STATEMENT OF
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President & Chief Economist
LACE Financial Corporation

Before the

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

Regarding:

The Ratings Game: Improving Transparency and
Competition Among the Credit Rating Agencies

September 14, 2004

Introductory Remarks before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises concerning the need to improve the recognition criteria to become an NRSRO company and potential conflicts between NRSRO-designated companies and the companies they rate.

Good morning, Chairman Baker and Members of the Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. Thank you for this opportunity to appear before you today.

NRSRO Criteria and the Application Process

LACE Financial (LF) has attempted to become a Nationally Recognized Statistical Rating Organization (NRSRO) for the last 12 years so that it could be on a level playing field with its competition. It took the SEC eight years before they acted on our first application, which they denied over the phone but gave no reason for the denial. I had to ask them to put the denial in writing and we received a letter stating that the denial was because we had only three analysts. I wrote back and told them we had eight of ten analysts involved in the rating process and supplied their names. We later received another denial letter stating the NRSRO criteria with a statement saying LF was denied NRSRO status because we "didn't meet the above criteria". We appealed our application on the basis that we were denied NRSRO status without being given a clear reason. This appeal has now been before the SEC for 2 years and three months. How long should this process take? Clearly there is a need for more transparency in the NRSRO application process.

When LF was started in 1984 we had a clear technological advantage over existing NRSRO companies in our credit rating process, which evolved from my doctoral research and from the development of the off-site rating systems by the committees of the three federal bank regulators which I chaired. When Thompson Bank Watch (our main competitor at the time) received NRSRO status, our growth in revenue basically stopped and was stagnant for approximately ten years. In the last two years, we have been growing about 20% per year, due largely to growth in our new issue rating business.

I believe LF would be a far larger company and a significant competitor to the existing NRSRO companies had NRSRO status not been withheld from our company for such a long time. The absence of NRSRO status makes it very difficult for new rating agencies to become established, especially in the United States, and for existing non-NRSRO firms to be effective competitors. Reporters have asked us if Moody's or Standard & Poors use unfair competitive practices against our company. The answer is: No, they don't have to. The SEC performs this function for them though their "Net Capital Rules" and through the withholding of NRSRO status.

LF is in a position to become an effective competitor with existing NRSRO companies because it now issues 80,000 credit ratings and approximately 70 new issue ratings per year. However, NRSRO status is necessary to break down barriers that prevent companies and municipalities from using our services. Lacking these barriers, we would likely be able to grow our revenues in the 40%plus range. That would make us more competitive with the existing NRSRO companies over time.

Conflicts of Interest that Arise Between NRSRO-designated Firms and the Companies They Rate

The exchange of money for a rating can obviously lead to a conflict of interest and can lead to higher ratings. I have provided to your committee our LACE Foreign Bank Rating Service. Comparison of our credit ratings (for which we do not charge the rated institutions) to those of NRSRO companies will show that NRSRO-designated companies tend to issue higher ratings to institutions that pay to be rated. To bring transparency to the rating process, a file should be required showing all revenues received for each rating issued by any rating agency. The SEC can then review this information if it receives a complaint concerning a conflict of interest in the rating process. I would also suggest that all rating companies provide a price list for all products and services to the SEC on an annual basis to help ensure more equal treatment in the charges for rating services. To help bring transparency to the rating process, all rating companies should show the date the rating was issued and the key data used in determining the rating, along with the rating itself.

By Barron Putnam, Ph.D.
President, LACE Financial Corporation

Attachments:

BIOGRAPHICAL SKETCH

Barron H. Putnam, Ph.D.

Prior to founding LACE Financial Corporation, Dr. Putnam had oversight responsibility for monitoring the financial condition of commercial banks and bank holding companies for the Federal Reserve System. He chaired the interagency committees of the three bank regulatory agencies that developed the Uniform Surveillance System that provided off-site financial ratings for insured financial institutions. During his sixteen years at the Federal Reserve Boards, he was manager of Surveillance Sections in the Division of Bank Supervision, Assistant Director of the Bank Holding Company Analysis Program, and Economist in the Division of Research and Statistics. Currently he is owner and president of LACE Financial Corporation of Frederick, Maryland which provides financial ratings on approximately 22,000 U.S. banks, savings and loans, credit unions, bank holding companies, and foreign banks. LACE Financial has been in business 20 years and has over 600 clients.

Research and Articles with the Banking Industry:

"An Empirical Model of Financial Soundness: A Case Study for Bank Holding Companies," Ph.D. Dissertation, George Washington University, Washington D.C., February 1983.

"Concepts of Financial Monitoring," Dynamics of Banking (Havrilesky, Schweitzer, and Boorman, Harlen Davidson, 1985).

"Evaluating the Financial Condition of Banks, and Managing Bank Stock Prices and Liabilities," Warren, Gorham and Lamont, Inc. Boston 1988.

"Too Big to Fail Doctrine," American Banker, New York, July 1991.

"Analyzing a Bank- A Simplified Approach," Public Investor, Chicago, February 1993.

"Super-regulator Could Reduce Duplication, Uncertainties," American Banker, New York, February 1994.

"Trade-Off: Deregulation for a Chinese Wall," American Banker, New York, March 1995.

"How to Survive Bank Mergers," Corporate Cashflow, Georgia, April 1996.

"Blindsided by Asia," Financial Executive Magazine, New Jersey, November-December 1998.

Educational Background:

New York University: B.S., 1962 International Banking and Finance.

University of California, Berkeley: M.S., 1966, Economics.

Stanford University: M.S., 1968, Applied Economics, Demography and Food Research.

George Washington University, Ph.D., 1983, Economics.

ABOUT LACE FINANCIAL CORPORATION

LACE Financial Corporation rates more financial institutions than any other rating service. Each quarter, LACE Financial Corporation provides their customers financial ratings on roughly 8,000 commercial and savings banks, 1,350 bank holding companies, 900 savings & loans, 1,500 to 9,400 credit unions (depending on the quarter), 200 of the largest foreign banks and 95 title insurance companies (all numbers subject to change). LACE also assigns sovereign ratings for roughly 56 countries. For clients, LACE Financial Corporation will follow/rate approximately 8,000 international banks.

LACE Financial Corporation's name is derived from the four major determinants of financial soundness: Liquidity, Asset Quality, Capital and Earnings. Although the company computerizes much of the information, a team of financial analysts reviews each institution separately. LACE Financial Corporation does not charge institutions for their ratings to avoid any bias in the rating process.

May 22, 2003

Subject: Rating of Resona's large
Bank subsidiaries.

Mr. Mark M. Attar
Special Counsel
Division of Market Regulation
United States Securities
and Exchange Commission
Washington, D.C. 20549

Dear Mr. Attar:

The purpose of this letter is to provide the SEC with information showing that LACE Financial provides far better credit ratings of financial institutions than the existing large NRSRO rating companies.

The three large NRSRO companies missed the failure (bail out) of one of the world's largest financial institutions the Japanese, Resona Holdings, Inc., which owns the $195.7 billion Asahi bank and the $110.4 billion Daiwa Bank. These banks were rated by the three large NRSRO companies with investment grade ratings before the banks failed, shown in the following tables.

Credit Ratings of Large NRSRO Companies of Rezona's Large Subsidiary Banks[1]

	Fitch	**Standard & Poors**	**Moody's**
Asahi Bank		AA-	Aa3
Daiwa Bank, Ltd.	BBB+	A-3	Baa3

Source: Thomson Bank Directory, December 2002- May 2003, page 1978[2]

LACE Financial provided investors and creditors with at least two years earlier warning that these institutions were likely to fail (with E ratings) and e-mailed an alert letter warning of their failure and suggested they secure their positions. Asahi Bank was rated

1
Fitch--BBB+ Obligation for which there is currently low expectation of investment risk (+ means high end of rating scale of BBB).
Standard and Poor's--AA Very high degree of safety with very strong capacity for repayment. (- means low end of rating scale for AA). A-3Short-term Investment Grade- Issues carrying their designation have adequate capacity for timely payment.
Moody's--Aa3 Bonds, which are rated as Aa, are judged to be of high quality by all standards. (3 means to be in the low end of the Aa rating). Baa3 Bonds which are considered as medium grade obligation (i.e. they are neither highly protected nor poorly secured).

Comment: Only the first sentence is used from each companies rating definitions and further information is given to qualify the meanings of the ratings.

an "E"[2] as of March 2001 and Daiwa Bank Limited and "E" [2]as of September 2000 (see attachment 1). We warned our clients on October 1, 2002 concerning the solvency of both banks and "strongly suggested that our clients secure credits" to these banks (see attachment 2).

LACE Financial has been rating U.S. banks and foreign banks before Moody's and Standard and Poors. In evaluating rating companies the SEC might investigate why all three existing NRSRO companies gave Asahi Bank and Daiwa Bank investment grade ratings prior to their failure (bailout). It should be clear to anyone, that with a ratio of nonperforming assets to capital and reserves[3] of 128% for Asahi Bank and 175% for Daiwa Bank that these banks were clearly insolvent.

LACE Financial Ratings of Resona's Large Bank Subsidiaries

Table 1

Resona Holdings, Inc.	TOTAL ASSETS (USD MIL)	NPA's/ EQT+ RSV. Current Period	NPA's/ EQT+ RSV. Previous Period	EQTY/ T.AST Current Period	ROA	LACE Rating 9/00	LACE Rating 3/01	LACE Rating 9/01	LACE Rating 3/02	LACE Rating 9/02	LACE Rating May 20, 2003
Asahi Bank	**195,706**	**127.77%**	**91.20%**	**2.97%**	**0.20%**	**C**	**E**	**E**	**E**	**E**	**C+**
Daiwa Bank, Ltd.	**110,442**	**174.77%**	**98.22%**	**2.67%**	**0.07%**	**E**	**E**	**E**	**E**	**E**	**C+**

*** Current ratings and data as of September 30, 2002**

Source: LACE Financial Foreign Rating Service, May 2003, p.15. Current ratings and data as of September 30, 2002.

With NRSRO Status, LACE Financial will first bring to the financial sector, and later the nonfinancial sector, pressure for better ratings, more frequent ratings on a timely basis and better disclosure of financials for which the ratings are based. In terms of price competition, we have previously stated to the SEC that we can provide new issue ratings for financial institutions at a cost factor of 5 to 10 times less than existing NRSRO companies.

In our survey, where the results were sent directly to SEC's Division of Market Regulation, 100 percent of the respondents stated we were a creditable rating service, 91 percent said we provided early detection in the change in the financial condition of a company, 95 percent said our analysts were responsive to client inquiries and 100 percent said that our analysts were knowledgeable about the institutions we rate. All respondents felt that LACE Financial provided better ratings because we did not accept monies from the companies we provide credit ratings. If this last sentence doesn't ring a bell as to why the large NRSRO companies are providing investment grade ratings to large companies prior to their failure, it should!

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[2] An "E" rating is LACE Financial's lowest rating and means that an institution has a very weak financial condition and is close to failure. Although these institutions can survive on their own, they generally need a capital injection or be restructured with outside help.

[3]

No matter how good we are, its to no avail without NRSRO status, because investors, brokers, and dealers are prevented from using our ratings. The longer the SEC holds up our application, the stronger the market power of the existing NRSRO becomes through name recognition and working relationship's with investment bankers and investors. If the SEC holds up this application long enough or denies it, it becomes questionable as to whether we should stay in this business. The real value of this company can only be attained by an NRSRO company and this is why the rating business has become so concentrated. Is this what the SEC wants? What is sad, is that past actions of the SEC points in this direction.

LACE Financial has been in business 19 years, issued over a million credit ratings and none of these companies have ever complained to a state or a federal regulator and no one has ever threatened to sue us. Approval of our application can only be pro-competitive by putting downward pressure on rating prices and to improve services to the investment community.

Sincerely,

Barron H. Putnam, Ph.D.
President and Financial Economist

BHP/tmf

Enclosures

CC: Mr. William Donaldson, Chairman, Securities and Exchange Commission
Mr. Paul Adkinson, Commissioner, Securities and Exchange Commission
Mr. Roel Campos, Commissioner, Securities and Exchange Commission
Ms. Cynthia Glassman, Commissioner, Securities and Exchange Commission
Mr. Harvey Goldschmid, Commissioner, Securities and Exchange Commission
The Honorable Barbara Mikuski, U.S. Senator
The Honorable Paul Sarbanes, U.S. Senator
Aurora A. Battaglia, Vice President, International Finance
LACE Financial Corporation Website, www.lacefinancial.com

July 30, 2001

SUPERIOR BANK, FSB FAILURE

The Office of Thrift Supervision shut down $2.3 billion in assets Superior Bank FSB of Hinsdale, IL late on the evening of Friday, July 27, 2001 and the FDIC was named conservator. LACE Financial rated the institution an "E" (our lowest rating) based on data reported to regulators on March 31, 2001 and notified our clients of the problems in a release on July 13, 2001. The insured deposits and most of the assets have been transferred to the newly chartered Superior Federal FSB (New Superior). Deposit customers of Superior Bank, FSB are now customers of the new Superior Federal FSB, and will have immediate access to their insured deposits. Superior Bank, FSB had total deposits of $1.6 billion—potentially $42.9 million of which may be uninsured. As de-facto manager of the new institution, the FDIC plans to contact the uninsured depositors to arrange meetings with claims agents. The FDIC also plans to extend a $1.5 billion line of credit to the new entity to ensure uninterrupted operations.

Superior Bank, FSB has been undercapitalized of late, especially after taking a ($69.9 million) loss during the first quarter of 2001, which helped drop equity capital 76% over the same quarter. LACE Financial notified its clients of this potential danger two weeks ago. Over the last two months, events unfolded that would bring the thrift down. Superior Bank, FSB had accumulated a type of asset known as "residual" interests. Essentially, the bank was originating subprime loans, packaging and securitizing them, and selling these off at a lower interest rate. The potential profit realized from the difference between the interests that Superior was paying versus what it was receiving, was considered an asset called a residual. It was the valuing of these residuals that ultimately hurt Superior Bank, FSB. As the private investors who were prepared to bailout Superior saw the valuations of these subprime residuals drop precipitously over the last two months, they dragged their feet on the bailout deal. The deal collapsed, hence the FDIC action this weekend.

The failure could possibly cost the FDIC's Savings Insurance Fund (SAIF) up to $500 million, with the final figures to be released later. This represents the third FDIC-insured failure this year.