Testimony Concerning:
"Transforming Credit Rating Agencies"

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

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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 Hearings[1] in August of this year and in April at the SEC roundtable.[2]

As the only company on this panel that is not an 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.

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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 though 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

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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, CLOs[3]), 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

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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.

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- 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. Deterring 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

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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

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another confusing ratings scale or it will be arbitraged 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

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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.

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