hold only securities with specific ratings encouraged some investors to rely too heavily on credit ratings. Eliminating these requirements over time, or clarifying that reliance on the rating does not satisfy due diligence obligations, would force investors to seek additional and alternative assessments of credit risk.

The IWG report also calls for more and better oversight from the SEC, increased and substantive disclosures about conflicts of interests, a higher standard of accountability, and finally a reduced reliance on credit ratings in statutes and regulations.

I will submit a copy of this report for the record. As you will note, these recommendations support in detail or in tone a number of the provisions in the House September 29th Discussion Draft.

Perspective of the CFA Institute Membership

As a global organization, we also have been called upon to consider credit rating reform from a number of other perspectives over the past year. To help inform our positions, we have surveyed our global membership on two occasions, most recently in April of this year. In response to the questions asked in that survey, our members conveyed a lack of trust in these firms. More than 60% of the 1,182 respondents concluded that the ratings issued by credit rating agencies are not valid. A nearly identical 60% stated that they don't find that such opinions are useful in their investment decision-making processes. When asked about government regulation of CRAs, more than 70% said that additional oversight was needed. On the other hand, 51% disagreed with steps by the U.S. government to deemphasize reliance on credit ratings for investors and issuers, alike.

These results point to a number of cross-currents in this CRA debate. We are currently caught in a world that is between full government regulation of ratings and a laissez faire model of these firms being an independent service provider to issuers. Our survey results and the seeming contradictions in their responses reflect this confused picture. As it currently stands, there is a very high distrust of the credit rating process. At the same time, a significant majority say more government oversight is needed, while a slim majority disagrees with steps to remove reference to CRAs and to deemphasize their role in providing rating services regulation.

We do not intend to defend members of the CRA industry, but realize they are clearly not the only ones to blame, only the easiest. The CRAs were in the unfortunate spot of being an early and visible target in this credit mess. The complexity and interconnectedness of

this crisis are still being sorted out, but most stakeholders were fairly clear on the role played by the CRAs and how various “credits” and instruments, held out to be the triple-A gold standard rating, were now imploding.

There are a few things to consider in this regard. While the government on the one hand was criticizing CRAs and the accuracy of their ratings, the ratings on firms associated with credit rescue programs such as the mono-line insurers and others, remained unchanged despite well-known problems. It was, and continues to be, a very mixed message and one that needs to be clarified. We must not have a situation where two sets of ratings apply—one for private companies and another for when government bailout funding is involved.

Responsibility of Users

Finally, users have an important responsibility to consider in this debate. It is clear that the credit ratings themselves, accurate or not, were being absolutely misused by many investors. Users have some responsibility to understand the basis for these ratings, and to do their own analyses of the credit and other risks to match their own investment circumstances. Blind reliance on the rating as the one and only due-diligence step happened with such frequency and ease that it had become the accepted industry practice. In this sense, it was the government’s endorsement and designation of NRSRO status that had the effect of a seal of approval. The fact that this unprofessional and careless practice became, in many cases, industry custom seems clear, but it must never again be acceptable practice for investment managers holding themselves out as experts. There has been much discussion about investors, in both conventional and structured products, “circling” (or purchasing) large multi-million dollar quantities, solely on the basis of a rating and without review of official investment documentation. The practice began with conventional corporate debt and carried over into the structured product market with ease. Our profession of investors and users of investment ratings must do better.

CONCLUSION

The CFA Institute Centre appreciates the opportunity to participate in these CRA hearings. We strongly believe that this area is in need of immediate reform and support Congressional action to strengthen SEC oversight, as well as to bolster efforts to improve the internal structure of credit rating agencies themselves. To that end, CFA Institute supports measures outlined in the Discussion Draft that give the SEC direct authority to review ratings and underlying methodologies, that address the management of conflicts of interest inherent in the issuer-paid business model, and that contemplate significant measures to increase transparency. CFA Institute is committed to providing our assistance to these efforts.

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**TESTIMONY OF DEVEN SHARMA
BEFORE**

THE UNITED STATES HOUSE OF REPRESENTATIVES

**FINANCIAL SERVICES SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES**

SEPTEMBER 30, 2009

Chairman Kanjorski, Ranking Member Garrett, Members of the Committee, good afternoon. My name is Deven Sharma. I am the president of Standard & Poor's ("S&P") and I am pleased to appear before you today. I want to commend you, Mr. Chairman and the Subcommittee, for having this hearing to air these important issues and continue this careful effort to construct the foundation for a sounder financial system. S&P is a 150-year-old company. By providing independent credit benchmarks, S&P helps create transparency — one important contributor to the development of the capital markets. S&P's ratings reflect the creativity, independence, rigor and hard work ethic that have built our great economy.

The job of a ratings analyst is a challenging one. It requires intellectual acumen, high integrity and analytic tools that give us the best opportunity to offer some relative predictability of what the future may bring. Over the course of S&P's history, investors have turned to S&P for its credit risk assessment of companies and securities. By and large, private sector investors and other market participants use our ratings, not because they are required to do so, but because our ratings add value to their important deliberations in making investment decisions.

Providing the public with quality ratings, which is our goal, is both an art and a science. We work hard, very hard to do what we do well and continually to improve the quality and timeliness of our work. But like every human endeavor, S&P continues to learn from its past. Among our disappointments has been the ratings of mortgage-backed securities issued between 2005- 2007. Over the course of 150 years, however, our track record is something in which our people can take pride.

We appreciate the Committee's goal to reinvigorate the economy and job growth through stability and innovation. Accordingly, we fully recognize and support the goals behind the

recent discussion draft entitled *Accountability and Transparency in Rating Agencies Act*. We will be studying your discussion draft in greater detail in the coming days and will continue to engage with you over the next few weeks. I can say now that we support many — indeed most — of the proposals. We also share the general view that through greater disclosure, oversight and accountability, confidence in ratings can be restored to overcome the recent disappointment in some ratings of residential mortgage-backed securities and related products.

As I will explain, however, some of the recent proposals to increase oversight of NRSROs are problematic and, in our view, would bring unintended harm to the markets. These proposals include amendments to the federal securities laws that would treat NRSROs far more harshly than any other defendant in securities fraud lawsuits, and other measures that would interfere with NRSROs' analytical independence. As I will explain, these proposals would inevitably curtail the scope and availability of credit ratings on a broad spectrum of businesses and the debt they issue. This would add greater hazards, systemic risks and inefficiencies to the market, and would cause confusion among market participants. Importantly, by encouraging homogenized, one-dimensional rating opinions, these proposals would also necessarily restrict the flow of capital across global markets, causing harm not only to established financial enterprises, but — even more so — to the small and medium-sized emerging businesses that are particularly dependent on access to capital and are so important to reinvigorating our economy.

Before discussing these proposals any further, I would like very briefly to address S&P's credit rating history, including the recent performance of our ratings on mortgage-backed securities, as well as important changes we have made to improve our processes and to enhance and broaden our communication with the market.

S&P's Ratings on 2005-2007 Residential Mortgage-Backed Securities

Accordingly, let me begin by acknowledging — as S&P has been saying for quite some time — that S&P is profoundly disappointed with the performance of many of its ratings on the aforementioned mortgage-backed instruments. Although we always expect that some portion of the debt we rate, even highly-rated debt, will ultimately default, our ratings of mortgage-backed securities issued in this time period have been unusually unstable and their performance has not matched our historical track record. Why did these ratings on mortgage-backed securities perform poorly? Put simply, our assumptions about the housing and mortgage markets in the second half of this decade did not account for the extraordinarily steep declines we have now seen. Although we did assume, based on historical data stretching back to the Great Depression, that these markets would decline to some degree, we and virtually every other market participant and observer did not expect the unprecedented events that occurred. It should go without saying that had we anticipated fully the speed and scope of the declines in these markets at the time we issued our original ratings, many of those ratings would have been different.

It is important for me to note, however, that overall S&P's ratings, including in the area of structured finance securities, have historically performed very well. We have been rating structured securities for over thirty years and have developed industry-leading processes and models for evaluating the creditworthiness of a wide array of structured transactions. Since 1978, only 1.15% of structured finance securities rated by us 'AAA' have ever defaulted. For RMBS securities, the percentage of 'AAA' ratings to default over this time period is 0.77%. Our ratings of non-mortgage asset-backed securities ("ABS") have performed notably well, even during the recent credit crisis. As of July 2009, of the more than 6,000 'AAA' ratings we issued

on non-mortgage ABS, approximately 90% have remained 'AAA' and only 1% have been downgraded below investment grade. Only four 'AAA' transactions in this group — or approximately 0.07 percent — have *ever* transitioned to default. Our ratings on corporate and municipal debt have also performed extremely well, reflecting a high correlation between rating levels and defaults.

Thus, employing the same general processes and ratings framework across all types of debt securities and issuers, we have historically had a very good overall track record, and our employees remain devoted to providing their highest quality credit analysis to the markets. Of course, we understand that this Committee's current focus, and the focus of investors and other market participants, is — as it should be — not just on our historical ratings history, but on our more recent ratings of mortgage-backed securities. We know we have more work to do in this regard and, both on our own initiative and with regulatory oversight by the Securities and Exchange Commission ("SEC"), we are well into making meaningful improvements.

Mr. Chairman and members of the Subcommittee let me assure you of two things. First, our ratings in the mortgage-backed securities area were not venal. These were honest views expressed based on the best information available, dealing with complex instruments. Second, and more importantly, we have learned from this experience and we have made major changes ourselves to restore confidence in our ratings.

Recent S&P Initiatives

In 2008, we announced a series of initiatives aimed at improving checks and balances in our organization and promoting four broad objectives: (i) ensuring the integrity of the ratings

process; (ii) enhancing analytical quality; (iii) providing greater transparency to the market by disseminating relevant information about ratings, as well as information to help the market form its own view of the soundness of rating analysis; and (iv) more effectively educating the marketplace about ratings. To date, we have made significant implementation progress.

For example, we have:

- Established distinct groups and invested significantly in processes around our Criteria, Quality, Compliance and Internal Audit functions each of which has a distinct and important role in the review of the ratings process and related controls;
- Established an Office of the Ombudsman. The Ombudsman addresses concerns related to potential conflicts of interest and analytical and governance processes that are raised by issuers, investors, employees and other market participants across S&P's businesses. The Ombudsman has oversight over the handling of all issues, with authority to escalate all unresolved matters, as necessary, to the CEO of The McGraw-Hill Companies and the Audit Committee of the Board of Directors;
- Instituted a rotation system for analysts;
- Established an enterprise-wide independent Risk Assessment Oversight Committee. The Committee assesses all risks that could impact the integrity and quality of the ratings process. This Committee also assesses the feasibility of rating new types of securities;
- Enhanced our analyst training programs and have introduced a new Analyst Certification Program in which all S&P rating analysts are required to participate;
- Enhanced and expanded our quality assurance and controls related to the development and implementation of criteria; and
- Created a separate Model Validation Group to independently analyze and validate all models, developed by S&P or provided by issuers, used in the ratings process.

In addition, we have taken steps to raise the disclosure levels on our analyses, strengthen the analytics and educate the market. For example, we have:

- Implemented procedures to collect more information about the processes used by issuers and originators to assess the accuracy and integrity of their data and their fraud detection measures so that we can better understand their data quality capabilities;
- Published a series of articles addressing certain “what if” scenarios; and
- Published a “Guide to Credit Ratings Essentials” that provides important information about ratings and their role in the markets.

A number of these changes are intended to enhance our controls and protections against potential conflicts of interest, an area which has received considerable attention of late. At the SEC Roundtable in April 2009, discussion among many panelists recognized that there are potential conflicts inherent in any NRSRO business model, including the issuer-pays model that we employ or other models such as the investor-pays model or, for that matter, a government-run model. An important conclusion was that, with any business model, potential conflicts must be managed through internal governance procedures and regulatory oversight. S&P has long maintained, adhered to, and recently strengthened policies that manage or prevent these conflicts. These policies include, among other things, the use of internal firewalls to maintain the independence and integrity of the analytic process, the use of rating committees, and the delineation of separate roles and responsibilities of personnel having an analytic versus a commercial role. These policies, along with the new initiatives discussed above, provide strong protections against potential conflicts and serve to promote the integrity of our ratings process.

Let me assure you that the various improvements I have discussed are substantive. We have gone to great lengths to make serious and meaningful changes in the way we go about doing our credit ratings and we believe the market is taking notice. Virtually everyone I speak to agrees that our ratings have served historically as an extremely valuable tool for evaluating the

creditworthiness of issuers and debt securities. We believe firmly that our ratings will continue to be an important part of the information available to investors and other market participants as we move forward and the financial markets continue to improve.

Proposals For Further Regulation

Another way to restore investor confidence in ratings — in addition to the sweeping changes I just described — is to pursue effective regulation of credit rating agencies. Currently, NRSROs are subject to the Credit Rating Agency Reform Act of 2006 (the “2006 Act”), which gave the SEC broad oversight authority and was intended to increase transparency about the ratings process and investor choice and competition among NRSROs. We believe those goals have been significantly advanced in the short time since the 2006 Act became effective. Indeed, the number of NRSROs has grown to ten, double what it was at the time the law was passed. As long as barriers to entry remain low, we expect the number of NRSROs to continue to grow, providing still more options for investors.

Also, as a result of the 2006 Act and implementing regulations, NRSROs are now required to disclose detailed performance data about their ratings. This facilitates comparisons of NRSROs and promotes more informed decisions about their strengths and weaknesses. NRSROs are also now subject to increasingly rigorous and regular oversight, including wide-ranging inspections, the first of which was conducted by SEC staff in 2007 and 2008. This inspection resulted in a lengthy report and a series of recommendations by the SEC for improvements — some of which overlap with the changes described above — which we have worked tirelessly to implement.

On top of this, the Commission issued another layer of rules governing NRSROs in February of this year. Those actions by the SEC require enhanced disclosures of performance measurement statistics and procedures and methodologies; new record-keeping standards; public disclosure of ratings histories; and a comprehensive annual report from each NRSRO. Just this past month, the Commission approved another set of rules which require more complete disclosures of credit rating histories, provide all NRSROs with access to information made available by issuers to NRSROs they pay to rate a transaction, and expand Regulation FD to allow access by NRSROs to sensitive issuer information even if the NRSROs do not make their ratings publicly available for free. The Commission also voted to propose new rules that, among other things, would require a new report from NRSROs that describes compliance reviews and steps taken to enforce compliance policies; and mandate additional disclosures about potential conflicts of interests, including the percentage of revenues attributable to the largest users of credit ratings.

Although the 2006 Act has resulted in a broad and robust regulatory scheme, S&P shares the view that further regulation, appropriately crafted, can serve the goal of restoring and maintaining investor confidence. In our view, such regulation should follow four broad principles: (i) it should be part of “beginning-to-end” regulatory solution; (ii) it should not interfere with analytical independence; (iii) it should foster greater competition in the ratings industry and not impose burdensome barriers to entry; and (iv) it should recognize the critical importance of international consistency. I will say a few words about each of these principles and then I will discuss in more detail some of the specific proposals that have been made.

Beginning-to-End Solutions: From our perspective, any regulatory approach regarding ratings should include “beginning-to-end” solutions. In other words, as noted in the Treasury Department’s June report, *Financial Regulatory Reform: A New Foundation*, regulation should cover all aspects of the capital markets that, taken together, contribute in a systemic way to their effective and efficient functioning. In structured finance, this would include not just ratings, but appropriate regulation related to the origination and pooling of assets, the structuring and underwriting of securities, the management of collateral held by a structured vehicle, and the marketing of securities. A “beginning-to-end” focus is important in avoiding the unintended consequences that too often result from piecemeal solutions. With respect to ratings, an appropriate regulatory framework should cover not just rating firms, but also those entities that can play a role in promoting the quality of ratings and their appropriate use. For example, an important factor in ratings quality is the reliability and accuracy of information available to be analyzed by rating analysts. That information is not generated by rating firms, but by others — e.g. corporations, mortgage originators, and underwriters. Still others, such as professional audit firms in the corporate world and third-party due diligence firms in connection with certain structured finance securities, are responsible for reviewing that information and verifying it. In our view, these entities and the roles they perform should be an integral part of any regulatory approach for all market participants.

Analytical Independence: We believe analytical independence is a fundamental principle. At its core, a rating is an analytical determination. It results from a group of experienced professionals analyzing a set of facts and forming a judgment as to what might happen in the future. For the markets to have confidence in those ratings, they must continue to

be made independently. That means, of course, that they must be free of undue commercial considerations — and S&P is fully committed to that principle — but it also means that they must truly reflect the substantive views of the analysts making them, not the dictates of regulators or other external authorities. Indeed, the key value of ratings is their independence from undue influence. Analytical independence is critical in furthering analytical innovation based on experience. Government mandates to set standard rating definitions or methods will also lead to over-reliance of investors on ratings — the chief reason given for removing government mandates that require use of ratings for certain investment purposes. Accordingly, we would be extremely concerned about regulatory measures that could force analysts to make judgments not based upon their own considered analysis and independent views and experience, but rather out of a desire to avoid subsequent second-guessing by regulators or others. Such proposals, in our view, would lead to uniformity of opinion and, ultimately, systemic risk as the market would be deprived of differing viewpoints on the creditworthiness of issuers and securities.

Fostering Competition in the Ratings Industry: A key aspect of the 2006 Act is a set of provisions designed to ease the burden of becoming an NRSRO. S&P strongly supports that legislative goal. Regulatory requirements, by their nature, are often seen by potential new entrants as burdensome; yet carefully crafted, balanced rules are necessary to establish a fair and level playing field. We believe that new statutory laws will be beneficial to investors and the markets generally, as long as they aim to increase competition in the ratings industry and among NRSROs in order to provide investors with more robust ratings and increased sources of information about evaluations of debt.

International Consistency: We also believe international consistency is critical to an appropriate regulatory framework. Ratings are issued and used globally. This reflects one of their many benefits — their ability to provide a common global language for analyzing credit risk and contribute to the global flow of capital. However, it also underscores the importance of a consistent approach to the regulation of ratings around the world. A rating produced under one set of regulations may not mean the same thing or address the same risks as one produced under another if those regulations are not compatible. Inconsistent ratings regulation could actually promote uncertainty in the global capital markets, at a time when it can be least afforded. To that end, we believe the G20's recent comments about the need for international consistency, and the model code of conduct published by the International Organization of Securities Commissions ("IOSCO") as a possible blueprint in that regard, are constructive.

Specific Proposals That Would Improve Ratings and Benefit The Markets

Let me speak now about specifics. There have been several recent proposals for additional legislative and regulatory action which, on top of the new and far-reaching rules issued by the SEC, would provide for extensive new regulation designed to increase NRSROs' accountability. As noted, S&P agrees with, and is prepared to support, many of the recent proposals to strengthen regulation of NRSROs by: (i) increasing SEC oversight; (ii) protecting against conflicts of interest, which inevitably exist in connection with any credit rating business model; (iii) promoting the use of high quality data by NRSROs; and (iv) improving transparency in the ratings process.

These recent proposals that we broadly support include, specifically:

Oversight and Accountability

- Creating a dedicated office within the SEC to oversee NRSROs and empowering the SEC to conduct frequent reviews of NRSROs to ensure that NRSROs follow their internal controls and policies for determining ratings and managing conflicts of interest;
- Providing the SEC with explicit authority to impose sanctions, including steep fines for NRSROs that fail to comply with the SEC's rules or their own policies and procedures, and to conduct regular, annual reviews of NRSROs;
- Designating a responsible officer (or officers) within each NRSRO with authority to review compliance with procedures and methodologies, administer rating policies, and oversee compliance with the securities laws and regulations;
- Requiring NRSROs to adopt payment practices that are based in part on ratings performance and ongoing surveillance, which will help promote comprehensive and thorough analysis; and
- Mandating comprehensive analyst training programs;

Conflicts of Interest

- Requiring disclosure of a uniform body of underlying information by issuers, according to requirements appropriate to every class of securities to all NRSROs, which would lead to increased transparency and promote the issuance of unsolicited ratings, thus improving competition in the rating industry;
- Requiring analyst rotations so that analysts do not consistently analyze the same issuer or security, further reducing the potential for conflicts of interest;
- Requiring "look-back" reviews whenever former NRSRO employees leave to work for an issuer, thus providing a further check on the integrity of the rating process;
- Requiring that fees for structured transactions are paid at defined milestones in the process, rather than when the transaction closes, which would help avoid potential conflicts of interest and protect against so-called "ratings shopping"; and

- Requiring issuers to make disclosures when they seek preliminary ratings from NRSROs, which will further protect against ratings shopping.

Data Quality

- Requiring disclosures about the use of any third party due diligence services; and
- Requiring NRSROs to receive due diligence certifications from independent, third party firms in connection with credit ratings on structured finance securities backed by residential mortgages.

Transparency

- Requiring frequent dissemination of robust and comparable data about the historical performance of ratings, including default and transition studies, which will permit investors and other market participants to compare NRSROs and improve competition in the industry;
- Requiring broad dissemination of ratings methodologies, analytical assumptions, and practices related to data quality;
- Requiring disclosures about the use of “servicer reports” in connection with structured finance transactions; and
- Improving documentation and broadening public disclosure of internal controls, including conflicts of interest policies and codes of conduct.

On this last category, I will add that while we believe strongly in promoting transparency and a well-informed market, the key is to promote *relevant* transparency; we should seek to avoid the risk of overloading the market with too much information that has no genuine use.

There have been other proposals which S&P generally supports. For example, with the expansion of the number of NRSROs that has occurred as a result of the 2006 Act, there appear to be good grounds for reevaluating the use of NRSRO ratings in federal laws and regulations. On this subject, we have always said that S&P did not seek to include the NRSRO designation in laws and regulations. We agree with the objective of such proposals — namely, to reduce the

potential for undue reliance on rating opinions and a misperception among market participants that Congress and the SEC are “endorsing” NRSROs’ processes or methodologies by influencing the meaning or substance of NRSROs’ ratings. Let me add that if regulators and policymakers ultimately choose to retain ratings in their rules as benchmarks, the use of additional benchmarks, addressing elements other than credit risk, may also be warranted.

S&P recognizes the potential benefits of further regulation and wishes to work with this Subcommittee and your colleagues to pursue meaningful change to the regulatory landscape which will, ultimately, restore and maintain the confidence of investors and provide them additional choice in what ratings they use. This is an important point in time, as extensive new regulation in this area will undoubtedly shape our capital markets for years to come.

Proposals That Raise Concerns For NRSROs and the Markets Generally

Although S&P broadly supports the proposals I have mentioned, there are several that raise particular concerns. Some of these can be alleviated by simple revisions to the proposed text while preserving the core goals of the proposals. Other provisions, however, raise serious concerns, not only for the significant effect the proposals would have on S&P and other NRSROs, but also for the broader implications they would have for the United States and global financial markets as a whole.

Amendments to Pleading Standards

One proposal that has been discussed in recent months could have the effect — at least as interpreted by aggressive plaintiffs’ lawyers not always seeking to advance the broader interests of the market — of lowering the threshold legal requirements for bringing a securities fraud claim against NRSROs and *only* NRSROs. On the subject of litigation, let me first correct one

misperception, namely, that the First Amendment insulates rating agencies from all liability. Although I am not a lawyer, I understand that courts have indeed affirmed that credit ratings are opinions that are matters of public concern protected by the First Amendment. However, the First Amendment provides no exemption from liability to any company, including a rating agency, that intentionally misleads or defrauds investors. Indeed, the First Amendment provides no protection in a securities fraud under the Securities Exchange Act — the very statute that this proposal would seek to amend.¹

If the proposal under consideration were to become law, plaintiffs' lawyers would use it to argue that NRSROs may be sued for securities fraud under the Securities Exchange Act whenever they act "unreasonably." This would differ materially from the legal standard applicable to *every other* defendant — including auditors, equity analysts, issuers, underwriters and others — who must be found to have acted intentionally with bad faith (or in legal terms with "scienter") before they can be found liable. Such a distinction is inappropriate and unfair. We are not suggesting that NRSROs should receive special treatment in such cases, but rather that they should be subject to the same pleading standards as other defendants.

Thus, under such a new legal framework, if a plaintiffs' lawyer were to bring a securities fraud suit jointly against three defendants -- a securities analyst, an auditor and an NRSRO -- the plaintiff would have to allege that the securities analyst and auditor acted intentionally in bad faith but, with respect to the NRSRO, would argue that it need to allege only that the NRSRO acted "unreasonably." In other words, materially different legal standards would apply in the

¹ For the information of the Subcommittee, I am attaching a copy of written testimony recently submitted by S&P's outside legal counsel, Floyd Abrams, to the House Committee on Oversight and Government Reform which addresses issues of rating agency liability.

same case. We respectfully submit that any such change is both unfair and unjustified. There is simply no basis for providing any less legal protection to NRSROs than, say, analysts who issue recommendations to buy or sell stock, or arrangers and sellers of securities.

This proposal could lead to a torrent of new litigation against S&P and other NRSROs, which would be in addition to the many lawsuits, seeking tens of billions of dollars, currently pending against us in state and federal courts across the country.

On this point, it is important to understand that the very nature of credit ratings makes NRSROs uniquely susceptible to potential harm from the creation of a new lower liability standard. Credit ratings are not statements of existing fact but rather opinions about the future. They are not some sort of guarantee of performance or investment recommendation but rather, by their nature, are forward-looking opinions that speak primarily to the *likelihood* that a particular security or obligor will default in the future. Market participants have long understood that some portion of rated debt — even highly rated debt — will ultimately be downgraded and, in some cases, default as issuers encounter financial difficulties, the markets they operate in shrink, or economies go into recession. That some percentage of defaults occur is not evidence that the initial ratings were “too high,” “too low,” or otherwise “inaccurate” and certainly not of wrongdoing that should expose NRSROs to expanded securities fraud claims as contemplated by proposals now before this Committee.

If S&P or other NRSROs could potentially be liable under the securities laws even where it acts in good faith, plaintiffs’ lawyers would inevitably file suit against them any time rated securities default, or even when ratings are simply downgraded. There would be limitless opportunities for such second-guessing because, at any moment, S&P has well over 1 million

ratings currently outstanding and rates more than \$32 trillion of debt. Our lawyers have explained that this dynamic could create the potential for an unprecedented number of lawsuits from an unknown but vast class of potential plaintiffs.

More importantly from a market perspective, the harm I am discussing would not just be limited to vastly increased litigation risks and costs for NRSROs. More to the point, any law that could be read as subjecting NRSROs to the prospect of liability, in hindsight, for opinions issued in good faith, would be affirmatively harmful to the markets as a whole. For example:

- ***NRSROs could adopt a one-dimensional approach:*** Exposing NRSROs to new expansive liability could well lead to a more homogeneous approach to ratings among NRSROs, resulting in less diversity of opinion and strong disincentives for analytical innovation, thereby stifling a prime goal of increased competition in the industry. Faced with potential liability under the proposed standard, NRSROs across the board would have strong incentives to adopt only those processes that courts would deem “reasonable,” even if they believe a different approach might be more appropriate analytically and provide more robust ratings for investors. The result could generate serious systemic risk. As NRSROs would adopt narrower, less diverse opinions, the market would be left with one uniform, conventional view of credit risk when making investment decisions and other financial judgments.
- ***The market would have access to fewer ratings:*** The proposal could also result in the scaling-back of ratings coverage, with the most profound impact felt by newer and smaller issuers, including those in emerging sectors critical to the future growth of our markets and economy. Faced with a dramatic increase in liability risk, NRSROs would likely rate only those entities and securities that are least likely to default or be downgraded or which have a long history of providing the highest quality data. As a result, issuers who are relatively new to the debt markets may have a difficult time getting rated and, therefore, greater difficulty accessing capital and contributing to the economic recovery. Since small and medium enterprises, as well as new technology companies -- for example, green energy producers and broadband providers -- represent critical and emerging elements in our national production and employment bases, this result could have long-standing, detrimental results for economic growth.
- ***There could be less comprehensive ratings analysis:*** Expanding the potential for litigation against NRSROs would create incentives for NRSROs to narrow the scope of their rating analysis in order, again, to minimize the areas for potential second-guessing by plaintiffs’ lawyers. For example, a number of NRSROs consider projections prepared by management when rating corporations, public finance issuers, and others. Performing a “reasonable” investigation of such projections — as would be required under the current

discussion draft — would be difficult if not impossible to do, yet an NRSRO would face new potential liability risk for failing to do so. Faced with this choice, an NRSRO might decide to stop taking such information into account. Ratings would thus become more backward-looking and, as a consequence, less geared towards their primary purpose: an assessment of likely credit quality on a going forward basis.

- ***NRSROs may avoid downgrades to limit potential liability:*** Ratings are forward-looking opinions. As such, they sometimes change as the economy does or as updated facts about a rated entity or security become available. Some rated securities inevitably default; others are downgraded as new facts surface. If NRSROs could be sued every time an obligor or security is downgraded or defaults, the ratings process itself could be distorted so as to avoid downgrading ratings even if circumstances warrant, thus lowering NRSROs' potential legal exposure.

I am not suggesting, of course, that S&P should receive special legal treatment in lawsuits for securities fraud under the Exchange Act. Rather, I am raising probable, unintended consequences not just for NRSROs but, more importantly, for issuers who must access the debt markets and for investors who want and need additional information about the debt. I am simply saying that we should be subject to the same legal standards as everyone else in such cases. The discussion draft suggests the possibility of new language explicitly stating that Congress would not be amending existing pleading requirements under the federal securities laws, and that NRSROs would be subject to the same legal standards that apply to issuers and underwriters. While this provision would certainly help to alleviate the significant concerns I have raised, the discussion draft still contains much of the problematic language I have discussed and, therefore, should be made clearer in order to avoid any possibility of these very serious potential harms.

Collective Liability

Another proposal that has given us great cause for concern is one that would subject each NRSRO to “collective liability” for judgments against any NRSRO. Thus, if an analyst at one NRSRO commits securities fraud, S&P could be required under some circumstances to

compensate the victim of the fraud even if S&P had nothing whatsoever to do with the other NRSRO's fraudulent activity. Respectfully, we believe there is no basis for this unique and unjust legislative scheme. Put simply: No NRSRO should be required to act as an insurer and compensate plaintiffs for harm caused by employees of its competitors.

This proposal is particularly alarming because it contrasts so sharply with the primary goal of the 2006 Act — to increase competition in the credit rating industry and lower barriers to becoming an NRSRO. Indeed, it is difficult to imagine a greater deterrent to entering this industry than the knowledge that one may be required to act as an insurer and held financially responsible for the fraudulent actions of and harm caused by its competitors and its competitors' employees.

In this regard, we must also recognize that the 2006 Act succeeded in increasing competition by reducing the authority of the SEC to evaluate the track records of entities seeking NRSRO status. S&P has always embraced more competition in the rating industry and we supported this purpose of the 2006 Act. We did not expect, however, that we would ultimately be made in effect a legal guarantor and insurer of the work performed these new entrants. Such a result is not fair, and there is no legal or policy basis for it.

Sharing and Verification of Information

The discussion draft includes another troubling provision, which would mandate that NRSROs disclose to one another all information they receive from issuers. On its face, the proposal would also require NRSROs to disclose — to competitors no less — all of their own internal work papers, meeting notes and any other analytical support for their rating opinions. This would constitute an unprecedented intrusion into competitive businesses and fundamentally

subvert intellectual property rights in a manner that would undoubtedly chill robust analysis by NRSROs and otherwise restrict development and innovation in the ratings industry.

In addition to such sweeping disclosures, the proposal would also require NRSROs to review and “verify” any information similarly disclosed to them by their competitors. This would constitute a seemingly insurmountable burden, considering that S&P alone has well over 1 million ratings outstanding right now and currently rates more than \$32 trillion of debt. The proposal raises a number of serious questions: How would an NRSRO go about “verifying” all of this information, which presumably would include financial statements, management projections, and the like? Would NRSROs be required to verify such information even if they did not rate the relevant issuer or security? Would NRSROs be expected to establish entire departments dedicated to verifying the reams of information flowing in from their competitors? Rather than NRSROs, these roles are properly held by those involved in the securitization process who are responsible for the review and verification of such information.

Whatever the answers to these and other questions raised by this provision, it is clear that this concept is unprecedented and would inevitably create extraordinary barriers to entry, particularly for start-up firms who would not conceivably be equipped to take on the massive burden of verifying information on virtually all of the major securities issuances in the U.S., as well other issuances abroad.

Potential Interference With Analytical Independence

A core provision in the 2006 Act prohibits the SEC from regulating “the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings.” This important limit on SEC authority was designed to protect NRSROs’ analytical

independence and to ensure that they are able to issue rating opinions free from government-mandated analytics, which would stifle innovation, lead to less robust ratings, and have the appearance to investors that the government is somehow “sanctioning” or “endorsing” a particular rating or NRSRO. Some recent proposals, however, cross that threshold and suggest a substantive role for regulators in determining how an NRSRO forms its rating opinions. One example is a provision in the discussion draft that would strictly define the meaning of a credit rating, limiting it to an assessment of risk that investors “may not receive payment in accordance with the terms of issuance” — in other words, the likelihood of default.

As I have discussed today, S&P’s credit ratings express forward-looking opinions about the creditworthiness of issuers and obligations. More specifically, our ratings express a relative ranking of creditworthiness -- issuers and obligations with higher ratings are judged by us to be more creditworthy than issuers and obligations with lower credit ratings. Legislative proposals attempting to define and limit the definition of a credit rating do not account for the reality that creditworthiness is a multi-faceted phenomenon. Although there is no “formula” for combining the various facets, our credit ratings attempt to condense their combined effects into rating symbols along a simple, one-dimensional scale, and the relative importance of the various factors may change in different situations.

While likelihood of default is the single most important factor in our analysis of creditworthiness, investors have repeatedly cited other factors as useful to them in their investment decisions. Our analysis therefore addresses secondary factors, including the payment priority of an obligation following default. For example, when a corporation issues both senior and subordinated debt, we typically assign a lower rating to the subordinate debt. We also

consider the projected recovery that an investor would expect to receive if an obligation defaults. Another factor is credit stability, which accounts for the expectation that some types of issuers and obligations are prone to displaying a period of gradual decay before they default, while others may be more vulnerable to sudden deterioration or default. Accordingly, in 2008, we introduced an explicit “stability” measure into our ratings criteria, which addresses whether, in our view, an issuer or security has a high likelihood of experiencing unusually large adverse changes in credit quality under conditions of moderate stress.

Any government mandate that arguably would prohibit an NRSRO from considering any secondary credit factors that are relevant to our opinion of creditworthiness would lead not only to homogenized ratings, thus depriving investors of the full breadth and diversity of NRSROs’ opinions, but could also result in undue investor reliance on rating opinions and a misperception that Congress or the SEC has endorsed NRSROs’ methodologies and their ultimate rating opinions -- again, precisely the opposite of Congress’ goal in pursuing proposals to remove the NRSRO designation from existing laws and rules. Such mandates could also lead to narrower, more homogeneous ratings, giving rise to many of the harmful market effects I have mentioned.

S&P supports a transparent system in which the market has the benefit of an NRSRO’s complete and independent opinion of a bond or security, along with a clear understanding about the different aspects of creditworthiness that ratings can address. This is far more beneficial to the market than a system in which the government mandates what a rating must mean or what it must address.

Removing Protections for Forward-Looking Statements

We also have serious concerns about proposals providing that rating opinions shall not be deemed “forward-looking statements” under the federal securities laws. These proposals ignore that the very essence of a rating is that it is forward looking — it speaks to the likelihood that a particular obligor will pay back principal and interest in the future. Unlike statements that speak to an entity’s current financial condition, ratings expressly relate to what may likely happen on a going-forward basis. If ratings were not forward-looking, but instead simply reported on existing facts about an issuer or security, they would serve very little, if any, purpose to the markets. Indeed, at S&P we have heard consistently from market participants over the years that ratings *must* be forward-looking in order to have value.

While we understand that one of the purposes of this proposal is to subject NRSROs to a high level of accountability and promote quality rating opinions, we believe legislation can achieve these goals in a manner that is consistent with the genuine nature of ratings.

Corporate Governance Restrictions

Another proposal would regulate and restrict the corporate governance practices at NRSROs or their parent companies. Among other things, the proposal would dictate the composition of boards of directors, restrict the activities of board members and control their compensation structure and length of term. In addition, board members would be required to oversee analytical processes, including the development of ratings criteria and methodologies — subjects that would ordinarily fall far outside the knowledge and experience of corporate board members, who are not trained analytical staff or management of NRSROs.

Such interference with NRSROs' corporate governance structure would treat NRSROs differently and much more harshly than all other market participants, including, for example, auditors and equity analysts. Members of Congress and critics of NRSROs have frequently observed that NRSROs should be treated "the same as" auditors and equity analysts; yet, the effect of this proposal represents the opposite approach.

Prohibitions on the Activities of NRSRO Affiliates

Finally another provision of the discussion draft would impose restrictions on the affiliates of NRSROs, prohibiting them from engaging in an array of services unrelated to any credit rating service. S&P has further strengthened its policies in this area since 2007 and strongly supports the goal of protecting against potential conflicts of interest. These new proposals, however, would sweep too broadly and would increase barriers to entry. By way of example, S&P is owned by The McGraw-Hill Companies, Inc., which itself operates a number of entities and business units that have nothing to do with — and are segregated both structurally and substantively from — S&P's credit rating activities. McGraw-Hill's education and information and media segments, for example, have nothing to do with S&P's ratings yet would be covered by this sweeping prohibition. Imposing restrictions on the ability of units like these to do business with issuers on matters totally unrelated to ratings would be unfair and could well prevent new businesses that currently offer similar services from considering entrance into the ratings business as an NRSRO.

This problem could be solved rather easily by creating a safe-harbor provision for those NRSROs, such as S&P, that maintain policies and procedures that establish firewalls to insulate ratings-related activities from other business activities under the same corporate umbrella. This

approach would be consistent with rules announced by the SEC earlier this year and now in effect, which include restrictions that are focused on situations in which affiliates of NRSROs provide consulting advice in connection with credit rating activity. We would be pleased to offer specific language to the Committee on this matter.

In summary, we are concerned not only with potential effects on S&P, but also the effects these changes would have on the market. While we agree completely with the goal of improving the quality and transparency of credit rating analysis, we urge caution in the crafting of proposals that would ultimately result in less comprehensive ratings, covering a narrower scope of world markets to the detriment of investors and business enterprises large and small. Any regulatory scheme that effectively scales back the availability of robust, independent rating opinions will result, inevitably, in a reduction to the flow of capital in global markets, stalling innovation and growth in emerging sectors and beyond.

Conclusion

I thank you for the opportunity to participate in this hearing. Since our founding over a century ago, S&P's consistent approach has been to learn from experience and to improve and strengthen our analytics, criteria, and review processes when appropriate. You can expect that same approach going forward. Let me also assure you again of our commitment to analytical excellence and our desire to continue to work with Congress and governments, legislatures and policy-makers worldwide as they strive to develop productive solutions that restore stability in the global capital markets. I would be happy to answer any questions you may have.

**Written Statement of Dominic Frederico
Chief Executive Officer
Assured Guaranty Limited
Before the House Subcommittee on
Capital Markets, Insurance and Government Sponsored Entities**

Chairman Kanjorski, Ranking Member Garrett, and members of the Subcommittee, my name is Dominic Frederico and I am Chief Executive Officer of Assured Guaranty Limited (Assured Limited), the holding company for Assured Guaranty Corp. (Assured Guaranty) and Financial Security Assurance Inc. (FSA). Assured Guaranty and FSA provide financial guaranty insurance for U.S. municipal and global public finance obligations, including municipal bonds, loans and infrastructure financings. Thank you for accepting my written statement in connection with this very important hearing.

Our service, financial guaranty insurance, is utilized in the financial markets to assist issuers of bonds (municipalities and other issuers) to reduce the cost of borrowing and to provide investors security and risk management. Our company and our industry are currently subject to the regulatory oversight of state insurance regulators. The current decentralized regulatory regime for monoline insurance has been stressed by the events of the last 24 months where various participants in the financial guarantor sector undertook strategies that have put their continued viability at risk. Unfortunately, the current regulatory regime lacks uniform, consistent credit, capital and financial strength standards. As a result of the lack of a single consistent regulator, the rating agencies have become the de facto regulators of our industry, placing this important sector at the mercy of three rating agencies with different requirements and models that are far from transparent and do not result in the consistent outcomes which are necessary for regulation and oversight.

FSA and Assured Guaranty, which commenced operations in 1985 and 1988, respectively, have come through this unprecedented period of turmoil in strong capital positions. Our two companies recently came together when Assured Limited acquired FSA from Dexia in a transaction that ensured that FSA would be able to operate exclusively as a municipal bond insurer, while its sister corporation, Assured Guaranty, would continue to operate as an insurer of both municipal and asset-backed obligations. We are confident that this new organization will allow investors to find value in the over \$660 billion of municipal and other bonds that carry our guaranty and for newly written policies for newly issued debt as is evidenced by the over \$28 billion of municipal securities that we have already insured during calendar year 2009. This continued strength is not only important to investors of existing securities, but also to the issuer who only purchases our services if the interest rate savings justify the expense of insurance. Recall too that the ultimate beneficiaries of the reduced borrowing cost of a municipal bond as a result of insurance are the state and local taxpayers who will be paying less for new schools, roads, bridges or other needed public projects.

Mr. Chairman, we want to commend you on your draft "Enhanced Accountability and Transparency in Ratings Act." We believe that many of the measures you have introduced will bring increased transparency and accountability to the rating agencies, which will benefit all market participants, including issuers, investors and companies who rely upon their credit rating to do business. As the last few years have demonstrated, there is a need for enhanced disclosure requirements and a more transparent rating regime.

We believe that your bill carefully balances the need to create a regulatory framework for the credit

rating agencies that provides appropriate levels of requirements, transparency and accountability without inhibiting their independent judgment in the actual ratings. Exercising that judgment in an environment where all market participants can better understand the methodologies employed, the data analyzed and the underlying economic assumptions consistently applied not only company-by-company but across all related companies, can only increase the depth of the understanding of the ultimate rating. Investors will then be armed with better information about the rating in order to make their own judgment about the viability and reliability of the rating.

While we will continue to strive to achieve the highest possible ratings, we believe that credit rating agency views currently play too singular a role in the evaluation of our financial strength, particularly when that role is played out in an opaque manner employing methodologies that are not understood or consistently applied. Ratings are based on criteria that vary and include many subjective characteristics and employ methodologies that are not readily transparent. Additionally, the three major rating agencies have different sets of guidelines, which present conflicting goals that make it difficult to manage a company in a rational manner. Importantly, investors cannot easily evaluate rating agency conclusions. Even worse, among the major credit rating agencies, there are different standards and assumptions applied to different companies within the same sector and industry.

We have reviewed your discussion draft and support the proposals that you have offered. We are in agreement that increased disclosure, transparency and oversight will help to restore market confidence in credit rating agencies and the service they provide. Furthermore, your legislation will help investors to better understand the assumptions underlying their ratings and thereby better put that analysis into context along with other credit analysis. This openness should provide opportunities for greater competition in the rating agency sector, competition that has been badly needed. We also believe that transparency will encourage the development of new entrants into the market – entrants that may bring unique specialties and business models that will ultimately benefit investors and the marketplace generally.

As the House Financial Services Committee begins to formally consider this legislation, we have what we hope will be perceived as constructive suggestions to your draft that we believe would make the transparency provisions even more effective, and permit the users of credit ratings to better understand how a rating was determined. As you have noted, the goal of part of the proposed legislation is to allow the public to “better understand credit ratings issued by the nationally recognized statistical rating organization[s].” We would respectfully submit to you the following additions to the requirements set forth in this section.

First, we strongly support a credit rating agency’s disclosure of any deviations from the consistent application of its assumptions, procedures and methodologies in rating different companies and issuers with similar products and in similar industries. In reviewing a credit rating report, a user relying on that rating should be able to consider the credibility and viability of the underlying assumptions utilized in arriving at a particular rating and whether the credit rating agency followed its procedures and methodologies, particularly when the credit rating agency is inconsistent in the application of these procedures and methodologies across one specific rating type. Disclosing any information related to a methodology and underlying assumptions and the consistency of the applications of those practices across the spectrum of rated issuers will only cause credit rating agencies to be more careful in deriving ratings and will permit users to consider the “full picture” when evaluating a credit rating.

Similarly, we would also mandate the disclosure of any deviation from the standard assumptions underlying those procedures and methodologies. Just as a user of credit ratings should know if the application of procedures and methodologies were applied inconsistently by a credit rating agency, we believe it is materially significant to warrant the disclosure of any instance where the underlying assumptions are not the same across the spectrum of rated issuers. Such transparency will not only provide the investor better information about what makes up a particular rating, but will also permit the investor to compare the strength and creditworthiness of different companies in the same sector (e.g. financial guarantors) and different companies within the same industry (e.g. financial guarantors, banks, insurance companies, investment banks, etc.)

Finally, we believe that each credit rating agency should be required to publish written comments received from any user of a credit rating related to the factors that go into determining a credit rating. The written comments could be published on the credit rating agency's website, with each issuance or company accessible by a specific, identifiable web link. Such a process would be relatively inexpensive to implement and provide for valuable additional transparency. In addition, it would provide a convenient, centralized forum to discuss the procedures, methodologies and data used by a credit rating agency in arriving at its credit rating.

Mr. Chairman, we congratulate you again for drafting such necessary and well-crafted legislation. We appreciate you and your colleagues' efforts to enhance regulators' oversight of the credit rating agency sector by increasing the level of transparency at this critical time. We look forward to working with you to achieve these goals.

Egan-Jones Ratings Company
Tel. 610-642-2411 Segan@Egan-Jones.com

*Providing timely, accurate credit
ratings to Institutional Investors*

September 29, 2009

Hon. Paul Kanjorski
Chairman
Hon. Scott Garrett
Ranking Member
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
U. S. House of Representatives
Washington, DC 20515

Gentlemen:

I am writing in connection with your ongoing examination and hearings to address problems in the rating industry. Inflated ratings have been and remain a principal cause of turmoil in the financial markets.

The proposed legislation in the form of the Discussion Draft released last Friday along with the rating agency legislation recently unveiled by the Treasury Department shows that public policy makers in Washington are coming to grips with the core problem in the credit ratings industry, namely that the agencies are being paid by the sellers of the securities rather than the investors who they are supposed to protect. We commend the efforts of your Subcommittee in serving as the catalyst for these much needed reforms.

At Egan-Jones, we do remain concerned that the liability issue which is featured in the Discussion Draft and is receiving increased attention as a potential remedy in this area will have the opposite effect of improving the quality of credit ratings.

By way of example, just yesterday, S&P downgraded MBIA to non-investment grade or junk status. Seven years ago, Egan-Jones issued a rating report that MBIA, which is the largest of the bond insurers, did not merit the Triple-A rating which Moody's, S&P, and Fitch accorded them.

When Egan-Jones continued to lower its MBIA ratings, we received a threatening letter from the company's Chief Executive Officer. The letter began by stating that "I find it difficult to understand how you could have an informed opinion" as to the financial strength of MBIA. It concluded by suggesting that we refrain from making any further "public statements" about the company.

As is well known, of course, the earnings, capital and stock prices of the monoline insurers collapsed in late 2007, but even during the time period when state insurance officials were actively pursuing multi-billion dollar restructurings for these companies, the dominant rating firms were still holding them at AAA.

When our modest-sized company takes on these multi-billion entities, we rely heavily on the First Amendment freedom of speech protection. This protection has enabled us to ignore the many threats similar to that which we received from MBIA.

Egan-Jones Ratings Co.

September 29, 2009

Please be aware that investors stand on both sides of the First Amendment issue, and, for this reason, we strongly encourage the Subcommittee to follow the recommendation of the Treasury Department by leaving the judicial aspect of rating agency reform to the courts.

Thank you for taking these views under consideration.

Yours sincerely,

Sean Egan



Statement of John A. Courson

President and Chief Executive Officer

Mortgage Bankers Association

for the Record of the

**Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises**

**Committee on Financial Services
United States House of Representatives**

**Hearing on
“Enhanced Accountability and Transparency in Credit
Rating Agencies Act”**

September 30, 2009

Statement of John A. Courson
Credit Rating Agencies Act
September 30, 2009
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The Mortgage Bankers Association (MBA)¹ appreciates the opportunity to provide this statement for the record of the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises' hearing on the Enhanced Accountability and Transparency in Credit Rating Agencies Act (Agencies Act).² The Agencies Act proposes to amend the Securities Exchange Act of 1934 to increase the oversight and transparency of nationally recognized statistical credit rating agencies (rating agencies). MBA commends Representatives Kanjorski, Kilroy and Kosmas for addressing this important topic.

MBA Position

MBA recognizes the pivotal role that rating agencies play in the real estate finance system by making assessments about financial services providers and financial instruments used in the secondary mortgage market.

Because of the high degree of sensitivity associated with credit ratings, MBA believes rating agencies and their ratings methodologies must be held to exacting standards. Therefore, MBA endorses efforts to increase transparency; reduce misrepresentations; improve investor access to underlying mortgage pool characteristics and securities' performance data; and reduce potential conflicts of interest among rating agencies and others in the industry.

MBA used these fundamental principals to evaluate the Agencies Act, and we offer the following perspectives. Presented first is a summary of the relevant section of the Agencies Act followed by paragraph(s) that address MBA's position.

- 1. Review of Internal Processes for Determining Ratings (Sec. 2 (3))** – The Securities and Exchange Commission (SEC) would review the extent to which each rating agency follows its own rating methodology, internal controls, and due diligence procedures.

While strongly supporting competent rating agency determinations, MBA has

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

² September 30, 2009.

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concerns that such a process would be duplicative with existing requirements for rating agency compliance officers to submit annual reports regarding these same issues. We believe that the intent of this proposal can be accomplished through enhanced rating method and data disclosure which will allow market participants to access the accuracy of credit ratings and provide the opportunity for other rating agencies to provide alternative ratings.

Moreover, the SEC rating agency evaluation would only address whether the rating agencies were following their prescribed methodologies, internal controls, and procedures and would not assess the accuracy or quality of the ratings models or methodologies themselves. Consequently, the SEC would not have authority to take action on ill-conceived rating models if the rating agency followed its prescribed methodologies, controls, and procedures.

2. **Designation of a Compliance Officer (Sec. 2 (h))** – The compliance officer would report directly to the Board of Directors and be prohibited from performing ratings. The compliance officer would also be required to establish procedures for addressing complaints and issuing an annual report.

MBA supports these measures to enhance the accountability and authority of rating agency compliance officers.

3. **Transparency of Credit Rating Methodologies and Information Reviewed (Sec. 2 (s))** – Rating agencies would be required to disclose information about assumptions made during the ratings process as well as the rating methodology employed. Potential shortcomings of the rating must be disclosed. The rating agency also must disclose if a third party due diligence provider was used to analyze data that was used in developing a rating. Rating agencies must disclose factors relating to the volatility of the rating and the circumstances that will result in a rating change.

MBA supports increased rating agency transparency including the disclosures specified in Sec. 2(s).

4. **Prohibition - Advisory Service Activities (Sec. 2 (t)(1)(A)(iii))** – Rating agencies that are rating a security would be prohibited from also providing risk management advisory and consulting services to the issuer.

MBA supports this restriction on rating agencies providing advisory or consulting arrangements with firms whose securities they rate. MBA notes the rating agencies themselves have publicly supported this prohibition.

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5. Issuer Disclosure of Preliminary Ratings (Sec. 5) – Rating agencies would be required to disclose preliminary ratings.

This is intended to address past problems with “rating shopping,” i.e., commissioning the rating agency that provided the most favorable preliminary rating. However, with increased transparency in the ratings process under this legislation, which would enable investors to compare unsolicited ratings to commissioned ratings, this problem is largely resolved. Moreover, since the term “preliminary rating” is not defined and may be interpreted too broadly, the legislation may present unintended consequences.

In the case of commercial mortgage-backed securities (CMBS), the pool of loans that receives a preliminary rating is often significantly altered (new loans are added and some loans that were part of the preliminary rating are taken out of the loan pool) by the time that the CMBS is issued. Consequently, examining preliminary ratings can be misleading because they may not represent the characteristics of the loan pool once it has been securitized. Because of these three considerations, MBA does not support the disclosure of preliminary ratings and opposes this provision.

6. Credit Ratings Methodology - Unique Identifier for Structured Securities (Sec. 2 (r)(E)) – Rating agencies will have to adopt rating symbols that distinguish among structured products, non-structured products, corporate offers, municipal offers, and such other products the SEC deems appropriate.

The Agencies Act would require the new rating symbol to be attached to all structured securities regardless of their recent or long-term performance. Such a symbol would brand all structured securities as a single asset category, despite the fact that different structured securities exhibit markedly different performance characteristics (e.g. CMBS, RMBS, and securities backed by credit card debt or automotive loans). We are concerned that this approach could spawn greater investor confusion because a wide variety of securities would be lumped into an equally broad investment category.

The performance of a security is primarily attributable to the performance of its underlying assets, not its structure. The use of a structured ratings symbol could be perceived as a broad cautionary signal when in fact the underlying assets determine the securitization’s risk parameters. As a consequence, such a symbol would potentially steer investors away from security types that have demonstrated very strong performance records, such as CMBS during the current credit crisis.

If enacted, this provision could force institutional investors to modify their lists of permissible investments. The provision would also necessitate amendments to

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federal and state laws, regulations and supervisory guidance in order for them to comport with the new ratings framework. This provision is also likely to instigate unnecessary short-term disruptions as institutional investors determine how to apply the new ratings framework to their existing holdings. This, in turn, could further depress liquidity in the market for structured products.

An additional concern is that this component of the Agencies Act is redundant with the additional ratings methodology and data disclosure requirements. As mentioned above, the Agencies Act requires rating agencies to disclose information they use to assign and monitor credit ratings, including their rating methods. MBA believes these disclosure requirements obviate the need for a separate ratings symbol.

For these reasons, MBA strongly opposes the inclusion of a requirement for such an identifier in this legislation. Such an approach would stigmatize a wide category of securities and create compliance burdens for bond holders.

- 7. Removal of Statutory References to Credit Ratings (Sec. 7) -** The Agencies Act removes reliance on ratings in federal statutes where references to ratings are made.

MBA supports a more harmonious reliance, on credit ratings, in the various rules and regulations of regulatory agencies in order to create a consistent standard and to avoid regulatory conflict between the different regulatory agencies. Unfortunately, this provision would lead to unintended consequences. For example, state statutes governing insurance companies that include references to ratings would not be impacted. In addition, international risk-based capital conventions to which the United States subscribes, such as Basel II, maintain references to ratings to determine risk-based capital requirements for certain structured securities. Consequently, the removal of reliance on ratings in federal regulations would create a potential conflict with state laws and international conventions. The latter could enable regulatory arbitrage opportunity for multi-national financial institutions. Therefore, MBA recommends that this provision be removed from the legislation.

Conclusion

MBA supports those provisions of the Agencies Act that promote ratings transparency, accuracy and reliability. However, at the same time, MBA believes that portions of the Agencies Act requiring rating agency reviews by the SEC, a unique identifier for structured securities, disclosure of initial ratings, and removal of the reliance on ratings in federal statutes would have unfortunate and potentially severe unintended consequences.

FitchRatings

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New York, NY 10004

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November 20, 2009

BY FACSIMILE

The Honorable Bill Foster
Member
U.S. House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
2129 Rayburn House Office Building
Washington, DC 20515

Re: Responses to Questions from Rep. Foster posed in connection with the
Hearing entitled "*Reforming Credit Rating Agencies*"

Dear Representative Foster:

I am writing on behalf of Fitch Ratings ("Fitch") to respond to the questions that you posed to Mr. Stephen W. Joynt, President and Chief Executive Officer of Fitch, in connection with his testimony before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises on September 30, 2009. Below are the questions that you asked and Fitch's responses to them.

Question 1:

While the bill mandates that the CRAs use generally recognized qualitative and quantitative models when arriving at their ratings, I believe providing greater detail under various market conditions would be beneficial to investors. For instance, I believe we should authorize a SEC or GAO study to propose standards for what might be called "ABZ" ratings-at-a-glance in which the three digits correspond to default probabilities under different levels of market stress: 1) the first digit represents the default probability under "normal" market stress (e.g. a 5% asset price drop, and 2% increase in unemployment); 2) the second digit represents the default probability under "severe" market stress (e.g. a 20% asset price drop, and 4% increase in unemployment); and 3) the third digit represents the default probability under "extreme" market stress (e.g. a 50% asset price drop, and 8% increase in unemployment). I would like for the panel to comment in detail on this proposal

Fitch Response:

Fitch believes that the market benefits from regulations for credit rating agencies that foster transparency and encourage the disclosure of ratings performance during various stages of the economic cycle. As a result, Fitch is in favor of any study that enhances the market's

*The Honorable Bill Foster
November 20, 2009
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understanding of how a given rating may perform at different stress levels. We are concerned, however, that the prescriptive nature of this proposed study might stifle competition and blur the differences in methodology and approach between the rating agencies.

A federally authorized study of rating agencies, with the proposed aim of developing standardized rating and default definitions (incorporating standardized stress scenarios), risks not just creating, but also requiring, one uniform credit view. Given the prescriptive nature of this study, this uniform credit view would be considered to be implicitly or explicitly endorsed by the government.

Each rating agency's approach to ratings is different. We believe that the market benefits from the variety of credit opinions and approaches provided by each agency so long as each agency's approach is transparent. The study, as proposed, risks standardizing the diverse methodologies used by the rating agencies.

We fear that this uniformity of definitions and stresses would not only be the first step towards the substantive regulation of rating methodologies by the government, but would also undermine the positive results of the SEC's designation of a range of NRSROs since the Credit Rating Agency Reform Act of 2006 went into effect, including increased competition. We believe that it is more constructive to use regulation to foster transparency of methodology, and to let the market determine which rating agency approach is most reliable, stable and prospective.

Question 2:

I believe we should expand the SEC study to include a redefinition of ratings. Specifically, the study should examine the desirability and feasibility of: 1) standardization of ratings terminology, so that all firms report ratings using identical terms; 2) standardization of stress conditions under which ratings are evaluated; 3) unambiguous, quantitative correspondence between ratings and default probabilities under standardized conditions of economic stress; and 4) standardization of terminology across asset classes, so that e.g. a given rating for municipal bonds and corporate bonds will have the identical default probability. Similarly, I would like the panel to comment on this proposal as well.

Fitch Response:

Fitch has long supported the concept of greater competition in the credit rating industry. As stated above, we believe that the market benefits from the existence of a variety of credit opinions. We, therefore, are concerned that the standardization of ratings terminology and stress conditions resulting from the proposed study would undermine the legitimate analytical differences between the credit rating agencies. This uniformity of approach would stifle competition and for all practical purposes lead to one rating agency.

We are also concerned that this proposal appears to assume that any given rating equates with mathematical precision to a specific default probability. This assumption is not the case. A credit rating is an opinion on a relative rank ordering of creditworthiness, not a specific prediction of a given default probability. The rating reflects substantial qualitative and quantitative inputs and assessments. A rating is not simply the result of a model where all rating agency models could be "made uniform" with uniform inputs and therefore uniform outputs.

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Question 3:

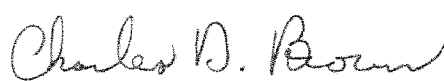
I think there needs to be greater oversight. In particular, I propose creating a new agency analogous to the Public Company Accounting Oversight Board (PCAOB), created by the landmark Sarbanes-Oxley Act in the wake of the wave of accounting by scandals in the early 2000's, to cover the CRAs. An agency modeled on PCAOB, which has a range of enforcement powers and is widely credited with helping restore investor confidence after it was passed, would similarly serve to restore investor confidence and bring much needed accountability to this industry. I would like the panel to comment on this proposal. Would a similarly situated agency to regulate the CRAs prove to be as beneficial as the PCAOB has been to the accounting industry? What specific powers should this agency have?

Fitch Response:

Fitch supports fair and balanced registration and oversight of credit rating agencies. We believe that the market benefits from consistent rules for credit rating agencies. While we support regulations that enhance transparency and integrity, we are wary of the creation of additional layers of bureaucracy to achieve these goals. There are currently proposals in Congress to enhance the regulatory oversight of the SEC over credit rating agencies. The purpose and responsibilities of another oversight body would have to be clearly defined to avoid redundant, and even inconsistent, regulation. Furthermore, it is important to note that the accounting industry is many times larger than the credit rating industry in terms of the number of companies, revenues and income. We have practical concerns regarding the potential cost of such an oversight body and its impact on the pricing, and therefore, availability of ratings. Given the current regulatory regime, the need for another oversight body is not readily apparent.

Please call me at (212) 908-0626 with any further questions that you might have about our response.

Very truly yours,



Charles D. Brown
General Counsel

cc: The Honorable Paul E. Kanjorski
Subcommittee Chairman

The Honorable Scott Garrett
Subcommittee Ranking Member

Questions from Representative Foster

1) While the bill mandates that the CRAs use generally recognized qualitative and quantitative models when arriving at their ratings, I believe providing greater detail under various market conditions would be beneficial to investors. For instance, I believe we should authorize a SEC or GAO study to propose standards for what might be called "ABZ" ratings-at-a-glance in which the three digits correspond to default probabilities under different levels of market stress: 1) the first digit represents the default probability under "normal" market stress (e.g. a 5% asset price drop, and 2% increase in unemployment); 2) the second digit represents the default probability under "severe" market stress (e.g. a 20% asset price drop, and 4% increase in unemployment); and 3) the third digit represents the default probability under "extreme" market stress (e.g. a 50% asset price drop, and 8% increase in unemployment). I would like for the panel to comment in detail on this proposal.

2) I believe we should expand the SEC study to include a redefinition of ratings. Specifically, the study should examine the desirability and feasibility of: 1) standardization of ratings terminology, so that all firms report ratings using identical terms; 2) standardization of stress conditions under which ratings are evaluated; 3) unambiguous, quantitative correspondence between ratings and default probabilities under standardized conditions of economic stress; and 4) standardization of terminology across asset classes, so that e.g. a given rating for municipal bonds and corporate bonds will have the identical default probability. Similarly, I would like the panel to comment on this proposal as well.

3) I think there needs to be greater oversight. In particular, I propose creating a new agency analogous to the Public Company Accounting Oversight Board (PCAOB), created by the landmark Sarbanes-Oxley Act in the wake of the wave of accounting scandals in the early 2000's, to cover the CRAs. An agency modeled on PCAOB, which has a range of enforcement powers and is widely credited with helping restore investor confidence after it was passed, would similarly serve to restore investor confidence and bring much needed accountability to this industry. I would like the panel to comment on this proposal. Would a similarly situated agency to regulate the CRAs prove to be as beneficial as the PCAOB has been to the accounting industry? What specific powers should this agency have?

CFA Institute would not support nor does it see the need for an entire new agency to oversee a handful of NRSRO's. We think it further signifies government oversight on the accuracy of ratings, which is what the CFA membership feels we should move away from.

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November 20, 2009

Thomas G. Duncan, General Counsel
United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Duncan:

Below please find my responses to the questions submitted by Representative Foster following the "Reforming Credit Rating Agencies" hearing on September 30, 2009, before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises.

Attached you will also find suggested corrections to the hearing transcript, as requested in your letter of October 16, 2009.

Question 1:

While the bill mandates that the CRAs use generally recognized qualitative and quantitative models when arriving at their ratings, I believe providing greater detail under various market conditions would be beneficial to investors. For instance, I believe we should authorize a SEC or GAO study to propose standards for what might be called "ABZ" ratings-at-a-glance in which the three digits correspond to default probabilities under different levels of market stress: 1) the first digit represents the default probability under "normal" market stress (e.g. a 5% asset price drop, and 2% increase in unemployment); 2) the second digit represents the default probability under "severe" market stress (e.g. a 20% asset price drop, and 4% increase in unemployment); and 3) the third digit represents the default probability under "extreme" market stress (e.g. a 50% asset price drop, and 8% increase in unemployment). I would like for the panel to comment in detail on this proposal.

Answer to Question 1:

While the goals of the "ABZ" approach may be appealing its implementation would be both extremely impractical and incompatible with the nature of ratings. The kind of analysis that rating agencies currently perform does not produce scenario-based conditional default probabilities, primarily because, in our view, the art of credit analysis is generally not precise enough to do so with sufficient confidence. That is largely why the most widely used credit rating systems have evolved into systems of relative rankings. Rating agencies generally have been able to produce relative rankings that are actually useful to investors because the rank ordering remains reasonably constant under a wide range of future conditions. The predicted conditional default frequencies contemplated by the "ABZ" system might lead investors to think that ratings are capable of more precision than justified.

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Moreover, although likelihood of default is a key component of creditworthiness, it is not the only component. Instead, ratings can also address other relevant factors such as payment priority, recovery in the event of default, and credit stability. Investors have made it clear to us that they want from ratings more than a narrow assessment of the likelihood of default.

More fundamentally, the "ABZ" approach would lessen the ability of ratings to capture and communicate the significant effect qualitative factors can have on an issuer's creditworthiness. For example, factors such as the quality of the management team at a particular rated entity or the political challenges facing a public finance issuer can greatly affect the likelihood of default or not, but simply do not lend themselves to quantification with any meaningful degree of precision.

If ratings were required to connote precise conditional default probabilities, they could only be meaningful, if at all, if restricted to relatively short-term and specific time horizons or target dates. Doing so could limit the utility of ratings to certain investors. Some investors may focus on short time horizons (e.g. one year), while other may have intermediate (e.g., five years) or long-term (e.g. twenty years) investment horizons. This suggests the possibility of assigning multiple ratings on the same security, which would be unwieldy and confusing, in our view. Moreover, ratings tied to specific target dates might still have to change with the passage of time, even if there had been no change in the fundamental creditworthiness of the subject issuer or obligation.

This does not mean, however, that we see no role for stress scenarios in ratings analysis. Indeed, stress scenarios can and do play an important part in our analysis, as explained further in our answer to Question 2 below. For example, hypothetical stress scenarios help us calibrate our rating criteria (methodologies) and maintain the comparability of our credit ratings across sectors and geographic regions, and over time. We intend for ratings in each successively higher rating category to withstand successively more stressful economic environments, which we view as less likely to occur. Applying stress scenarios across ratings enhances our ability to further this important goal.

In short, as with any analysis of the future, assessing creditworthiness is not an exact science and we believe the market benefits from having a diversity of opinions and approaches. However, we would be concerned about implementing a regime that would suggest to investors that ratings are somehow precise measurements of expected default probabilities rather than opinions about relative creditworthiness

Question 2

I believe we should expand the SEC study to include a redefinition of ratings. Specifically, the study should examine the desirability and feasibility of: 1) standardization of ratings terminology, so that all firms report ratings using identical terms; 2) standardization of stress conditions under which ratings are evaluated; 3) unambiguous, quantitative correspondence between ratings and default probabilities under standardized conditions of economic stress; and 4) standardization of terminology across asset classes, so that e.g. a given rating for municipal

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bonds and corporate bonds will have the identical default probability. Similarly, I would like to panel to comment on this proposal as well.

Answer to Question 2

Each of the proposals in this question implicates the crucial principle of analytical independence. Standard & Poor's is concerned that, if enacted, this proposal could lead to less information to investors -- and less diversity of opinion -- rather than more -- for the reasons laid out below. This would not only be inconsistent with Congress' stated goal of increasing ratings quality through competition, but it would also replace the independent judgment of ratings analysts on crucial analytical issues with that of the government. The Credit Rating Agency Reform Act of 2006, numerous market participants, and the SEC itself have recognized that this would be an inappropriate role for government to play.

The specific proposals in Question 2 are addressed in turn below.

Standardized Terminology: As discussed in response to Question 1, assessing creditworthiness is not an exact science and reasonable professionals can and do differ in how to define, analyze, and interpret credit factors. Some rating agencies may focus more on likelihood of default, while others may give additional weight to factors such as recovery upon default or stability. The market benefits from having more than one approach since it allows for informed analysis from multiple perspectives. The key is that each rating agency communicates clearly what its ratings mean and the methodology used to arrive at the rating.

Mandating uniform rating definitions would encourage more homogeneous analysis among rating agencies, thus depriving the market of the value of diverse approaches and opinions. Accordingly, we believe the focus of any efforts in this area should be not on dictating a rigid one-size-fits-all approach, but on ensuring that rating agencies are transparent about their methodology, their ratings, and what those ratings mean.

Standardized Stress Conditions: Ratings are forward-looking opinions based on consideration and analysis of a host of potential factors. Key macroeconomic factors, such as the unemployment rate or declines in GDP, are useful in connoting a general level of stress that might be associated with each generic rating category. However, when we rate a specific issuer or obligation, the relevant economic or business factors will vary. Projected oil prices may be important for an energy producer or an airline, while population growth may be important for a school district. It would not be feasible or useful to develop standardized scenarios for the thousands of issuers and issues that we rate. Moreover, different rating agencies may reasonably differ in how they associate industry- or sector-specific stress factors with macro-level stresses. Those differences reflect the fact that there can be more than one view as to what is likely to happen in the future and different professionals acting diligently can form different opinions as to which factors will play which role. As noted, this diversity of approach and opinion is an important market benefit.

Quantitative Correspondence: As detailed in response to Question 1, given the nature of ratings there are substantial pitfalls in trying to establish a forward-looking, quantitative correspondence

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between ratings and default probabilities. Meaningful analysis must recognize the dependence on the macro environment, which means that any notion of absolute (*i.e.*, unconditional) default probability is virtually meaningless. However, as noted above, even assessing default probabilities conditional on specific scenarios is unrealistic in that it both (i) connotes a false precision and (ii) marginalizes other dimensions of credit quality. Other factors, such as payment priority, recovery and credit stability, can significantly influence creditworthiness, and our ratings and research reports emphasize the importance of considering those factors when assessing creditworthiness.

Cross-Asset Class Standardization: Standard & Poor's strives to make our rating symbols reflect a broadly comparable view of creditworthiness wherever they appear. Thus, when we assign a given rating symbol to multiple issuers, we intend to connote roughly the same opinion of creditworthiness, irrespective of whether the issuers are a Canadian mining company, a Japanese financial institution, an Illinois school district, a British mortgage-backed security, or a sovereign nation.

Question 3

I think there needs to be greater oversight. In particular, I propose creating a new agency analogous to the Public Company Accounting Oversight Board (PCAOB), created by the landmark Sarbanes-Oxley Act in the wake of the wave of accounting scandals in the early 2000's, to cover the CRAs. An agency modeled on PCAOB, which has a range of enforcement powers and is widely credited with helping restore investor confidence after it was passed, would similarly serve to restore investor confidence and bring much needed accountability to this industry. I would like the panel to comment on this proposal. Would a similarly situated agency to regulate the CRAs prove to be as beneficial as the PCAOB has been to the accounting industry? What specific powers should this agency have?

Answer to Question 3

S&P strongly supports many of the measures recently introduced to increase transparency and accountability for rating agencies and to promote more meaningful ratings coupled with greater disclosure to investors. We also share the view that confidence in ratings can be restored through greater oversight, disclosure, and accountability. We believe a robust oversight framework for rating agencies should cover areas such as the integrity of an agency's rating processes, its vigilance regarding the quality of its rating methodologies, its measures for protecting against conflicts of interest, its commitment to transparency in the ratings process and the use of high quality data as well as its approach to safeguarding confidential information. An oversight framework should also promote greater transparency to the market by requiring the dissemination of information regarding rating performance data and the meaning, and limitations, of ratings.

We believe that under the auspices of the SEC many of these oversight goals have been advanced during the short time since the Credit Rating Agency Reform Act of 2006 became effective. Moreover, the creation of a dedicated office within the SEC to oversee rating agencies and the conduct of regular reviews by that office should provide meaningful assurance going forward that NRSROs are follow their policies and procedures for determining ratings and

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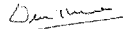
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managing conflicts of interest. Providing the SEC with explicit authority to impose fines for failures by NRSROs to comply with the SEC's rules or their own procedures (in addition to the censure authority the SEC already has) will only enhance this oversight.

S&P is concerned, however, that creating a PCAOB-like entity to replace or even supplement the SEC for rating agencies would be both unwise and unnecessary. With limited exception, the SEC, already has the very oversight powers and more that the PCAOB has, as constituted under Section 101(c) of the Sarbanes-Oxley Act. Moreover, ratings differ fundamentally from professional auditing standards, the application of which commonly leads to highly similar methodologies and outcomes that are binary – either a clean or a qualified audit opinion. This outcome is quite distinct from a credit opinion which encompasses a variety of elements and ranges of considerations, as described above. Replacing SEC oversight with that of a PCAOB-like body could therefore jeopardize analytical independence which is key to promoting both ratings quality and investor confidence. Such independence also allows for diversity of approach and opinion, which benefits the market so long as rating agencies make their rationale transparent and their ratings are grounded in publicly disclosed analytical criteria and methodologies – the application of which should be subject to rigorous regulatory oversight.

In contrast, the PCAOB sets auditing standards and disciplines that, in turn, must be adhered to by all registered auditing firms in conducting audits. There is no “one size fits all” for ratings analysis, and mandates such as those promulgated by the PCAOB for accountants would likely lead to undue reliance by investors on ratings – the chief reason given for removing government mandates that require use of ratings for certain investment purposes. Accordingly, we would be extremely concerned about regulatory measures, including the establishment of an agency, that could force analysts to make judgments not based upon their own considered analysis and independent views, but rather out of a desire to avoid subsequent second-guessing by regulators or others, while simultaneously producing ratings that would carry greater weight in the minds of investors.

Sincerely,



Deven Sharma
President, Standard & Poor's

Attachment

Statement of the
COMMERCIAL MORTGAGE SECURITIES ASSOCIATION
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GSES
Hearing on “Reforming Credit Rating Agencies”

September 30, 2009

The Commercial Mortgage Securities Association (“CMSA”) is grateful to Chairman Kanjorski, Ranking Member Garrett, and the Members of the Subcommittee for giving CMSA the opportunity to share its perspective concerning credit rating agency (“CRA”) reform. Today, there are enormous challenges facing the \$3.5 trillion commercial mortgage market, and our goal is to work with policymakers to ensure that regulatory reforms support, and do not undermine, the commercial real estate sector and our nation’s overall economic recovery.

As described below, our collective members, and specifically investors, continue to have serious concerns about a widely rejected proposal to require credit ratings to be differentiated for certain types of financial products. Generally speaking, “differentiation” (or the use of “symbolology,” such as “AAA.SF”) is an overly simplistic and broad proposal that provides little value or information about credit ratings. In fact, a broad coalition of market participants – including issuers, investors, and borrowers seeking access to credit – remain overwhelming opposed to differentiation because it will only serve to increase confusion and implementation costs, while decreasing confidence and certainty regarding ratings.¹ Such effects would, in turn, create market volatility and undermine investor confidence and liquidity, which could exacerbate the current constraints on borrowers’ access to capital. Most concerning, these superfluous changes have been re-proposed at a time when policymakers are employing every reasonable means to get credit flowing again and the economy is struggling to regain equilibrium.

In this regard, it is worth noting that the concept of differentiation has been examined extensively and rejected in recent years by the Committee on Financial Services, as well as the Securities and Exchange Commission (“SEC”), and the ratings agencies themselves, for most (if not all) of the foregoing reasons. Nothing has changed in the interim. Accordingly, we urge the Subcommittee not to include a differentiation requirement as part of its CRA reform bill.

Background on the Commercial Mortgage-Backed Securities (“CMBS”) Market

CMSA represents the full range of CMBS market participants including investors at every risk level; investment and commercial banks; rating agencies²; accounting firms; servicers; and other service providers to the industry. CMSA has been a leader in the development of standardized practices and in ensuring transparency in the commercial real estate capital market finance industry.

¹ In a June 9, 2008 letter to the House Financial Services Committee, the Commercial Mortgage Securities Association, American Securitization Forum, Mortgage Bankers Association, NATIONAL ASSOCIATION OF REALTORS®, and The Real Estate Roundtable expressed their opposition to using separate ratings symbols, citing unintended consequences that would increase costs for investors and further erode liquidity that is critical to the extension of credit for borrowers.

² This Statement does not necessarily reflect the views of CMSA’s credit rating agency members.

Because our membership consists of all constituencies across the entire market, CMSA has been able to develop comprehensive responses to policy questions to promote increased market efficiency and investor confidence. For example, our members have worked closely with policymakers in Congress, the Administration, and financial regulators, providing practical advice on measures (such as the Term Asset-Backed Securities Loan Facility and the Public-Private Investment Program) to restore liquidity to the commercial mortgage market. CMSA also has advised on measures that can hinder economic recovery efforts, such as retroactive changes to securitization accounting, known as FAS 166 and 167, which throw into question the future of securitized credit markets.³

The CMBS market is a responsible and key contributor to the overall economy that has provided a tremendous source of capital and liquidity to meet the needs of commercial real estate borrowers. CMBS helps support the commercial real estate market that fuels our country's economic growth, while helping provide jobs and services to local communities, as well as housing for millions of Americans in multi-family dwellings.

Unfortunately, turmoil in the financial markets coupled with the overall downturn in the U.S. economy have brought the CMBS market to a standstill and created many pressing challenges, specifically:

- No liquidity or lending – While the CMBS market provided approximately \$240 billion in commercial real estate financing in 2007 (nearly 50% of all commercial lending), CMBS issuance fell to \$12 billion in 2008, despite strong credit performance and high borrower demand. There has been no new private label CMBS issuance year-to-date in 2009, as the lending markets remain frozen;
- Significant loan maturities through 2010 – At the same time, there are significant commercial real estate loan maturities this year and next – amounting to hundreds of billions of dollars – while the capital necessary to re-finance these loans remains largely unavailable and loan extensions are difficult to achieve; and
- The U.S. economic downturn persists – The U.S. recession continues to negatively affect both consumer and business confidence, which impacts commercial and multifamily occupancy rates and rental income, as well as business performance and property values.

The securitized credit markets are crucial to providing liquidity and facilitating private lending, both of which are essential to any economic recovery. As Treasury Secretary Geithner stressed during the introduction of the Administration's Financial Stability Plan, "Because this vital source of lending has frozen up, no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small." In this regard, private investors in CMBS are absolutely critical to restoring credit availability in these markets, as they provide tremendous capacity that allows lending to occur. As such, government initiatives and reforms must strongly consider the impact on private investors who bring their own capital to the table and fuel private lending.

³ The implementation date of FAS 166 and 167 is Jan. 1, 2010. CMSA and a diverse coalition of 15 trade groups have raised concerns with the timing and scope of FAS 166 and 167, given the impact on credit availability, which has been highlighted by Federal Reserve and other banking regulators.

Differentiated Credit Ratings Do Not Serve Investors' Interests

As financial policymakers consider new and unprecedented regulatory reform proposals that will change the nature of securitized credit markets at the heart of recovery efforts, a key component is credit rating agency reform. CMSA strongly supports efforts to strengthen our system for credit ratings in order to provide investors with the information they need to make sound investment decisions. As such, CMSA has long been an advocate within the industry for enhanced transparency, including with respect to credit ratings. However, at the same time, investors in structured finance products overwhelmingly oppose efforts to differentiate credit ratings, and CMSA has been a strong opponent of such reforms that lack substance and undermine our recovery.

Today, the credit rating agency methodologies are created based on the principle that ratings are comparable across asset classes because the underlying assessment is the same regardless of asset class – that is, the likelihood that the bond obligations will be repaid in accordance with their terms. The introduction of a separate rating structure for structured finance products would be inconsistent with this longstanding principle and would create significant confusion for the investors in CMBS and other structured finance markets. In fact, the use of ratings symbols (such as “AAA.SF”) would, in fact, suggest that any modifier actually changes the meaning or nature of the rating.

Additionally, the universe of structured finance products includes many distinct asset classes, such as residential mortgage-backed securities (“RMBS”), CMBS, student loan asset-backed securities (“SLABS”), automobile loans, credit card receivables, etc. Imposing a single differentiated rating scheme or reporting requirement across the entire range of structured finance asset classes would be an overly simplistic approach that provides investors with no useful information or value given the very different risk profiles and underwriting mechanics for each individual asset class.⁴ The result would be less, rather than more, investor confidence in ratings.

Finally, the imposition of a new, differentiated rating structure also could impede the ability of state and federally regulated financial institutions to invest in structured finance products, which would cripple recovery efforts to utilize the securitized credit markets to provide liquidity and facilitate lending. In fact, many institutional investors are required to only consider securities that are in the highest or one of the highest investment ratings categories by nationally recognized statistical rating organizations (“NRSROs”). If differentiated ratings were required, it would not be clear whether such ratings satisfy these investment requirements, potentially creating more confusion, imposing widespread costs to modify and update the statutory and regulatory requirements, prolonging the illiquidity in the CMBS market for the foreseeable future. The structured finance markets likely would remain at a standstill for what could be a lengthy transition period.

⁴ There are significant differences between CMBS and other asset-backed securities markets, including:

1. the borrower (sophisticated business with income producing property who has a non-recourse loan);
2. the structure of CMBS (100-300 loans in a CMBS bond; non-statistical analysis performed on CMBS pools; rating agencies and investors gather and review information about the property, loan and business);
3. the existence of third-party investor, or “B-piece buyer”, who purchases the first-loss position, conducts extensive due diligence, and re-underwrites proposed loans in a potential pool (with “kickout” rights);
4. greater transparency (CMBS market participants have access to loan, property and bond-level information at issuance and while securities are outstanding through the CMSA Investor Reporting Package®).

Moreover, even investors not subject to such statutory and regulatory investment constraints would be forced to revise their investment policies to incorporate this new rating structure, to develop new analytical and monitoring infrastructure to interpret the new ratings, and to determine whether they need to have a specific investment allocation for each asset class. This process also would add significant challenges for investors, adding costs and eroding liquidity during this challenging time.

For these reasons, the investor community has rejected proposals to differentiate ratings each time such proposals have been advanced:

- In comments to the CRAs, which sought feedback on differentiation proposals in 2008 and ultimately was rejected after market participants “overwhelmingly” opposed it;⁵
- During the Financial Services Committee’s consideration of the Municipal Bond Fairness Act (H.R. 6308) last year, which ended with a unanimous vote to adopt a Manager’s Amendment offered by Chairman Frank and Ranking Member Bachus requiring CRAs “to apply ... rating symbol[s] in a consistent manner for all types of securities and money market instruments;” and
- In an SEC rulemaking proceeding that resulted in the SEC shelving a differentiation proposal in December 2008 due to extraordinarily negative feedback from all market participants.

It also is important to note that investors in structured finance products are sophisticated “institutional” entities (for example, pension funds, life insurers, and money managers). Instead of differentiated ratings, what these investors have consistently sought is new, targeted transparency and disclosures about the ratings of structured products, to build on the already robust information CRAs provide in their published methodology, presale reports, and surveillance press releases.⁶

Indeed, because a single and consistent ratings structure is critical to bond investors who want the ability to compare a multitude of investment options across asset classes, CMSA urges the Subcommittee to include language in the Discussion Draft consistent with that already passed by the Full Committee in the Municipal Bond Fairness Act, requiring CRAs to use ratings symbols that are consistent for all types of securities. Ultimately, investors (who are critical to our recovery) expect and demand a common rating structure to provide a meaningful foundation for our markets and ratings system. Such consistency will promote certainty and confidence among investors and all market participants, which can only help at this difficult time in the nation’s economic recovery.

⁵ For example, see the results of Moody’s Request for Comment: “Should Moody’s Consider Differentiating Structured Finance and Corporate Ratings?” (May 2008). Moody’s received over 200 responses, including from investors that together held in excess of \$9 trillion in fixed income securities. In their responses, market participants overwhelmingly rejected the idea of a separate ratings scale.

⁶ In comments filed with the SEC in July 2008, CMSA listed a number of recommendations for enhancements that would serve the investor community, such as publication of more specific information regarding NRSRO policies and procedures related to CMBS valuations; adoption of a standard pre-sale report template with specified information regarding methodology and underwriting assumptions; and adoption of a standard surveillance press release with specified information regarding the ratings. CMSA believes that such information would allow investors to better understand the rating methodology and make their own determinations about the rating and overall relationship.

Questions from Representative Foster

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