OVERSIGHT OF THE CREDIT RATING AGENCIES POST-DODD-FRANK

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

JULY 27, 2011

Printed for the use of the Committee on Financial Services

Serial No. 112–51

OVERSIGHT OF THE CREDIT RATING AGENCIES POST-DODD-FRANK

OVERSIGHT OF THE CREDIT RATING AGENCIES POST-DODD-FRANK

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

JULY 27, 2011

Printed for the use of the Committee on Financial Services

Serial No. 112–51

U.S. GOVERNMENT PRINTING OFFICE

67–946 PDF WASHINGTON : 2012

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

SPENCER BACHUS, Alabama, *Chairman*

JEB HENSARLING, Texas, *Vice Chairman*
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
SCOTT GARRETT, New Jersey
RANDY NEUGEBAUER, Texas
PATRICK T. McHENRY, North Carolina
JOHN CAMPBELL, California
MICHELE BACHMANN, Minnesota
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
STEVAN PEARCE, New Mexico
BILL POSEY, Florida
MICHAEL G. FITZPATRICK, Pennsylvania
LYNN A. WESTMORELAND, Georgia
BLAINE LUETKEMEYER, Missouri
BILL HUIZENGA, Michigan
SEAN P. DUFFY, Wisconsin
NAN A. S. HAYWORTH, New York
JAMES B. RENACCI, Ohio
ROBERT HURT, Virginia
ROBERT J. DOLD, Illinois
DAVID SCHWEIKERT, Arizona
MICHAEL G. GRIMM, New York
FRANCISCO "QUICO" CANSECO, Texas
STEVE STIVERS, Ohio
STEPHEN LEE FINCHER, Tennessee

BARNEY FRANK, Massachusetts, *Ranking Member*
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN McCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
GWEN MOORE, Wisconsin
KEITH ELLISON, Minnesota
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
ANDRÉ CARSON, Indiana
JAMES A. HIMES, Connecticut
GARY C. PETERS, Michigan
JOHN C. CARNEY, JR., Delaware

LARRY C. LAVENDER, *Chief of Staff*

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

RANDY NEUGEBAUER, Texas, *Chairman*

MICHAEL G. FITZPATRICK, Pennsylvania, *Vice Chairman*
PETER T. KING, New York
MICHELE BACHMANN, Minnesota
STEVAN PEARCE, New Mexico
BILL POSEY, Florida
NAN A. S. HAYWORTH, New York
JAMES B. RENACCI, Ohio
FRANCISCO "QUICO" CANSECO, Texas
STEPHEN LEE FINCHER, Tennessee

MICHAEL E. CAPUANO, Massachusetts, *Ranking Member*
STEPHEN F. LYNCH, Massachusetts
MAXINE WATERS, California
JOE BACA, California
BRAD MILLER, North Carolina
KEITH ELLISON, Minnesota
JAMES A. HIMES, Connecticut
JOHN C. CARNEY, JR., Delaware

CONTENTS

OVERSIGHT OF THE CREDIT RATING AGENCIES POST-DODD-FRANK

Wednesday, July 27, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. Randy Neugebauer [chairman of the subcommittee] presiding.

Members present: Representatives Neugebauer, Fitzpatrick, Pearce, Hayworth, Renacci, Canseco; Capuano, Miller of North Carolina, Himes, and Carney.

Ex officio present: Representative Bachus.

Also present: Representatives Garrett and Stivers.

Chairman NEUGEBAUER. Good morning. This hearing will come to order.

We will have opening statements, and I remind Members that your opening statements will be made a part of the record. I am going to ask unanimous consent today that we allow Mr. Garrett to participate in the hearing. Also, without objection, written testimony submitted by the FDIC will be made a part of the record.

We will now have opening statements, and the Chair yields himself 4 minutes.

Today's hearing is about the rating agencies. And I guess that the topics will be fairly broad, and we will cover a lot of ground. I think this is a very important time to have this hearing.

If you look back to the financial crisis and the Dodd-Frank Act and all of the things that followed, some people indicated that they felt that the rating agencies had some culpability in the credit crisis, that the ratings did not actually reflect the risks that were being taken.

Subsequent to that, we passed Dodd-Frank, and a lot of attention was given to the rating agencies in Dodd-Frank. Some of those regulations have now come out, and some of them have not come out.

One of the things was that there was deemed to be too much dependence on the rating agencies in the markets, and particularly in some of the financial institutions. And Dodd-Frank asked that the references to those ratings be really expunged and that the agencies, the regulators, would come up with new criteria for measuring risk that was not necessarily tied to the rating agencies.

One of the things we will want to hear from our regulators today is where we are in that process.

The other thing that still is of concern to some folks is the fact that there still continues to be a concentration in just three of those agencies. Between Moody's, Standard & Poor's, and Fitch, they have covered about 98 percent of the ratings and 90 percent of the revenue, and some people are concerned that access for other entities to become Nationally Recognized Statistical Rating Organizations (NRSOs) is still limited, particularly when you look at some of the regulation that is coming out and making it more and more burdensome and more difficult for other firms to come into that. And I think we will hear something about that today.

Also of interest to me is that when we look at the fact that some people say that we ended too-big-to-fail with Dodd-Frank, some of us do not believe that actually ended too-big-to-fail, but many of us somewhat believe that it probably contributed to furthering too-big-to-fail.

When you look at the major financial institutions in this country, a lot of people thought that they should be smaller after Dodd-Frank. What we have seen is that many of these institutions are actually larger.

And what we also now see within the rating industry is that there is still a reward for being considered one of those systemically risky financial institutions and, in fact, that these institutions are getting somewhat of a bump or upticks over other financial institutions, which may in fact have a better baseline financial rating.

So these are some of the things that we are going to want to look at today. My guess is that some of my colleagues will want to discuss something that is relevant to these times and that is the role of the rating agencies as it pertains to the United States sovereign debt. And I suspect there will be some questions along those lines as well.

But I look forward to a very robust hearing. This is a very important part of our economy. A lot of people still put a lot of credence into these ratings. Some people feel like they have lost their credibility. And as we are moving forward, one of the things that we feel is going to be extremely important is restoring a little bit more certainty in the marketplace.

And so, with that, I will then recognize my good friend, the ranking member, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman.

First of all, welcome to all our panelists.

I know that a lot of people today are going to want to talk about the removal of references. Though I am interested in that, I am more interested in other aspects.

It is well known by everybody, actually, including all the testimony, the Majority memo on today, that faulty ratings contributed significantly to the recent economic problems that we have had. We all know that. It is accepted. There is really no debate about that any further.

I am particularly interested in where we are now and how we go forward. And I am particularly interested in how the budgetary constraints might have impacted some of your agencies relative to implementing some of Dodd-Frank and whether, even in implementing Dodd-Frank, it has hurt other parts of your activities.

I think that is a very important aspect to this. It doesn't do any good to have the greatest regulations in the world if you cannot enforce them or oversee them.

I am interested in the overall report as to whether the credit rating agencies are doing their job, whether we should be concerned any further about—at least currently, I know things can change tomorrow, but as of the moment—whether they have finally done what we had all hoped and wanted them to do.

And I, from where I sit, think they have done a better job. They are more reliable, more independent, and have changed their model significantly. But I would like to hear your opinions as to whether or not that is a fair assessment.

I am also interested in your opinions as to how we are doing with the bill that we passed. Like any bill, like particularly a major bill, I have always known, we have always known, that any major bill, no matter how good or bad you think it is, needs to be tweaked as you go forward. What did we do wrong? What can we do better? What should we be doing that we didn't think of?

Because the truth is our economic situation right now, the debt limit obviously is the crisis of the moment. Hopefully, we will pass that in the next few weeks or so, but that doesn't solve all our problems. I think everybody here knows that.

We have other problems. We have other things we have to address. And we have other economic issues that are related to the credit rating agencies. And if they do their job, I believe our entire system will work better, and that is really what I am interested in hearing today.

So with that, I will yield back.

Chairman NEUGEBAUER. I thank the gentleman.

I now recognize the chairman of the full committee, Mr. Bachus, for 3 minutes.

Chairman BACHUS. I thank the chairman for convening this hearing to examine the future of credit rating agencies post-Dodd-Frank.

The credit rating agencies failed spectacularly in the years leading up to the financial crisis. A government seal of approval for credit rating agencies led to a mispricing of risk and the subsequent collapse in market confidence.

House Republicans identified this as a significant problem and proposed removing references to credit ratings in Federal statutes. Unlike most of our proposals, which were rejected by the then-Majority, this one was adopted and incorporated into the final legislation with bipartisan support. I commend all the members of the committee for that.

Section 939A of Dodd-Frank requires all Federal agencies to review and replace references to credit ratings in their regulations with alternative measures of creditworthiness. The significance of Section 939A cannot be overstated. Because the provision had overwhelming bipartisan support throughout the regulatory reform debate, I fully expect the regulators to implement it consistent with legislative intent.

This provision has been discussed and debated within this committee and on the House Floor and the Senate Floor since 2009. If the regulators had concerns prior to Dodd-Frank's enactment about their ability to develop suitable alternatives to credit rating, I am unaware of them having articulated any of those concerns to Members of Congress.

While Section 939A is an important step to de-emphasize credit rating, the Dodd-Frank Act, in some cases, lacks consistency in its approach to credit rating. Provisions such as Section 939F, the so-called Franken Amendment, works against the intent of Section 939A. The Franken Amendment reinforces the significance of credit rating by requiring the government to establish a system for the SEC to choose a rating agency to evaluate an issuer's structural financial product.

Regulations adopted by the SEC under Dodd-Frank appear to also contradict the goals of an earlier credit rating agency reform law authored by our colleague from Pennsylvania, Mr. Fitzpatrick. That was the Credit Rating Agency Reform Act, which sought to reduce the barriers to entry for credit rating agencies seeking the Nationally Recognized Statistical Rating Organization designation (NRSRO).

However, the 517 pages of rules adopted by the SEC in May to implement sections of Dodd-Frank erect new barriers to entry for prospective NRSROs. SEC Commissioner Kathleen Casey stated that these rules may be life-threatening to smaller credit rating agencies.

Finally, Dodd-Frank removes the expert liability exemption under the Securities Act for credit rating agencies. In addition to causing a dislocation in the asset-backed security market, a new liability standard further discourages new entries to the rating agency arena. I am pleased that last week this committee approved legislation authored by the gentleman from Ohio, Mr. Stivers, to repeal this counterproductive provision of Dodd-Frank.

Mr. Chairman, all this shows why today's hearing is very important. I look forward to hearing from our witnesses.

Chairman NEUGEBAUER. I thank the gentleman.

And now I would like to recognize the vice chairman of the subcommittee, Mr. Fitzpatrick, who has done a lot of work in this area and has been a great advocate for making sure that we have more competition. And so with that, I recognize the gentleman for 2 minutes.

Mr. FITZPATRICK. Thank you, Mr. Chairman. Thanks for your leadership in convening this hearing. I know that we are all really looking forward to the testimony coming of both panels.

Credit rating agencies have a role to play in our financial system. The problem is that the system has not always worked, especially for all of the users. In 2006, as the chairman indicated, I wrote legislation, the Credit Rating Agency Reform Act, designed to open the door to more participation and more competition in your industry. It began a process that has led to this day. However, in the interim, we had a catastrophic failure in the system that actually hastened the reform.

I think it is striking that one of the few bipartisan understandings to come out of Dodd-Frank was that reliance on credit ratings have become too ingrained and too pervasive in our statutes. However, Dodd-Frank instituted additional provisions that seem to contradict our bipartisan agreement and, in fact, now create additional barriers to competition in the industry.

It is timely that we are having this discussion in the midst of our debt negotiations here in the Nation's Capital. The full faith and credit of the United States is on the line. We are at a crossroads where we need to decide if we are going to heed the economic warnings and get our fiscal house in order or just continue to have the Federal Government make the easy choices.

So I think today's hearing will contribute to that debate as well, and I look forward to participating.

Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

I now yield 1 minute to the gentleman from Texas, Mr. Canseco.

Mr. CANSECO. Thank you, Mr. Chairman.

The financial crisis of 2008 reinforced the fact that the largest credit rating agencies carry a tremendous amount of influence over our economy. Largely because of a government stamp of approval, the ratings assigned to securities from Nationally Recognized Statistical Rating Organizations were used as regulatory benchmarks for determining appropriate capital standards.

NRSRO's designation was also a cause of investor complacency when these rating agencies began to rate complex asset-backed securities and collateralize debt obligations, even though they had no experience rating such instruments, and as we now know, these instruments were not really understood by anybody.

In order to help decrease the dependence on a few organizations to have such an outsized influence in our financial system, a bipartisan proposal was added to the Dodd-Frank bill that required regulators to cease their reliance on credit ratings and instead adopt their own standard of creditworthiness. Unfortunately, some banking regulators have not fully embraced this common-sense proposal, and I have great concern over the impact of their decision.

I look forward to hearing from our witnesses today on this very important matter.

Thank you.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from New Jersey, Mr. Garrett, for 1 minute.

Mr. GARRETT. Thank you. And I thank the chairman for holding this very important and timely hearing today.

The consideration of regulatory reform legislation that Congress passed last year unfortunately was very partisan, and the overreach that resulted from that partisan structure is now needlessly restricting our economic growth and limiting job creation.

However, as was just pointed out, one significant area of bipartisanship did emerge through deliberation, that dealt with credit rating agencies. There was broad agreement that investors, because of the government's explicit requirement of ratings, had become basically overreliant on the rating agencies and failed to do their due diligence. And so by having the government require these ratings, investors believed that the ratings had a stamp of approval from the Federal Government.

In order to refute this, Ranking Member Frank, Chairman Bachus and I crafted language to remove all rating requirements from the statutes and the regulations. So, I am pleased to see that in some regards, the regulatory community has been moving forward on implementing that.

I understand that changing from that old system to a new system can be difficult for all involved, but I know with bright minds, we have a regulatory community that can figure out a way to make this system work in the future.

As we can see by the discussion going on this week surrounding the debt debate, however, the rating agencies' opinion still does carry quite a bit of weight. And while ratings can play a role in evaluating the credit of a company, security, or even a country, it should not be the sole determinant.

In conclusion, we must continue to work to lessen investors' reliance on these rating agencies and disconnect any belief that the government somehow stands behind their opinions.

And with that, I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now we will go to our panel. I remind the panelists that your full written statements will be made a part of the record.

Our first panel consists of: Mr. John Ramsay, Deputy Director, Division of Trading and Markets, U.S. Securities and Exchange Commission; Mr. Mark Van Der Weide, Senior Associate Director, Division of Banking Supervision and Regulation, Federal Reserve Board; and Mr. David Wilson, Senior Deputy Comptroller and Chief National Bank Examiner, Office of the Comptroller of the Currency.

Mr. Ramsay, you are recognized for 5 minutes.

STATEMENT OF JOHN RAMSAY, DEPUTY DIRECTOR, DIVISION OF TRADING AND MARKETS, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. RAMSAY. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, my name is John Ramsay, and I am a Deputy Director in the Division of Trading and Markets at the Securities and Exchange Commission. Thank you for the opportunity to testify on behalf of the Commission concerning its oversight of credit rating agencies and the regulatory treatment of ratings.

The Commission first gained regulatory authority over rating agencies in 2006 with the passage of the Credit Rating Agency Reform Act, which mandated that the Commission establish a registration and oversight program for Nationally Recognized Statistical Rating Organizations, or NRSROs.

Yet, it is important to note that the Commission is prohibited from regulating the substance of credit ratings or rating agency procedures or methodologies.

From 2007 to 2009, the Commission adopted rules under this authority to address conflicts of interest, establish recordkeeping and reporting requirements, and require rating agencies to publish historical and performance data on the ratings they issue.

Following the financial crisis, which highlighted problems in the performance of credit rating agencies, the Dodd-Frank Wall Street Reform and Consumer Protection Act mandated a comprehensive additional set of rules in this area. In May of this year, the Commission proposed rules under this new authority.

In all of its efforts in this area, the Commission has strived to achieve three general goals: to address conflicts of interest and improve the integrity of rating processes and methodologies; to provide more transparency so that investors have more and better information about ratings and can better compare the performance of rating agencies; and to promote competition in the market for rating agency services.

While my written testimony details the Commission's significant regulatory efforts to date, I would like to highlight just a few of those actions.

Many of the existing rules are directed to the integrity of the rating process. For example, the Commission's rules require the rating agencies to have procedures to manage conflicts of interest and that prohibit certain other conflicts.

The agencies are prohibited from structuring the same products that they rate, and employees who participate in determining credit ratings are not allowed to participate in fee negotiations. Under the rules we recently proposed, these requirements would be strengthened by prohibiting credit analysts from being involved in any way in sales or marketing activities.

In order to promote better transparency, the Commission's rules require NRSROs to make various disclosures about rating histories, methodologies, and performance statistics among other items. Our recent proposals aim to strengthen these requirements by increasing the amount of public data and standardizing the way performance information is provided so as to be more useful to investors.

In addition, each published rating would need to be accompanied by information to make the ratings more understandable, and the rating agencies would be required to adopt procedures to clearly define each rating symbol and to make sure that symbols are applied consistently.

The Commission also has sought to improve competition for rating agency services. For example, our rules provide a mechanism for a ratings agency that has not been hired to rate a structured finance security to be able to access the information it would need to rate the security on an unsolicited basis.

In May of this year, the Commission issued a request for public comment as part of the effort to complete a study required by the Dodd-Frank Act addressing the process for rating structured finance products and the conflicts of interest that arise from the way the rating agencies are paid for these ratings.

The study will focus specifically on the feasibility of establishing a system in which a public or private utility or self-regulatory organization would assign agencies to determine ratings for these products.

The Commission is also seeking to eliminate references to credit ratings in its rules, in order to reduce reliance on credit ratings. As required by Dodd-Frank, already this year the Commission has proposed to remove numerous rule references to credit ratings and to substitute other standards of creditworthiness where necessary.

Finally, the Dodd-Frank Act requires the Commission to conduct examinations of each NRSRO at least annually and to issue a report summarizing the findings. The staff is currently in the process of completing the first cycle of these exams.

I would be pleased to answer any questions you may have.

[The prepared statement of Mr. Ramsay can be found on page 95 of the appendix.]

Chairman NEUGEBAUER. Thank you.

Mr. Van Der Weide?

STATEMENT OF MARK E. VAN DER WEIDE, SENIOR ASSOCIATE DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VAN DER WEIDE. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, thank you for the opportunity to discuss credit ratings and Section 939A of the Dodd-Frank Act.

To help achieve the important goal of reducing governmental and private sector reliance on credit ratings, Section 939A of the Act requires all Federal agencies to remove references to credit ratings from their regulations and replace them with appropriate alternative standards of creditworthiness.

For many years before the introduction of credit ratings into Federal regulations, investors had used credit ratings to assist them in making investment decisions. Credit ratings provided a uniform, market-driven third-party assessment of the creditworthiness of countries, State and local governments, and companies.

Federal agencies later incorporated credit ratings into their regulatory frameworks in part because of these same attributes.

The recent financial crisis, however, made plain serious flaws with the methodologies and processes around the determination of credit ratings, particularly ratings for structured finance positions. These flaws contributed to the issuance of credit ratings that severely underestimated the credit risk of many mortgage-backed securities.

Investors for their part relied too heavily and uncritically on these ratings for making their investment decisions. And downward revaluations of many of these securities by market participants between 2007 and 2009 and the resulting loss of confidence in the accuracy of credit ratings contributed meaningfully to the destabilizing dynamics of the crisis.

Section 939A of the Dodd-Frank Act is one of a number of provisions of the statute that are intended to address problems with credit ratings and rating agencies.

The Board has identified 46 references to credit ratings in its regulations. Most of these references are in the Board's risk-based capital requirements for State member banks and bank holding companies. And the Board's greatest challenge in implementing Section 939A is completely removing those credit ratings from our risk-based capital rules.

To protect the safety and soundness of individual banking firms and financial stability more broadly, we are striving to develop alternative standards of creditworthiness for use in our capital rules that possess the virtues of credit ratings, but not the vices.

There are several key characteristics of a good creditworthiness standard. First, and most importantly, the standard should be reliably risk sensitive. It should effectively measure the relative credit risk of various types of financial instruments.

Second, the standard should result in a consistent and transparent application across different types of financial instruments.

Third, the standard ideally should auto adjust on a timely basis to reflect changes in the credit risk profile of instruments and should auto adapt to cover new financial market practices.

Finally, the standard should be relatively simple to implement and should not increase regulatory burden for banking firms, particularly small banks.

Obviously, credit ratings themselves do not meet all of these criteria and developing good replacements for credit ratings is a particularly difficult task.

Since the Dodd-Frank Act was signed into law last July, the Board has been working with the OCC and the FDIC to carry out the 939A mandate. In August of 2010, 1 month after the Act was passed, the banking agencies issued an Advance Notice of Proposed Rulemaking (ANPR) on alternative standards of creditworthiness for use in our capital rules. In November of last year, the Board hosted a roundtable discussion with the other banking agencies, academics, and private sector participants to solicit views on this issue.

Public commenters on our 939A efforts have expressed concern about the statutory mandate, have suggested it could lead to competitive distortions across the global banking system and across the domestic banking landscape, and have urged the agencies to develop alternatives that are risk sensitive, consistent across banks, and easy to implement.

We continue to work closely with the other banking agencies to develop our appropriate alternative standards. We are considering a number of approaches, including approaches that rely on market-based indicators such as bond spreads, approaches that rely on balance sheet financial ratios, and approaches that rely on internal assessments of credit risk by banking firms.

Each of these approaches, like the use of credit ratings, has strengths and weaknesses. The Board anticipates that it will propose amendments to remove references to credit ratings from our regulations in the near future.

The Board also has been active in the international efforts by the Financial Stability Board and the Basel Committee to encourage reduced dependence on credit ratings across the global financial system.

Although the international financial regulatory community is working to reduce reliance on credit ratings, the Basel capital framework continues to incorporate credit ratings in material ways. Accordingly, we will need to find ways to synchronize our 939A changes with the global bank capital accords.

The Board welcomes input from the public and from members of the subcommittee on this important issue of public policy. Thank you for the chance to describe the Board's efforts to date to implement Section 939A. And I am happy to answer any questions.

[The prepared statement of Mr. Van Der Weide can be found on page 209 of the appendix.]

Chairman NEUGEBAUER. Thank you.

Mr. Wilson?

STATEMENT OF DAVID K. WILSON, SENIOR DEPUTY COMPTROLLER, BANK SUPERVISION POLICY, AND CHIEF NATIONAL BANK EXAMINER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. WILSON. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, I appreciate the opportunity to testify about the initiatives the OCC has undertaken and the challenges that we are facing in our work to implement Section 939A of the Dodd-Frank Act.

Section 939A does require each Federal agency to review its regulations that refer to and require the use of credit ratings. And each agency must then modify its regulations to remove any reference to, or requirement for reliance on credit ratings to, and substitute alternative standards of creditworthiness that the agency determines is appropriate. Section 939A also requires each agency to transmit a report to Congress, and the OCC will be submitting that report today.

OCC regulations affected by this provision include the interagency risk-based capital regulations and also OCC-specific regulations pertaining to national bank investment securities activities, securities offerings, and international banking activities.

The banking agencies' risk-based capital standards use credit ratings to determine appropriate capital requirements and assign risk weights to securitizations and exposures to qualifying securities firms.

Credit ratings are also used to assign risk add-ons under the agency's market risk rule and to determine the eligibility of certain guarantors and collateral for credit risk mitigation purposes.

Section 939A could also significantly affect future implementation of other Basel Accord capital requirements in the United States. These include the standardized approach for credit risk, which relies extensively on credit ratings to assign risk weights, as well as the 2009 revisions made by the Basel Committee to enhance and strengthen international risk-based capital standards.

The OCC's investment securities regulations use credit ratings for determining credit quality, marketability, and appropriate concentration levels of investment securities purchased and held by national banks.

Credit ratings are also referenced and used in our regulations governing securities offerings by national banks and the types of assets Federal branches and agencies can hold as a capital equivalency deposit.

The OCC has issued two Advance Notices of Proposed Rulemaking to seek input on how to revise our regulations to implement 939A. An interagency ANPR sought comment on several approaches for developing creditworthiness standards for agencies' risk-based capital rules, and these approaches varied in complexity and risk sensitivity.

We also issued a similar ANPR on alternative creditworthiness standards for our noncapital regulations.

The agencies, as Mark said, also hosted a roundtable discussion attended by bankers, academics, asset managers, credit rating staff, and others to discuss alternatives to credit ratings. Commenters on the ANPRs and roundtable participants generally expressed concerns with the removal of credit ratings from our regulations and asserted that credit ratings can be a valuable tool for assessing creditworthiness.

Many commenters believe that the simple approaches outlined in the option, due to their lack of risk sensitivity, create incentives for inappropriate risk arbitrage. However, commenters were also concerned that the more complex and risk sensitive an approach is, due to the depth and types of analysis that would be required, pose a disproportionate burden on small banks.

Commenters also expressed concern that certain alternatives could create competitive inequities and inconsistencies with the international capital standards established by the Basel Committee.

These comments reflect the challenges that the OCC and the other Federal banking agencies are facing as we work to implement 939A. We believe that with appropriate operational and due diligence requirements, credit ratings can be one valuable factor to consider when evaluating the creditworthiness of financial instruments.

In our view, an approach that precludes undo or exclusive reliance on credit ratings rather than imposing an absolute prohibition on their use would strike an appropriate balance between the need to address the problems created by the overreliance on credit ratings with the need to enact sound regulations that can be consistently implemented.

Notwithstanding these challenges, we are continuing our work to revise our regulations to be consistent with Section 939A. We are being careful and thorough in order to ensure that the result is not a step backward in assuring that banks of all sizes conduct their activities in a safe and sound manner and that reflect sound credit judgment and adequate capital for the risk they take.

Thank you.

[The prepared statement of Mr. Wilson can be found on page 242 of the appendix.]

Chairman NEUGEBAUER. Thank you.

So we have heard your testimony. Section 939A basically says that we are going to move away from the references to rating agencies in our financial institutions as a part of regulatory capital.

And, Mr. Ramsay, I think you said that—have you all published a definition for your standards of creditworthiness? Where are you all in that process?

Mr. RAMSAY. Mr. Chairman, we have currently, I think, proposed to remove references from 11 separate rules or sets of rules—in some cases, nine different forms.

Actually, just yesterday the Commission adopted the removal of ratings as a criterion for so-called short form or shelf registration.

So we are coming along in the process of adopting some of our proposals.

It is tricky because each rule has to be looked at individually. The right sort of alternative for creditworthiness is not going to be the same in all cases. It has to be sort of calibrated, if you will, to the purpose for the particular rule.

Chairman NEUGEBAUER. Thank you.

Mr. Van Der Weide, where is the Federal Reserve in this process? Have you all developed a definition of creditworthiness?

Mr. VAN DER WEIDE. We are working on that. We issued a first proposal on that last summer. We have been engaging over the past year in extensive discussions with the OCC and the FDIC on this topic.

Part of our particular challenge that is causing us to take a little more time is the core regulation set that we have to worry about is the bank capital rules. And the bank capital rules, as I think we have learned in part through the financial crisis, are extremely important to ensuring the safety and soundness of banks and the financial stability of the United States.

We have to be very careful about how we amend our capital rules. We need to take our time and make sure it gets done right. The capital rules are also an area where a fair amount of risk sensitivity is required. It is not an on/off switch, investment grade or not. So it requires a little bit more work to make sure that we have a more granular system like that.

Other complexities that we are working on are it is an interagency process. The bank capital rules are importantly interagency. So there are a number of us working on it. It is not one agency. That will result in a better product at the end, but it will lengthen the processing time a little bit for this effort.

And the final complication that we have is, the capital rules are negotiated internationally at the Basel Committee, so there is an international bank capital accord which we have been implementing in the United States. And as you know, there is some tension between the international capital accord, which does contain references to ratings and what we are trying to do under 939A. So we also need to synchronize our efforts with the international accord.

We are working very hard on it. We don't have concrete proposals to propose at this time, but we will have some in the near future.

Chairman NEUGEBAUER. Mr. Wilson?

Mr. WILSON. The capital rules are an interagency process, so my answer is very similar to Mark's.

But the other thing in the capital rules, in addition to what Mark mentioned, is we are trying to implement an accord that has been done internationally. There is extensive reliance on credit ratings and the standardized approach. There is extensive reliance on securitizations.

But also importantly, some of them, like securitizations, are very granular. So it is hard to come up with definitions that provide that level of granularity to put risk weights into buckets like the Basel accord did.

But in addition to that, as I have mentioned, we have OCC-specific rules primarily in investment securities. That is more of an on/off switch, and we can take an approach, and we have proposed an approach similar to what the SEC is proposing and just having a descriptive standard of creditworthiness.

Chairman NEUGEBAUER. I appreciate the fact that you are looking at an interagency approach to this. And, of course, I think there needs to be some standardization. I think there is a feeling here that this process is not moving extremely swiftly.

One of the concerns that I have is that under FSOC, the Treasury Secretary is supposed to provide some leadership to this coordination among the regulators. And I would mention that the Secretary was—we did ask Treasury to provide a witness today, and this is the second hearing in a row that we have had that the Treasury has elected not to send a representative.

And so we think it is very important for the Treasury Secretary to be very engaged in this disharmonization within the regulatory framework, because we can't go and talk about harmonization with Basel and these other countries if we don't have our own plan. And so, I would encourage you to make sure that we move along in that process and make sure that happens.

I would just close with this interesting concept and just a quick question. If we are going to expunge that from our capital rules and some of the other rules, what would be the response if we just did away with the NRSRO designation?

Mr. Ramsay?

Mr. RAMSAY. I think I should maybe use some background, and indicate that the NRSRO designation has been used for quite some time. It used to be used as part of an informal, no-action letter process, which for many years is the way that agencies were recognized.

Chairman NEUGEBAUER. I am sorry to interrupt you here. My time is, unfortunately, expiring. Could you just give me the short answer? Would you support doing away with the NRSRO designation?

Mr. RAMSAY. I guess the short answer, Mr. Chairman, is that I think there are arguments that could be made for and against, but the Commission certainly hasn't taken a position on—

Chairman NEUGEBAUER. Mr. Van Der Weide?

Mr. VAN DER WEIDE. The Fed also does not have a position on that question.

Chairman NEUGEBAUER. Could you develop one?

Mr. VAN DER WEIDE. I will take that back.

Chairman NEUGEBAUER. Yes.

Mr. Wilson? I guess your answer is going to be the same?

Mr. WILSON. Yes.

Chairman NEUGEBAUER. Thank you. And with that, my time has expired.

The gentleman from North Carolina, Mr. Miller, is recognized for 5 minutes.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

One of the lessons I took from the financial crisis is when the folks in the financial sector say, "Everything is under control; there is nothing to worry about," but they have a desperate look in their eyes, I worry, because I think maybe they know something they are not telling.

What really happened in September of 2008 was described in the press as interbank lending freezing up. And in fairness to the press, it is going to be pretty hard to explain it any more deeply than that.

But in a part of the shadow banking system that hardly any American knows anything about, hardly anyone in Congress knows anything about, and those who know something about it don't know very much, was the repo market. And as much money was moving around every night in the repo market as there was in bank deposits.

Bear Stearns was getting $70 billion a night in repo market lending, every night. What they were doing with that money was making longer-term loans. Using very short-term borrowing for longer-term loans is not a formula for financial stability. And what happened was that there was an old-fashioned run, like what you saw in, "It's a Wonderful Life," that used to happen to depository institutions before there was deposit insurance in the repo market.

U.S. Treasuries seemed to be the principal collateral for the repo market and for the derivatives market. If our debt is downgraded, have any of you given any thought, do any of you have any clue what effect that might have on the repo market, on the derivatives market and the use of that debt as collateral in those markets?

Mr. WILSON. Yes, it is something that we have considered. It is one of many things as we try to look at what the impact might be. The best guess is that there would be an adjustment of the margin required. So you wouldn't be able to borrow as much through the repo market. There would be more margin for the given amount of collateral that you have.

We think that is manageable in the short-term because, for example, going from AAA to AA, you still have a very high quality security. And it is still considered one of the safest instruments in the world, but who knows what will happen long term.

Mr. MILLER OF NORTH CAROLINA. I have gotten a letter from my State's treasurer saying, "Please, please, please, don't allow Federal Government debt to be downgraded because North Carolina's State debt will almost certainly be downgraded as well if that happens." I understand the same is likely true of all manner of other kinds of debt—Fannie's debt, Freddie's debt, Federal Home Loan Bank debt, and on and on.

Do you have any sense of what the ripple effect will be in other forms of debt if Treasuries are downgraded?

Mr. WILSON. Yes. The only sense is that will probably happen. The extent of it, just like in 2008, what we saw, some of our predictions and what might happen in some of these markets were just blown away with what actually happened. So we believe there will be an effect, but the size of the effect is hard to measure.

Mr. MILLER OF NORTH CAROLINA. Okay. And also—somebody else? Did you—

Mr. VAN DER WEIDE. If I could address a little bit your previous question on the repo markets. The repo markets are not what they were in 2006 and 2007. There has been a reduction in the amount of short-term funding financing long-term assets through the repo markets over the past few years.

There has also been a lot of work done, both at the private sector level and on an interagency regulatory basis, to make the infrastructure of the repo markets stronger.

There is also recognition going forward of the reality now that the borrowers in the repo market are much more well-capitalized than they were leading into the crisis.

And there is also a new regulatory framework that is coming on line, the Basel Accord. The new capital requirements under Basel, the new liquidity requirements that are under Basel, are all designed to make that repo market safer and sounder and more stable to deal with potential adverse effects.

Mr. MILLER OF NORTH CAROLINA. Okay. Also, I understand a great many funds require that all the debt they hold be AAA. Do you have any idea of what effect may be on funds? Will they have to dump Treasuries? What effect will that have on the financial system?

Mr. RAMSAY. I guess I should say that my understanding is that, at least according to our rules, the rules don't require a AAA rating generally for money market funds. They require where funds hold government securities or securities that are guaranteed by the full faith and credit, that is sufficient now. Individual funds may have investment guidelines that would require a AAA rating. And I think they are in the process of looking at those guidelines and determining whether they should make changes.

Mr. MILLER OF NORTH CAROLINA. I guess one summary question, since my time has technically expired, but the chairman has not brought the gavel down yet, am I right to worry that this could be really bad if our debt was downgraded?

Mr. WILSON. It is hard to measure, but I think you are right to worry. It could happen. It could be a big thing.

Mr. MILLER OF NORTH CAROLINA. Okay. My time has expired.

Chairman NEUGEBAUER. I thank the gentleman.

And now the chairman of the full committee, Mr. Bachus, is recognized for 5 minutes.

Chairman BACHUS. I thank the chairman.

And the gentleman from North Carolina, I think, is right to be concerned about a default. I think he would also be prudent to worry about unsustainable spending. Although a default may be a more immediate problem, the overwhelming problem is structural long-term changes. And both of those ought to be addressed, and until both of them are, there won't be a lasting solution.

I have listened to your testimony, and I acknowledge that 939A is giving you some problems, particularly the bank regulators, the OCC and the Federal Reserve. You have not moved very quickly on implementing it.

If you read it, it asks you to replace the reliance on credit rating agency as the sole basis with alternative systems of creditworthiness, which could include credit rating. It could include credit rating, but it would be an alternative which would suggest other criteria.

If you notice the—you have mentioned your coordination with our European brethren, our international coordination. The European countries of the E.U. are making great efforts to end their reliance or overreliance on credit rating. In fact, they have followed, I think, our example.

And I noticed on July 11, 2011, European Commissioner member Michael Barnier stated that the Commission's credit rating legislation would address overreliance on credit ratings. The Financial Times just this week said that Europe intends to end its reliance on credit ratings. And I think that means overreliance, not reliance.

Have you been in discussions with them as they are moving towards implementing provisions, or are you aware and are you coordinating your efforts with theirs?

Mr. WILSON. Yes, absolutely. And I want to be clear, I don't think anybody disagrees that we shouldn't reduce reliance on credit ratings. That is a Financial Stability Board pronouncement. It is something we agree with, something that we all think is a good thing.

But to address your earlier comment, if we can read 939A to use a credit rating as one component in an overall credit analysis with appropriate due diligence and appropriate verification, that would make our job easier in order to conform to the Basel Accord because—but even the enhancements that were done in 2009 by the Basel Committee recognizes this and put in additional due diligence and requirements before you could rely on a credit rating.

Chairman BACHUS. Yes, I think what one of the goals behind it was that you heard investors, you heard particularly in residential mortgage-backed securities, I think, that was the spectacular failure. On municipal bonds, corporate debt, municipal debt, I think the credit rating agencies did a much better job.

I think that is part of your hesitancy, that, in fact, on other asset-backed securities, they had a mixed record, but it was of more value.

I think what we didn't want is people telling us that they were required by the regulators to basically make purchases or allocate their assets or their reserves based on that sole criteria.

But I will say this: I did not hear any expressions from either the OCC or the Federal Reserve during the entire debate. I don't recall anyone coming to us and saying, "This is a real problem." So I would say going forward, I would encourage you to have discussions with us.

This is not a holy grail, as we very much know up here. And I will just ask you to work with us on this.

I have one final suggestion. I have 30 seconds left. I know it is a complicated job, and it is easy to criticize, but you are the professionals, and we did intend to give you discretion, but we also intended to give you direction.

And one of those directions is Section 112, where we said that as you cooperate, that the FSOC, which you are members of, may be used as a coordinating body. And I don't know whether you have done that or you are aware of Section 112, but I would say, take a look at that in your efforts.

Thank you very much.

Chairman NEUGEBAUER. I thank the chairman.

And now, Mr. Carney is recognized for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman. Thank you for having this panel today. It is timely, given all the things that we are looking at here with the debt ceiling.

It is also timely with respect to a hearing that we had in the Financial Institutions Subcommittee last week about H.R. 1539, which as you may know, strikes 939G of Dodd-Frank, which would have required a higher level of liability for the rating agencies. And the effect, as my colleague from Ohio said, was to dry up the asset-backed security market for a big employer in his district, and that was the motivation behind his bill.

The SEC apparently had a regulation or has a regulation that requires that ratings be part of the prospectus for such a security. And I understand that they suspended that regulation so that the market, I guess, would come back.

The former chairman, the ranking member, said that the provision of Dodd-Frank would require the SEC to withdraw that regulation to be consistent with the current law. Is that your understanding, Mr. Ramsay? Or could you elaborate on this situation?

Mr. RAMSAY. Sure. I will try to briefly do so, although it is a little bit of a complicated issue.

Mr. CARNEY. Which is why I asked the question.

Mr. RAMSAY. We previously, actually, the Commission proposed at one point or put out for comment the idea of removing this special exemption, if you will, for rating agencies from the higher liability standard. So I think we recognize that there are arguments that could be made for or against. The Commission never came to a consensus on that.

The Congress essentially made the decision for us. As you noted, because the ABS market, because our rules require that the rating be included in the prospectus, the result of removing the exemption meant that rating agencies would have to consent to have the rating information included in the prospectus.

They refused to consent. As a result, there was the potential that the registered ABS market would be shut down or that there wouldn't be any deals being done. We thought that that was a bad result for the markets and for investors, and so we issued a no-action letter to allow that business to continue. And that no-action letter was recently extended.

So that is where we are at this point.

Mr. CARNEY. How about the last part, the claim by Ranking Member Frank that the SEC would be required to make its rules and regulations consistent with Dodd-Frank and thereby, I guess, withdraw that requirement?

Mr. RAMSAY. We haven't done anything to alter 436G or what was done in the statute. The only thing that we did was to issue a no-action letter with respect to the ABS market.

Mr. CARNEY. Do you have a view or do other panelists have a view on whether the rating agencies should be subject to that expert standard? People do listen to the rating agencies. We are seeing that right now.

When I was in State government, we listened. In fact, when the rating agencies said, "Jump," we said, "How high?" And we would go—I was secretary of finance—we would go to the legislature and say, "You can't do that, because if you did that, it could affect our rating." Now, we have the debate over the debt ceiling and, of course, the big argument is, we don't want to default. We don't want to downgrade.

And so people do listen. Some of the discussion and argument is, do they rely on the ratings too much? But what about the standard? The liability standard has a way of disciplining what might be put in a rating and included in a prospectus.

Mr. WILSON. We don't have a view on it. I think both of those statements are correct.

Mr. CARNEY. Does anybody else have a view? And if you don't, or you don't want to offer one, that is fine, too.

Let me ask this question, then. What does a different world look like if we have too many people—I, frankly, think ratings and the opinions that go with them are very meaningful and have always been in the world that I live in—so what does a different world look like where we don't rely so heavily on ratings?

Going back to the chairman—he is not here—Mr. Bachus' question, does anybody have a view of what that world looks like?

Mr. WILSON. Back to Mr. Bachus' comments about where the real problems were with the securitization structures. And the view of the world is there will be some reliance on credit ratings, but there should be additional due diligence. There should be an understanding on the parts of the banks we regulate and other investors on what is actually underlying that securitization.

That is not a new view for the OCC. We had guidance in that area. We reaffirmed it and strengthened it in 2009. Arguably, we didn't enforce it as much as we should have, but I think that the view is again back to this idea of reducing reliance on credit ratings.

Mr. CARNEY. Thank you. I see my time has expired. I thank the Chair for the additional seconds.

Chairman NEUGEBAUER. I thank the gentleman.

And now, the vice chairman, Mr. Fitzpatrick, for 5 minutes.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

Mr. Ramsay, I want to follow up on Chairman Neugebauer's line of questions earlier having to do with the designation process of the SEC for recognizing the Nationally Recognized Statistical Rating Organizations. I think you testified that for years the Commission had a policy of issuing a no-action letter. Can you expand on that, what the process was and what it currently is?

Mr. RAMSAY. Sure. I think beginning in 1975, if I am not mistaken, the Commission, when the first use of the term "NRSRO" was included in the Commission's rules, essentially the Commission granted what we call no-action relief, which is essentially a letter issued by the staff that says it would not recommend enforcement action if a private market participant operated in such a particular way.

So these letters were essentially ways of recognizing individual rating agencies, and those ratings would then be recognized in particular rules.

That process was criticized as being not very transparent, I think probably rightfully so. And so as a result, in 2006, the Congress created a structure that created a much more transparent process for applicants to come in and register.

Since that authority was granted, we have registered 10 different entities. We have only turned down one. The only one that we turned down was unable under the laws of its local jurisdiction to be able to say that it could provide us with the documents and examination authority that we would need.

So we have been trying to use the registration process and the authority that we have been given to encourage competition, but recognizing that we have to be able to make some baseline findings that are required by the statute that the agencies that come to us qualify.

Mr. FITZPATRICK. Is it your sense that the additional market participants are increasing the quality of the information, increasing the quality of what is out there for investors, but also may be even decreasing the cost?

Mr. RAMSAY. I would be hesitant about talking about quality because, of course, as I mentioned, we are prohibited from regulating the substance of ratings. I think we do believe that the rating process that exists now is more—substantially more—transparent, that the rating agencies are more accountable now.

We think the proposed rules that we have put out there will make that much more the case. And, hopefully, more competition will exist as well.

So we recognize that the rules that we proposed will impose some compliance costs. And those rules are still out for comment. We have asked for comment about if there are ways that our rules can be crafted so they don't impose so much in the way of the costs.

We certainly think that more competition is a healthy development.

Mr. FITZPATRICK. How about the opportunity for smaller rating agencies to participate in the market? Are you guys taking a look at the definition of what a small agency would be?

Mr. RAMSAY. We are. And, I think the rules are relatively new. The authority is relatively new.

And so, we have had some people come in to us, and we have been in discussions with them. There is not much of a precedent or a track record there, so it is a little hard to figure out. We are sort of going through that process for the first time.

Mr. FITZPATRICK. Sir, there was an Executive Order and a memorandum from President Obama unequivocally calling for regulations to be applied in the least burdensome manner in order to reduce unnecessary regulatory obstacles to competitiveness in the industry.

So, given that the three large NRSROs control over 80 percent of the credit rating market and have significantly larger profit margins that allow them to sort of absorb the higher compliance costs, do you believe your proposed rules address the disproportionate impact of compliance on smaller rating agencies?

Mr. RAMSAY. Congressman, as I mentioned, I think, the rules are still out for comment, and we have asked for comment. We really do want to hear from people as to whether the costs are excessive, if there are ways that we could scale them back. I should be clear that the statute is fairly prescriptive in terms of the things, the kind of rules that we are required to adopt.

We have tried in our proposed rules as much as possible to adopt what I call a "policies-and-procedures approach," which is that we require agencies to adopt policies and procedures to achieve a specific objective rather than try to dictate the way in which they have to achieve it.

And there are aspects of our rules by creating more information that allow investors to be able to compare performance of rating agencies that we hope over the long haul will actually spur competition.

Mr. FITZPATRICK. Okay. Thank you.

Chairman NEUGEBAUER. I thank the gentleman.

And now the ranking member, Mr. Capuano.

Mr. CAPUANO. Thanks, Mr. Chairman.

And thank you, gentlemen.

I just want to jump into a quick couple of things. As I said at the beginning, the 939A stuff, though I think it is good, is there anything in any rule anywhere that prohibits the market from looking at a credit rating from anybody?

Mr. WILSON. No.

Mr. CAPUANO. So that you can't make them do it, but you can't stop them from doing it either? Is that a fair statement?

Mr. WILSON. It has to be removed from the regulations. It doesn't mean that the investor can't—

Mr. CAPUANO. That is what I am suggesting. The market is going to call for a credit rating no matter what we do. I think it is a good thing to get them out. I think it is a good thing to do. But I don't want to pretend that is going to be the end of all our troubles. The market is still going to be looking for a credit rating.

Do you think that is a fair statement? Does anybody think it is an unfair statement?

Mr. VAN DER WEIDE. It seems fair.

Mr. CAPUANO. Thank you. I guess on the, what, the 939G, the Section 11 section, again, it is not in the prospectus, but am I wrong to think that most credit ratings are available to the general public whether it is in the prospectus or not?

Mr. Ramsay?

Mr. RAMSAY. I think generally the information does get into the market one way or the other. We prefer to have the—I should say this is a matter that is under review, so we have to—the advantage of having the—

Mr. CAPUANO. Right now, as I understand it, credit rating agencies are not allowing their ratings to go into the prospectuses, because they are concerned about this rule, which is fine. But that doesn't mean that I can't find their rating as a private citizen in a thousand different places. Is that a fair statement?

Mr. RAMSAY. I believe that is a fair statement.

Mr. CAPUANO. So we are talking about a real technical aspect where they don't do one thing and somehow prevent themselves from being held liable under one section of the law. That is all we are talking about.

Mr. RAMSAY. Yes. I think there is nothing that—we can't force rating agencies to consent under the scheme that we have. And so, as a result, the failure to consent means that—

Mr. CAPUANO. But their ratings are still available to the public. Is that a fair statement?

Mr. RAMSAY. The ratings are still available to the public. That is correct.

Mr. CAPUANO. So that by them simply not putting it into the prospectus, it doesn't mean that somehow they are hiding it and putting it in the bottom drawer. No one can see it.

It just means it is not in a technical piece of a document, a technical document that is technically available. but yet, it is available every place else, other than that document.

Mr. RAMSAY. That is correct.

Mr. CAPUANO. And there is nothing in this regulation or any other regulation that can supersede a law of the Congress. Is that a correct statement?

Mr. RAMSAY. I would say that is correct.

Mr. CAPUANO. So Congress has said to get rid of this. The SEC has not done it yet. I would argue that it doesn't matter what your regulations say. What matters is what Congress says, whether people like it or not.

Congress has said it no longer is relevant, so, therefore, do whatever you want. Section 11 doesn't apply. It is an illegal regulation that the SEC has hung onto for no particularly good reason. That is number one.

Number two, relative to Section 11, it doesn't relate to the other liability that was put in place by Dodd-Frank that says the credit rating agency that can be held liable for knowingly or recklessly conducting their business. Is that a fair statement?

Mr. RAMSAY. I'm sorry?

Mr. CAPUANO. Fair enough. I assume none of you are lawyers. Or are you all lawyers?

Mr. RAMSAY. I am a lawyer. We may all be lawyers, yes.

Mr. WILSON. I am not.

Mr. CAPUANO. I am a lawyer, too. So, two good guys and one so-so. So I am the only one who is going to defend you guys. Don't worry, because as far as I see it, one liability in Section 11 is a technical aspect. "Knowingly and recklessly" is still there for anybody to use. And nothing that anybody does can stop that.

Now, I know it hasn't been used yet, but it is still there. So let us not pretend that Section 11 is the only thing that is out there protecting people from the credit rating agencies.

Mr. RAMSAY. Yes, I agree, Congressman, 10-b5 liability is there, and continues to be. And, in fact, the Dodd-Frank Act sort of made the pleadings standards easier with respect to rating agencies.

Mr. CAPUANO. Right. I know it hasn't been used yet. And that is fair and well. I am not looking—

Mr. RAMSAY. But that is obviously for the courts to sort out.

Mr. CAPUANO. Absolutely. And I will be honest with you, I hope it never gets used, because all I have ever wanted is for credit rating agencies to do their jobs.

Now, I want to get back to my opening statement. As you have been going through this, I would like to—this is an opinion question, and you may or may not be comfortable answering it.

Do you have an opinion as to whether credit rating agencies in general are doing their job more efficiently, more effectively, than they were prior to the crisis? That is a straight-up question. It puts you on the spot. I am not trying to, but what the heck, that is my job.

Go ahead, Mr. Wilson. You seem—

Mr. WILSON. Yes, as an opinion, there has obviously been lots of energy devoted to the problems that we all saw, including the rating agencies. In addition to that, there are going to be a lot of additional requirements—

Mr. CAPUANO. Do you think they are doing a better job than they were before?

Mr. WILSON. Yes.

Mr. CAPUANO. Mr. Van Der Weide?

Mr. VAN DER WEIDE. I think they are doing a better job. I think they and many of us have reacted to the lessons learned by changing our ways and improving the way we estimate risks and model risks. So I think they are doing better.

Consistent with comments that Dave made earlier, the crucial thing is that no matter how good we think they are doing, we not overrely on them, not the government, not the private sector. So I think that is the chief goal here.

Mr. CAPUANO. That is a very good statement.

Mr. Ramsay?

Mr. RAMSAY. I do think it is fair to say that because the regulations that are in place, they are more consistent in terms of their methodologies. And certainly, the amount of disclosure that is out there that investors can use is much greater.

Mr. CAPUANO. Mr. Chairman, with your indulgence, one final question.

Mr. Ramsay, if your agency was tasked with creating an office of credit rating, would you have been able to do this if you had been allowed to reprogram your money?

Mr. RAMSAY. My understanding, Congressman, is that the reprogramming authority that was required from the House has not been granted. And so as a result, what we have done is take resources from our other examination areas in order to complete the annual examinations that we are required to do this year.

We have had to draw resources from the investment adviser, from joint investment adviser broker dealer exams. And those are exams we would like to do more of, so that has imposed some strain on our resources.

Mr. CAPUANO. Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from Texas, Mr. Canseco, for 5 minutes.

Mr. CANSECO. Thank you, Mr. Chairman.

Mr. Wilson, your testimony describes difficulty in identifying a workable replacement for credit ratings. Among other authorities, Section 112 of Dodd-Frank empowers the Financial Stability Oversight Council, FSOC, with the authority to coordinate rulemaking and recommend regulatory principles to FSOC members.

Have you requested assistance from the chairperson of the Financial Stability Oversight Council, the FSOC, to use its authority under this section to provide assistance in 939A rulemaking?

Mr. WILSON. To my knowledge, we have not in 939A.

Mr. CANSECO. Okay.

Mr. Van Der Weide?

Mr. VAN DER WEIDE. No, we have not. I think we have concluded that the core coordination that is needed in this process is between the banking agencies, because we have a lot of common regulations, most importantly the capital rules. So it is critical that the banking agencies coordinate. We are coordinating fairly intimately, are meeting very frequently with our working groups to develop alternatives.

We have also consulted with the SEC and the CFTC and the other agencies. I can't call it a coordination process, but we have consulted with them. So there is a lot of coordination and consulting going on. But we have not asked the FSOC to get involved.

Mr. CANSECO. Mr. Ramsay?

Mr. RAMSAY. I am not aware that the FSOC in particular has been involved in this issue. As Mark said, I think the agencies themselves have been talking to each other a fair amount.

Mr. CANSECO. Okay. Thank you.

Mr. Wilson, the SEC has made significant progress in removing references to ratings and even began the process when this seemed a likely legislative possibility in 2009. Why is the SEC able to move forward while you are here only talking about the challenges? Are you going to fulfill your statutory duties?

Mr. WILSON. Yes, we will have to. I will say that we talked before in our testimony about how there are a couple of challenges related to the capital rules that are different than a lot of the other rules, and that would include OCC-specific rules that are more similar to many of the SEC rules, where it is more of an on/off switch or maybe a two-bucket approach where it is either investment grade or it is not. And that is easier to address in a definitional way.

But when you have capital rules, for example, our current advanced approach securitization rule that has, like, 12 buckets, it is really hard to distinguish risk between those buckets without something fairly granular like a credit rating. So that is part of the difficulty that we have to find a solution for.

Mr. CANSECO. Thank you.

Mr. Ramsay, in your opinion, how does making it easier to sue Moody's and S&P allow investors to better assess their own risks and reduce their reliance on ratings?

Mr. RAMSAY. Congressman, I guess I wouldn't want to proffer an opinion on what you specifically suggested. I think that the potential liability is something that exists for all actors in the markets. Section 11 liability is one sort of step up from 10b liability. And as I said, I think there are policy arguments as to whether rating agencies should be treated like accountants for those purposes. The Commission hadn't sort of reached a result on that.

But 10b-5 liability is available for a variety of actors, and that is basically for the courts to sort out, not for the SEC.

Mr. CANSECO. Do you think, Mr. Ramsay, that this cloud of liability improves the accuracy of the credit rating agencies?

Mr. RAMSAY. I guess I am not sure what the connection might be. I am not sure of any research on that. And so, I wouldn't want to proffer an opinion on what the connection might actually be.

Mr. CANSECO. Would you agree with me that the prospect of liability or exposure is a damp rag over the accuracy of a credit rating agency?

Mr. RAMSAY. I am not, as I said; I don't think I am in a position or qualified to offer an opinion on what the relationship between the level of liability and sort of the ultimate quality of the ratings might be.

Mr. CANSECO. Thank you, Mr. Ramsay.

Mr. Wilson, one last question. Do you believe it is good public policy for the government to mandate the use of credit ratings by privately owned companies, then use those ratings as the basis for capital requirements?

Mr. WILSON. It is one of those where it is the best option we have. And I think that is what the Basel Committee came to. So it is a hard answer. But until we can find a better option, I think that is at least what the Basel Committee decided.

Mr. CANSECO. Do you have an opinion, other than the Basel requirement?

Mr. WILSON. Yes. I think it is difficult because I don't have another option that is better.

Mr. CANSECO. Okay.

Mr. WILSON. If you want to be risk sensitive.

Mr. CANSECO. Thank you very much.

I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from New Mexico, Mr. Pearce, for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

Mr. Wilson, right as Mr. Miller was closing, he asked if it was right to worry about a potential downgrade, and your comment was something like that it could happen. Is that right?

Mr. PEARCE. The worry is that it could happen.

Mr. WILSON. We have done a lot of work on this and talked with a lot of folks, and it is as you know very difficult to assess the impact—

Mr. PEARCE. But you said the problem is that it could happen?

Mr. WILSON. That is correct.

Mr. PEARCE. —and if it doesn't happen, then, whew, it is okay.

Mr. WILSON. Yes, absolutely.

Mr. PEARCE. Okay. I am going to pursue that and drill down just a little bit on that, if you don't mind.

Mr. Van Der Weide, on page 2, you described things that caused the ratings to be bad—untested models, flawed assumptions, limited, unverified data about underlying asset pools, default frequencies, potential conflicts.

And then on page 3, you say these flaws contributed to issuance of credit ratings that severely underestimate the credit risk of the—anyway, they underestimate the risk.

And so my question is, is it possible for us to underestimate the risk with regard to the Federal Government?

Mr. VAN DER WEIDE. I think there is a fair amount of uncertainty.

Mr. PEARCE. So even if we don't default on August the 2nd, are there uncertainties still lying out there?

Mr. VAN DER WEIDE. There certainly are uncertainties. And part of our job as bank regulators, the Fed, the OCC—

Mr. PEARCE. Who is in charge of making sure that those bond ratings, those rating agencies adequately correct the problems on the previous page? Who is responsible to make sure that doesn't happen again?

Mr. VAN DER WEIDE. It is a complicated question. Our specific responsibility—

Mr. PEARCE. Basically, if it is complicated, that means nobody is responsible.

Mr. VAN DER WEIDE. I'm sorry?

Mr. PEARCE. Nobody is responsible. Any time I hear the words, "it is complicated" in Washington, it means nobody is responsible.

Mr. VAN DER WEIDE. There are different agencies that are responsible for part of the solution.

Mr. PEARCE. And if we are all responsible, none of us are responsible. I already know that. I have six brothers and sisters. If we could ever make it a big deal, it was not a small deal. It wasn't us.

Mr. VAN DER WEIDE. Yes, sir. But the banking agencies are responsible for doing their part to remove the references from our regulations, and we are working on that.

Mr. PEARCE. Okay. So as we look then, I was going through a fascinating process yesterday looking at a failed bank. And it was really a solid-looking bank, solid, solid, solid, and they went in, and they realized they had not adequately judged the asset pool, not looked at things. And so all of a sudden, it skyrocketed in risk, because the rating agencies suddenly became aware of that.

Then Mr. Miller made these very precise comments, and I know that they are accurate, about the repo accounts and Bear Stearns. And they were doing things that were risky. And you have said that we have cured that risk.

So my question, Mr. Wilson, is would it worry you that the asset pool of the U.S. Government repaying our debt is actually being printed by the guy sitting next to you, a deal called quantitative easing? Chairman Bernanke came in the day before, or a few days before, and said he is fully ready to do it again, Quantitative Easing 3.

You mention on page 2 of your testimony that you all do alternative creditworthiness standards. Now, I know they haven't been downgraded and they may not be downgraded on August the 2nd. But, you saw the falseness of Bear Stearns doing what they were doing, the repos. The oversight agencies have seen the falseness of what was going on in banks.

Is anyone daring to speak—are you internally developing alternative creditworthiness standards for the U.S. Government?

Mr. WILSON. We are not.

Mr. PEARCE. That is fine enough. But we are all participating in a little process here. We are going to print money and make sure that we can pay the bills, and we are going to make sure we pass that legislation so that we don't default, because that is a huge deal, and we can't stand that.

I think in truth the creditworthiness of the U.S. Government has never been adequately looked at and is not being adequately looked at now. So if we pass August the 2nd, I think we still have a system that is very badly out of kilter, and we are printing money to make it work, and we are going to act like we can just continue to whistle while we work. And somewhere somebody ought to get some truth in the system.

I yield back, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

And now, I recognize Ms. Hayworth for 5 minutes.

Dr. HAYWORTH. Thank you, Mr. Chairman.

And, gentlemen, thank you for being here.

The E.U. Commissioner in charge of financial reform is Michel Barnier. And I am going to quote something that he said: "The CRA ratings are too embedded in our legislation, and I intend to reduce as much as possible the references made to those ratings in our prudential rules. That is my first priority today." This was last week.

"I can already tell you that the first of these measures to limit overreliance will be integrated into the upcoming modification of the capital requirements directive—otherwise known as CRD 4—and which is the effective translation of Basel III into E.U. law. I will make these proposals on the 20th of July. To limit overreliance we will be strengthening the requirement for banks to carry out their own analysis of risk and not rely on external ratings in an automatic and mechanical way."

And, as I understand it, our current statutory requirements are to—on our side, as well—to limit the weight of CRA ratings in these capital requirements.

Given that, of course, you rely on the statutory authority from our Congress and you work with our European counterparts to create the compliance with Basel III, what is your plan to advance—do you have a plan to advance the goal of not automatically and mechanically having CRA ratings be a part of how you evaluate bank capital?

Any of you? Thank you.

Mr. VAN DER WEIDE. We do.

I think it is important to note that there is an evolving, perhaps evolved, global consensus on this particular issue at this point. I think all the major jurisdictions are moving towards removing reliance by government and private sector reliance on credit ratings and removing them from the bank capital requirements.

We are in extensive discussions with our international counterparts, both through the Financial Stability Board and the Basel Committee about what the right way to do that is.

The focus of attention, I think, in the short term is where the rating agencies screwed up the worst, and that is in the structured finance area. So we are having active discussions in international fora about what the right way is to reduce international capital rules reliance on rating agencies. I think we are making some good progress on that.

And we are also spending a lot of time—the OCC, the Fed, the FDIC—working through the different alternatives for removing those ratings from the U.S. implementation, the U.S. form of the global capital rules—

Mr. WILSON. I just would echo almost everything Mark said.

We all agree that this rote mechanical reliance on credit ratings was not the right way to go. There is global consensus on that. We are all looking for good ideas to reduce reliance. I think, again, the question is reducing reliance or just absolutely banning reliance on it, so—

Dr. HAYWORTH. Thank you. Thank you both.

It certainly sounds as though, of course, there is—speaking as a consumer of information and as an investor in my own life, it is challenging. I trust that you are working on what we can offer to assure our consumers of financial products that there is, in fact, a way in which we can reliably use parameters to judge the quality of capital at our institutions.

One appeal, obviously, of having credit rating agencies is that if it works right, then you have a standard. But the problem seems to have been that, unfortunately, that standard was not one on which we could rely as scientifically as we thought.

Is that an accurate impression?

Mr. VAN DER WEIDE. Yes, I think that is pretty accurate.

I think one of the core principles that we have in the interagency working group that has been looking at this issue is to try to find a replacement for credit ratings that is transparent and consistent across different banks, across different financial instruments.

We think that is useful to the markets, useful to the banking system, useful to the regulatory agency, so transparency is one of the hallmarks that we are striving for.

Dr. HAYWORTH. Thank you all.

And I yield back my time, Mr. Chairman. Thank you.

Chairman NEUGEBAUER. I thank you.

Mr. Stivers is recognized for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman.

I am Steve Stivers. I represent Columbus, Ohio, and the surrounding areas. In my district, we have a big Honda plant that makes about a half million cars a year and employs about 4,400 people, and uses asset-backed bonds to finance the building and financing of cars. And so, I have some questions for Mr. Ramsay.

The first question I have, the gentleman from Massachusetts earlier sort of embedded in a question, assumed that the ratings are not in prospectuses anymore of asset-backed bonds, but, in fact, they are indeed still in the prospectuses. And the SEC is still requiring that, aren't they, Mr. Ramsay?

Mr. RAMSAY. Our rules currently still, as I understand it, require ratings in prospectuses. But that is a topic that is out for public discussion and comment.

Mr. STIVERS. Great. And the status of that—is there a pending proposed rule out there? These are yes-or-no questions, if you could. It's really easy.

Mr. RAMSAY. Yes.

Mr. STIVERS. So it is a proposed rule, or is it in draft form?

Mr. RAMSAY. I believe there is a proposed rule.

Mr. STIVERS. Okay. And it would remove the ratings. Because I have not seen the proposed rule—I have heard there is a discussion draft, but I have not seen a proposed rule.

Mr. RAMSAY. I believe the Commission yesterday put out a proposed rule to remove, at least for shelf registration ABS, the requirement for ratings.

Mr. STIVERS. Great, thank you.

And the next question I have goes to sort of how these things happen. So is the credit rating agency involved in preparing a prospectus, reviewing a prospectus, or is the credit rating agency just taken and inserted by attorneys and accountants in the prospectus?

Mr. RAMSAY. Congressman, you are getting out of my depth in terms of the way that those things are prepared. I think the rating agencies have—I am not aware that they are involved heavily in the preparation of the prospectus itself—

Mr. STIVERS. That is my understanding, as well. And I guess that just goes to the point that the prospectus is not their document.

And so let us talk for a second about what you know about Section 932, 933 of Dodd-Frank. The gentleman from Delaware alluded to this, as well. Is there not indeed still liability for the credit rating agencies under those sections, even if 939G were to go away?

Mr. RAMSAY. In general terms, Congressman, yes, there are two potential routes for liability. One is Section 11, which is the, sort of, higher standard of liability that exists for accountants and certain other experts. And then there also is, sort of, general anti-fraud liability under Section 10-b.

Mr. STIVERS. And even before Dodd-Frank, weren't the credit rating agencies sued before that new clause of liability was inserted?

Mr. RAMSAY. They have been from time to time—

Mr. STIVERS. And successfully sued in cases.

Mr. RAMSAY. I am not aware exactly what the court precedent is. I am not aware that there is any one pattern of decisions on this.

Mr. STIVERS. But it has not been universally unaccepted. That is the point. We didn't even need the new liability in section 932 and 933 of Dodd-Frank. Nobody is proposing that to go away. But certainly the 939 provision, I think, is of concern to a lot of us, because it has frozen up the asset-backed market. The market is depending on an indefinite no-action letter from the SEC.

I am excited to hear that yesterday you proposed a new rule. I will have to go check that out, but I had not seen it. I had heard there was a discussion draft, but I hadn't seen it, so I will certainly go look for it today.

Thank you. I yield back.

Mr. CARNEY. Will the gentleman yield?

Mr. STIVERS. Sure.

Mr. CARNEY. Yes, thank you to the gentleman from Ohio.

I would just like clarification from Mr. Ramsay. You said—I thought I heard you say that your requirement that the rating be in the prospectus is still enforced. Is that what you said?

Mr. RAMSAY. My understanding, Congressman, is that for asset-backed deals generally there is still a requirement that the rating information be included. There is a no-action letter that is out that is sort of—

Mr. CARNEY. So the no-action letter, and you just mentioned that a minute ago, frankly, means that the ratings, as I understand it, are not being included in the prospectuses but they are being included in the selling documents. Is that your understanding?

Mr. RAMSAY. That is my understanding.

Mr. CARNEY. I just wanted to clarify that for the record.

Mr. STIVERS. That is not my understanding, I will tell you. I believe that they are being included. And, frankly, the no-action letter applies to the 939G provisions of holding people liable as experts. Is that not correct, Mr. Ramsay?

Mr. RAMSAY. Congressman, at this point perhaps I should have my friends in the Division of Corporation Finance get back to you with that before I—

Mr. STIVERS. I am pretty sure that—I have talked to them. I could be wrong, but I am pretty sure that is right.

Thank you.

I yield back, Mr. Chairman.

Chairman NEUGEBAUER. Thank you.

I think that is all of the questions from both sides. We want to thank this panel. And with that, we will dismiss this panel and call up the second panel.

I would like to welcome our second panel here: Mr. Deven Sharma, president of Standard & Poor's; Michael Rowan, global managing director, Commercial Group, Moody's Investors; Mr. James Gellert, CEO of Rapid Ratings; Mr. Jules Kroll, chairman and CEO, Kroll Bond Rating Agency; Mr. Lawrence J. White, Robert Kavesh professor or economics, Stern School of Business at New York University; and Mr. Gregory Smith, chief operating officer and general counsel, Colorado Public Employees Retirement Association.

I would remind you that your written statements will be made a part of the record, and you will each be recognized for 5 minutes.

Mr. Sharma?

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

Mr. SHARMA. Thank you, Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee. Good morning.

My name is Deven Sharma, and I am the president of Standard & Poor's and have served in that capacity since September 2007. I am pleased to appear before you today.

Much has changed with regard to credit ratings and credit rating agencies over the past several years, both in terms of how we go about our work and the regulatory framework in which we operate. For our part, we at Standard & Poor's have undertaken a variety of initiatives in recent years designed to further our fundamental mission of providing the market with high-quality independent benchmarks about the creditworthiness of debt securities.

These initiatives include measures designed to strengthen the governance and control framework and has the analytics and criteria we use to rate issues and issuers and clearly communicate the rationale behind our actions and better identify and report on key areas of risk in order to further transparency in the markets.

These initiatives reflect the great lengths and significant efforts we have made to enhance the way we go about serving investors, regulators, and the capital markets. Put simply, with these added checks and balances and enhanced analytics, our organization today operates very differently than it did even just a few years ago.

These changes include investing significantly in our compliance and quality operations, including significant staff additions; establishing an independent criteria review and approval process; supplementing existing controls against potential conflicts of interest, including implementing look-back reviews and an analyst rotation program; and adopting enhanced ratings definitions and updating of criteria across major asset classes to map it to those definitions.

This has enhanced ratings comparability across asset classes and across geographic regions. It has also led us, on balance, to look for stronger credit characteristics for securities seeking higher ratings, enhancing disclosure in the ratings reports of applicable factors and variables, applicable criteria and the assumptions underlying their analysis, and finally, increasing analytical training of our analysts, including a new analytical certification program.

A more comprehensive list of these initiatives can be found in my written submission, as well as on our Web site, www.standardandpoors.com.

Of course, the regulatory landscape of credit ratings has also undergone major change. Through legislation and related rulemaking, regulatory measures have reinforced and strengthened the integrity of the ratings process through increased oversight, greater transparency and accountability, and improved analyst training.

Specifically, the passage of the Credit Rating Agency Reform Act in 2006, together with a rigorous set of governing rules adopted by the SEC, established the first comprehensive regulatory scheme governing credit rating agencies.

NRSROs are now required to make extensive disclosures of procedures and methodologies for determining ratings, performance measures, and statistics for credit ratings, policies for addressing and managing potential conflicts of interest.

The CRA Act also empowered the SEC to conduct detailed and lengthy examinations of rating agencies' practices and procedures and lowered barriers to entry for other credit rating agencies to register with the SEC. Indeed, several new ratings agencies have been registered in recent years, including those that employ the investor-paid business model and the rating agencies that use different analytical approaches in deriving ratings. S&P believes increased diversity of approaches and views benefits the markets with more information.

Dodd-Frank represented another significant event in the evolving landscape for rating agencies. One notable aspect of Dodd-Frank is its requirement that Federal agencies review the use of credit ratings in rules and regulations and remove references to ratings from several areas of Federal law. S&P has long supported addressing undue reliance on ratings by the market through elimination of legal mandates in the use of ratings.

Standard & Poor's welcomes many of the regulatory changes and enhancements that have been put in place in recent years. We also firmly believe that perhaps the most important value of ratings is the independence and forward-looking view they express about future creditworthiness.

For the markets to have confidence in those ratings, they must ultimately represent the independent view of rating agencies. That means, of course, that they should be free of commercial considerations, and S&P is fully committed to that principle. But it also means that they must be free of regulatory or governmental influence as to their analytical substance.

As Dodd-Frank rulemaking progresses, we believe it is critical that new regulations preserve the ability of NRSROs to make their own analytical decisions without fear that those decisions will be later second-guessed, if the future does not turn out to be as anticipated or that in publishing a potential controversial view, they will expose themselves to regulatory retaliation.

Pressures of that sort could only undermine the significant progress we believe has been made over the years by rating agencies and regulators alike to provide the market with transparent, quality, and generally independent views about the creditworthiness of issuers and their securities.

I thank you for the opportunity to participate in the hearing, and I would be happy to answer any questions you may have. Thank you.

[The prepared statement of Mr. Sharma can be found on page 118 of the appendix.]

Chairman NEUGEBAUER. Thank you.

Mr. Rowan?

STATEMENT OF MICHAEL ROWAN, GLOBAL MANAGING DIRECTOR, COMMERCIAL GROUP, MOODY'S INVESTORS SERVICE

Mr. ROWAN. Good morning, Mr. Chairman, and members of the subcommittee. My name is Michael Rowan, and I am the global managing director of the Commercial Group at Moody's Investors Service.

On behalf of my colleagues, I would like to thank you for the opportunity to participate in today's hearing and to speak to you about Moody's, the role credit rating agencies can play in the markets, our competitive landscape, and the impact of Dodd-Frank on the credit rating agency industry so far.

In providing you with our perspective on these questions, I would like to outline two principles that have guided us over the years.

First, Moody's believes that the legislative initiatives that periodically review and update the regulatory regime under which market participants operate are both necessary and healthy. They can increase market confidence that rules are fair and the playing field is level. They also encourage best practices among and across industries.

Second, we think that markets thrive when the regulatory landscape allows for and encourages numerous differing views while permitting market participants to choose opinion providers based on quality.

It is equally important that contrarian opinions not only be tolerated, but encouraged.

For these reasons, Moody's has been a strong advocate of competition in our industry, so long as that competition occurs on the basis of quality.

Moody's has developed our reputation over a long period of time. We are, however, also well aware of the loss of confidence in the credit rating industry, largely driven by the performance of the U.S. residential mortgage-backed securities sector and related collateralized debt obligations.

Over the past several years, Moody's has adopted and will continue to adopt a number of measures to regain confidence of our ratings in that sector.

The actions and initiatives that we have pursued in the recent past can be categorized into five broad areas: strengthening the analytic integrity of credit ratings; enhancing consistency across ratings groups; improving transparency of credit ratings and the ratings process; increasing resources in key areas; and bolstering measures to mitigate conflicts of interest.

One initiative that I wish to underscore is the creation of the department which I head, Moody's Global Commercial Group. Our mandate builds on prior measures through which Moody's had first prohibited rating analysts from discussing fees with issuers and then extended that prohibition to their managers.

Last year, we took those efforts one step further and created the Commercial Group to strengthen separation between our credit rating and credit policy functions on the one hand and our commercial functions on the other. My position in particular was established to bring the commercial functions under common leadership.

The Commercial Group is responsible for business strategy and planning, new business origination, and managing the relationships with issuers for the rating agency. The employees of the Commercial Group have no involvement in determining or monitoring credit ratings or developing or approving rating methodologies.

Equally as important, Moody's analytic employees are not involved in the commercial activities of the company, which adds another layer of protection against the potential of conflict.

In addition to our own internal efforts, Moody's supports regulatory reform and believes that effective regulation of credit rating agencies is positive for our industry and the broader market.

For example, the Credit Rating Agency Reform Act of 2006 and Title 9 of the Dodd-Frank Act call upon nationally recognized statistical rating organizations to be transparent about their rating opinions and methodologies and to effectively address conflicts of interest.

Dodd-Frank also introduced measures to enhance credit rating agencies' accountability and reduce the regulatory use of credit ratings.

In particular, Moody's has long supported removing references to credit ratings in regulation. We believe that mechanical triggers, regardless of whether they are ratings based on market signals or another type of measure, can inadvertently harm markets by amplifying rather than dampening the risks in the system.

Finally, over the past year, the Securities and Exchange Commission has been proposing rules and seeking comments for studies related to the credit rating agency industry, as mandated by the Dodd-Frank Act.

Moody's has submitted comments on these proposed rules and studies and will continue to provide our views throughout the SEC's public comment process. We anticipate that the new rules will spur various changes in Moody's processes and operations, as well as lead to the codification and deepening of some of Moody's existing practices.

While we anticipate that the evolving regulatory landscape will lead to further change, our objective remains what it has been for the past 100 years: to provide the highest quality credit opinions, research and analysis.

Thank you, again, for inviting me to testify on this important matter. And I look forward to answering your questions.

[The prepared statement of Mr. Rowan can be found on page 102 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

Mr. Gellert?

STATEMENT OF JAMES H. GELLERT, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, RAPID RATINGS INTERNATIONAL, INC.

Mr. GELLERT. Thank you. On behalf of Rapid Ratings' employees and shareholders, I would like to thank Chairman Neugebauer, Ranking Member Capuano, and the members of the subcommittee for asking me to join you today. My name is James Gellert, and I am the chairman and chief executive officer of Rapid Ratings.

As we arrive at the 1-year anniversary of Dodd-Frank, we face essentially the same or worse ratings landscape as 1 year ago. S&P, Moody's, and Fitch have undiminished influence, competitors that are NRSROs have even more challenges and costs, and non-NRSRO rating agencies are even less likely to apply to be one.

Rapid Ratings is neither an NRSRO nor a traditional rating agency. We are 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 from 70 countries. We re-rate all U.S. filers quarterly. We use only financial statements, no market inputs, no analysts, and have no contact with issuers, bankers or their advisers.

In a recent third-party academic paper, we are identified as being 2.9 years earlier than Moody's in downgrading to below investment grade companies that ultimately fail. We represent innovation and competition in ratings.

Dodd-Frank has positive and negative initiatives, but ultimately it penalizes the wrong players, creates disincentives for new players to enter the business, and misses opportunities to truly change the ratings industry.

The biggest positive initiative is the removal of NRSRO references from Federal regulations. Many have covered that, and I think will, so I will skip that for the moment and refer you to my written testimony on that subject.

The negative developments can largely be grouped as increased reporting, oversight, board construction, administrative and compliance duties.

I do not disagree with prudent governance and compliance, but I am discouraged by the immense costs associated with complying. Many of these rules were implemented to address the conflicts of interest and behavioral issues of the big three, and ironically those companies are the only ones that can easily afford to comply.

Increased liability dominated the reform debate throughout 2009 and into the enacting of Dodd-Frank. It is perhaps the most politically charged and roundly understood concept for reform by the public at large.

It may be fair to levy stricter liability standards on those agencies that contributed directly to the crisis, but Dodd-Frank changed the relevant language from NRSRO to credit rating agency at the last minute. This change was the only material instance where non-NRSROs were captured by this new statute. I wonder why. I suspect to prevent NRSROs from unregistering. If so, this is quite a statement about how the drafters felt Dodd-Frank would go over with the big three rating agencies.

I suggest that CRAs that have never been NRSROs should be given safe harbor from these liability provisions. Section 932 of Dodd-Frank covers the disclosure of ratings methodologies in the attempt to measure ratings accuracy. The SEC's implementation regulations, which are out for comment, propose so much disclosure of underlying methodology that they put at risk the intellectual property of a firm like Rapid Ratings that is innovation-driven. This is overkill.

On accuracy, without question, more accurate ratings are good for the market. However, regulatory enforcement of a prescription of accuracy—of accurate ratings—is not. Markets drive innovation, not regulations.

If a standard for ratings accuracy is prescribed by regulation, over time agencies will engineer ratings to the standard by which they are being measured. This means fewer diversified opinions, not more. Homogenizing ratings only correlates risk-taking and increases systemic risk.

A major shortcoming of Dodd-Frank is it does nothing to expand NRSROs' access to data used by other NRSROs in the ratings process. Firms can now access due diligence data on some forms of structured products, but not nearly enough. Collateralized loan obligations are the perfect example, as detailed in my testimony.

Next week, I will propose in a comment letter to the SEC a simple yet potentially wide-reaching initiative to assist in the improvement of this industry. All NRSROs should be required to file an affirmative statement with the SEC that they confirm or change each previously issued and outstanding rating on a quarterly basis.

This initiative would force firms to think more carefully about their initial ratings and ensure they stand by their product, promote some confidence in the ratings process among users, make asset managers more responsible for understanding more frequent ratings changes instead of arbitraging stale ratings, and ensure that the SEC has more performance data.

Effective reform will only come with the following: not stifling competition through compliance costs; removing references from regulations to decrease dependence on NRSROs; promoting innovation and avoiding the homogenization of ratings; and increasing the flow of data critical to providing new ratings into the market.

Why take a young, hungry competitor in the rating space and subject it to all manner of change, increased scrutiny, costs, liabilities, uncertainties and a playing field that changes and then changes again? Until there are benefits that outweigh the costs, we will build our business outside the NRSRO network.

Thank you.

[The prepared statement of Mr. Gellert can be found on page 64 of the appendix.]

Chairman NEUGEBAUER. Thank you.

Mr. Kroll?

STATEMENT OF JULES B. KROLL, EXECUTIVE CHAIRMAN, KROLL BOND RATING AGENCY, INC.

Mr. KROLL. Thank you for the opportunity of speaking with you this morning, Chairman Neugebauer, Mr. Capuano, and other Members of Congress.

My statement is a very personal statement. I built my previous company starting 40 years ago focused on the concept of due diligence, and focusing on the concept of fighting corruption in the corporate world and ultimately in the government world.

It was all about bringing professionalism to an industry which was not held in very high repute in those days, called the private detective industry. So unlike James, I can't take on the attributes of the young, hungry competitor, so consider me an old, hungry competitor.

Thank you, Larry.

A couple of things I would like to say personally. I had sold my company. I was in pretty good shape. My wife was complaining I was hanging around the house a little too much. And I began to look at things where I might apply my experience and the experience of my colleagues to an important public policy issue, as we had with corruption and payoffs and kickbacks in the 1970s, 1980s, and 1990s.

I had always marveled at the racket that these big rating agencies had. It was beautiful. Charge whatever you want. Take no responsibility. Hide behind the First Amendment. Make a lot of money. It looked like a good business model to me. So I began to study it and to see whether our skills and our history and our knowledge could be applied here.

Now, this is a personal statement from me. My view is the whole concept that you hide behind the First Amendment and accept no accountability for your work is irresponsible, and it is scandalous. I have yet to hear people say at the big three that they are sorry. They have said they underestimated the depth of the housing crisis in America. Who do you think contributed to it?

I don't want to whine about that. I want to tell you what I am doing about it and the traction that we are getting, but some of the obstacles we face. So I don't know about the rest of you, but when I read a novel, I cheat. I go to the end. I want to see is the hero or the heroine still alive. So I won't hold you in suspense in my remaining 2 minutes and 34 seconds.

We became an NRSRO because we felt when it came to public pension funds and it came to corporate pension funds and university endowments and other foundations, there was no official status to your rulings unless you were an NRSRO. So as long as there is an NRSRO, we had to become one.

So we bought the tiniest one there was. It was a little company doing $1 million a year. We developed a marvelous business model. We managed to spend more money on lawyers and compliance in the last year than that little company had revenue. Now, my wife has informed me this is not a good business strategy, but it is an essential one, because we needed a better foundation to build on.

So here are my asks. Number one, let us go back to the Fitzgerald bill and its attempt to encourage competition. And there were a few little firms that came in. One of them, we bought. Another one, Egan-Jones, is still in business. And then there is Realpoint that was acquired by Morningstar.

Those are the three smaller ones. And by the way, there is nothing that James has said that I don't completely endorse. Whether an NRSRO or not an NRSRO, he has gotten it right.

So number one, we have to look at the 500 pages of regulations that the SEC promulgated in response to Dodd-Frank, no less on my birthday, May 18th, and I was meeting with them on May 19th. They have made an effort to comply. They have tried in each and every way to be in sync with the legislation from Dodd-Frank.

But when you are making rules for, in effect, an oligopoly, with massive numbers of people who are working in every discipline and opining on which countries should be downgraded or not downgraded, that is a different species. The mice can't run and compete with the elephants, if we have the burdens and the expense that are laid on because of this.

And I have some sympathy for the big three, but frankly not much, given the amount they make. These are among the most profitable companies in America. It is time for them to reinvest in the quality of what they do.

Our business is totally focused on where the problem was. We are totally focused in the structured finance area. And we are building it silo by silo, and we are making headway. So my ask is lighten up on the burdens from a regulatory point of view and let us just get on the field and compete face to face on the accuracy and the quality of our ratings and let us not hide behind the First Amendment. Let us be accountable for our work.

Thank you.

[The prepared statement of Mr. Kroll can be found on page 89 of the appendix.]

Chairman NEUGEBAUER. Thank you, Mr. Kroll.

Mr. White?

STATEMENT OF LAWRENCE J. WHITE, PROFESSOR OF ECONOMICS, STERN SCHOOL OF BUSINESS, NEW YORK UNIVERSITY

Mr. WHITE. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, my name is Lawrence J. White.

I am a professor or economics at the NYU Stern School of Business. I represent solely myself at this hearing. Thank you for the opportunity to testify today on this important topic.

The three large U.S.-based credit rating agencies—Moody's, Standard & Poor's and Fitch—and their excessively optimistic ratings of subprime residential mortgage-backed securities in the middle years of the past decade played a central role in the financial debacle of the past 2 years.

Given this context and history, it is understandable that there would be strong political sentiment, as expressed in Section 932 of the Dodd-Frank Act, for more extensive regulation of the credit rating agencies in hopes of forestalling future debacles.

The advocates of such regulation want figuratively, perhaps literally, to grab the rating agencies by the lapels, shake them, and shout, "Do a better job."

This urge for greater regulation is understandable and well-intentioned, but it is misguided and potentially quite harmful. The heightened regulation of the rating agencies is likely to discourage entry, rigidify a specified set of structures and procedures, and discourage innovation in new ways of gathering and assessing information, new technologies, new methodologies, and new models, possibly including new business models, and may well not achieve the goal of inducing better ratings from the agencies.

Ironically, these provisions will also likely create a protective barrier around the larger credit rating agencies and are thus likely to make them even more central to and important for the bond markets of the future.

Why would we want to do that?

You just heard from Mr. Gellert and Mr. Kroll about all the problems that Section 932 creates, especially for the smaller agencies.

There is a better route. That route is also embodied in the Dodd-Frank Act. It is sections 939 and 939A. These are the sections that remove statutory ratings—references to ratings—and that instruct Federal agencies to review and modify their regulations so as "to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standards of creditworthiness as appropriate."

Doing so would really open up this bond information industry in a way that it has really not been open since the 1930s.

Unfortunately, financial regulators, especially the bank regulators, have been slow to implement these provisions. You heard from them earlier today. They have been slow, especially the bank regulators.

On one level, this slowness, this reluctance is understandable. Regulatory reliance on an existing set of rating agencies is easy. It is a check-the-box kind of approach. It is easy for the regulator. It is easy for the regulated.

But at another level, this is not rocket science we are talking about. The approach of the regulators ought to follow the same approach that bank regulators already use—they currently use—for assessing the safety and soundness of the other kinds of loans that are in bank portfolios.

That approach basically says, "Place the burden directly on the bank or other financial institution to demonstrate and justify the safety and soundness of their bond portfolios." That is essential. That safety must—and the regulatory approach to that safety must—remain.

The financial institutions can do this either by doing their own research and analysis themselves in-house, or they can rely on third-party sources of creditworthiness information. Third-party sources might encompass the existing incumbent NRSROs or other sources of creditworthiness information—and there are other sources: There are the smaller non-NRSROs. Mr. Gellert represents one of them. There are creditworthiness fixed-income analysts at securities firms. And in a more open environment, these analysts might be encouraged to hang out their own shingles and start doing more independent analysis on their own.

Of course, regulators have to check on the competence of the financial institutions in doing that research or in employing the services of those creditworthiness advisers, but it can be done.

So Section 939 and 939A are the direction to go. When they are fully implemented, then there wouldn't be any need for the NRSRO system, to address a question you raised earlier, Mr. Chairman.

And if we can somehow avoid the dangers of Section 932—ideally, if it were my choice, I would repeal 932 in a heartbeat—then the bond information market, and that is really what we are talking about, would be opened to innovation and entry in ways that have not been possible since the 1930s.

My written statement expands on these ideas. Thank you, again, for the opportunity to testify this morning. I would be happy to answer questions from the committee.

[The prepared statement of Dr. White can be found on page 216 of the appendix.]

Chairman NEUGEBAUER. Thank you, Mr. White.

Mr. Smith, you are recognized for 5 minutes.

STATEMENT OF GREGORY W. SMITH, GENERAL COUNSEL AND CHIEF OPERATING OFFICER, COLORADO PUBLIC EMPLOYEES' RETIREMENT ASSOCIATION

Mr. SMITH. Thank you. Mr. Chairman, Ranking Member Capuano, and members of the subcommittee, thank you for having me. Good afternoon. I am Greg Smith, general counsel and COO of the Colorado Public Employees Retirement Association (PERA). I am also a member of the board of directors of the Council of Institutional Investors.

I appreciate the opportunity to speak to you today. My testimony is going to emphasize three points: first, the systemic risk being created by the premature removal of credit ratings from all regulations from the perspective of an investor; second, the SEC's role in oversight of credit rating agencies and what it takes to accomplish that goal; and, finally, the critical nature of the provisions making credit rating agencies accountable, as are others, for their products that they sell.

Colorado PERA is a pension fund with more than $40 billion in assets. And, as general counsel and COO, I am responsible for protecting the retirement security of more than 475,000 participants and beneficiaries in that system.

In that capacity and as a board member of the council, I have had the opportunity to study the issues surrounding the credit ratings industry and the ways in which ratings agencies' actions impact institutional investors and pension funds.

At the outset, it is important to note that neither prior to the financial crisis nor subsequent to the passage of Dodd-Frank has Colorado PERA ever relied on rating as a sole source of buy-sell decisions. Rather, ratings are used as a part of a mosaic of information we consider during the investment process. That is the way all responsible institutional investors have done it and continue to do it.

Our investment process involves risk budgeting, an effort to ensure that investment managers are generating appropriate returns within a specified range of risk. A consistent and reliable risk measure is critical to institutional investors in order to manage those risk budgets. In addition, ratings are an important factor in our decision to participate in short-term credit facilities, such as cash accounts and money market funds.

We fully agree with the conclusions of the Financial Crisis Inquiry Commission and many others that, "the failures of credit rating agencies were an essential cog in the wheel of financial destruction."

In light of those failures and the credit rating agency provisions of Dodd-Frank that followed, Colorado PERA has begun a process of consulting with internal fund managers and outside experts in order to identify appropriate alternative measures of risk.

We are hopeful that, once identified, such measures can also help to define in our investment management agreements the level of risk to be taken on by our individual portfolio managers. The process, however, as we have heard from the OCC as well as the Fed today, is a challenging one. And to date, identifying cost efficient measures that could comprise a robust, objective evaluation of credit risk remains elusive.

In the meantime and to the extent that credit rating agencies continue to act as gatekeepers for the financial markets, we strongly believe that rating agencies should have an appropriate level of government oversight and accountability to investors at least as rigorous as auditors, investment banks, and other financial gatekeepers.

Providing an appropriate level of government oversight for credit rating agencies requires sufficient funding of the SEC so that they can implement and enforce the provisions of Dodd-Frank that begin to address credit rating agency conflicts of interest, lack of transparency, and other deficiencies.

As you are aware, SEC funding does not increase the Federal deficit, because its budget is fully offset by fees imposed on financial entities engaged in SEC-regulated securities transactions.

Depriving the SEC of necessary funding as a supposed punishment for past failures is counterproductive and contrary to the needs of investors. Providing an appropriate level of accountability to investors requires that credit rating agencies be subject to liability to investors for poor performance and poorly managed conflicts.

As you might expect, we were disappointed by the Committee on Financial Services' vote last week in support of House Resolution

1539. As you are aware, that bill would amend Dodd-Frank to provide those NRSROs that directly contributed to the multitrillion global financial crisis a shield from accountability to investors.

We note that a similar shield from liability is not provided under the Federal securities laws to any other financial gatekeepers.

Colorado PERA and the council stand ready to work with this subcommittee, the SEC, and other interested parties to better ensure that the credit rating agencies post-Dodd-Frank will, to the extent possible, more effectively and efficiently serve the needs of investors and all participants in the U.S. financial system.

That concludes my prepared remarks. I look forward to your questions. Thank you.

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

Chairman NEUGEBAUER. I thank the panel.

And we will start with questions. I will recognize myself first for 5 minutes.

I want to put up a chart. I know it is hard to read, and so that chart is being passed out, and we will make sure the panelists get one as well.

Basically, where I am going with this is that one of the things I feel like Dodd-Frank does is it makes the big get bigger and it is not—what we have heard is testimony here that even in the rating agency space—but also what I think Dodd-Frank has also done and what is going on in the rating agency is they are kind of complicit in the fact that we are helping the big financial institutions actually stay bigger and actually giving many of those an unfair advantage.

And so what you have here is a chart that basically shows the ratings of four banks, and so there is a kind of a before the uplift and after. And basically, what you see are two banks, SunTrust and TrustMark, that actually have a before uptick ratings of A3, and then we have Bank of America and Citigroup has a Baa2 rating, in using ratings of bank financial strength, C, and the two other banks, C-minus.

But when you look at the upticks that they are getting, for example, Bank of America is getting a 5-point uptick. And so, it takes it up to Aa3 and Citigroup gets an uptick 4 to A1.

And so the concern here is, and what I am hearing over and over again, is that we haven't cured this too-big-to-fail perception out there among the rating agencies, and that, in fact, the rating agencies today are giving these systemically important financial institutions advantage over other financial institutions that may, in fact, from a core standpoint be more, obviously, from your own ratings, maybe be a better financial risk on a standalone basis.

So my question is, where are we in this process of removing this too-big-to-fail advantage for these large financial institutions?

Mr. Sharma, I will start with you.

Mr. SHARMA. Thank you, Mr. Chairman. In the spirit of our objectives of transparency and clarity, we have recently also clarified how we are going to rate banks in the future.

And we start with looking at the stand-alone credit risk assessment of a bank on a number of factors that include business position, risk exposure, funding, and liquidity.

But then after we do the stand-alone credit risk assessment, we do look at what external support it may be provided by a holding company or by a parent institution or by government support. And in that context, we have created a very simple framework that looks at different governments based on their policies and regulations and history as to whether they are supportive or supportive-uncertain or interventionist.

And then we look at different institutions as to how important they are for the economy, the size, the concentration, the interconnection across the different market participants. And based on that, we determine how much support we believe the government may provide to these institutions when there is a crisis or a situation.

So in that context, we do believe, given the situation, we are recognizing the Dodd-Frank Act has a very clear aim to bring stability and raise the capital of the banks and the fact that the banks should not be provided any support.

But our role is to provide the investor with a forward-looking view. And in that context, our analysts have said, were a similar situation to exist, we think, based on the history, based on the size of the banks and the connectivity, that there may be attempts at changing the policies to support the banks in the future.

Chairman NEUGEBAUER. But based—attached to the handout there—based on a statement that was recently issued by your company, you questioned whether the too-big-to-fail issue has actually been settled.

Mr. SHARMA. Mr. Chairman, that is my co-panelist's company, Moody's, but we have also recently published research that highlights the fact that we recognize the Dodd-Frank Act and the aim of the Dodd-Frank Act to sort of take this too-big-to-fail support away.

But we recognize on some of the connectiveness, the high concentration of the large banks, the importance to the sovereigns, that in a similar situation, policymakers may end up looking at changes to the law to give support to the institution in the future.

Chairman NEUGEBAUER. And just for the record, the statement, though, that is up there is a statement from—Moody's is—these are ratings from—the table is from Moody's, but the statement is from Standard & Poor's?

Mr. SHARMA. Yes, and that is what I said. We have recently published a similar—

Chairman NEUGEBAUER. Yes. Just quickly, Mr. Rowan, your response, because your company does the very same thing.

Mr. ROWAN. Yes, Mr. Chairman.

Chairman NEUGEBAUER. Won't you push your—yes, thank you.

Mr. ROWAN. Sorry about that. Mr. Chairman, as the head of the commercial group, I am completely removed from the rating analysis, rating committees and the formation of the methodologies, so I am not the person who can speak authoritatively on the question and point that you are asking.

Chairman NEUGEBAUER. At least let me ask you a question. Do you think it give financial institutions an unfair advantage that they get anywhere from two to four upticks for being considered a risky financial institution? Do you think that gives them an unfair advantage in the marketplace?

Mr. ROWAN. Mr. Chairman, as I said, I am not involved in the methodology, and I am aware that the methodology incorporates the—

Chairman NEUGEBAUER. I am not talking about methodology. I am talking about common sense here. Do you think it is an unfair advantage for an entity to get upticks just because the Federal Government has not sent a clear signal whether it will bail that entity out or not? Yes or no?

Mr. ROWAN. Mr. Chairman, I am not the right person who can give you a yes-or-no answer, but I can arrange to have the right people speak with you and your staff, if that would be helpful.

Chairman NEUGEBAUER. So you don't have an opinion on that?

Mr. ROWAN. As a representative of Moody's, sir, that is not my specific area of expertise. I wouldn't want to mislead you.

Chairman NEUGEBAUER. Okay.

Ranking Member Capuano, for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman.

Mr. Sharma, just to clarify, under your understanding of current law, current law alone, you don't think we have made any changes? I know what you said is, based on what you think we might do, that is what you think. But based on current law, do you think that too-big-to-fail still exists?

Mr. SHARMA. The current law clearly states that, and it is very clear about that, that it—

Mr. CAPUANO. Clearly states what?

Mr. SHARMA. That it will not provide any—

Mr. CAPUANO. That we will not. So it does not provide. Therefore, your opinion is based on your opinion that we might act.

As a matter of fact, obviously, I won't read the transcript, but I wrote it down, I think, pretty clearly, that your opinion is based on the fact that you think we maybe will attempt to change the policies, which means the current policy to support. So when your opinion is based on your fact that you think, in your professional opinion, which you are entitled to, that we would change our current policies to react to a new situation?

Mr. SHARMA. Yes, that is exactly what our analysts have said.

Mr. CAPUANO. That is fair.

Mr. SHARMA. That is their future view of how things may happen.

Mr. CAPUANO. That is a very fair statement. I just wanted to be clear about that. You don't think that we do it now. You think that we would react to it. And as long as it is a statement of your opinion of what we would have to do, we would have to change current law and our current activities in order to do this again—

Mr. SHARMA. Correct.

Mr. CAPUANO. —which, of course, we could change law to do anything we wanted.

Mr. SHARMA. Sure.

Mr. CAPUANO. That is the whole idea of why Congress exists, to change laws.

I appreciate that, Mr. Sharma. I just want to make that clear. It is your opinion of what we might do in the future.

And, Mr. Rowan, I know you are not the perfect person to answer this. It is my understanding that Moody's has officially said that they think that too-big-to-fail has been ended. Is that a fair reading of what—not yours; I am not asking for your opinion. I recognize you said you are not the guy here, but I would hope that you would know what Moody's has said as a general statement.

Mr. ROWAN. Mr. Congressman, I am not sure that is Moody's official statement. I can arrange to have the individuals who are responsible for that—

Mr. CAPUANO. That is fair enough.

Mr. ROWAN. —but I can't answer your question.

Mr. CAPUANO. I think that you should arrange to have them put their official documents on the record, because it is my understanding that Moody's has said so. I am not going to hold you to it, and maybe I am wrong. I guess I am rolling the dice here, but I have been led to believe that Moody's has said that, and, therefore, I would like Moody's to go on the record one way or the other what you think about too-big-to-fail, because I have been led to believe they do.

Shifting to another thing, Mr. Kroll, I wanted to push a little bit. You had earlier said that you would agree with Mr. Gellert on everything, yet your comment on the First Amendment indicated that you may not agree, and I am not so sure.

As I understand it, the reason that we had to change some of the laws to take away or to limit the First Amendment defense of the credit rating agencies, we put in "knowingly or recklessly," which is now under the law, under the Dodd-Frank law, the new standard as to credit rating agencies.

It has nothing to do with the First Amendment. The First Amendment is what has been used up until now to prevent them from having any liability whatsoever.

Do you disagree with that, first of all, understanding?

And, second of all, do you think that we should get rid of the new standard of extending liability to rating agencies under a "knowingly or recklessly" standard?

Mr. KROLL. I am not sure what your question is.

Mr. CAPUANO. The question is, you said that—I want to make sure I understood it. I am under the impression you said we should get rid of the First Amendment defense?

Mr. KROLL. No. What I said was the rating agencies should be accountable like lawyers, like auditors—

Mr. CAPUANO. I agree.

Mr. KROLL. —like investment bankers—

Mr. CAPUANO. But the courts—

Mr. KROLL. —and not hide behind the First Amendment and not be accountable.

Mr. CAPUANO. But the courts up until now have stated that the First Amendment protects them.

Mr. KROLL. Yes.

Mr. CAPUANO. So, therefore, the only way around it is to provide a different standard, and the different standard in Dodd-Frank is to say that they are now subject to a "knowingly or recklessly" standard, therefore opening the door. It does exactly what, I think, you suggest we should do.

Mr. KROLL. I think it is doing surgery instead of with a laser, doing surgery with a meat cleaver. I believe that the attempt to rectify the behavior can be done very simply and create the same standard, the same standard for rating agencies as every other professional in the financial marketplaces. That would solve the problem.

Mr. CAPUANO. I would suggest that you talk to your lawyers, because I am pretty sure it is the same standard, "knowingly or recklessly," that applies to everybody else. And if your lawyers, or anyone else, have a suggestion of how we could have done it surgically to get rid of—

Mr. KROLL. I am a lawyer.

Mr. CAPUANO. And how could we have circumvented a long-standing series of court decisions that has said that they are protected by the First Amendment?

Mr. KROLL. If you look at the recent ruling of the 2nd Circuit—

Mr. CAPUANO. And I have.

Mr. KROLL. —which was very favorable to the rating agencies, very favorable—

Mr. CAPUANO. But not based on the "knowingly or recklessly" standard. It was a completely different approach, which I actually thought was a stupid approach.

Mr. KROLL. Okay. If you are saying "knowingly and recklessly," that is a separate issue. If you are talking about having an absolution from general behavior and liability, that is what I am focusing on. I think under reckless behavior, anybody could be found liable, if that could be proven.

Mr. CAPUANO. I would be interested to hear what your standard would be, because "knowingly or recklessly"—if you are a lawyer, you know this—has been a longstanding standard that has applied to virtually everybody. It is actually a relatively—it is a very common standard.

The First Amendment defense—I thought it was a very unique defense brought before the courts many years ago. It is surprising that the courts upheld it. And I would be interested to pursue with you or your lawyers at a later time any other way to do it, because I am not stuck on "knowingly or recklessly" here. I just couldn't find one any other way.

Mr. KROLL. It is really simple. There are standards that bankers, auditors, lawyers, and other people in the financial process system are susceptible to and they are liable for.

There should be—the rating agencies wield enormous power. We see it every day. They are deciding on which countries should be upgraded or downgraded, including our own country. They are doing all sorts of things, and they are doing it in effect, without any legal responsibility.

Mr. CAPUANO. They have responsibility now. And "knowingly or recklessly" is the standard that is applied to virtually everybody else. And if there is another standard, I would like to know what it is.

Mr. KROLL. If you want me to keep going on this, I will.

Mr. CAPUANO. Just tell me what standard it should be.

Mr. KROLL. I just told you. The standard should be the level of liability that every other professional has in the securities process.

Mr. CAPUANO. As a lawyer, you know that is not a legal answer. That is a generic answer. What is the standard that other people have? And the answer for me is that it is "knowingly or recklessly."

Mr. KROLL. Staying with this point, for example, if you have an investment banker or an auditor or a lawyer who acts negligently, they are going to be liable, if you can prove that is the case.

Mr. CAPUANO. Under the "knowingly or recklessly" standard?

Mr. KROLL. If that is the case with a rating agency, good luck.

Mr. CAPUANO. That is the new standard. I do wish you good luck. Thank you.

Chairman NEUGEBAUER. I thank the gentleman.

Now the vice chairman, Mr. Fitzpatrick.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

I want to thank all the witnesses for their testimony. This is very helpful.

Mr. Rowan, the question I have for you relates to—in the written testimony of Mr. Gellert, he has proposed an initiative that would apply to all NRSROs that would require them to file an attestation on a quarterly basis, essentially reconfirming the ratings and opinions previously issued.

He is doing that. I guess he believes it would provide confidence to the public that the rating agencies are standing by the ratings and their opinions.

Is Moody's prepared to file quarterly attestations? And would Moody's stand by the ratings on an ongoing basis going forward?

Mr. ROWAN. Congressman, Moody's on a regular basis reviews and maintains its credit opinions. Our willingness or capacity to sign an attestation on a quarterly basis is something that I can't answer for you today. But I do know that we regularly review and monitor our ratings on all of the instruments that we have ratings on.

Mr. FITZPATRICK. Mr. Rowan, how long have you been with Moody's?

Mr. ROWAN. For about 15 years.

Mr. FITZPATRICK. Fifteen years. So certainly, you remember 6 or 7 years, ago Enron and WorldCom went bankrupt. Moody's had rated both of those entities as investment grade 5 days before their filings for bankruptcy.

Had Moody's been standing by its ratings and filing quarterly updates, investors would have had better information about what was coming down the pike, would they have not?

Mr. ROWAN. I believe that Moody's had continuously reviewed and monitored those ratings, and that as information becomes available, it is incorporated into the rating. And those ratings and the issues surrounding those events are fairly well documented, Congressman. I don't know whether or not a quarterly attestation would have changed those ratings.

Mr. FITZPATRICK. Mr. Gellert?

Mr. GELLERT. Thank you, Congressman.

Rapid Ratings had Enron as a below investment grade credit in the mid 1990s. Re-rating things on a quarterly basis gives an accurate perspective of the credit quality as it changes. Companies do not maintain one single credit quality—or securities don't maintain one single credit quality for decades at a time.

And one of the fundamental tenets of the traditional ratings process from the big three is the concept of rating through the cycle. Rating through the cycle is essentially putting a rating on a security and having it be good for some period of time that is undefined and indefinite.

The concept is that it is fine until we say otherwise. And the problem is, that has been proven to be incorrect over and over again.

Mr. KROLL. Congressman, my former company ran Enron in bankruptcy for 4 years, and we studied every single fraudulent act in that company, going back historically because of all the legal liabilities.

James has a good idea. What we are doing with structured products is something Moody's and Standard & Poor's failed to do, which was a key part of this crisis. They stopped doing something called surveillance in the structured products area.

What does that mean? It means for years—for years—when we thought they were watching the ship, they weren't. They were not conducting surveillance.

Now James' idea is worth thinking about, because it forces you to do that. We have committed to investors that we are going to provide surveillance every month, whether we get paid for it or not, through the life of the bond.

I think rating agencies need to be held accountable and put on the record. That is a very interesting way to do it.

Chairman NEUGEBAUER. I thank the gentleman.

Mr. Carney, you are recognized for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman.

I really just have two basic questions.

And one goes to something, Mr. Sharma, that you said in your remarks, referring to look-back reviews. And looking through your testimony, that is part of the action you have taken to ensure integrity and independence.

Could you tell me a little bit about what that means in that context? And then I would like to ask it in another context as well.

Mr. SHARMA. Congressman, as part of our number of actions that we had announced in early 2008 to make changes in the business, to improve our governance and checks and balances, including our analytical independence, one of the things we looked at was looking at people who would leave our organization to go to an issuer, and to then examine all the ratings that they may have been involved with, but when they were at our organization and conducting the ratings for an issuer with whom—

Mr. CARNEY. So it is a look-back at personnel and where they move and—

Mr. SHARMA. And the ratings that they had performed.

Mr. CARNEY. Right, right, right.

Mr. SHARMA. And now, that has become a part of the regulation. And we had adopted that, and we had announced that we would adopt that in 2008.

Mr. CARNEY. So if you go the next section, "Actions taken to strengthen analytics," it doesn't use the term "look-back reviews." But do you do look-back reviews?

You talk about creating an independent model validation group, which in some ways could be validating models that were used. Did you look back at some of the structured products that you had rated that fell apart, rated AAA and they turned out to be less than that, let us just say?

Mr. SHARMA. Congressman, like many other participants, we have also reflected on and learned from many lessons of this. But just as a context also, clearly, there were many lessons we learned out of the U.S. residential mortgage-backed securities.

Mr. CARNEY. What would you mention as the most important of those lessons?

Mr. SHARMA. Part of it was sort of looking at our analytics and making sure some of our ratings are completely comparable, looking at the stress scenarios that we apply to them, and enhancing surveillance. We have always conducted surveillance, and we have enhanced them. We have strengthened our surveillance programs.

Mr. CARNEY. When you say "surveillance," what do you mean?

Mr. SHARMA. It is when the rating is—once it is new—rating is issued on new issuance, then we continue to monitor it. We get monthly reports on the servicers. We review it. We look at it. What we have now done is we have gone one level below. We are looking at the underlying collateral, etc., that makes up a structured security.

So we have really expanded and enhanced our surveillance. But the surveillance program was always in place, that we would look at this on a quarterly basis—

Mr. CARNEY. So you discovered through the surveillance process that you had rated securities that didn't perform at AAA securities?

Mr. SHARMA. We learned why the ratings sort of behaved the way they did, what were some of the things to learn and observe. Another aspect was information quality. We have now—not only have we done that, we are looking at the rating of different information that we receive based on the credibility of the source of the information. And so, we have started to apply that framework against it and it is also being introduced as part of the regulation.

Mr. CARNEY. So changing gears a little bit as my time runs out, what does it mean to you—and I will ask the others as well—to stand behind your rating?

Mr. SHARMA. First of all, we are accountable. We are accountable to the regulators to make sure that what we do follows our process, policies, regulations as appropriate.

Secondly, we are accountable through market scrutiny. And at the end of the day, it is our credibility and our reputation of our ratings. And the fact of the matter is, there are independent reports—for example, IMF recently came out and looked at the sovereign credit ratings and our performance in those sovereign ratings, and how it has performed over time.

Mr. CARNEY. So Mr. Rowan, yourself—

I apologize for interrupting, but my time is running out.

How about Moody's?

Mr. ROWAN. Mr. Congressman, the concept of credibility that Mr. Sharma just mentioned is an integral part of the business of a rating agency. And putting the brand and franchise behind the rating is important, and the users of ratings look to Moody's longstanding track record of credibility and consistency of performance of our ratings in many areas outside of residential mortgage-backed securities.

Mr. CARNEY. So we had a big discussion earlier, and you were all here, about 939G in the liability section. What is your view of that provision?

Mr. ROWAN. Congressman, I am not a lawyer.

Mr. CARNEY. Okay. So we will go Mr. Sharma, then, if you can't answer.

Mr. SHARMA. Congressman, do you mean 436G or—

Mr. CARNEY. Section 939G, as I understand it, is the section that imposes the provision for a stricter liability standard.

Mr. SHARMA. Oh. Sorry. Yes.

As I mentioned, we are accountable, and we recognize that Dodd-Frank Act changes the pleading standard, which is actually unique to rating agencies, unlike any other market participants, that the pleading standard has now been changed on us.

But otherwise, we are sued. We are sued. And cases have been filed on us and on other laws that are on the books.

Mr. CARNEY. So does anybody—Mr. Smith, I think I heard you articulate a different view of that?

Mr. SMITH. We believe that in our review of the credit rating agency line in case law, the ranking member is correct that the standard that has been imposed by Dodd-Frank is exactly the standard that is imposed on every other participant in the financial markets—certainly, the lawyers, the accountants—a knowing and reckless standard.

It is not a negligence standard. It is a knowing and reckless standard, and it is one that makes them realize that what they have done is wrong or that they were so reckless in their disregard for whether it was wrong that they should be held accountable for it.

I think that is the correct standard, and it is a standard that applies across-the-board.

Mr. CARNEY. Thank you, Mr. Smith.

And I thank the Chair for the extra time.

Chairman NEUGEBAUER. I thank the gentleman.

And now the chairman of the Capital Markets Subcommittee, the gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. I thank you. And I thank the panel.

So the panel probably heard the earlier panel, some of the questions with regard to the larger issue that is affecting this country right now, and that is the debt limit. And so, there are certain questions there.

I will start with Mr. Sharma. Could you comment on the evaluation of the potential for a downgrade on the President's position or his solution to the problem as whether we will still get a downgrade?

Mr. SHARMA. Congressman, the way our sovereign analysts look at it is they look at five variables to sort of assess the creditworthiness of this commercial debt of a sovereign. They look at the fiscal aspect. They look at the monetary. They look at the economic strength of the country, as well as look at the liquidity and funding, and then, of course, the political institutions that formulate the policy and—

Mr. GARRETT. And so one of those five—I only have so much time. I realize the five-point analysis, and one of those points of the analysis is what structural changes that the Congress is going to pass. So were you able to look at what the President has presented and be able to give an evaluation on that, whether that is sufficient?

Mr. SHARMA. What we have said is our analysts have said that there has to be a credible plan to reduce the debt burden, as well as reduce the deficit levels.

Mr. GARRETT. I understand. So I serve on the Budget Committee, and there is now that infamous statement from CBO where they said, "We do not evaluate speeches."

Is there something that you were able to evaluate with regard to the Administration as to whether their plan is credible? Do they have a plan that you are able to look at?

Mr. SHARMA. Congressman, there have been a number of plans that have been announced by the Administration—

Mr. GARRETT. Have you been able to look at them?

Mr. SHARMA. —and we think some of the plans to reduce debt levels could bring the U.S. debt burden, as well as the deficit levels, in the range of a threshold for a AAA rating. And so we have analyzed it, but we are waiting to see what the final proposal is for a sovereign analyst to really analyze it more thoroughly and then to opine on it.

Mr. GARRETT. So the story is—at least one of the stories out there is, with regard to the Reid plan, that it would be a better plan to ensure that we would not get a downgrade according to some of the rating agencies. Is that story true, that it is one that would aid better or is one that is satisfactory?

And I say that partially with regard to your own analysis of July 14th that says what we really need to have here in order to avoid a downgrade is a $4 trillion structural change. As far as I know, the Reid plan does not reach that level. So would that be satisfactory?

Mr. SHARMA. Congressman, I think we were misquoted. We do not comment on any specific plan or the political choices or policy choices being made. We are just commenting on what is the level of debt burden, what is the level of deficit that must meet the threshold to retain its AAA.

Mr. GARRETT. Okay.

Mr. SHARMA. And since there was a $4 trillion number put forward by a number of Congressmen, as well as by the Administration, our analyst was just commenting on those proposals, that that would bring the threshold within the range of what a AAA-rated sovereign debt would require.

Mr. GARRETT. So watching my time, first, is something under that then potential still be able to maintain a AAA rating?

Mr. SHARMA. Congressman, I would leave that to our analysts to determine that. And it is a decision that is made by the ratings committee and by our sovereign analyst. We have criteria on sovereigns that we have published. We have thresholds that are out in the public domain.

Mr. GARRETT. I know the original plans, the so-called grand plan was in the $4 trillion size. The Reid plan is substantially under that, $1.5 trillion or so under that. So you have not made any other pronouncements since the July 14th letter analysis saying that whereas $4 trillion would be satisfactory, we have seen these other potential plans out there, and they would or not—you have not produced any other documents in that regard. Is that correct?

Mr. SHARMA. No, Congressman, we have not. We are waiting for the plans to come.

Mr. GARRETT. Does Moody's want to chime in on this?

Mr. ROWAN. Congressman, I am not a rating analyst. But Moody's has placed the rating for the U.S. Government under review for possible downgrade—

Mr. GARRETT. Yes.

Mr. ROWAN. —looking at two dimensions: one, the short-term risk of a disruption; and two, the longer-term issue of the level of debt in relation to the overall economy.

Mr. GARRETT. Right. And I know you are not the analyst there, so do the plans that we have seen either from the White House, which are—I haven't seen anything on paper—or from Reid, which is more specific, which come under the $4 trillion level, do they satisfy those criteria?

Mr. ROWAN. To my knowledge, Moody's has not published anything in regard to specific policy issues or the specific parameters that the rating committee will consider for the review action.

Mr. GARRETT. Okay.

Mr. Kroll, do you want to chime in?

Mr. KROLL. I don't think rating agencies have the wherewithal, the intellectual range, the experience to be doing ratings on—

Mr. GARRETT. Sovereigns?

Mr. KROLL. —100 countries around the world. I question whether this is the job of a private sector entity to be looking at the United States Government or, frankly, any other government and reaching decisions on their levels of creditworthiness.

And what we have seen throughout history is a constant activity of being a day late and a dollar short and running around in front of the parade.

So is this new news? What makes these organizations—we are not qualified to do this. We are too small. But I question conceptually whether private enterprise should be in this business for pay.

Mr. GARRETT. I thank you.

I think my time is up.

Chairman NEUGEBAUER. I thank the gentleman.

And now the gentleman from Texas, Mr. Canseco, for 5 minutes.

Mr. CANSECO. Thank you, Mr. Chairman.

Mr. Sharma, do you believe that the amount of debt held by the United States poses a systemic risk to our economy?

Mr. SHARMA. Our sovereign analysts in the publication have highlighted that the debt burdens and the growth rate of the debt burdens is something that does need to be addressed for us to continue to assess the creditworthiness of the sovereign commercial debt at AAA levels.

Mr. CANSECO. In the political discourse that we are seeing today, do you think that it is the job of a credit agency to get involved in trying to make a decision one way or the other on a political basis? Do you think that is interference on the part of the credit rating agencies to be stepping in at this stage and making an assessment?

Mr. SHARMA. Congressman, sovereign debt is a large asset class that many investors around the world invest in. And our role is to really provide an independent view and a future forward-looking view for the investors as to what the risk levels are for those assets that they invest in.

And that is what we are doing today. We are really for the benefit of investors giving them a perspective and a point of view that says what do we believe, whether the risks are rising for any sovereign, whether it is here or Europe or anywhere else. We are doing the same that we do in any other part of the world, that we are speaking to the risk that the investors invest in.

And this is a large asset class that investors invest in, and they are the ones who determine what to pay for those risks.

Mr. CANSECO. Do you honestly believe that the United States could default on its debt?

Mr. SHARMA. Our analysts don't believe they would. And by the way, changing a rating doesn't mean it would default. AAA, all it means is that it is a low probability, a very low probability of a default. That is all it means. And if you change a rating, it means that the risk levels have gone up. It doesn't mean it is going to default. If you believe that, they would change it to a default status.

Mr. CANSECO. Thank you.

Mr. Gellert, is there information to which Moody's and S&P have access that your firm cannot access?

Mr. GELLERT. A significant amount, actually. And in addition, there is a lot of information that they have that even NRSROs like Kroll Bond Ratings can't access. I think it is 17(g)(5) that is the rule that created last year, or in late 2009, an ability for—in structured products for data that is being used by a paid-for rating to be shared and accessed by another NRSRO for an unsolicited rating.

As a non-NRSRO, we don't have access to any of that. As an NRSRO, what Mr. Kroll would not necessarily have is access to things like the underlying data that goes into a collateralized loan obligation (CLO) security. CLOs are very, very closed. They are not covered in the asset-backed securities that are really covered under 17(g)(5). And in fact, the SEC doesn't have purview over the loans themselves, the underlying collateral for those types of securities.

So there is a whole world of information that none of us have access to that really would open up the space to competition, as well as providing the investor community information that they directly could use, if that information was available to them.

Mr. CANSECO. Thank you.

Mr. Kroll, would your answer be the same or different?

Mr. KROLL. As an NRSRO, which is one of the reasons we became an NRSRO, we do have access to most of the information. So, for example, we have just in the last 30 days rated 3, and in 2 weeks it will be 5, commercial mortgage-backed deals. We are privy to the same information that the oligopoly gets, if they are on those deals.

Mr. CANSECO. Okay.

Mr. Gellert, were you disappointed or pleased with the provisions of Dodd-Frank related to credit rating agencies?

Mr. GELLERT. I think by and large, I was disappointed with them. I think the idea behind Dodd-Frank, in my understanding, was to, vis-a-vis rating agencies, was to create transparency, create accountability, increase competition.

In fact, I think what happened was a lot of punitive, directed initiatives towards the big three with unintended consequences that hurt the variety of us who would consider being NRSROs or even those firms that are NRSROs.

Ultimately, innovation and competition in this space is what is going to evolve it, and I don't think Dodd-Frank as a whole really helps contribute to that mission.

Mr. CANSECO. As a non-NRSRO player in an entrenched field, what is the biggest challenge your firm faces?

Mr. GELLERT. I think there is still a certain amount of or a decent number of institutional investors that are paying attention to the NRSROs before they will pay attention to a non-NRSRO, in part because of the infrastructure in the regulatory environment that continues, although it may be evolving, but continues to support them.

For us, we don't mind the hard work. We are in this for the long term and we are in this to grow our business. And doing the hard work and explaining our ratings to a variety of potential and current users is very much a part of what we do, but we are trying.

This example of the quarterly ratings affirmation, we believe even as a non-NRSRO, we are leading the field in best practices in certain areas and will continue to try to do that. So we are prepared to compete, but obviously it becomes harder with certain folks, given the entrenchment.

Mr. CANSECO. Thank you.

I see that I am out of time, Mr. Chairman, so thanks very much.

Chairman NEUGEBAUER. In consultation with the ranking member, we are going to provide members another round of questions. And so, I will start that.

Mr. Sharma, in the last 6 or 7 months, have you had conversations with Secretary Geithner about the ratings of U.S. sovereign debt?

Mr. SHARMA. Mr. Chairman, like we do for all entities that issue debt, we meet with the management, in this case the Treasury is the management for us, and so our sovereign teams have had ongoing dialogue. And we do this with not only with the sovereign governments around the world. We do that with companies. We meet them regularly and sometimes hourly when they have new updates to information.

So our sovereign team has been meeting and discussing and dialoguing with the Treasury, as well as other parts of the Administration and some Members of Congress to just better understand what the situation is, what policies are being formulated, how credible would those plans be in that to be put into place. So they have been having a regular ongoing dialogue in the spirit of getting better understanding.

Chairman NEUGEBAUER. So let me re-state my question. Have you and Secretary Geithner had a conversation about the rating of U.S. sovereign debt?

Mr. SHARMA. No, Mr. Chairman. I have not had any direct conversation with Secretary Geithner.

Chairman NEUGEBAUER. Yes, and so what about—I know this sovereign debt thing is not just a U.S. issue right now, but it is a global issue, particularly in the European Union and the European Central Bank. Have those entities been having ongoing dialogue on how you might be rating their debt in the same respect?

Mr. SHARMA. Congressman, first of all, our sovereign analysts meet with the central banks, with finance ministries, Treasuries and other policymakers around the world on a regular basis. We rate about 126 countries, and we have over 100 analysts in sovereign. So they are really meeting with all the people around the world all the time.

And from time to time, yes, I do in my role meet with central banks as well as finance ministry and Treasuries around the world to just exchange views, but not on their ratings per se.

Chairman NEUGEBAUER. And so, here is the question. What about countries that can monetize their own debt, like the United States and some other countries? Would a country that can print money get a higher credit rating than a country that doesn't have that ability available to it?

Mr. SHARMA. Yes. In our criteria, we explicitly say that countries that can have their own currency, and in this case U.S. is a global reserve currency, so it does get a lift. I am not exactly sure how much lift, but yes, they do get a lift.

Chairman NEUGEBAUER. Yes. It would be interesting, I think, for me at least and maybe some of my Members to know what the lift is for countries that can print money.

Mr. SHARMA. Sure. I think we may have published it, and we will make efforts to get it to you.

Chairman NEUGEBAUER. Another question here is when you are looking at the potential—what a rating is is the potential or what you think the risk of default is. What percentage of a country's government expenditures attributed to interest would begin to cause you to enhance the potential for default?

In other words, some countries, their interest is 5 percent, 10 percent. Some countries are 25 percent interest. At some point in time, it is squeezing out the amount of government expenditures and forcing either additional taxes or—but would the interest carry be a factor that you would—

Mr. SHARMA. It is. And cost of debt servicing is an important factor, as is the total debt level, as is the deficit, as is the economic growth prospects, because they all influence the trajectory of the growth of the debt levels for the country.

So clearly, we have thresholds for each rating category against many indicators that we look at. At this point in time, I don't know explicitly what that threshold is for a AAA for the debt servicing, but we can look at our published documents to see if it is in there and then can send it to you.

Chairman NEUGEBAUER. Last point, in a country that the debt levels are increasing, in other words, the interest carry is increasing at a faster level than the GDP, the growth in the economy, what is the pathway for that country?

Mr. SHARMA. It all is a function of that, plus it is a function of— the total debt level is a function of the debt deficit. It is a function of the economic growth, and then, of course, of what steps are going to be taken to address all these things. So you can change the trajectory by using a number of other variables.

And then, as you mentioned, the dollar as a global reserve currency also brings some benefits also to the creditworthiness.

Chairman NEUGEBAUER. Would you say this is a fair assumption that the comments you made recently about U.S. debt was not whether we were going to default or not, but whether we were going to actually address the massive deficits that this country is running?

Mr. SHARMA. Mr. Chairman, that is it exactly. The more important issue is really the long-term growth rate of the debt as it is driven by the debt burden, as well as the deficit. That is the more important issue at hand. And to your point, that is the more important issue.

Chairman NEUGEBAUER. I thank you. My time has expired.

Ranking Member Capuano?

Mr. CAPUANO. Thanks, Mr. Chairman.

Mr. Chairman, I just want to point out that I have the Bloomberg News report on the 2nd Circuit opinion. It deals with underwriters. Apparently, Moody's and Standard & Poor's and others were sued as underwriters.

I can't imagine why they would sue you as underwriters. No one, other than probably this plaintiff, would have considered you to be underwriters. You are in the business of making thoughtful, professional opinions, not underwriting.

I guess the plaintiffs made no other legal claim. So I am glad you won the case because I wouldn't want to get into this mess. But that has nothing to do with other cases that may come.

Mr. Smith, I wanted to pursue another area. And I am not sure whether Colorado PERA is considered in the class as a muni type of bond. Are you in that category?

Mr. SMITH. As far as an issuer?

Mr. CAPUANO. Yes.

Mr. SMITH. No, sir.

Mr. CAPUANO. No, so you don't get tax-exempt status?

Mr. SMITH. No, we do not issue bonds. We are a pension fund that acquires assets, pays benefits, but we are not a part of the State. We are an arm of the State, but we are not a part of the State for purposes of issuing debt.

Mr. CAPUANO. Okay. I appreciate that. I wanted to ask because I want to find—look, guys, I have been chasing the credit rating agencies for years, before this problem.

And it really had to do with because I am a former mayor, and I was kind of giving you a little bit of taste of what I got from my 9 years as mayor. I didn't like it.

As Mr. Carney said earlier, when you guys came in the door, I had to jump through hoops that were ridiculous to get ratings that were below what I deserved.

And then, when I got here, I realized that I did get ratings below what I deserved, because my risk of default, which is really the only basis for which I thought anybody worked, was significantly in a different standard.

Dodd-Frank was supposed to address some of these things, and I guess I would like to pursue as to whether it has.

In the last couple of years—I have the numbers before me, but they are up until 2008; I have not updated them—but prior to 2008, the historic ratings of all rating categories, all of them, AAA down to noninvestment grade, munis by Moody's standards were 97 percent times less likely to default than corporate bonds, yet were rated lower. By S&P's standard, they were 45 times less likely to default, yet rated lower.

Have you changed your ways? Are you now rating municipal and other governmental agencies as if they were corporations, again, based on one thing and only one thing, which is the risk of default?

Mr. Sharma?

Mr. SHARMA. We have always had one scale, a consistent scale, that we have tried to adopt across all our asset classes. And, as a result, you will see we have been—our municipal ratings are generally higher than the corporates, of course, and other types of institutions, financial institutions.

And we have now even made vigorous attempts to really make our ratings very comparable, whether it is munis or corporates or whether it is financial institutions, whether it is in the United States or it is in Europe.

So we are striving toward getting comparability of our ratings across all asset classes, across all geographies.

Mr. CAPUANO. So, the reason I ask, because in 2008—again, not updated, but I know it has changed a little bit, but my guess is—let me ask a basic question, are you aware that munis have defaulted at any higher rate than corporate bonds?

Mr. SHARMA. I don't have that data exactly, but, as I mentioned, we are aiming to get comparability of our ratings across all asset classes and geographies.

Mr. CAPUANO. That would mean, basically, that you would now start rating what was once rated in 2008 as maybe a BA or BB, up to a AAA. They had approximately the same default rate as a AAA corporate bond.

And I would argue that since default rates are really the only thing that matters in the final analysis, because, again, am I wrong to think that the only thing that matters is the likelihood of getting repaid?

And if that is the only thing that matters, you should, based on historic data, absent individual items, that munis should be rated—BBA munis should be rated AAA. So are you telling me you have addressed that issue and that now that all munis are addressed comparable to corporates?

Mr. SHARMA. We are working toward it. We are recalibrating. We have, in fact, recalibrated our criteria across many areas, including structured finance, sovereigns, governments, and we have been also recalibrating our criteria on municipals, with the aim and objective to sort of have comparability of ratings and across all our sectors, across all asset classes and geographies, but this is forward-looking—

Mr. CAPUANO. Mr. Rowan, has Moody's made some progress on this as well?

Mr. ROWAN. Yes, Mr. Congressman, I am aware that since 2008, Moody's has recalibrated, formally recalibrated, all of the U.S. public finance ratings to move them on to a scale that is comparable to corporate ratings, financial institutions—

Mr. CAPUANO. Based on historic default rates?

Mr. ROWAN. There was a research piece and a lot of analysis around that recalibration that I can make sure is provided to you and your staff.

Mr. CAPUANO. My staff will be in touch with both of you to try to catch up on some of the data.

Mr. Gellert, do you do governmental issues? I don't know whether you do or not.

Mr. GELLERT. We do not. But I would point out, and I am not sure the data that you are referring to, but I will point out, of course, a lot of the municipal issuants were insured, so you definitely have a skewing of default stats and statistics and ratings—

Mr. CAPUANO. Actually, these are based on noninsured.

Mr. GELLERT. Okay, fine.

Mr. CAPUANO. And that was my basic argument, that I believed then that munis were being chased into insurance that they didn't need.

Mr. GELLERT. I was just clarifying.

Mr. CAPUANO. Mr. Kroll, do you do munis?

Mr. KROLL. Yes.

Mr. CAPUANO. Do you—

Mr. KROLL. We are releasing a—

Mr. CAPUANO. Oh, your microphone, please.

Mr. KROLL. We are releasing—yes, we do munis. We are just starting. We will release a study in September, taking the 200 most liquid muni issues. Many involve States. Some involve cities. And we are looking at the actual financials, so we will not be using dated information, and sometimes a year, year and a half dated, to come up with our ratings of those. So stay tuned for September.

Mr. CAPUANO. I am looking forward to it.

Thank you all very much. I appreciate it.

Chairman NEUGEBAUER. I thank the gentleman.

And, now, the vice chairman, Mr. Fitzpatrick.

Mr. FITZPATRICK. Mr. Sharma, I want to follow up on the line of questions of the chairman earlier.

In a letter sent to this subcommittee dated June the 13th, Secretary Geithner acknowledged that he, along with Deputy Secretary Wolin, OMB Director Lew, and a representative of the Vice President's office, met with S&P personnel on April 13th, an actual meeting.

Are you aware of what was discussed at that meeting?

Mr. SHARMA. Congressman, no, I am not. I know our team, as mentioned, regularly meets with them as part of the process on trying to get a better understanding, and they met with the Treasury.

I wasn't even aware that they met with the members that you just said, but I know they had a meeting. They met with them.

I am not privy to people they meet, once they are in the ratings process.

Mr. FITZPATRICK. According to documents obtained by this committee, 2 days after that meeting, on April 15th, David Beers reached out to Under Secretary Goldstein to let Treasury know the rating committee's outcome.

Do you know what was discussed on that call?

Mr. SHARMA. No, Congressman, I don't. Normally, the process would be once the ratings committee makes a decision, we write up the decision. We also inform the issuer of the rating action, if there is a change or if there is an affirmation. And if there is any publication that we are going to do, we do share it with them also.

Mr. FITZPATRICK. So you would have informed the issuer before the public would find out what the—

Mr. SHARMA. We let them know that we would be taking a rating action, yes.

Mr. FITZPATRICK. Shortly after that call, Mary Miller of Treasury reached out to David Beers of S&P for a draft press release on the outlook change. This was 3 days before the actual press release occurred.

What would be the purpose of sharing a draft press release with the issuer?

Mr. SHARMA. It is to give the issuer a chance. If there are any factual errors or anything else in the press release, then there is an opportunity to correct that, so that we want to give the public a completely error-free information. And so, that is the opportunity for them.

Mr. FITZPATRICK. And that is standard practice?

Mr. SHARMA. That is standard operating procedure, yes.

Mr. FITZPATRICK. Do you know whether or not the Department made any substantive changes to the press release?

Mr. SHARMA. Congressman, I don't know that.

Mr. FITZPATRICK. The next day, which was 2 days before the actual press release, another Treasury official reached out to John Chambers and asked if there is a communications director that Treasury's press people can connect with. And it appears that a call actually did take place.

Do you know what happened on that call, what might have been discussed?

Mr. SHARMA. I don't know specifically, but generally, there is—they may have wanted to coordinate as to when we will be releasing our information so they can plan their own releases of information that they may have intended to do so.

And that is a normal process that even a corporation that we rate, where if we are going to announce a rating action, which they believe is material, then they may want to coordinate with their own communications group as to what they may want to say to the public along the timelines of when we will say.

Mr. FITZPATRICK. But you don't know what occurred on the telephone call?

Mr. SHARMA. No, I don't.

Mr. FITZPATRICK. And you don't know whether or not Treasury asked for any substantive changes to the draft press release in the days before it was issued?

Mr. SHARMA. As I said, the purpose of sharing the draft release is only if there is a factual error. Once a rating committee decision is made, we proceed along those lines.

Mr. FITZPATRICK. And you believe that is an appropriate process?

Mr. SHARMA. We believe that is an appropriate process, because it allows elimination of any errors that may occur by mistake or by any other reason. But once the rating action is done, we follow the process, and we follow it very rigorously within our organization.

Mr. FITZPATRICK. Mr. Chairman, I would just ask that the Secretary's letter dated June 13th and the attachments be made a part of the hearing record.

Chairman NEUGEBAUER. Without objection, it is so ordered.

Mr. CAPUANO. Mr. Chairman, if the gentleman would yield for a minute?

Mr. FITZPATRICK. Yes.

Mr. CAPUANO. Thank you.

Mr. Sharma, again, I want to be clear. As I said, as a former mayor, I got phone calls from your agency before you came out with a rating. It is common throughout everything you do. Is that a fair statement?

Mr. SHARMA. Just to be—

Mr. CAPUANO. Every rating you do, you give the individual being rated an opportunity to correct factual disagreements?

Mr. SHARMA. Yes.

Mr. CAPUANO. Mr. Rowan, does your company do the same thing?

Mr. ROWAN. Our company has the same policy, Congressman, for the same purpose, to ensure that there isn't a material misstatement of fact or inadvertent disclosure.

Mr. CAPUANO. I know you do, because Moody's called me, too.

Mr. Gellert, again, you are a little different, in that you don't do public stuff, but do you do something similar?

Mr. GELLERT. We have absolutely no contact with issuers at all.

Mr. CAPUANO. Because you don't make public statements of any kind, then?

Mr. GELLERT. That is correct.

Mr. CAPUANO. That is what I thought.

Mr. Kroll, on your public aspects?

Mr. KROLL. On the issuer-paid side of our business, because we also have a subscription business—

Mr. CAPUANO. Yes.

Mr. KROLL. —on the issuer-paid, which has done our first five transactions, we do the same thing. But it is only about correcting any factual error that we may have.

Mr. CAPUANO. So it is a standard practice in the industry?

Mr. KROLL. Correct.

Mr. CAPUANO. Thank you.

Chairman NEUGEBAUER. I want to thank this panel. This has been a very good hearing. And we appreciate your time and your thoughtful testimony.

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.

If there is no further business, this hearing is adjourned.

[Whereupon, at 1:02 p.m., the hearing was adjourned.]

APPENDIX

July 27, 2011

Opening Statement
Chairman Randy Neugebauer
Oversight & Investigations Subcommittee

"Oversight of the Credit Rating Agencies Post-Dodd-Frank"

July 27, 2011

Today, the Subcommittee meets to discuss the state of the credit rating industry for the first time since the passage of the Dodd-Frank Act. This hearing will highlight another failure of Dodd-Frank to provide coherent and meaningful reforms to get our economy back on track.

Just as Dodd-Frank perpetuates 'Too Big to Fail' - a fact acknowledged and affirmed by Moody's, S&P and Fitch through ratings enhancements for systemic firms- the Act perpetuates the market share stranglehold of the big 3 credit rating agencies by erecting new barriers to entry. I am concerned that many of the new rules could potentially reverse much of the progress achieved by the Credit Rating Agency Reform Act of 2006 – legislation drafted by my good friend from Bucks County, PA Mr. Fitzpatrick.

Many of the new Dodd-Frank rules are a dream for the entrenched raters – in fact you will hear about their support today. The more stringent regulations such as enhanced internal controls, conflicts of interest rules, and training requirements will raise the cost of providing ratings, which in turn will discourage new competitors and new entrants.

The prescriptive rules on ratings methodologies will result in more standardized and homogenous ratings, which will discourage innovation. This coupled with the liability provisions, which will increase legal risk for credit rating agencies that stray from the narrow standards, will further discourage new business models, new ideas and new methodologies. The result will be the perpetuation and entrenchment of the government-sponsored oligopoly of Moody's, S&P and Fitch.

Dodd-Frank also has incoherent and conflicting goals related to the "Nationally Recognized Statistical Rating Organization" (NRSRO) designation process. On one hand, as stated earlier the bill retains the NRSRO structure and allows the SEC to limit competition by anointing only certain firms as NRSROs. On the other hand, the bill seems to eliminate the need for the NRSRO category by instructing agencies to remove references to ratings in federal law. Under the latter approach - which I strongly support - market forces can be brought to bear, the NRSRO structure could be phased out over time, and investors could choose from a wider array of sources to judge the health of their bond portfolios. This could be the light at the end of the tunnel for the credit rating industry.

The removal of credit rating references in statute has overwhelming bipartisan support and I plan to work with Chairman Bachus and Chairman Garrett to hold all of the agencies accountable for hitting the statutory objectives of these provisions. It is also worth noting that Secretary Geithner, as Chair of the FSOC, has a statutory duty to facilitate coordination on all interagency rulemakings, including Section 939A of Dodd-Frank. Yet, since the enactment of Dodd-Frank, there appears to be serious deficiencies in rulemaking coordination and I am concerned that Section 939A is just another example of FSOC's failure to lead.

We asked the Department to provide a witness to discuss this role and they declined the invitation for the second hearing in a row; thus demonstrating their unwillingness to lead. I want to stress that without strong leadership from the Chairman of FSOC, regulatory incoherence and overlap will continue to dampen the recovery of the U.S. economy.

I thank the witnesses for being here today and I look forward to a robust discussion of the rating industry.

###

Testimony Concerning:
"Oversight of the Credit Rating Agencies Post Dodd-Frank"

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

Before the
United States House of Representatives

Committee on Financial Services,
Subcommittee on Oversight and Investigations

July 27, 2011

On behalf of Rapid Ratings' employees and shareholders, I would like to thank Chairman Neugebauer, Ranking Member Capuano and members of the Subcommittee for asking me to submit testimony for the hearing titled *Oversight of the Credit Rating Agencies Post Dodd-Frank* before the United States House of Representatives' Committee on Financial Services, Subcommittee on Oversight and Investigations.

As we arrive at the one year anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) we continue to face essentially the same ratings landscape as one year ago. The Big Three ratings firms, S&P, Moody's and Fitch, have had banner years given record bond issuance for most of the year and their influence is undiminished, competitor NRSROs have even more challenges than ever before, and non-NRSRO rating agencies, like Rapid Ratings, watch the disincentives to an NRSRO application mount ever higher.

Dodd-Frank and the Securities and Exchange Commission's (SEC) implementing regulations, which are currently out for comment, are a combination of positive, negative and worrisome initiatives. Dodd-Frank does not do much to truly foster competition in the market, and depending on how the SEC decides to implement its new oversight responsibilities, may even directly hinder it. Moreover, we know Dodd-Frank adds significantly to costs for smaller NRSROs in terms of legal, administrative and compliance expenses, board compensation, insurance costs, and more.

Dodd-Frank has some positive elements for effective change in this industry, but it also gets bogged down in window dressing that ultimately does little except apply a disproportionate burden on the small NRSROs while providing little more than an administrative hassle to the Big Three. Dodd-Frank is right to reduce references to NRSROs in federal regulations. But, it is drifting down a slippery slope in increasing liability standards for CRAs. In an effort to determine accuracy in ratings and oversight of methodology, Dodd-Frank risks actually homogenizing ratings, increasing systemic risk and putting competitors' intellectual property at risk. In the following pages we detail many of the sections within Dodd-Frank and highlight what we consider good, bad and neutral in the new rules.

There is no silver bullet to change this industry. Use of NRSROs is too embedded in workflow practices of the investment community and in not just federal regulations but is prevalent in state regulations, private contracts, bank pricing grids, pension parameters, internal risk guidelines of institutional investors and on and on. But change can happen with effort. Like whale oil to petroleum, horses to cars, typewriters to computers and mail to email, innovation comes to markets that are not artificially protected and supported. New ideas, methodologies, ambitious teams of people, capital, hard work, and time, will ultimately prevail. It is incumbent upon legislators and regulators to help, not unintentionally hinder, this evolution.

Background

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 have an impressive record for far outperforming the traditional issuer-paid rating agencies in innumerable cases and also generally outperforming the prevalent market-based default probability models.

We rate companies irrespective of whether they are bond issuers. We also do not distinguish between those companies that are issuing new securities versus those who have securities outstanding. Unlike the Big Three, we are focused on providing ratings that are updated quarterly and provide the highest accuracy, breadth of coverage and speed to market to reflect the changing financial health profile of firms we rate. The Big Three are naturally focused on primary issuance, where they traditionally get paid the majority of their fees, and risk surveillance of ratings already issued is a secondary focus. This is one of the great failings of the incumbent system and a perfect example of where a new player employing an innovative methodology can provide great value relative to the status quo.

Much has been made of the ratings industry problems: conflicts of interest, inaccurate ratings, lack of proper oversight, unchecked growth, fight for market share, overreliance on NRSRO ratings, lack of competition in the market to challenge the "Big Three" (S&P, Moody's and Fitch), and the list goes on.

Dodd-Frank is supposed to curb conflicts of interest, reduce the risks inherent in the current ratings industry market structure, add transparency, force compliance, instill accountability, promote ratings accuracy, lower investor reliance, evolve the structured products ratings process and foster competition in the ratings industry.

US legislative and regulatory attention to the ratings industry is concentrated on the NRSRO designation and therefore the 10 players that currently carry that status. Since my business partners and I acquired Rapid Ratings and moved the business from Australia to the US in 2007, we've taken the view that having an NRSRO registration was undesirable given the dramatically changing environment for NRSROs. Little has changed my view over the past few years of SEC and Congressional activity. Why take a young, hungry competitor in the ratings space and subject it to all manner of change, increased scrutiny, costs, liabilities, uncertainties and a playing field that changes, then changes again, and so on?

My background, prior to the acquisition, was not in the ratings business. I was a debt capital markets officer for large banks, a technology entrepreneur and a boutique investment banker for small to mid-sized enterprises. I had extensive interactions with the rating agencies, particularly the big three NRSROs. I saw ratings shopping, I worked with bankers who had just arrived fresh from jobs at the Big Three agencies and were hired to advise bank clients on how to get the best ratings from their ex-colleagues, and in general the agencies were a central feature of any bond issue – structured bond or plain vanilla corporate issuance.

As a ratings entrepreneur however, I would like to think I did, and do, view the ratings business from a fresh perspective. The opportunities for a sophisticated and innovative competitor firm are significant; however, so are the obstacles. No business I have ever run, worked in or advised, has ever operated in such an idiosyncratic market -- historical regulatory support for incumbent players, a true oligopoly, massive criticism every few years followed by superficial *mea culpas*, well-meaning but often less than effective reforms, and tremendous lobbying by the incumbent players.

It is important to recognize that there are many market players who benefit from, and support, the status quo. After all, it is easy to rely on S&P and Moody's. It is cheaper to rely on S&P and Moody's than to staff an independent credit department. It is simpler to use the government sponsored imprimatur than to decide on what alternatives to use. It is advantageous for funds that are not allowed to buy below investment grade bonds to buy the highest yielding, lowest investment grade bonds because there is a regulatory arbitrage to do so.

Rapid Ratings' Evaluation of the NRSRO Opportunity

In prior testimonies such as to the Securities & Exchange Commission's *"Roundtable to Examine Oversight of Credit Rating Agencies,"* to the U.S. Senate Committee on Banking, Housing, and Urban Affairs at a hearing titled *"Examining Proposals to Enhance the Regulation of Credit Rating Agencies,"* to the United States House of Representatives' Committee on Financial Services' Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises at a hearing titled *"Transforming Credit Rating Agencies,"* and to the International Organization of Securities Commissioners ("IOSCO") Standing Committee Six, Rapid Ratings has been clear that getting the NRSRO designation at present would be more a contingent liability than an asset.

Given this position, we observe all of the changes that come from Dodd-Frank from three perspectives: 1) What if we were an NRSRO now? 2) Do we want to consider applying to become an NRSRO now? and 3) What effects will Dodd-Frank have on us as a non-NRSRO if we remain as such?

While the answers are complex, they can be summarized:

1) If we were an NRSRO now we'd be subject to massive increases in our operating costs and significantly more complex internal processes. We'd be taking on increased liability. We'd be at the mercy of the SEC and its eventual rules for disclosure of methodology and procedures, ratings accuracy, and other transparency--oriented initiatives.

2) As far as we can tell, the ultimate landscape for operating as an NRSRO is still very much up in the air. We consider many of the SEC's proposed methods of discharging their responsibilities under Dodd-Frank to be threatening our critical Intellectual Property and revenue model. The uncertainty on these issues alone is a massive disincentive to file an NRSRO application.

3) Until the SEC finalizes its rules and policies for carrying out Dodd-Frank, we cannot really answer this question for ourselves. The increased liability notwithstanding, we can continue to do our business and grow successfully, but have no further incentive to pursue the NRSRO status than we have had in the past.

In order to understand the ratings market and to reform the industry, it is critical to appreciate the complexities that abound and how deeply ingrained the use of traditional ratings has become. To those less familiar with the industry, it seems like one that can be altered through seemingly simple solutions – change the payment structure to disallow issuers to pay for their ratings and force transparency on the raters. But the use of the Big Three's ratings goes much deeper than it appears, and the roots of their influence run wider than most understand.

Dodd-Frank and Reform in the Ratings Industry
Increasing reporting, increasing liability and even removing references to NRSROs are all elements, but not solutions unto themselves. More regulation and reporting requirements, and even increased liability, have the opposite of the intended effect; they help the incumbents as much as they hinder them.

Reform will ultimately only come when the following facets of change are promoted effectively:

- Increase the landscape for competition. Do not allow unintended barriers and compliance costs to stifle smaller players and newer revenue models;

- As mandated by Dodd-Frank, remove references to NRSROs from regulations in an effort to, over time, decrease dependence and irresponsible, risky reliance on the Big Three firms;

- Promote innovation in ratings and market stakeholders' use of myriad risk management inputs. Do not allow a homogenization of ratings;

- Increase the flow of data critical to providing new ratings into the market;

- Recognize that the status quo is supported on all fronts by some, though not all, players. This includes ratings firms, sell-side shops, regulatory and legislative infrastructure and members of the investment community;

- In the following sections, we've outlined Dodd-Frank developments that we believe are positive, negative and neutral at present. We also highlight a few areas uncovered by Dodd-Frank. Finally, we also include a suggestion for a simple, yet powerful addition to the SEC's oversight in the ratings industry:
    - **Positive Developments**
        - Removal of statutory references to ratings
        - Accountability and transparency of NRSROs —Look-back requirement
    - **Negative Developments**
        - Accountability and transparency of NRSROs —Methodologies reviewed
        - Accountability and transparency of NRSROs —Ratings performance
            - *Why are accurate ratings good?*
            - *What are the economic effects of the stability vs. accuracy debate?*
            - *Absolute vs. Relative Risk*
            - *How can ratings accuracy be bad?*
            - *Disclosure of ratings histories*
        - Accountability and transparency of NRSROs —Board composition
        - Eliminating the three-year requirement in NRSRO accreditation
        - Liability issues
    - **Neutral Developments**
        - Qualifications standards for NRSRO analysts
        - Separation of sales/marketing and ratings analysts
    - **Other Factors**
        - Access to data required for unsolicited ratings
        - Corporate counterparty risk
        - The Franken Amendment
        - Rapid Ratings Proposal for Increased Ratings Accuracy and Integrity

Positive Developments

SEC. 939. REMOVAL OF STATUTORY REFERENCES TO CREDIT RATINGS[1]

We believe that the removal of statutory (laws) and regulatory (administrative requirements) references is one of the key tenets to ultimate change in the ratings industry. References in federal statutes have been a major contributor to the market's reliance on the dominant NRSROs for decades. Combined with statutory and regulatory references, investment

[1] United States. Cong. House of Representatives. *Dodd-Frank Wall Street Reform and Consumer Protection Act.* 111th Cong., 2nd sess. H.R. 4173. Washington: GPO, 2010. Web. (508) http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf

managers have constructed policies to comply with the NRSRO standards, international standards such as Basel I, Basel II and Basel III international banking regulations have followed suit and thus the market has been able to rely on the constant presence of NRSRO ratings in myriad ways. In many respects, nothing has contributed as much to the market overreliance on NRSROs as these references and the explicit mandate that they be used.

We accept that removing references is easier than finding their replacements. Various federal agencies have been instructed by Dodd-Frank to make changes such as striking "'nationally recognized statistical rating organization' and inserting 'meets such standards of credit-worthiness as the Commission [Securities and Exchange Commission] shall adopt.[2]'" Nevertheless, a pure "replacement" may be impossible to find and we challenge the view that any single replacement would be appropriate given that the original option (NRSRO ratings) did not pan out particularly well as a standalone risk measurement

As an example, Credit Default Swaps are often proposed as an appropriate proxy for risk. While CDS are likely the most sophisticated measure of the market-based options, they have significant limitations:

- **Narrow Range:** There are not CDS on enough issuers, thus giving only partial coverage of the investible universe, and there are few CDS on private companies;
- **Liquidity:** Some credit default swaps are traded in much larger volume and with much greater frequency than others;
- **Volatility:** CDS, as with all market measures, have inherent volatility. This means a regulatory framework where capital is benchmarked to CDS will fluctuate, potentially significantly. As with all market measures, CDS are subject to technical factors that have nothing to do with the credits themselves but will have to do with overall market liquidity, volatility, short-selling, etc. The swings that can occur due to these factors, particularly if they are market-wide, can skew the risk profile of a portfolio that will improve or deteriorate in a correlated fashion instead of on a credit by credit basis. Good credits will be unnecessarily penalized while poor credits may well be obscured or buffeted inappropriately.

  As cases in point, if risk was benchmarked to CDS, GE/GECC would have been rated CCC in March of 2009 and Italy, Spain and various global commercial banks would have been downgraded to junk in the weeks leading up to this hearing.

Rapid Ratings firmly believes that market-wide risk management should not be prescriptive but that players needing to manage risk must be encouraged to take diverse approaches. There is no single measure of risk that is appropriate for all market players at all times. Multiple factors

[2] (H.R. 4173, 511)

need to be taken into account and federal agencies need to be creative in replacing the NRSRO references. Most importantly, agencies need to avoid being reductionist and looking for an answer that is too simple.

Irrespective of the above and of the ultimate conclusion of each federal agency, removing NRSRO references is an essential place to start and is fundamental to sending the clear message to the market that dependence on traditional ratings is no longer acceptable, reliable or responsible. Investors must look for alternatives and many must deepen their own work.

SEC. 932. ENHANCED REGULATION, ACCOUNTABILITY, AND TRANSPARENCY OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS
(4) LOOK-BACK REQUIREMENT

This "look-back" provision is a positive development although it is unlikely to have a major effect. For decades banks have been hiring from the rating agencies into "rating agency advisory" groups dedicated to guiding issuers (bank clients) in how to get the best rating from the agencies. Essentially it has been the most institutionalized form of "ratings shopping" and non-trading "ratings arbitrage" in the market. Forcing disclosure of such employment transitions will put a spotlight on this practice and possibly deter some potentially conflicted hirings from taking place. This is peripheral in the broad scheme of ratings reform however.

The more direct practice of hiring an NRSRO employee is also addressed: "person subject to a credit rating of the nationally recognized statistical rating organization or the issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating of the nationally recognized statistical rating organization."[3] If the employee participated in the ratings process and gets hired by the issuer or banker, this new provision will certainly bring to light, if investigated, any blatant acts of bribery or rewarding of rating agency employees who move from the agency. We doubt there are actually many instances of this happening, but the Dodd-Frank provisions can provide some comfort that there will be a responsibility among NRSROs to bring the possible instances to light.

__Negative Developments__

SEC. 932. ENHANCED REGULATION, ACCOUNTABILITY, AND TRANSPARENCY OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS
(s) TRANSPARENCY OF CREDIT RATING METHODOLOGIES AND INFORMATION REVIEWED

We view the information prescribed for disclosure to be troubling. While we appreciate the intended outcome is to increase disclosure and transparency into ratings, we believe there is potential for a far greater negative effect. The information required as per the Dodd-Frank language will jeopardize the private nature of some ratings intellectual property. Given the

[3] (H.R. 4173, 508)

choice to be an NRSRO and have private property rights at risk and remaining a non-NRSRO, our route is clear. Moreover, we are certain that others who will one day bring innovation to the ratings space will think similarly.

Specifically, the language required in (1) FORM FOR DISCLOSURES, (A) information relating to – "(i) the assumptions underlying the credit rating procedures and methodologies"[4] has, depending on interpretation by the SEC, threatening ramifications. If assumptions underlying methodologies are at one level of depth, that is benign. If it is at a deeper level, it could be probing information that is proprietary and commercially sensitive.

Then in the following two subsections listing qualitative and quantitative disclosure criteria, there are many items which in isolation may or may not be acceptable, but in aggregate present a tremendous threat to intellectual property protection of a ratings firm:

''(3) CONTENT OF FORM.—
''(A) QUALITATIVE CONTENT.—Each nationally recognized statistical rating organization shall disclose on the form developed under paragraph (1)—
''(ii) the main assumptions and principles used in constructing procedures and methodologies, including qualitative methodologies and quantitative inputs and assumptions about the correlation of defaults across underlying assets used in rating structured products;
''(iii) the potential limitations of the credit ratings, and the types of risks excluded from the credit ratings that the nationally recognized statistical rating organization does not comment on, including liquidity, market, and other risks;
''(ix) such additional information as the Commission may require.

''(B) QUANTITATIVE CONTENT.—Each nationally recognized statistical rating organization shall disclose on the form developed under this subsection—
''(i) an explanation or measure of the potential volatility of the credit rating, including—
''(I) any factors that might lead to a change in the credit ratings; and
''(II) the magnitude of the change that a user can expect under different market conditions;
''(ii) information on the content of the rating, including—
''(I) the historical performance of the rating; and
''(iii) information on the sensitivity of the rating to assumptions made by the nationally recognized statistical rating organization, including—
''(I) 5 assumptions made in the ratings process that, without accounting for any other factor,

[4] (H.R. 4173, 504)

would have the greatest impact on a rating if
the assumptions were proven false or inaccurate;
and

"(II) an analysis, using specific examples, of
how each of the 5 assumptions identified under
subclause (I) impacts a rating;
"(iv) such additional information as may be
required by the Commission.[5]

It does appear as though the SEC is interpreting these requirements to pertain only to structured product ratings and as such may not directly apply to Rapid Ratings unless we move into this asset class. However, for other quantitatively oriented firms that want to get into this ratings class, these data requirements are unprecedented and, in the extreme, would allow the reverse engineering of our methodologies. Again, as things stand, the cost benefit calculus of becoming an NRSRO and subjecting ourselves to this disclosure is clear -- remain a non-NRSRO.

SEC. 932. ENHANCED REGULATION, ACCOUNTABILITY, AND TRANSPARENCY OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS
(q) TRANSPARENCY OF RATINGS PERFORMANCE

Accuracy of ratings is a key element of Dodd-Frank Subtitle C. It appears as a justification for the Establishment of Office of Credit Ratings at the SEC, in instructions to the SEC on enforcement of Dodd-Frank provisions, in transparency of ratings performance and in a number of other instances.

There is a subtle but critical distinction that needs to be recognized when discussing accuracy: more accurate ratings are good for the market. Regulatory enforcement of a prescription of accurate ratings is bad for the market. It is not regulations and rules that produce accuracy; it is innovation and competition in the marketplace.

Why are accurate ratings good?

As stated in the preamble to Subtitle C "In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies." The accuracy of Big Three ratings has long been the subject of debate. That debate is strategically important because it makes the incontrovertible argument that accuracy is more important than the "stability" of ratings. The traditional issuer-paid firms have used "rating stability" as a shield to deflect attention from the challenge and charge of "inaccurate ratings."

[5] (H.R. 4173, 505-506)

The Big Three produce ratings that they refer to as "rating through the cycle" as a means of providing "stable" ratings. The concept of rating through the cycle is to have ratings that reflect the longer-term perspective of an issuer at the conclusion of its cycle, rather than reflecting the intra-cycle condition of the company. The result, of course, is ratings that exhibit little or no change because the agency is not continually reflecting any ups and downs the issuer may experience over time. Only when the agency considers a truly material change to warrant a rerating will there be a change. The precipitous drops of homebuilders long after the market knew of the housing crises, Enron's remaining investment grade until hours before it filed for bankruptcy and countless other examples expose the weakness of this methodology.

The Big Three typically defend this position by citing studies that the investment community wants to have ratings stability. While there are studies that document the opposite position, in fairness, many institutional investors do want to avoid volatility in rated portfolios given the inconvenience of frequent portfolio rebalancing. Further, some regulators have supported the view that monitoring firms' capital adequacy frequently is too burdensome on the firms and the regulators. Unfortunately, rating through the cycle means being less sensitive to the short and medium term changes in a credit that make it more or less healthy at any given time. Being rated too low incorrectly has primarily opportunity cost implications. Being rated too high incorrectly can have material real dollar cost implications. Having widespread risk benchmarking correlated to these insensitive measures has real systemic risk cost.

A recently released working paper, *"Does the Bond Market Want Informative Credit Ratings?"* by Cornaggia and Cornaggia[6] tackles the question as to whether market participants benefit more from relatively stable ratings utilizing traditional methodologies than from quantitatively derived ratings that are timely and accurate. Moody's Credit Ratings (MCRs) are employed as a proxy for the Big Three. Cornaggia and Cornaggia categorize the MCRs as compensated by issuers and based on qualitative analysis geared toward stability in rating levels that reflect only relative risk.

In order to test and benchmark MCRs, they select a system that provides contrast on multiple criteria. Cornaggia and Cornaggia write, "The Financial Health Rating (FHR) produced by Rapid

---

6 Cornaggia J, Cornaggia, K. Does the Bond Market Want Informative Ratings? http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1705843&download=yes. Jess Cornaggia, PhD, is an Assistant professor at Indiana University Bloomington - Kelley School of Business. Kimberly Rodgers Cornaggia, PhD, is an Associate Professor American University - Kogod School of Business. **The authors note**: "To support our use of Rapid Ratings as an exemplar, we note its recognition by regulators, law makers, and market participants. RR was the only non-Big-3 credit rating agency invited to speak on the ratings competition panel at the SEC Roundtable in 2009 and to testify before both congressional bodies in the run up to the most sweeping change in rating agency regulation in history."

Ratings (RR) is compensated by subscribers, based on quantitative models, and geared toward the timely release of information as it pertains to absolute credit risk." [7]

In the body of the working paper, MCRs are tested rigorously for information content against FHRs. The authors write, "We document that among bonds that ultimately default, RR downgrades the FHR to speculative grade status long before the Moody's credit rating follows suit." The data tests speak to the magnitude of these findings demonstrating that Rapid Ratings is 2.9 years earlier than Moody's.

One test in the study compared default frequencies among issues with investment grade ratings. The professors report a higher default frequency among issues with investment grade ratings according to the MCR compared to the FHR, writing "2.61% of defaulting firms had FHRs classified as investment grade one year prior to default." The corresponding number of defaulting firms with investment grade MCRs is 5.67%.

Cornaggia and Cornaggia contextualize these findings with respect to Moody's' stated position that stable ratings help avoid market disruptions. They postulate that gradual ratings downgrades may have disrupted the financial markets less than the huge volatility spikes and losses of investor confidence that accompanied the too-late downgrades of Enron and AIG among others. This bolsters the position of those who have claimed that over-reliance on traditional credit agency ratings increase vulnerability to sudden market shocks.

What are the economic effects of the stability vs accuracy debate?

Wealth effects are also quantified in this study by calculating the differences that would have been realized by trading on the early versus late downgrade. A portfolio manager selling bonds on FHR downgrade would significantly mitigate losses relative to selling at the MCR downgrade. In the study's own words, "The results indicate significant differences in the prices and yields at the various points in time. Prices are significantly lower ($11.70 to $15.40) and yields are significantly higher (5.9% to 9.7%) when Moody's downgrades the bonds to speculative grade than when RR downgrades the bonds' issuers. These results highlight the costly consequences of delaying sales beyond the earlier FHR warning." The authors point out that this result is significant given evidence of "fire sales associated with regulatory compliance."

[7] Gellert, James H. The United States of America. *Competition in the Credit Rating Industry: Are we asking the right questions and getting the right answers?*. Washington: , 2009. Web. 25 Jul 2011. http://www.sec.gov/comments/4-579/4579-20.pdf

Absolute vs Relative Risk

Much is made of the ratings scales that dominate the ratings industry. Symbology and commonality of the scales are referred to often in Dodd-Frank.[8] However, the traditional alpha scale is both ordinal and less informative than the Rapid Ratings' cardinal scale. For instance, ask anyone familiar with ratings what it means to be a "single A credit." Then ask them what it means to be a "BBB credit." Then ask what the difference is between those two. Then ask what it means to be a certain rating this year vs. next year vs last year. None of these questions will have satisfactory answers. The reason is that default associations with each traditional rating letter grade change yearly. And, while users know that an A is better than a BBB, which is better than a BB and so on (relative risk), the distance between them, the magnitude of that distance and the importance relative to health or failure among them is unknown (absolute risk) using the traditional ratings systems.

To highlight this problem, Cornaggia and Cornaggia site as examples the following: "4.1% of bonds rated A3 (investment grade) defaulted in 2003 yet no bonds rated B2 (speculative grade) defaulted in 2007. As another example, 30.6% of bonds rated A1 defaulted in 2008" (extreme example influenced by the Lehman Brothers failure).

The professors add, "We confirm that the FHR better reflects absolute credit risk than the MCR. Default frequency within investment and speculative grade classifications, as indicated by the MCR, varies significantly from year to year. However, default frequency within investment and speculative grade classifications, as indicated by the FHR, exhibits less variation. The distinction between absolute and relative credit ratings has potential implications for efficient capital allocation."[9]

How can ratings accuracy be bad?

Dodd-Frank and the SEC seek to determine what are accurate ratings and what are not, as a means of providing transparency in, and disclosure from, the ratings industry. There is a natural desire to provide insight into how agencies score in getting ratings right, and getting them wrong. In concept this is reasonable except for three important concepts: 1) not all ratings are created to measure the same things; 2) how does one, the SEC or otherwise, determine what is "accurate;" and 3) what happens when all agencies begin producing ratings knowing they will be measured by a specific definition of accuracy?

1. Traditional agencies solve for slightly different definitions of ratings. S&P claims to rate the ability and willingness of an issuer to meet its financial obligations in full and on time. Moody's claims to rate an issuer's likelihood of default and any financial loss

[8] (H.R.: 4173, 510)
[9] (Cornaggia and Cornaggia, 5)

suffered in the event of default. Rapid Ratings provides a firm's Financial Health Rating (FHR), a measure of how efficiently a company is run and how well positioned it is to maintain its competitive position against its global, industry-specific peer group. This measure is highly correlated to defaults (low FHRs to high default histories,) but in fact is not a default measurement. As time goes on, we anticipate other methodologies and ratings standards to also emerge if the market is attractive to new entrants.

2. Rating accuracy is difficult to measure and the SEC has proposed a wide variety of elements for comment covering ratings transitions, default associations, etc. How the SEC will determine what constitutes accuracy is anyone's guess at this stage.

3. In many respects, what is more challenging to imagine than how the SEC will define ratings accuracy, is what happens if they do? In our view the fastest way to positively evolve the ratings industry is for more ratings opinions and innovative ways of measuring risk to be available to the marketplace. If ratings "accuracy" is prescribed by regulation, over time, agencies will naturally engineer ratings to the standard by which they are being measured. Those that become "most accurate" will be those that are least differentiated and most highly correlated. This means fewer diversified opinions, not more. In the end, it should be what the market accepts as the new standard for determining accuracy, rather than regulatory guidance that determines what is accurate and what is not given different investments and conditions. Our concern is based on our knowing that in the ratings industry regulations can have decades-long negative effects.

   In the extreme, if most agencies wish to be viewed as "accurate" and benefit from all that a high accuracy score may provide, the regulatory framework will counter-productively be promoting a homogenization of ratings, not an improvement in the ratings industry.

   If these guidance-based ratings are broadly used in the market, this prescriptive ratings paradigm will increase the systemic risk embedded in the market, not reduce it. Correlating the risk management measures of wide swaths of ratings users could be one of the most short -sighted outcomes conceivable from the entire Dodd-Frank era.

Disclosure of ratings histories

Rule 17g-2[10] requires an NRSRO to provide ratings histories to the public for free in order to allow their ratings to be judged by market players. This topic has been troubling for Rapid Ratings and for others for a number of years. As we assess NRSRO status, the requirement to publish our ratings for free to the market has always been entirely cannibalistic for our revenue model – to get paid by subscribers for our ratings. Nevertheless, when the SEC created the one year embargo for issuer-paid firms and a two year embargo for subscriber-paid firms we thought this was at least more palatable.

Having this distinction between issuer-paid firms and subscriber-paid was a significant development in SEC ratings oversight two years ago. It provided some confidence that the SEC appreciated the distinction between the revenue models and was not trying to paint reform with a wide brush. However, the recent proposed rules by the SEC request comment on the appropriateness of the 1 year and 2 year grace periods. It is disconcerting that the embargo time frames are out for comment again, suggesting the SEC may reconsider their original decision on this topic.

SEC. 932. ENHANCED REGULATION, ACCOUNTABILITY, AND TRANSPARENCY OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

'(t) CORPORATE GOVERNANCE, ORGANIZATION, AND MANAGEMENT OF CONFLICTS OF INTEREST

Another perplexing provision of the accountability rules concern Board of Directors composition and governance. As stated:

"(1) BOARD OF DIRECTORS.—Each nationally recognized statistical rating organization shall have a board of directors.
"(2) INDEPENDENT DIRECTORS.—
"(A) IN GENERAL.—At least ½ of the board of directors, but not fewer than 2 of the members thereof, shall be independent of the nationally recognized statistical rating agency. A portion of the independent directors shall include users of ratings from a nationally recognized statistical rating organization."[11]

[10] *PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934*. Washington: Web. 25 Jul 2011. http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=47b43cbb88844faad586861c05c81595&rgn=div5&view=text&node=17:3.0.1.1.1&idno=17#17:3.0.1.1.1.2.96.408 (Rule 17g-2)
[11] (H.R.: 4173, 507)

There are costs, hidden costs and new conflicts of interest embedded in these rules:

- *"a portion" of directors "shall include users of ratings" from a NRSRO.* This is problematic because the firm will be required to share inside information with an institutional investor
- These outside board members will be terribly conflicted if they indeed work at an institutional investor. The level of detail they would have about capital markets trends, specific information on market players and issues would be stunning and unprecedented for a member of the buy-side of Wall Street. Alternatively, a sell-side professional would be just as conflicted under these circumstances.
- As per section 932 of Dodd-Frank, the board has authority over the ratings methodology. Once again, this means the institutional investors on the board would have access to potentially conflicted data and process information.
- With the increased liability provisions of Dodd-Frank in particular, the role of an NRSRO board member is not that attractive. Given the increased liability, finding someone to take this role could be a challenge and will certainly be costly in terms of compensation
- Directors and Officers insurance is also a significant cost and going higher for NRSROs. One can only imagine the cost, if it is obtainable at all, for a firm when the carriers understand the potential conflicts of interest inherent in having institutional investors on the boards of rating agencies

Dodd-Frank allows for a small company exception for these board rules. However, there is little insight into who qualifies and how a firm adjusts once that exemption becomes disallowed due to growth in size.

SEC. 932. ENHANCED REGULATION, ACCOUNTABILITY, AND TRANSPARENCY OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS

CONFORMING AMENDMENT SEEMINGLY ELIMINATING THE "THREE YEAR" REQUIREMENT FOR NRSRO APPLICATION[12]

There is an obscure Conforming Amendment that seems to modify an important component of the Credit Rating Agency Reform Act of 2006[13] (CRA Act) requiring new NRSRO applicants to have been rating in an asset class for three years prior to submitting an application. We were encouraged at the initiative to roll back this particularly poor element of the CRA Act. Nevertheless, we understand now that this was an erroneous reference and is being corrected. The result is that indeed the three year requirement stands.

[12] (H.R. 4173, 508)

[13] United States. Cong. Senate. *Credit Rating Agency Reform Act of 2006.* 109th Cong. 2nd Sess. S. 3850. Washington: GPO, 2006. Web. http://www.gpo.gov/fdsys/pkg/BILLS-109s3850pcs/pdf/BILLS-109s3850pcs.pdf

This was going to be a positive development for industry competition. Many observers were perplexed when the CRA Act included this provision, and it was perceived to be a last minute addition to the drafting of the Act possibly to satisfy a lobbying demand. In essence, the restriction has been a massive barrier to entry to competitors, almost guaranteeing the Big Three were able to maintain their oligopoly in structured products ratings leading up and into the Subprime Crisis. Only one viable new structured product player and NRSRO applicant emerged in the years immediately following the Act and they covered commercial mortgage backed CDOs, and not residential.

From a competitive standpoint, if a ratings firm wishes to become an NRSRO, we believe they should be able to apply and be granted the designation if they are deemed to qualify by the SEC. Practically speaking, having a three year hurdle was likely a disincentive to new players entering over the past few years. Removing this would be a very positive step and having it survive as a key criterion for NRSRO application means there continues to be a significant barrier to entry for new competitors. For asset classes like structured products and municipal ratings, where there are few non-NRSRO players that can demonstrate a three year track record, the closed nature of the club remains.

SEC. 933. STATE OF MIND IN PRIVATE ACTIONS- LIABILITY ISSUES

The increased liability provision of Dodd-Frank facilitates actions against any Credit Rating Agency if they "knowingly or recklessly failed"

''(i) 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
''(ii) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.''[14]

Liability dominated the reform debate throughout 2009 and into the enacting of Dodd-Frank. It is perhaps the most political charged and roundly understood concept for reform by the public at large. It may indeed be fair to levy stricter liability standards on those agencies that made such egregious errors contributing to the crisis. But, facilitating private actions against all CRAs, regardless of whether or not they are NRSROs is a significant barrier to entry not just to the NRSRO club but to companies' getting into ratings in the first place.

[14] (H.R.: 4173-509)

As a quantitative business and one that has no contact whatsoever with issuers in the ratings process, Rapid Ratings is affected somewhat differently than a highly qualitative business and one that focuses on due diligence and issuer contact as their cornerstone. Nevertheless, all ratings firms are experiencing increased legal bills and higher insurance costs of all kinds. The threat of suits, whether meritorious or not, is a concern that all firms have to manage.

The issuer-paid firms have higher risks in this regard since subscriber-paid firms have bilateral subscription contracts with users of their ratings, but it is problematic for all.

A fascinating development as Dodd-Frank was being resolved was the subtle change in language in Sec 933 from NRSRO to "credit rating agency." This change was the only material instance where even non-NRSROs were captured by new statute. The definition of credit rating agency is rather broad and certainly open to interpretation. From the Credit Rating Agency Reform Act of 2006:

SEC. 3. DEFINITIONS.
"(a) SECURITIES EXCHANGE ACT OF 1934.—Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is amended by adding at the end the following new paragraphs:
''(60) CREDIT RATING.—The term 'credit rating' means an assessment of the creditworthiness of an obligor as an entity or with respect to specific securities or money market instruments.
''(61) CREDIT RATING AGENCY.—The term 'credit rating agency' means any person—
''(A) engaged in the business of issuing credit ratings…"[15]

Without question this definition, and therefore increased liability, is affecting many firms whether they saw themselves as potential NRSRO candidates at some point in the future or not. Nevertheless, any new player looking at entering the market needs to be very sensitive to this increased liability and to make sure they are properly capitalized for the legal costs at set-up and as an ongoing concern.

What it unclear is why this wording change from NRSRO to CRA occurred. The most logical explanation is that the drafters wanted to make sure the liability provision affected the current NRSROs even if the firms decided to unregister as NRSROs. This says to us that the drafters knew there was a chance that the rest of the Dodd-Frank reforms would be so unpalatable to current players that they might try to escape the grasp of the new framework. If true, this is a powerful statement of recognition of the punitive nature of these reforms. One option, if this punitive change remains, is to give a safe harbor to CRAs that have never been NRSROs.

[15] (S. 3850, 3)

Neutral Developments

SEC. 936. QUALIFICATION STANDARDS FOR CREDIT RATING ANALYSTS

Instituting standards of training and competence for NRSRO analysts seems like a perfectly reasonable concept. In response, the SEC has proposed Rule 17g-9(c)[16], which would require the NRSRO to implement standards of testing and experience requirements. Having better trained analysts is a good goal. However, having the NRSRO responsible for designing and implementing the training does little to challenge old ways of thinking with new ways of thinking. "Path dependence" is one of the causes of the financial crisis, so letting the old teach the new within the agencies seems to encourage a perpetuation of old-school thinking.

One of the elements of this new rule would be a requirement for the analysts to understand the measurement of accuracy of ratings. Please refer to page 11 in this submission for thoughts on ratings accuracy and the challenges of requiring this knowledge.

SEC. 932. ENHANCED REGULATION, ACCOUNTABILITY, AND TRANSPARENCY OF NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS
(3) SEPARATION OF RATINGS FROM SALES AND MARKETING

The concept of separating sales and marketing from ratings is fine, but too much is made of this as a major initiative; it is marginal, at best. Rule 17g-5, new paragraph (c)(8)[17] prohibits NRSRO employees from participating in both sales and marketing efforts of an NRSRO and also rating securities. This removes the most egregious potential conflict but it is naïve to think that ratings analysts are then somehow insulated from the knowledge that firm success is dependent on ratings business. Every employee at an issuer-paid NRSRO, whether involved with sales or not, knows that they do well if the business does well (whether compensation is directly tied to growth or whether growth simply provides job security) and the business does well if they rate more securities. This was at the heart of the clamor for structured product ratings market share and the degradation of ratings standards that accompanied that land-grab.

Dodd-Frank does provide for small firm exceptions, which is positive. But there is no definition for what is small, or when one might lose its "small' status, or how much flexibility small firms might have. All of that, of course, creates compliance costs to understand and manage the constraints.

[16] (*PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934.*, Rule 17g-9(c))

[17] (*PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934.*, Rule 17g-5)

Other Factors

Access to information required for unsolicited ratings

In this entire area of structured product information disclosure, Dodd-Frank provides little improvement. In addition to all the new compliance rules and liability facing new entrants, those same new competitors are offered none of the additional disclosure or information that is required to evaluate, rate, and monitor structured finance vehicles such as CLOs. Prior SEC rules open up access to underlying data used for some structured product, but not for all. Basically, new competitors are offered new risks for little new opportunity. It is a material disincentive against entering the NRSRO and rating agency space.

For example, Collateralized Loan Obligation ("CLO") ratings

CLOs remain a viable asset class unlike many structured finance vehicles of the past several years. CLOs are important in the credit creation process and this helps the economy by allowing more credit to flow to companies beyond what is available from the banks and leveraged loan mutual funds. In CLO structures, the demand for higher risk loans is extended to high grade investors as a result of the higher rated tranching process. The CLO, like subprime RMBS, is another structured finance vehicle with universally high ratings from the rating agencies, and that can be a cause of concern over time depending on the quality of the assumptions and the underlying assets. The ratings process for such securities is stuck in the issuer-paid model and is a captive of the rating oligopoly the Fitzpatrick bill was supposed to help address. Dodd Frank has done nothing to correct some of the insurmountable barriers on the disclosure front.

The lack of disclosure on CLO structures combined with the tendency of originators to sell high risk loans into such structures does create significant risks of "excess" in hot markets that should be more closely monitored by investors. Investors need to do additional due diligence on such securities for their own safety and to reduce reliance on the rating agency oligopoly for models and assumptions.

As vehicles created by underwriters and managers of high risk debt instruments and placed with investment grade holders, the only detailed disclosure is in the hands of the large rating agencies (who award high ratings to the structures), the underwriters that sell the tranches, and the packagers and managers of such instruments. The underlying loan documentation and financial statements of the issuers whose loans have been sold into the structures often include private companies (LBOs etc.) where the high grade, high quality investor cannot gain access to the underlying documentation.

If investors and independent parties such as new rating agencies could gain access to the private companies' loan documents and financial statements packaged into CLOs and also get access to the CLO offering documents, meaningful competition could be brought into the ratings of CLOs. This is not just at new issue but also for purposes of ongoing risk surveillance. Distinct and similar disclosure improvement could also apply to other structured finance instruments. All of this information is readily available despite what lobbying groups will concoct. The idea that such disclosure will chill financings, proffered by some, is a Wall Street sales pitch and in fact a bluff since issuers get less expensive funding and more lenient structures through such vehicles. Dodd Frank does nothing to advance this disclosure and even crystallizes the obstacles by deterring competitors and leaving such disclosure concentrated in the hands of the major agencies. Unnatural barriers to entry in turn stack natural barriers to entry even higher.

The situation with CLOs, is made worse by the regulatory turf questions between the SEC and some of the bank regulators (Fed, OCC, FDIC). CLOs and disclosure rule for the underlying assets should be under the SEC, but the underlying assets (loans) are not securities and fall under the bank regulators (though there is no meaningful regulation of buying and selling bank loans). The fact that high risk assets are being repackaged and sold to high grade investors would seem to call for some more information so investors can defend themselves and rely less on the ratings issued by an oligopoly that gets fees for the high new issue ratings.

New rating agency competitors as well as investors in the CLOs cannot get access to the full range of underlying documents and asset level detail in such structures. Given that CLOs are high risk leveraged loans which are rolled up into investment grade structures in the AAA and AA range, such lack of disclosure leads to reliance on the rating agencies once again.

While these CLO structures did not create the magnitude of toxic problem we saw with subprime RMBS and commercial real estate in this past cycle, the overriding principal is still the same in that there is an *absolute* barrier to entry based on information availability that Dodd Frank fails to recognize or address. Investors end up relying on the agencies and cannot do the level of due diligence themselves given the closed information loop on such structures.[18]

Encouraging or mandating the SEC to revisit the breadth of the 17g-5 information access would be a positive direction. Getting the SEC purview over loans used as collateral for securities would be a significant leap forward. The two combined could lead to meaningful reform.

Corporate Counterparty Risk

When considering CLOs, and the companies that comprise their collateral, it is interesting to note that many international corporations use ratings for risk management purposes of their own. Ratings, from NRSROs, firms like Rapid Ratings as well as "credit bureaus," like Dun & Bradstreet (D&B) and Experian, provide ratings to corporations globally for assessing the risks

[18] "for a well prepared description of the CLO information conundrum, please refer to the April 10, 2009 submission to the SEC by CreditSights' CEO, Glenn Reynolds: http://www.sec.gov/comments/4-579/4579-19.pdf"

of customers (credit extension and accounts receivable management) and supply chain risk management. Interestingly, the credit bureaus are explicitly carved out of the CRA Act despite their providing a series of ratings for companies' risk management. The ratings also get used within financial institutions in vendor management (supply chain risk management) within large financial institutions, insurance companies, hedge funds and others. So, while the discussion about NRSROs is almost always focused on their capital markets' use, it is worth noting that their reach is much broader.

These corporations will often use NRSRO ratings and/or use the credit scoring of companies like D&B (by far the largest market share holder in this space) across their organizations for risk management purposes. Although corporations are much more forward thinking in using non-NRSRO and D&B type services than some institutional asset managers, there are still wide swaths of the corporate market that are correlating their risks on slow to change and rudimentary risk measures like S&P and Moody's ratings and payment-derived scores.

The "Restore Integrity to Credit Rating (Franken) Amendment"[19]

The Franken Amendment creates a government appointed board to distribute asset-backed security rating duties to NRSROs, hypothetically relieving NRSROs from the temptation to inflate ratings to attract issuers. Ratings contracts would be distributed depending on the accuracy of each NRSRO's historical rating record, thereby increasing competition and rewarding rating accuracy. Though these goals are worthy, the Franken Amendment is a poor idea on many levels. The fundamental reason for its creation was to try and prevent conflicts of interest and an oligopolistic paradigm within ratings, yet it addresses this by creating further conflicts of interest and a slightly broader oligopolistic paradigm.

In market practice the Big Three won almost 100% of the structured products ratings business leading into the financial crisis. The Franken Amendment will award business to other qualifying NRSROs that rate structured products too. This includes three other players at present. This means structured product ratings will now be shared around to six players instead of three, but issuers will still get ratings from one or more of the Big Three because they are the recognized names in the market. And, the Big Three can still rate these issues on unsolicited bases and award whatever ratings they would have otherwise. Ultimately, there is little initiative here other than a new issue subsidy redistribution to three more companies. Further, with business being awarded regardless of quality of rating, there will be little impetus for firms to innovate and improve.

[19] Franken, Al. The United States of America. *Restore Integrity to Credit Rating Amendment.* Washington D.C: , 2010. Web. 12 Jul 2011. <http://franken.senate.gov/files/docs/Final_Language_Franken_CRA.pDodd-Frank >. (3)

There are significantly more problems with the Franken Amendment:

- The Amendment gives the Commission power for determining the fees NRSROs can charge. But what happens to the firms if the committee decides to drop fees to an unpalatable level? For this or for any other reason if all the raters who rate an asset class decide to stop en mass, it would cause an international crisis of confidence.
- The amendment presupposes all ratings are the same and their providers are interchangeable. If this is the case, there will be no incentive for new players to innovate and there will be no incentive for the current players to improve
- An issuer that gets assigned a newer agency may disagree with the methodology or the philosophy of that firm's rating (not to mention outcome) and go to one of the Big Three in any event in addition. This will increase the issuer's gross borrowing cost
- Composing the committee will be a significant challenge as it will be full of conflicted parties themselves

Rapid Ratings Proposal for Increased Ratings Accuracy and Integrity

We would like to suggest an addition to the SEC's oversight process that we believe will have significant and meaningful implications to the rating industry reform effort. We would characterize this as a high potential benefit with low regulatory cost initiative. It is motivated by the following:

- Issuer-paid ratings have lost significant credibility
- There are potential conflicts of interest in the issuer-paid revenue model and many market participants believe ratings inflation is the result
- The issuer paid firms tend to have slow to change ratings, as described above
- The principal business model of issuer-paid firms is primarily issuance focused (where they get paid) and less on "maintenance" or "surveillance" ratings, where there is less money and more work
- The SEC has a challenge to oversee ratings performance and, if there are ultimately more NRSROs, this problem will become harder
- Whether we believe it should be or not, liability of ratings firms is an important element of legislative and regulatory reform initiatives

The proposal is both simple in concept and potentially wide reaching in its benefits: Require NRSROs to positively affirm by statement filed with the SEC that they stand by each previously issued rating on a quarterly basis or to make whatever ratings change is appropriate given the changed quality of issuer/security. If deemed to be too costly for the smaller NRSROs, an exemption could be granted with voluntary participation encouraged.

The potential benefits of this initiative are:

- Firms will not be able to hide behind the "our rating is good unless we say otherwise" positioning that permeates the market today
- Firms will have to properly reassure the market that their ratings have been reviewed and that the reputation of the firm is at stake continuously. Given the loss of confidence they have caused, it would be unwise for the Big Three to vehemently protest this initiative
- If a CRA will not attest to a rating on a quarterly basis, both the firm and the rating should be considered suspect
- At least one of the firms requires analysts to reaffirm the ratings for internal use only on a quarterly basis. This initiative would only be requiring them to make public these reaffirmations
- Potentially more ratings will be changed over time as their credit quality in fact changes, as opposed to having the agencies hide behind the rating through the cycle curtain
- Ratings volatility may increase slightly, but ultimately having asset managers responsible for understanding more frequent ratings changes instead of arbitraging stale ratings is a positive development
- Firms will have to think twice about their initial ratings given they will be responsible for attesting to its accuracy from there on out through time. Likely this will lead to less aggressive and more realistic initial ratings when/if there is a question in the minds of the ratings committees deciding on the initial level
- The SEC will have more data from which it can analyze rating agency performance
- If there are significant discrepancies among agencies on an individual security or company rating, the SEC will have the ability to check into the accuracy of the ratings, but in a targeted way highlighted to it from the NRSROs' attestation reporting
- This can be accomplished without an increased burden at the SEC and in fact can be accomplished electronically by pushing some oversight responsibility to the ratings firms themselves while overseen by the Commission

Conclusion
It seems clear the focus of Dodd-Frank was on controlling S&P, Moody's and Fitch with compliance, disclosure and the threat of liability. It was not on increasing the disclosure of information necessary to facilitate competition nor on the consequences of the Dodd-Frank provisions on current or prospective competitors.

The problem of the incumbent ratings paradigm cannot be legislated or regulated away. Only through the myriad efforts will we see meaningful change in this market: reducing investor reliance on NRSROs, removal of NRSRO references from statutes and regulations, increased access to data for analysis by competitors, facilitating not hindering new players, encouraging innovation, encouraging investors to evaluate various risk management factors in decision making combined with reasonable regulatory oversight, incumbent behavior modification and time.

Encouraging choice, and facilitating new players to bring this to the market unimpeded, will over time transform this industry. As case in point, Rapid Ratings' being shown to be 2.9 years ahead of Moody's in identifying companies that ultimately fail is the kind of innovation that is being embraced and will continue to decrease investors' reliance on the status quo.

We are pleased that this committee is taking the opportunity at this time to evaluate the state of affairs and consequences of Dodd-Frank on players such as Rapid Ratings and the effect on the industry overall. There is still much to do.

Thank you

Testimony before
The Oversight and Investigations Subcommittee of the House Financial Services Committee on
"Oversight of the Credit Rating Agencies Post-Dodd-Frank"

Jules B. Kroll
Executive Chairman
Kroll Bond Rating Agency, Inc.
Wednesday, July 27, 2011

Good morning, Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee. Thank you for inviting me to today's hearing on "Oversight of Credit Rating Agencies Post-Dodd-Frank" to help you examine the effects of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") on credit rating agencies one year after its enactment. I have also been asked to address whether Dodd-Frank impairs market entry for a new Nationally Recognized Statistical Rating Organization ("NRSRO") and whether Dodd-Frank further entrenches the top three (3) credit rating agencies.

As Executive Chairman of Kroll Bond Rating Agency, Inc. ("Kroll Bond Ratings"), a relative newcomer, I may have a unique perspective on Dodd-Frank's effect on competition in the credit rating agency arena, but I hope to provide a more broad-based view as well.

I originally entered this business in order to provide an alternative to legacy ratings. As we analyzed the state of the capital markets in 2007 and 2008, it was clear that things had gone badly off the rails as fixed income investors suffered significant losses in structured finance securities that were initially rated 'AAA' by the incumbent rating agencies, Moody's, Standard & Poor's and Fitch. Consequently, we chose to concentrate on structured products as a priority. It is no mystery at this point that the incumbent rating agency oligopoly let us all down very badly. My own background is in the area of risk management, investigations and due diligence. As we analyzed the shortcomings in credit ratings, it became apparent that those skills were in short supply during this crisis. I personally believe that the world standing of the United States – and even our national security – has been negatively affected by the financial crisis. NRSROs are an integral part of the capitalist system and it is essential that this field be professionalized and standards of care more vigorously followed.

Kroll Bond Ratings was formed in 2010. We are privately held, but we have investors who represent more than 35 pension funds and family offices, including my own family. We feel that our primary obligation is to, and the key to our future contribution and success will be, the investment community, which is comprised of the ultimate buyers of securities that we rate. To this end, we have built a team of highly seasoned credit market professionals from different disciplines, with a mission to break the oligopoly by responding to the needs of investors, bankers and issuers for a new ratings approach to restore confidence in the value of ratings and to help set a standard of performance that should be uniform for all NRSROs. We intend to offer the marketplace an alternative; an alternative that retains aspects of proven approaches to credit analysis, but with a rigorous focus on accuracy of ratings, due diligence, transparency, which we define as disclosure regarding the rationale underlying a rating, and post-issuance surveillance.

Kroll Bond Ratings has two business models operating simultaneously. The subscription model is primarily devoted to financial strength ratings on more that 16,000 financial institutions, including commercial banks, thrifts and credit unions, among others. Our subscribers pay us for these ratings. This is currently a small business that we acquired in August 2010. Our second business model is reliant on fees paid by bond issuers and we have attempted to mitigate the appearance of conflict in a number of ways.

Already, we have begun to establish traction in the marketplace, particularly in the CMBS area where we have been selected to rate five (5) new debt offerings. We have been able to overcome barriers which we examine later in this testimony by recruiting an outstanding team from the capital markets, publishing our criteria and approach to these matters, raising capital and continuing to educate the investor community as well as the issuer community. Simultaneously, we have begun to publish our criteria and related studies to enable us to provide ratings in other structured finance categories, including RMBS, CLOs, and other asset backed securities collateralized by credit card receivables, auto loans, auto leases, dealer floor plan financings, student loans, consumer leases, equipment loans and leases, and similar financial assets. I believe that competition in these and other areas can bring certain benefits, including increased choice and reduced costs for market participants, as well as reduced concentration of the credit rating agency industry in a few credit rating agencies.

I appreciate that the Securities Exchange Commission ("SEC"), was, and continues to be, in the difficult position of determining how best to effect sweeping reform of credit rating agencies. At Kroll Bond Ratings, we support the goals of Dodd-Frank, which include increased accountability and transparency, and we support the efforts of the SEC in pursuing those goals. At the same time, we have to deal with the SEC's attempt to articulate responsive regulations.

On May 18th, the SEC released 500 pages of proposed regulations for comment. A small NRSRO, with very few exceptions, is subject to these rules. They will be expensive and time consuming especially for the smaller NRSROs; small company exemptions need to be expanded to level the field.

The credit rating agency industry is already an industry with fairly high barriers to entry with respect to the licenses, substantial financial resources and staff required to start a credit rating agency. The Credit Agency Reform Act of 2006 was a good first step, however the rules and regulations promulgated thereunder (collectively, the "Reform Act"), contains a few provisions that are, in practice, anti-competitive and discourage new entrants to the rating agency arena. Certain provisions of Dodd-Frank, and the rules proposed thereunder, have compounded the barriers to entry.

An example of an existing barrier to entry in the Reform Act is a provision of Rule 17g-5 promulgated by the SEC, that prohibits an NRSRO from issuing or maintaining a credit rating solicited by a person that, in the most recently ended fiscal year, provided the NRSRO with net revenue equal to or in excess of ten percent (10%) of the total net revenue of the NRSRO for such fiscal year ("Ten Percent Rule"). For established NRSROs, the amount required to reach ten percent (10%) of net revenue – and thereby violate the Ten Percent Rule – would likely be a large sum. For a new entrant to the market, the sum required to reach ten percent (10%) of net revenue is much smaller, placing the new entrant in danger of violating the Ten Percent Rule when it receives rating fees for a single transaction. The notion that a new entrant to the market must view revenue, which is typically a positive occurrence, as an event that could cause violation of the Ten Percent Rule does not encourage entry into the industry nor does it facilitate the success of new entrants.

The Reform Act introduced, and Dodd-Frank significantly supplemented, the regulatory framework applicable to NRSROs. Dodd-Frank and related rule-making will create or augment requirements with respect to, among others, transaction-related disclosure, record-keeping, and historical ratings disclosure. Some provisions are already in place and some remain subject to final approval. The costs of compliance for any NRSRO are substantial. In and of itself, this could be a disincentive to entering the industry. For example, Kroll Bond Ratings has expended more funds on compliance and legal costs during the past year than the revenue earned by its subscription based service.

In an effort to minimize conflicts of interests, Dodd-Frank mandates separation of those responsible for sales and marketing from those responsible for determining credit ratings. Conceptually, prohibiting those responsible for credit ratings from negotiating fees with clients will minimize conflicts of interest. However, care must be taken when enforcing this type of prohibition, so that the benefits of reduced conflicts do not come at a cost of limiting the gathering of information by the marketplace. For example, if "marketing" is defined too broadly, then rating analysts may be precluded from having meaningful exchanges with potential and existing clients. Creating this kind of barrier to robust dialogue runs counter to the aims of Dodd-Frank. At Kroll Bond Ratings, we believe that in order to provide increased transparency to the marketplace, we should be able to allow those best equipped to answer such questions, without violating the mandated separation and without such dialogues constituting "marketing." If Dodd-Frank is construed as prohibiting analysts from discussing how credit ratings are determined with market participants, this would seem to contradict the statutory goals of increased disclosure and transparency. The SEC has requested comment on the rules promulgated that address this issue and we would urge the SEC to carefully consider the practical consequences of this mandated separation.

In addition to anti-competitive provisions of the Reform Act, there are also provisions within Rule 17g-5 that have hindered the very purpose they were intended to achieve, which in turn makes it difficult for new and existing rating agencies to provide what the market most needs: accuracy in ratings, due diligence, transparency and post-issuance surveillance. Kroll Bond Ratings is committed to each of these goals, but in many respects the requirements of Rule 17g-5 have run counter to its stated purposes. Instead of promoting enhanced competition, due diligence and disclosure, the application of certain provisions of Rule 17g-5 have, in many ways, hindered meaningful diligence and disclosure in that deal-specific information provided via websites, and available only to NRSROs, is pro forma which can chill meaningful exchanges between rating agencies and issuers.

Again, Kroll Bond Ratings supports the intentions of Dodd-Frank and believes that increased disclosure and transparency for investors and minimizing conflicts of interest will be beneficial to the marketplace. However, there are instances in which compliance with particular provisions and/or certain proposed rules may not further the intentions of Dodd-Frank. For example, the proposed disclosure form, intended to accompany every transaction and specifying precise language supporting the rating rationale, likely will not achieve its desired effect in part because standardizing such disclosure will make it less meaningful. This rule proposal is an interesting paradigm, because it exacerbates several problems, while missing the point at which Dodd-Frank was aimed. The disclosure form would impose significant administrative and recordkeeping tasks on credit rating agencies, and would tend to homogenize their work product. It would also give credence to the idea that the regulatory focus is on rigidly following mechanical processes, rather than on output. Moreover, monitoring compliance with this form will absorb the time and resources of both the rating agencies and the SEC examiners, while making it more difficult for the marketplace to differentiate one rating agency from another. As mentioned, we appreciate that the SEC is trying to regulate a complex field with limited resources. For that reason, their resources should be focused on regulation that promotes competition. Specifically, regulation should focus on the quality of rating agency output: are the ratings accurate; and are they monitored and updated promptly. Those are also elements that allow for differentiation among the competing rating agencies, and are therefore key considerations for investors. Regulation that focuses on clear disclosure of accuracy of ratings, and helps investors see how responsive those ratings are to changes in the market, will be pro-competitive, and I would suggest that is where the focus of rule-making should be. The marketplace will determine the substance of the transparency it requires and will naturally gravitate towards the rating agencies that provide it.

Competition is also hindered by some widely followed market practices, such as investment guidelines established by institutional investors, including pension fund and insurance companies, that require a rating on a security by Moody's, Standard & Poor's and/or Fitch. It is self-evident that this practice further entrenches the incumbent rating agencies. As an illustration, Kroll Bond Ratings conducted an informal survey of the top 100 pension funds; of the sixty seven (67) pension funds with published guidelines, approximately sixty five percent (65%) of those pension funds mandate the use of ratings by at least one of Moody's, Standard & Poor's or Fitch, and in some cases, two of the incumbent rating agencies. There is a greater need for competition within this space; however, if their investment guidelines require a Moody's, Standard & Poor's and/or Fitch rating, the institutional investors will not be able to purchase securities rated by another NRSRO.

In order to reduce reliance on ratings, Dodd-Frank requires all federal agencies to remove references to credit ratings and replace them with alternative standards of credit-worthiness. Federal agencies should be free to decide what measures – and from what sources – their needs will best be met.

Credit ratings have been part of the financial landscape for more than a century. The fiasco in structured finance notwithstanding, on average, across time and across sectors, credit ratings have demonstrated their ability to signal losses to bondholders well in advance of default. The craft of credit analysis provides broad coverage, accuracy and independence. When produced without undue business pressure, credit ratings can exhibit characteristics necessary for the protection of both investors and taxpayers.

It is Kroll Bond Ratings' hope that our commitment to accuracy in ratings, due diligence, transparency and post-issuance surveillance, in each instance supported by sophisticated transaction modeling and analysis, will set us apart from other rating agencies. Our belief in the value of due diligence translates into not only our transaction reviews, but will include thorough evaluation of the issuer's corporate structure, ownership and management in instances where such evaluation is additive to our analysis, as well as a site visit and meetings with management and testing of certain processes. Kroll Bond Ratings looks forward to the leveling of the playing field for new entrants to the marketplace and meaningful credit agency reform through the Reform Act and Dodd-Frank that is responsive to investors and market participants and enables Kroll Bond Ratings to provide what we believe the marketplace wants and deserves.

Testimony on "Oversight of the Credit Rating Agencies Post-Dodd-Frank"

by John Ramsay
Deputy Director, Division of Trading and Markets
U.S. Securities and Exchange Commission

Before the Subcommittee on Oversight and Investigations of the United States House of Representatives Committee on Financial Services

Wednesday, July 27, 2011

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee:

My name is John Ramsay, and I am a Deputy Director in 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 and the regulatory treatment of ratings.

Introduction

The Commission's efforts to increase oversight of rating agencies began before the financial crisis with the adoption of rules under authority granted by the Credit Rating Agency Reform Act of 2006 ("Rating Agency Act"), which mandated that the Commission establish a registration and oversight program for nationally recognized statistical rating organizations ("NRSROs"). The Rating Agency Act expressly prohibits, however, the Commission from regulating the substance of credit ratings or the procedures and methodologies used by NRSROs to determine credit ratings.

In June 2007, the Commission adopted new rules establishing a regulatory program for NRSROs, and later that year, 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. In order to address deficiencies that were identified in those examinations, and to take further action to improve the integrity of the ratings process, the Commission adopted two substantial new sets of rules in 2009. Most recently, in May of this year, the Commission proposed a comprehensive set of additional requirements ("Dodd-Frank rule proposals") under the mandate established by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") with a comment period that runs through August 8th. The Commission currently also is working to complete studies related to rating agency reform required by the Dodd-Frank Act. Further, the Commission has increased its examination focus on NRSROs and is on track this year to complete an examination of every NRSRO.

In its regulatory initiatives in this area, the Commission has focused special attention on ratings of structured finance products. As is now well-known, faulty ratings of mortgage-related and other structured finance instruments played a significant role in the financial crisis by facilitating the accumulation of excessive risk in the financial system. The Commission's efforts in this area have been designed to address conflicts of interest, make more transparent the process for rating structured securities and the basis for individual ratings, and promote competition among rating agencies that are involved in this business.

In addition to its efforts to increase oversight of NRSROs, the Commission is also seeking to eliminate references to credit ratings in its rules in order to reduce reliance on credit ratings. Acting in response to the mandate of the Dodd-Frank Act, the Commission has proposed to remove numerous references to credit ratings or NRSROs in its rules and to substitute appropriate standards of creditworthiness.

Improving Oversight of NRSROs

Improving the Integrity of the Rating Process

In accordance with the goals of the Rating Agency Act, the Commission has sought to improve the integrity of the ratings process through its regulation of NRSROs. The Commission's initial rules adopted in June 2007, for example, require NRSROs to have written policies and procedures to prevent the misuse of material nonpublic information and to manage certain conflicts of interest. In addition, the rules prohibit certain other conflicts of interest outright and prohibit NRSROs from engaging in certain unfair, coercive or abusive practices. In 2009, the Commission expanded its conflict of interest rule to prohibit an NRSRO from: (1) structuring the same products that it rates; (2) allowing analysts who participate in determining credit ratings from negotiating the fees that issuers pay to be rated; and (3) allowing analysts to accept gifts in any amount over $25 from entities that receive ratings from the NRSRO.

Conflicts of Interest. The rules proposed in May 2011 under the Dodd-Frank Act include several proposed amendments to strengthen the existing conflict of interest rule to more completely separate the credit analysis function from sales and marketing activities. These amendments would:

- prohibit an NRSRO from issuing or maintaining a credit rating when an employee who participates in sales or marketing activities also participates in determining a credit rating or in developing the procedures or methodologies used to produce the credit rating;
- create a mechanism for a small NRSRO to seek relief from this absolute prohibition if, due to the size of the NRSRO, the separation of sales and marketing activities from the production of credit ratings is not appropriate; and
- set forth findings the Commission would need to make to suspend or revoke the registration of an NRSRO if the Commission found that the NRSRO violated the conflict of interest rule.

The Commission also proposed a new rule that would require an NRSRO to have policies and procedures to address the potential for a credit rating to be influenced by a credit analyst seeking employment with the entity being rated or the issuer, underwriter, or sponsor of the securities being rated. The Dodd-Frank Act established a self-executing provision requiring an NRSRO to conduct a one-year "look-back" review when a credit analyst leaves the NRSRO to work for an entity rated by the NRSRO or an issuer, underwriter, or sponsor of securities being rated by the NRSRO. The purpose of the look-back review is to determine whether the credit analyst's prospects of future employment influenced a credit rating. If such influence is discovered, the proposed rule would require the NRSRO to have policies and procedures to immediately place the credit rating on credit watch, promptly determine whether the credit rating must be revised so it no longer is influenced by a conflict of interest, and promptly publish a revised credit rating or affirm the credit rating, as appropriate.

Ratings Procedures and Methodologies. The Commission also proposed a new rule in May 2011 that would require an NRSRO to have certain policies and procedures designed to improve the integrity of its credit ratings procedures and methodologies. More specifically, the proposed rule would require an NRSRO to have policies and procedures reasonably designed to ensure, among other things:

- that the methodologies the NRSRO uses to determine credit ratings are approved by its board of directors or a body performing a similar function and that such methodologies are developed and modified in accordance with the policies and procedures of the NRSRO;

- that any material changes to the methodologies are applied consistently, and that they are applied to currently outstanding credit ratings within a reasonable period of time, taking into consideration the number of ratings impacted, the complexity of the methodologies, and the type of entity or security being rated; and

- that the NRSRO promptly publishes notice of material changes to rating methodologies and of any significant errors that are identified in a rating methodology.

Analyst Standards. Finally, the Commission proposed a new rule that would require an NRSRO to have standards of training, experience, and competence for its credit analysts that are reasonably designed to ensure that the NRSRO produces accurate credit ratings. The proposed rule would set forth factors an NRSRO would need to consider in designing such standards and require that the standards provide for the periodic testing of credit analysts and that at least one individual with three years or more experience in performing credit analysis participates in the determination of each credit rating.

Governance and Internal Controls

In addition to targeting improvements to the integrity of the ratings process, the Commission's NRSRO rules also establish recordkeeping and annual reporting requirements designed to improve NRSROs' governance and internal controls as well as to facilitate the Commission's oversight and monitoring of NRSROs. For example, the rules adopted in 2007 require an NRSRO to make and retain certain records relating to its business as a credit rating agency and to furnish to the Commission certain financial reports on an annual basis, including audited financial statements and separate unaudited financial reports. In 2009, the Commission added requirements that each NRSRO make and retain records of all rating actions and document the rationale for any significant "out-of-model" adjustments used in determining a credit rating whenever a quantitative model is a substantial component of the credit rating process. In addition, the 2009 amendments require NRSROs to retain records of any complaints regarding the performance of a credit analyst in determining, maintaining, monitoring, changing, or withdrawing a credit rating.

The rule proposals under the Dodd-Frank Act would require each NRSRO to file an annual report with the Commission regarding its internal control structure as it concerns policies, procedures, and methodologies for determining credit ratings, including a description of the responsibility of management in establishing and maintaining the internal control structure as well as an assessment of the effectiveness of those internal controls. Each NRSRO would also be required to have policies and procedures in place to ensure that its rating methodologies are approved by its Board of Directors.

Disclosure and Transparency

Performance Disclosures. Historically, the ratings process has suffered from a lack of transparency. Investors have not been given clear or consistent information about the meaning of particular ratings, and investors have had limited ability to compare performance among rating agencies. The Commission has taken significant steps to address these issues by establishing extensive and wide-ranging disclosure requirements for NRSROs. The Commission's June 2007 rules require NRSROs to make public disclosures about, among other things, ratings performance statistics, ratings methodologies, conflicts of interest, and analyst experience. The 2009 NRSRO rule amendments include a significant set of enhancements to these disclosure requirements, including requiring NRSROs:

- To publish performance statistics for 1, 3, and 10 years within each rating category;
- To disclose how frequently credit ratings are reviewed; whether different models are used for surveilling ratings, compared to those used for issuing ratings; and whether changes made to models are applied retroactively to existing ratings; and
- To make publicly available in a machine-readable format ratings action histories for all credit ratings (regardless of the business model under which they are determined) that were initially determined on or after June 26, 2007 (the effective date of the Commission's regulations implementing the Rating Agency Act), with each new ratings action to be disclosed on a delayed basis;

The Dodd-Frank rule proposals would standardize the production and presentation of the transition (i.e., a change from one rating category to another) and default rates that NRSROs are required to disclose, with the goal of making these performance statistics more comparable among NRSROs and easier for users of credit ratings to understand. The proposed amendments would also upgrade the information about credit rating histories that NRSROs are required to disclose in an XBRL format. Specifically, an NRSRO would be required to include in the XBRL file each credit rating that was outstanding as of June 26, 2007 and any subsequent actions taken with respect to those ratings. In addition, the proposed amendments would increase the number and scope of the data fields that must be disclosed about a rating action.

Usability Improvements. The May 2011 proposals would also require an NRSRO to disclose certain quantitative and qualitative information in a form to accompany the publication of each credit rating. The required information would include, among other things, information about the potential limitations of the rating and information about the methodology used to determine the rating, including the main assumptions underlying the methodology.

The Commission also proposed to require an NRSRO to adopt policies and procedures designed to ensure that ratings can be more readily understood by investors. More specifically, the proposed rules would require an NRSRO to have policies and procedures reasonably designed to: (1) assess the probability that an issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with its terms; (2) clearly define each symbol in the rating scale used by the NRSRO; and (3) apply any such symbol in a consistent manner. In addition, in December 2010, the Commission issued a request for comment in connection with a study, mandated by the Dodd-Frank Act, that will address the feasibility and desirability of standardizing credit rating terminology. The comment period for this study ended in February of this year, and Commission staff are currently in the process of reviewing these comments and preparing the required study.

Structured Finance Products

As I noted earlier, the Commission has focused special attention on ratings for structured finance products in recognition of the role that those ratings played in contributing to the financial crisis. In late 2007, the Commission staff conducted in-depth examinations of the three largest NRSROs that were most active in rating structured finance products linked to aggressively underwritten mortgages. These examinations generally covered the period from January 2004 through July 2008, although the Commission did not have regulatory authority over the examined NRSROs until their registration in September 2007. The findings of the examinations have informed the Commission's subsequent rulemaking, which contains a number of provisions designed to apply to structured finance products.

Facilitating Competition. For example, the Commission's 2009 rulemaking sought to increase competition for structured finance ratings by creating a mechanism for NRSROs not hired to rate structured finance products to nonetheless determine and monitor credit ratings for these instruments. This rule requires NRSROs that are hired by issuers, sponsors, or underwriters ("arrangers") to determine an initial credit rating for a structured finance product to disclose to other NRSROs (and only other NRSROs) that they are in the process of determining such a credit rating. The hired NRSRO must then obtain assurances from the arranger that it will provide to other NRSROs the information necessary for them to issue an unsolicited rating for the same transaction. This rule change is one way that the Commission has sought to promote competition and address conflicts of interest in ratings for structured finance products.

The 2009 rule amendments also require disclosure by NRSROs of the way they rely on the due diligence of others to verify the assets underlying a structured product and prohibit NRSROs from structuring the same products that they rate.

Disclosure. In January of this year, the Commission implemented Section 943(1) of the Dodd-Frank Act by adopting a rule requiring NRSROs to include, in any report accompanying a credit rating relating to an asset-backed security, a description of the representations, warranties and enforcement mechanisms available to investors and a description of how they differ from the representations, warranties and enforcement mechanisms in issuances of similar securities. Further, the Commission proposed additional rule amendments with respect to due diligence services for asset-backed securities as part of the Dodd-Frank rule proposals. Specifically, the Commission proposed to require an issuer or underwriter of an asset-backed security to disclose the findings and conclusions of any due diligence report obtained by the issuer or underwriter. This disclosure would need to be made directly by the issuer or underwriter or, alternatively, by an NRSRO, if the issuer or underwriter obtains a representation that the NRSRO will make the disclosure.

To facilitate this disclosure, the Commission proposed to require a provider of third-party due diligence services for an asset-backed security to provide a certification to any NRSRO that is producing a credit rating for the security. The certification would need to include the findings and conclusions of the due diligence firm, and an NRSRO would be required to publish the certification with the disclosure form that accompanies the rating.

Finally, in May of this year, the Commission issued a public request for comment in connection with a study, required by the Dodd-Frank Act, addressing the credit rating process for structured finance products and the conflicts of interest associated with the issuer-pay and the subscriber-pay models, as well as the feasibility of establishing a system in which a public or private utility or a self-regulatory organization assigns NRSROs to determine credit ratings for structured finance products. In order to ensure that as many parties as possible have the opportunity to comment, the Commission has established an extended comment period for the study.

Removing Rule References

Section 939A of the Dodd-Frank Act directs the Commission, along with all other federal agencies, to remove references to credit ratings from its rules and forms and to substitute such alternative standards of creditworthiness as the Commission determines to be appropriate. The Commission began the process of removing references to ratings in its rules and forms in rule amendments approved in 2009. Earlier this year, the Commission proposed to remove references to credit ratings from rules governing the operation of money market funds and the eligibility for companies registering securities for public sale to use "short-form" registration. The Commission also proposed to remove references to credit ratings in the rules applicable to broker-dealer financial responsibility, distributions of securities, and confirmations of transactions. In each case, the Commission's goal is to reduce undue reliance on credit ratings and to encourage independent assessments of creditworthiness. Of particular interest to the Commission is whether the standards it has proposed for creditworthiness are appropriate and workable and whether they can be implemented without imposing undue costs or reducing investor protection.

Regulation FD

As required by the Dodd-Frank Act, in September 2010, the Commission amended Regulation FD, which addresses the selective disclosure of information by publicly traded companies and other issuers, to remove the specific exemption from the rule for disclosures made to NRSROs and credit rating agencies for the purpose of determining or monitoring credit ratings. Pursuant to Commission rules, NRSROs are already required to have written policies and procedures reasonably designed to prevent the inappropriate dissemination within and outside the NRSRO of material nonpublic information obtained in connection with the performance of credit rating services.

Examinations

Finally, the Dodd-Frank Act requires the Commission to conduct examinations of each NRSRO at least annually and to issue an annual report summarizing the exam findings. Commission staff is currently in the process of completing the first cycle of these exams, which the Commission anticipates will be completed this year. Going forward, these examinations will be critical to enforcing compliance with the substantial new compliance obligations created by the Dodd-Frank Act and the Commission's rules. Fulfilling this objective will, of course, place a burden on the Commission's examination resources.

Conclusion

We look forward to receiving and reviewing comments on our current NRSRO rule proposals and studies required by the Dodd-Frank Act. The Commission will continue its efforts to promote integrity and transparency in the ratings process and competition among credit rating agencies. Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.

Testimony of Michael Rowan

Managing Director

Moody's Investors Service

Before the

United States House of Representatives

Committee on Financial Services

Subcommittee on Oversight and Investigations

July 27, 2011

Good morning Chairman Neugebauer, Representative Capuano and members of the Subcommittee. My name is Michael Rowan, and I am the Global Managing Director of the Commercial Group at Moody's Investors Service ("**Moody's**"). My group is responsible for Moody's business planning and strategy, which includes new business origination and the commercial side of the interactions that Moody's has with issuers. My position and my entire group were established to bring together all of our commercial functions under common leadership. This structure reinforces the separation between our analytical teams and the company's commercial activities. On behalf of my colleagues, I would like to thank you for the opportunity to participate in today's hearing and to speak to you about Moody's, the role that credit rating agencies can play in the market, our competitive landscape, and the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**") on the credit rating agency industry.

In the past few years, numerous reform proposals affecting the regulatory infrastructure of the financial services sector have been the subject of vigorous, public debate. Moody's has welcomed the opportunity to discuss with private and public sector participants the role that rating agencies play in and the value that credit ratings can bring to the markets. As the supervisory framework for rating agencies has evolved, both in the United States and abroad, we have embraced the need for change because we believe that a modernized oversight regime will help increase confidence in credit ratings and the rating process, as well as instill greater discipline in the industry as a whole.

In providing you with our perspective on these questions, I would like to outline two principles that have guided us over the years.

First, Moody's believes that legislative initiatives that periodically review and update the regulatory regime under which market participants operate are both necessary and healthy. They can increase market confidence that the rules are fair and the playing field level. They also can encourage best practices among and across industries. In this regard, we supported the broad goal of the Credit Rating Agency Reform Act ("**2006 Act** ") to improve credit rating quality in the industry. Similarly, we believe that the Dodd-Frank Act promotes an important goal of bringing the regulatory infrastructure in line with recent market developments and innovations.

Second, we think that markets thrive when the regulatory landscape allows for and promotes differing views. It is equally important that contrarian opinions not only be tolerated but encouraged. For these reasons, Moody's has been a strong advocate of competition in our industry, so long as that competition occurs on the basis of credit ratings quality.

In my statement below, first, I will provide background on Moody's, including our credit rating system, the value we believe credit ratings bring to the market, and the use of credit ratings in the market. Second, I will address Moody's efforts to advance the quality, transparency and independence of our credit ratings. Third, I will discuss our support for healthy competition based on credit ratings quality. Finally, I will speak to the regulatory landscape for our industry and how it has evolved over time, highlighting our continuous support for reducing the mechanistic use of ratings in regulation.

I. Background on Moody's

Credit rating agencies occupy a narrow but important niche in the investment information industry. Our role is to disseminate forward-looking opinions about the relative creditworthiness of, among other things, financial obligations of corporations, banks, governmental entities, and pools of assets collected in securitized transactions.

Moody's is the oldest bond rating agency in the world, having introduced ratings in 1909. Since then, the industry has grown considerably. Today, there are over one hundred credit rating agencies around the world, and ten firms are registered with the SEC as Nationally Recognized Statistical Rating Organizations ("**NRSROs**").

Today, Moody's is one of the world's most widely used sources for credit ratings and research. Our credit ratings and analysis track a wide variety of issuers and debt instruments, including sovereign nations, corporate issuers, municipal issuers, and structured finance obligations. In addition, Moody's publishes credit opinions, transaction research, and commentary serving market participants around the globe.

A. Moody's Credit Rating System

Moody's credit ratings are forward-looking opinions that address just one characteristic of fixed income securities – the likelihood that debt will be repaid in accordance with the terms of the debt instrument. Our credit ratings reflect an assessment of both the probability that a debt instrument will default and the amount of loss the debt-holder is likely to incur in the event of default. In assigning our credit opinions, our analysts adhere to Moody's published credit rating methodologies, which we believe promote transparency and consistency in our global ratings.

Our credit ratings are expressed according to a system of letters and numbers, on a scale that has 21 categories ranging from Aaa to C. The lowest expected credit loss is at the Aaa level, with a higher expected loss rate at the Aa level, an even higher expected loss rate at the A level, and so on down through the rating scale. Moody's rating system is not a "pass-fail" system; rather, it is a probability-based system in which the forecasted probability and magnitude of credit losses rise as the rating level declines.

B. Value to Market

To meet market needs over time, our credit ratings have developed certain attributes:

- Insightful and robust analysis;
- Symbols that succinctly communicate opinions;
- Broad coverage across markets, industries and asset classes, enabling comparability; and
- Public availability of opinions.

These attributes have enabled our credit ratings to serve as a common point of reference for credit. That in turn has provided financial market professionals with a common language to compare credit risk across jurisdictions, industries and asset classes, facilitating the efficient flow of capital worldwide. In this regard, credit ratings can contribute to an improved knowledge of credit risk, which can promote market discipline. At Moody's, we intend for our credit ratings to help promote dialogue and debate among market professionals, who we expect to use our opinions as a point of consideration, not a replacement of their own credit analysis.

C. Use of Credit Ratings

Moody's credit ratings are opinions about credit risk, and as such they should be used as just one perspective on an issuer's or debt obligation's creditworthiness. Moody's also has always been clear and consistent in telling the market that our credit ratings should not be used for any purpose other than as a gauge of default probability and loss in the event of such default. In particular, Moody's credit ratings are not statements of fact about past occurrences or guarantees of future performance. They are not investment advice. Credit ratings do not address many other significant factors in the investment decision process, including, for example, price, term, likelihood of prepayment, liquidity risk and relative valuation. The likelihood that debt will be repaid is just one element, and in many cases may not be the most important element, in an investor's decision-making process for buying credit-sensitive securities.

II. Moody's Efforts to Advance the Quality, Transparency and Independence of Credit Ratings

Moody's has developed our reputation over a long period of time. We are, however, also well aware of the loss of confidence in the credit rating industry, largely driven by the performance of the U.S. residential mortgage-backed securities sector and related collateralized debt obligations. Over the past several years, Moody's has adopted – and will continue to adopt – a number of measures to regain the confidence of our ratings in that sector. These measures have been based on feedback we have received from the private and public sectors, as well as on our own deliberations and analysis of our ratings performance and credit market developments. The actions and initiatives that we have pursued in the recent past can be categorized into five broad categories:

- Strengthen the analytical integrity of credit ratings;
- Enhance consistency across rating groups;
- Improve transparency of credit ratings and the ratings process;
- Increase resources in key areas; and
- Bolster measures to mitigate conflicts of interest.

The Annex to my testimony summarizes a number of the recent initiatives we have pursued.[1]

One initiative that I wish to underscore is the creation of the department for which I am responsible: the Commercial Group. As explained at the outset of my testimony, this group is charged with business strategy and planning, new business origination, and business relationships with issuers. My position in particular was established to further bolster the management of the potential conflict of interest posed by our business model by, among other things, bringing the commercial functions under common and separate leadership. The Commercial Group's mandate builds upon measures that pre-dated the financial crisis, in which Moody's had first segregated rating analysts from fee discussions with issuers, and then extended that prohibition to their managers. Last year, we took those efforts one step further and created the Commercial Group to reinforce and strengthen the separation between our analytical functions on the one hand, and our commercial functions on the other. For example, the employees of the Commercial Group have

---

1 In line with our continuing efforts to be as transparent with the market as possible, we also have published a series of Special Comments describing the measures we had taken as of August 2008, December 2008, November 2009 and June 2011. These publications can be found on moodys.com. See *Strengthening Analytical Quality and Transparency: An Update on Initiatives Implemented by Moody's in the Past Twelve Months*, August 2008 (Document No. 110613); *Strengthening Analytical Quality and Transparency: An Update on Initiatives Implemented by Moody's in the Past Eighteen Months*, December 2008 (Document No. 113751); *Analytical Quality and Transparency: An Update on Initiatives Implemented by Moody's over the Past Two Years*, November 2009 (Document No. 119843); and *Moody's Investors Service Looks Forward as Regulatory Landscape Evolves*, June 2011 (Document No. 133553).

no involvement in determining or monitoring credit ratings or developing or approving rating methodologies. Equally as important, Moody's analytical employees are not involved in fee or payment discussions with issuers, which adds another layer of protection against the potential of conflict.

Moody's is continually analyzing and reevaluating our processes in an ongoing effort to strengthen internal mechanisms to manage conflicts of interest, as well as improve the quality, transparency, usefulness and integrity of our credit ratings.

III. Competition and Diversity of Opinions

Moody's competes in a large field of opinion providers, and we do not view other credit rating agencies as our only competitors. Rather, Moody's competes in a broader field that includes providers of purely quantitative and market based measures of credit risk, such as bond price indicators and credit default swap spreads. Moody's has continuously supported regulatory initiatives that encourage and increase the number of diverging, and at times contrarian, opinions.

From our perspective, healthy competition amongst the various opinion providers is good for the market because it provides incentives to improve the quality of opinions over time. We believe that more opinions can encourage dialogue and debate, which necessarily will improve broader market understanding of credit risks. Healthy competition, however, is not achieved if the number of credit rating providers increases while diversity in rating opinions declines.

A regulatory framework that produces the same opinion from multiple sources would eliminate quality-based competition and substitute in its place less investor protection-oriented alternatives. To support an information-efficient capital market, credit rating agencies should compete vigorously on the basis of the reliability and usefulness of differing and independently formed opinions. As a result, we have cautioned against regulating the substance of how rating agencies determine credit ratings. We have expressed this concern because some regulation can require or promote harmonization in the substance of rating opinions, methodologies or process, which undermines healthy competition and diminishes the diversity of opinions in the market. In our view, it is unhealthy for the markets if regulation demands or encourages one and only one prediction of the future.

IV. Changing Regulatory Landscape

Moody's supports regulatory reform and believes that effective regulation of credit rating agencies can help restore confidence and encourage greater discipline in our industry. We further believe that regulation is most successful when it is adopted with a clear understanding of the role of credit ratings in the financial system:

- First, credit rating agencies are providers of independent credit opinions.
- Second, their opinions speak to forward-looking and longer term credit risk to bond investors.
- Third, credit rating agencies compete among a number of opinion providers and market signals that offer different measures of credit risk.
- Fourth, the success of a credit rating agency depends on its ability to consistently provide predictive opinions about relative credit risk.

Moody's believes that the market is best served when legislation and regulation of the credit rating agency industry are consistent with the role that rating agencies play in the market.

A. 2006 Act

In September 2006, the 2006 Act was passed into law, establishing a formal regulatory regime for credit rating agencies for the first time. Specifically, it amended the Securities Exchange Act of 1934 by authorizing the Securities and Exchange Commission ("**SEC**") to oversee rating agencies that choose to apply for and become recognized by the SEC as NRSROs. The objective of the 2006 Act 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 agency industry".[2] The legislation sought to:

a) enhance accountability by providing the SEC with oversight authority to assess the continued credibility and reliability of NRSROs;

b) promote competition through a clear process by which a credit rating agency can apply for and receive NRSRO designation; and

c) improve transparency by requiring NRSRO to make publicly available most of the information and documents submitted to the SEC in their applications.

In June 2007, the SEC published rules to implement the 2006 Act and achieve rigorous oversight of NRSROs, and on September 24, 2007, Moody's became a registered NRSRO. The SEC adopted additional final rules in February 2009 and November 2009. These initial and supplemental SEC rules have included, for example:

- Transparency requirements: concerning credit rating methodologies, rating performance, internal processes, and information pertaining to conflicts of interest.
- Conflict management requirements: regarding limits on the percentage of total net revenue an NRSRO can receive from any person or entity soliciting a credit rating, barring analysts from rating securities they own, and prohibiting analysts from making recommendations to any rated issuer.

In addition, using the statutory authority created under the 2006 Act, the SEC has conducted multiple examinations of NRSROs on a variety of subject matters.

B. The Dodd-Frank Act

In July 2010, the Dodd-Frank Act was signed into law to, among other things, *"promote the financial stability of the United States by improving accountability and*

---

2 2006 Act, Preamble.

transparency in the financial system…".[3] The Dodd-Frank Act has affected a number of institutions and industries, including credit rating agencies. Moody's is committed to implementing those provisions that are specific to our industry as effectively as possible.

Title IX, Subtitle C of the Dodd-Frank Act seeks to, among other things, enhance transparency and accountability in the credit rating agency industry, as well as strengthen management of conflicts of interest and reduce regulatory use of credit ratings. Moody's supports these objectives, and we believe they are positive for our industry and the broader market.

In particular, Moody's has long-supported removing references to credit ratings in regulation. Mechanical triggers, regardless of whether they are based on ratings, market signals or another type of measure, can inadvertently harm markets by amplifying rather than dampening the risks in the system. Specifically, automatic triggers can cause involuntary and mandatory reactions, such as augmenting capital cushions or divesting of exposures, with little room for discretion to consider more tempered responses. We caution that risks to market safety and stability will remain so long as any alternative measuring system is used to trigger overly mechanistic responses.

The majority of the provisions in Subtitle C seek to regulate the activities of those credit rating agencies that are registered as NRSROs. The general framework of Subtitle C can be categorized under two broad headings:

1) Provisions that will take effect after the SEC implements new rules.
2) Provisions that became effective immediately.

Over the past year, the SEC has been proposing rules and seeking comments for studies, as mandated by the Dodd-Frank Act. The SEC's published calendar for rule-making indicates that it expects to complete the rule-making process for NRSROs by the end of 2011. Moody's has submitted comments, and will continue to provide our views, throughout the SEC's established public comment process.

---

[3] Dodd-Frank Act, Preamble.

As the SEC continues its rule-making, we anticipate that the new rules will spur various changes in Moody's processes and operations, as well as lead to the codification and deepening of some of Moody's existing practices. In addition, because the majority of the provisions of the new requirements will be implemented through SEC rule-making, some uncertainty remains with respect to the final form and content of the overall regulatory regime for NRSROs. As rules develop and as our processes change in response, we intend to continue our communications with the market and policy makers.

***

While we anticipate that the evolving regulatory landscape will lead to further changes in Moody's processes, our objective remains what it has been for the past 100 years: to provide the highest quality credit opinions, research and analysis.

Thank you again for inviting me to testify on this important matter, and I look forward to answering your questions.

ANNEX

Moody's Initiatives to Strengthen the Quality, Transparency and Independence of Our Credit Ratings

To assist the Subcommittee in its deliberations, this Annex summarizes various initiatives to strengthen the quality, transparency and independence of our ratings that Moody's has undertaken in the past couple of years.

The SEC has not completed the rulemaking required under the Dodd-Frank Act. Our processes will, of course, be changed and enhanced as a result of additional rules adopted by the SEC. Those anticipated modifications to our policies and practices are not catalogued below. Rather, this Annex includes only those initiatives that are currently in place. Moreover, this summary is intended to illustrate the types of initiatives we have been pursuing but is not a comprehensive list of all such initiatives.

I. General

» ***Revised Major Policies:*** We revised several core policies in 2010 to reflect changes we have made to our structures, practices and systems as part of our ongoing efforts to implement regulatory reforms and enhance confidence in the quality, integrity and independence of our ratings. Among other things, we revised the Moody's Investors Service Code of Professional Conduct ("**MIS Code**"), the Moody's Corporation ("**MCO**") Code of Business Conduct, and the MCO Securities Trading Policy.

II. Strengthening Analytical Quality of Credit Ratings

» ***Established Macroeconomic Board:*** In prior publications we explained how, as part of our efforts to promote greater consistency across rating groups, credit opinions now incorporate a common, central macroeconomic scenario and alternative risk scenarios that are developed by MIS on a semi-annual basis. We publish these scenarios as part of our Global Risk Perspectives series. In 2010, in response to MIS's perception of the significance of macroeconomic assessment as part of the ratings process, MIS established the Moody's Macroeconomic Board. The Macroeconomic Board is chaired by MIS's Chief Credit Officer and consists of Moody's economists and sovereign analysts. Broadly, the Macroeconomic Board is responsible for: (1) determining a consistent set of macroeconomic forecasts for use in the rating process; (2) facilitating analysts' access to these forecasts; and (3) encouraging the development of macroeconomic sensitivity analysis within each sector.

» ***Recalibrated U.S. Public Finance Ratings:*** In 2010, we recalibrated our long-term U.S. public finance credit ratings to our global rating scale, thereby enhancing the comparability of ratings across the MIS-rated universe.

- » ***At Least Annual Reviews of Ratings:*** Except for ratings that clearly indicate they do not entail ongoing monitoring, once MIS publishes a rating, we monitor it on an ongoing basis and modify it as appropriate in response to changes in our opinion of the creditworthiness of the issuer or obligation. Prior versions of the MIS Code reflected our commitment to this monitoring through periodic reviews as well as reviews triggered by MIS's receipt of information that might reasonably be expected to result in a rating action. In 2010, we enhanced this provision to reflect our intention to conduct at least annual reviews of all credit ratings, except those that expressly indicate that they are not subject to ongoing monitoring.
- » ***Annual Methodology Reviews:*** In the past few years Moody's has reinforced the independence of our Credit Policy function and taken steps to enhance our existing methodology review and approval processes, under the oversight of the Credit Policy Group. For example, we revised the MIS Code in 2008 to codify our practice of conducting periodic methodology reviews and expressly assign responsibility for these reviews to the Credit Policy Group. In 2010, we further revised the MIS Code to provide that such reviews will be conducted at least annually.
- » ***Methodological Initiatives:*** On an ongoing basis, MIS takes steps to update and enhance the predictive content of its rating methodologies. In addition, since late 2009, we have pursued a number of major methodological initiatives. These include: (1) adopting a new money market fund rating methodology and symbols; (2) revising our guidance on how we assess hybrid securities; (3) proposing a set of operational risk principles to be considered in ratings of structured finance transactions; (4) publishing two sets of guidance on our approach to global standard adjustments in our analysis of the financial statements of financial institutions and non-financial companies, respectively; (5) publishing guidance on the circumstances in which we will, or will not, rate contingent capital securities; (6) seeking comment on alternative approaches for assessing the impact of temporary missed debt payments; and (7) proposing an update to our joint support methodology for letter of credit-backed transactions in the U.S. municipal market.

III. Improving Transparency of Credit Ratings and Ratings Process

- » **Enhanced disclosures associated with credit rating announcements:** Since late 2009, MIS has introduced a variety of enhancements to the disclosures incorporated into most credit rating announcements. For example, MIS now discloses in most rating announcements: (1) the types of information sources used to prepare the credit rating; (2) if an obligation is supported by a new asset type or possesses a unique structural feature that is significant and noteworthy to the market; (3) that MIS considers the quality of the information available with respect to the issuer or obligation satisfactory for the purpose of assigning or maintaining the credit rating, as applicable; (4) if a rating action is based on limited historical data; and (5) if the rating was initiated by MIS and not requested by the issuer or if the issuer did not participate in the rating process. In addition, MIS's credit rating announcements in respect of structured finance instruments also now disclose, among other things whether or not MIS received and took into account any third party due diligence reports on the underlying assets and, if so, the impact, if any, such reports had on the rating.

» ***Added structured ratings indicator:*** Since August 2010, MIS has been using a structured finance ratings indicator on a global basis for its new and existing credit ratings. The indicator, which takes the form of "(sf)", appears following the rating in all MIS press releases and research reports.

» ***Added hybrid indicator for financial institutions:*** In January 2011, MIS began using a hybrid securities indicator on a global basis for all its new and existing credit ratings of hybrid instruments issued by financial institutions. The hybrid indicator, which takes the form of "(hyb)", signals the potential for ratings volatility due to the securities' equity-like features and the potential impact of hard to predict events such as regulatory or government intervention.

» ***Extended rating history data files:*** In 2009, MIS began publishing complete rating histories in a downloadable, machine-readable file for a random sample of 10% of credit ratings. In 2010, MIS also began publishing a separate, downloadable, machine-readable file containing rating histories for all MIS credit ratings that MIS initially determined on or after June 26, 2007. These data files are now available in XBRL format. These data files supplement the various ratings performance studies that MIS makes available to the public on the Ratings Performance page on moodys.com.

» ***Research focusing on areas of interest for users of ratings:*** To improve transparency, MIS has been publishing additional research for those areas where users of our ratings have expressed a particular interest. These areas are subject to changes in the market and the needs of users of our ratings. For example, given the increased level of interest in U.S. public finance issuers, we have, among other things, published an updated default study, a series of comments on state and local government issuers' pension obligations, a series on market access rollover risks of short-term debt and bank-supported debt instruments, in-depth research on the credit risks posed by governance and management at not-for-profit issuers like hospitals and universities, and a comparison of U.S. states to companies. We also launched the Muni Monitor, a periodic compilation of key research on the most pressing issues in the U.S. public finance market. In both 2009 and 2010, we published a series of "Roadmaps" that identified the key credit factors we expected to be prominent in our analysis of U.S. public finance obligations over the coming year. In the financial institutions sector, we revised the format of our Banking System Outlooks by introducing a consistent set of credit factors and metrics to enhance the clarity and comparability of our analysis across regions. We also have published a number of special comments outlining how we conduct "stress tests" in the financial institutions sector and analyzing the stress tests being conducted by financial sector authorities.

IV. Bolstering Measures to Manage Conflicts and Promote Analytical Integrity

» ***Reinforced operational segregation of credit rating and credit policy functions from commercial functions:*** MIS analysts have been prohibited for quite some time from discussing fees with issuers and, several years ago, we extended this prohibition to managers of rating teams. In 2010, we further enhanced the operational segregation of the credit rating/policy functions from commercial functions by establishing the MIS Commercial Group. It is responsible for business strategy and planning, new business origination, and business relationships with issuers. Members of the Commercial Group do not have any involvement in determining or monitoring credit ratings or developing or approving rating methodologies.

V. Enhancing Resources and Their Use in Key Areas

» ***Compliance:*** MIS continues to add resources allocated to our Compliance function to facilitate policy development, monitor adherence to policies and conduct training. For example, in 2010-11, we created and staffed four management-level positions. Two of these new positions focus on compliance at a regional level, while the other two positions have global responsibilities relating to, among other things, policy development, training, and the investigation and resolution of alleged breaches of policies.

» ***Change Leadership:*** In 2010, we created and staffed a managing director ("**MD**") level position at MIS focusing on change leadership. Our new MD of Global Operations is working with management of MIS and others to integrate the broad spectrum of resource, project and change management activities underway in MIS in order to address changes in the regulatory and competitive environment, improve MIS's operational efficiency and better position MIS to achieve its strategic objectives.

» ***Quantitative Tools:*** In 2010, MIS created new teams within the rating groups to focus on developing and expanding the quantitative tools that support MIS's credit analytical functions. These teams are being staffed primarily by existing employees who have special skills in data analysis and computational engine development as well as knowledge of MIS's rating operations.

- ***Board Oversight:*** In 2010, the board-level oversight of certain MIS activities was strengthened. Enhancements at the board level include allocating to independent directors responsibilities for, among other things, overseeing MIS's policies and procedures for determining credit ratings, internal controls relating to those policies and procedures, and policies and procedures relating to conflicts of interest.
- ***Surveillance Initiatives:*** MIS continues to enhance its approach to ratings surveillance across the various rating groups. For example, since late 2009, MIS has hired additional analysts focusing on surveillance of U.S. local government issuers and is investing further in technology to enhance the surveillance process in this sector.
- ***Training:*** Since late 2009, we have enhanced our training programs in three key areas: knowledge and skills training for analysts, leadership and management training, and compliance training. For example, we have extended the range of courses offered as part of our continuing education program for analysts, delivered more classes in-person in MIS's smaller offices, added courses targeted to the specific needs of smaller analytical groups, and provided more courses targeting soft skills such as writing and communication skills. We also are launching a curriculum-based training program for junior analysts that is based on a common framework, which is then tailored to the needs of specific geographic regions and analytical sectors. Our online and instructor-led management training programs enhance our operational efficiency and better position those with management responsibilities to develop and motivate MIS employees as well as promote MIS's values of integrity, independence, insight, inclusion and intellectual leadership. Our compliance training programs are designed to inform MIS employees of new regulatory requirements, reinforce their understanding of existing compliance policies and procedures and provide additional opportunities for employees to seek guidance from Compliance staff on the interpretation of specific requirements.
- ***Enhanced Middle Office Frees up Analytical Resources:*** As part of MIS's efforts to improve its operational efficiency, certain tasks relating to the rating process that do not require credit analysis have been transferred from rating teams to MIS's Global Middle Office ("**GMO**"), thereby enabling our analysts to devote more of their time to analytical work. For example, the preparation and dissemination of rating letters, which communicate to the issuer the rating assigned by MIS, are now carried out by our GMO.

TESTIMONY OF DEVEN SHARMA

PRESIDENT, STANDARD & POOR'S

BEFORE

THE UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

JULY 27, 2011

Chairman Neugebauer, Ranking Member Capuano, members of the Subcommittee, good morning. My name is Deven Sharma. I am the president of Standard & Poor's ("S&P") and have served in that capacity since September 2007. I am pleased to appear before you today.

While much has changed with regard to credit ratings and credit rating agencies over the course of the past several years, our fundamental mission at S&P remains the same: to provide the market with independent benchmarks about the creditworthiness of debt securities. Towards that end, at S&P, we have undertaken a variety of initiatives designed to strengthen our governance and control framework, to enhance the analytics and criteria we use to rate issues and issuers, and to clearly communicate the rationale behind our actions and better identify and report on key areas of risk in order to further transparency in the markets.

In that regard, while S&P has undertaken changes on its own, we have also supported, and adapted our processes to address, many changes that have occurred in the regulatory environment, both here and overseas. Through legislation and related rule-making, regulatory changes have reinforced and strengthened the integrity of the ratings process through increased oversight, greater transparency and accountability, and improved quality in analyst training. They have also addressed undue reliance on ratings by the market, particularly by removing legal requirements mandating the use of credit ratings — an effort S&P has long supported. S&P has taken major steps to meet these new regulatory expectations and integrate our reform initiatives into them. I will address these changes in my testimony.

S&P's Credit Ratings:

At the outset, I would like to take a moment to speak generally about S&P and our ratings process, as well as explain what ratings are and are not intended to convey. Over the course of its history, S&P has sought to help create transparency in capital markets by providing independent credit benchmarks. Investors and other market participants have long 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 provide valued perspectives they may use in their important deliberations about making investment decisions.

An S&P credit rating reflects our current view about the ability and willingness of an issuer to meet its financial obligations in full and on time. S&P's ratings are not statements of fact, but rather expressions of opinion about the likelihood that certain events will or will not happen in the future. S&P's ratings do not speak to what the market value of a security should be or the potential volatility of its price, both of which can be significantly affected by factors other than underlying creditworthiness. Importantly, S&P's ratings do not make recommendations to buy, sell or hold a security. Rather, they simply provide the market with a forward-looking view based on analysis that different market participants — whether they be investors, issuers, or regulators — may choose to use as part of their own assessment of the credit risks attendant to a particular security or entity.

S&P forms its ratings through quantitative and qualitative analysis performed by rating analysts applying analytical criteria that we publish to the market. These analysts gather information about a particular obligor or debt issue, analyze the information according to our criteria, form views about the information and then present their findings to a committee of analysts that votes on what ratings to assign. After a public rating is formed, S&P publishes it in real-time and for free on our Web site, www.standardandpoors.com. S&P also generally publishes a narrative along with our ratings that provides detailed information about our opinion.

Our ratings are intended to convey a reasonably comparable view of creditworthiness across asset classes over time. That is, when we assign a particular rating to a manufacturing company, for example, we mean to connote that in our view the creditworthiness of that company is reasonably comparable to the creditworthiness of a telecommunications corporation receiving the same rating.

Our goal is to provide the public with timely, quality ratings and with insights and understanding as to the analysis that underlies them.

Initiatives undertaken by S&P:

Since 2008, we have undertaken a number of initiatives aimed at promoting four broad objectives: (i) ensuring the integrity and independence of the ratings process; (ii) enhancing analytical quality; (iii) providing greater transparency to the market by disseminating more information about ratings, as well as information to help investors form their own views of the soundness of rating analysis; and (iv) more effectively training our analysts and educating the marketplace about ratings.

We have made significant investments and enhancements to our internal processes and controls in these areas. Some examples include:

Actions taken to ensure integrity and independence:

- Investing significantly in our compliance and quality operations, including significant staffing additions;
- Establishing an independent criteria review and approval process. Our independent criteria team is now responsible for the approval of criteria;
- Establishing a Risk Assessment Oversight Committee, comprising senior leaders from various parts of S&P who are independent of rating teams, to identify and address current and emerging risks;

- o Implementing a robust quality review program, through which independent quality officers review our analysts' compliance with procedures and policies;
- o Supplementing existing controls against potential conflicts of interest. For example, in addition to our traditional use of a committee process and separation of commercial and analytical functions, we have also implemented "look-back" reviews and an analyst rotation program;
- o Establishing an independent Policy Governance Group with a mandate to develop and approve all new ratings policies and procedures. This group is also responsible for maintaining policies that are clear, measurable, and consistent with our quality standards; and
- o Increasing compliance oversight and training, including reinforcement of prohibitions on structuring or providing advice to issuers;

Actions taken to strengthen analytics:

- o Adopting enhanced ratings definitions and updating our criteria across most major asset classes to map it to those definitions. This has enhanced ratings comparability across asset classes and across geographic regions as criteria is now calibrated to meet these more specific definitions. It has also led us on balance to look for stronger credit characteristics for securities seeking higher ratings;
- o Creating an independent Model Validation Group with responsibility for reviewing models used in the ratings process; and
- o Enhancing the ratings process with respect to data and information, as well as introducing additional analysis such as sensitivity scenarios;

Actions taken to increase transparency:

- o Launching a new corporate Web site which provides easier access to credit ratings and various reports and articles, including criteria, relevant to the ratings process. In addition, the new Web site has enhanced search functionality;
- o Enhancing disclosure of applicable factors and variables in our ratings reports of applicable criteria and the assumptions underlying our analysis; and
- o Publishing a number of "what if" scenario analyses to provide the market with our views on the possible rating effects of potential scenarios before they occur;

Actions taken on training and education:

- o Increasing analytical training and education of our analysts, and introducing a new Analytical Certification Program which our analysts fulfill in order to act as a primary analyst on a rating or to vote in a rating committee;
- o Increasing the distribution of information about our ratings performance, as well as ratings transitions, via several newsletters the company publishes, as well as audio and visual presentations; and

- Publishing a "Guide to Credit Ratings Essentials" that provides important information about ratings and their role in the markets.

Let me assure you that the various improvements I have discussed are substantive and they have had a real impact on the personal and professional lives of our more than 1,300 analysts worldwide, with numerous additional analytical and process requirements, new controls throughout the ratings process and increased checks and oversight of their work. The organization, with added checks and balances as well as enhanced analytics, operates in a different way today. We have gone to great lengths to take serious and meaningful initiatives in the way we produce our credit ratings and we believe we are better serving investors, regulators, and the capital markets. S&P will spend over $90 million this year in the changes we are making in our compliance and oversight framework; over the past 5 years, we have spent more than $300 million. Historically, ratings have served as a valuable tool for evaluating the creditworthiness of issuers and debt securities. We believe firmly that with these enhancements in place our ratings will continue to be a meaningful part of the information available to investors and other market participants going forward.

The Credit Rating Agency Reform Act and Related Rulemaking:

Of course, the regulatory landscape for credit ratings has also undergone major change. The passage of the CRARA in 2006 established the first comprehensive regulatory scheme governing credit ratings, chiefly by establishing a registration and application system for those credit rating agencies seeking registration as a nationally recognized statistical rating organization ("NRSRO"). As detailed in that law, the NRSRO application requires the disclosure of a wide variety of information, including, among other things, information on the NRSRO's procedures and methodologies for determining ratings; performance measurement statistics for credit ratings; and a description of the NRSRO's policies for preventing the misuse of material, non-public information and for addressing and managing potential conflicts of interest.

The CRARA gave the Securities and Exchange Commission ("SEC") broad oversight and enforcement powers over NRSROs, through extensive examination and inspection authority, as well as the power to take disciplinary action against NRSROs — whether by censure, fines, or even revocation of their registration in certain circumstances. The CRARA also granted the SEC broad authority to promulgate rules implementing the new law. Thus far, the SEC has completed three waves of rulemaking which have resulted in a vigorous set of governing rules for NRSROs and the credit rating process.

The first set of SEC rules, which became effective in June 2007, addressed a number of topics. Under these rules, certain practices are prohibited outright, such as issuing ratings for entities that provided the NRSRO with ten percent or more of its net revenue in the most recent fiscal year, or conditioning the issuance of a credit rating on the purchase of other services or products provided by the NRSRO. The rules also require that certain practices must be disclosed and managed, such as the receipt of compensation for ratings analysis (from either issuers or subscribers) and the provision by NRSROs of non-ratings services to issuers. Extensive record-keeping requirements and disclosure to the SEC of financial information, including revenues received from large issuers, are also required under the initial rules.

In 2008, the SEC adopted a second wave of rules governing NRSROs. Among other things, these new rules require enhanced disclosures of ratings performance data, rating methodologies, and when certain ratings deviate materially from the output suggested by rating models. The 2008 rules also prohibit NRSROs from rating an issuer or security if the NRSRO provided recommendations to the issuer; and from rating an issue or issuer if it receives gifts of more than de minimis value. Under a third set of rules adopted in 2009, the SEC requires NRSROs to facilitate the disclosure to other NRSROs of underlying data provided by issuers, so as to allow those NRSROs to issue unsolicited ratings on structured finance securities if they so wish.

The CRARA also empowered the SEC to conduct detailed and lengthy examinations of NRSROs' practices and procedures. In S&P's case, the first such exam began shortly after implementation of the 2007 rules and focused on its ratings of structured finance securities. The exam involved dozens of meetings and interviews and the production of a significant volume of documents. It resulted in recommendations which we have sought to implement on topics including staffing and resource levels, documentation of policies and procedures and potential conflicts of interest, and ratings analysis, including surveillance of existing ratings. A second SEC examination began in late 2010 and the results of this additional extensive exam are pending.

In practice, the CRARA has also lowered barriers to entry for other credit rating agencies to register as NRSROs, and several new NRSROs have been registered in recent years. New NRSROs include rating agencies that employ different business models, such as the "investor pays" model, and/or different processes and methodologies to determine their ratings. The result is an increase in the information and breadth of views available to investors in the market. In our view, this is a good development, and S&P welcomes the competition these additional NRSROs provide.

Amendment of the CRARA by Dodd-Frank:

The Dodd-Frank Act, signed into law just over a year ago, amends the CRARA to impose several new requirements on NRSROs which promote the quality and transparency of credit ratings as well as regulatory oversight of the ratings processes. S&P has been active in taking steps to comply with the Act. These steps include the formation of a new Board including independent members, which is charged with overseeing the establishment, maintenance, and enforcement of S&P's policies and procedures regarding credit ratings and conflicts of interest, as well as overseeing the effectiveness of our internal control system with respect to ratings policies and procedures.

Several other Dodd-Frank requirements — many of which S&P had already undertaken on its own initiative — and SEC powers are already in effect, or will go into effect pending on-going rulemaking by the SEC. These include:

- The separation of compliance functions from ratings and sales; maintaining separations between marketing and analytical activities; and look-back reviews when employees leave NRSROs to work for rated entities.
- Provisions directing NRSROs to consider any information they find "credible and potentially significant to a rating decision" as part of the ratings process.
- Provisions directing NRSROs to refer alleged securities law violations to authorities.
- Whistleblower protections: Federal whistle-blower protections are now extended to NRSRO employees.
- Elimination of Statutory References to Credit Ratings: Dodd-Frank requires that federal agencies review their use of credit ratings in rules and regulations, and that, within two years of enactment of the Act, statutory references to credit ratings be removed from several areas of federal law.
- Initial Credit Rating Assignments for Structured Finance Products: The SEC is studying the feasibility and advisability of a proposal which would establish an SEC-run assignment system for initial ratings of structured debt.

The SEC's rulemaking process is underway to implement the requirements of the Dodd-Frank Act, and S&P is reviewing those proposed rules closely as part of the public comment process.

The Importance of Analytical Independence:

We at S&P certainly share the goal of enhancing the transparency, integrity and quality of ratings and the ratings process. We also firmly believe that perhaps the most important value of ratings is their independence. At its core, a rating is an analytical determination. A group of knowledgeable and well-trained analysts, with years of experience working in the financial markets, sit down to analyze a set of facts together with historical information to develop a forward-looking opinion that others may use as a benchmark in connection with their own analysis. For the markets to have confidence in those ratings, they must ultimately represent the independent view of the rating agency. That means, of course, that they should be free of undue commercial considerations — and S&P is fully committed to that principle — but it also means that they must be free of undue regulatory or governmental influence as to their substance.

S&P supports a transparent system in which the market has the benefit of an NRSRO's complete and independent view of a bond or security, along with a clear understanding about the different aspects of creditworthiness that ratings do and do not 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 account for. Similarly, the independence of rating agencies to develop their own methodologies, rather than be pushed by regulation toward a common methodology, mitigates the systemic risk that ratings could become indistinguishable from agency to agency. In a global economy where we rate more than 120 sovereign governments, it is particularly important that rating methodologies not become subject to influence by one or more countries seeking to benefit its own rating, which would undermine the independence, comparability and value of ratings to all. Accordingly, as rulemaking associated with the Dodd-Frank Act progresses, it is critical that new regulations preserve the ability of NRSROs to make their own analytical decisions without fear that those decisions will later be second-guessed if the future does not turn out as anticipated or that, in publishing a potentially controversial view, they will expose themselves to regulatory retaliation. Pressures of that sort could only undermine the significant progress we believe has been made over the years by rating agencies and regulators alike to provide the market with transparent, quality, and genuinely independent opinions about the creditworthiness of issuers and their securities.

I thank you for the opportunity to participate in this hearing, and I would be happy to answer any questions you may have.

COLORADO PERA

Testimony of

Gregory W. Smith

General Counsel & COO

Public Employees' Retirement Association of Colorado

before the

Subcommittee on Oversight and Investigations

of the

Committee on Financial Services

on

Oversight of the Credit Rating Agencies Post Dodd-Frank

July 27, 2011

COLORADO PERA

Testimony of
Gregory W. Smith
General Counsel & COO
Public Employees' Retirement Association of Colorado
before the
Subcommittee on Oversight and Investigations Subcommittee
of the
Committee on Financial Services
on
Oversight of the Credit Rating Agencies Post Dodd-Frank
July 27, 2011

Table of Contents

TABLE OF CONTENTS

COLORADO PERA

Testimony of
Gregory W. Smith
General Counsel & COO
Public Employees' Retirement Association of Colorado
before the
Subcommittee on Oversight and Investigations
of the
Committee on Financial Services
on
Oversight of the Credit Rating Agencies Post Dodd-Frank
July 27, 2011

Full Text of Statement

Mr. Chairman, Ranking Member Capuano, and Members of the Subcommittee:

Good morning. I am Gregory W. Smith, general counsel and COO of the Colorado Public Employees' Retirement Association (Colorado PERA) and board member of the Council of Institutional Investors (Council).

I am pleased to appear before you today on behalf of Colorado PERA to share with you my views on the topic of oversight of credit rating agencies subsequent to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

My testimony begins with a brief overview of Colorado PERA and the Council. The bulk of testimony sets forth Colorado PERA's views on five issues that Subcommittee staff indicated that I might address as part of my testimony at this important hearing: (1) Whether Colorado PERA's utilization of credit ratings has changed since the passage of Dodd-Frank; (2) Whether Dodd-Frank's required removal of references to credit ratings in all federal statutes and regulations will benefit Colorado PERA and other institutional investors; (3) Whether credit rating agencies have self-corrected their practices since the passage of Dodd-Frank; (4) Whether credit rating agencies are held to a sufficient level of liability under Dodd-Frank; and (5) Whether the provisions of Dodd-Frank intended to improve transparency of credit rating agencies are likely to be effective.

***Colorado PERA*[1]**

Colorado PERA provides retirement and other benefits to more than 476,000 plan participants and beneficiaries of more than 400 government agencies and public entities in the state of Colorado. We are the 21st largest public pension plan in the United States (U.S.) with invested assets of more than $40.2 billion. We maintain a diversified portfolio of investments, including approximately 22% in domestic fixed income securities, while adhering to a long-term, strategic asset allocation policy.

***The Council*[2]**

Colorado PERA is an active member of the Council of Institutional Investors. The Council is a not-for-profit association of public, corporate, and labor pension funds with combined assets exceeding $3 trillion. Council members are responsible for investing and safeguarding assets used to fund the pension benefits of millions of participants and beneficiaries throughout the U.S. Similar to Colorado PERA the average Council member has approximately 25% of its portfolio in domestic fixed income securities.[3]

Over the last three years, the Council has taken an active role on policy issues relating to credit rating agencies, including (1) a membership approved statement on credit rating agencies and other financial gatekeepers supporting

[1] For more information about Colorado Public Employees' Retirement Association (Colorado PERA), see Colorado PERA's website at http://www.copera.org/pera/about/overview.htm.
[2] For more information about the Council of Institutional Investors (Council), see the Council's website at http://www.cii.org/about.
[3] Council of Institutional Investors, 2011 Asset Allocation Survey (forthcoming).

continued reforms "to ensure the pillars of transparency, independence, oversight and accountability are solidly in place;"[4] (2) membership endorsed recommendations of the Investors' Working Group (IWG) on reforming credit rating agencies;[5] and (3) a Council commissioned white paper entitled "Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective."[6] All three items are included as attachments to this testimony.

Whether Colorado PERA's utilization of credit ratings has changed since the passage of Dodd-Frank

It is important to note that neither prior to the financial crisis, nor after the passage of Dodd-Frank, has Colorado PERA ever relied on ratings, including those issued by Nationally Recognized Statistical Rating Organizations (NRSROs), as a sole source of buy/sell decisions. Rather, credit ratings are used as a part of the mosaic of information we consider during the investment process. Many institutional investors approach ratings in the same manner. Relying exclusively on ratings would be a failure to fulfill their fiduciary obligations.

---

[4] Council of Institutional Investors, Statement on Financial Gatekeepers 1 (revised Apr. 13, 2010), http://www.cii.org/UserFiles/file/Statement%20on%20Financial%20Gatekeepers.pdf (see Attachment 1).

[5] Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective 19-21 (July 2009), http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%27%20Working%20Group%20Report%20(July%202009).pdf (see Attachment 2). Following its issuance, the Investors' Working Group (IWG) Report was reviewed and subsequently endorsed by the Council board and membership. For more information about the IWG, please visit the Council's website at http://www.cii.org/iwgInfo.

[6] Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective* (Apr. 2009), http://www.cii.org/UserFiles/file/resource%20center/publications/CII%20White%20Paper%20-%20Rethinking%20Regulation%20of%20CRAs%20April%202009.pdf (see Attachment 3).

As for Colorado PERA, traditionally, our first step in contemplating an investment is to define our risk tolerance and then determine what type of allocation is necessary to stay within that field. Ratings have proven to be useful as a first cut to identify instruments eligible for further consideration and analysis. Without such a tool, we and many other investors would have no initial way to screen literally tens of thousands of new instruments that we consider each year.

Ratings are also used to aid Colorado PERA in establishing the initial risk parameters for both our internal and outside portfolio managers. In addition, they serve as an important factor in our decision to participate in short term credit facilities, such as cash accounts and money market funds.

We fully agree with the conclusions of the Financial Crisis Inquiry Commission and many others that "the failures of credit rating agencies were essential cogs in the wheel of financial destruction."[7] In light of those failures, and the credit rating agency provisions of Dodd-Frank, Colorado PERA has begun to reevaluate our internal use of credit ratings. We are currently in the process of consulting with internal fund managers and outside experts in order to identify appropriate alternative measures of risk. We are hopeful that such measures can also be used to help define in our investment management agreements the level of risk to be taken by individual portfolio managers. The process is a

---

[7] The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report *xxv* (Jan. 2011), http://www.gpoaccess.gov/fcic/fcic.pdf.

challenging one in that to-date no single appropriate substitute for a robust, objective evaluation of credit risk has yet been discovered.

However, we believe that our initiatives and the contributions of other groups wrestling with the same challenge will result in the identification of alternative methodologies to efficiently evaluate the risk properties of investment products. Ideally, the alternative approach would be an accurate reflection of the risk parameters we aim to measure, and be forward-looking, objective, easy to verify, and simple to compute.

In addition to our efforts to identify alternative measures of credit risk, we are also working to establish procedures for evaluating the additional disclosures rating agencies will be required to make under new SEC proposed rules as mandated by Dodd-Frank. Colorado PERA intends to take full advantage of the increased disclosure requirements, discussed further below, in order to better assess the soundness of an individual credit rating, the risks of the rated security itself, and the overall value of a rating agency's work.

Whether Dodd-Frank's required removal of references to credit ratings in all federal statutes and regulations will benefit Colorado PERA and other institutional investors

Colorado PERA has some general concerns about Section 939A of Dodd-Frank that requires each regulatory agency to review any regulations issued that require the use of an assessment of the credit-worthiness of an issuer, security or money market instrument and any references to or requirements regarding credit ratings. After identifying such regulations, the agencies are to remove any reference to or requirement of reliance on credit ratings and to substitute standards of credit-worthiness as each agency deems appropriate.

Colorado PERA shares legislators' interest in reducing widespread reliance on credit ratings in securities industry regulations. We appreciate the difficult task the U.S. Securities and Exchange Commission (SEC or Commission) and other regulators have been charged. However, we believe the use of a robust indicator of credit quality in industry regulations is systemically important to controlling risk in the financial system.

As described above, Colorado PERA has taken deliberate steps to begin to identify suitable alternative measures of credit risk. We applaud the work regulators, such as the SEC, the Commodity Futures Trading Commission and the Federal Reserve, have done thus far to lessen their reliance on ratings. However, just as it is not feasible or practical for us or other institutional investors to simply stop using credit ratings altogether, it may not be feasible or practical for federal agencies to strike, in one fell swoop, ratings from all of their rules and regulations.

Mandates to use ratings have become part of the fabric of financial regulations, and cannot be unwoven instantaneously. The more practical course for the near term is for the SEC to continue its work to reform the credit rating industry with rules promoting transparency, instilling accountability and reducing conflicts of interest. In the long-term, regulators and market participants must work in tandem to reduce their reliance on ratings.

We are concerned that hasty efforts to eliminate credit ratings prior to the development of effective substitute tools increases risk to investors, the regulatory environment of insurance companies, banking institutions and others whose capital and reserve requirements are dependent, in part, upon credit ratings, as well as counterparty risk. Therefore, we encourage regulators to take a careful, deliberate approach to eliminating references to ratings over time.

Whether credit rating agencies have self-corrected their practices since the passage of Dodd-Frank

While credit rating agencies clearly have made changes to their practices since the passage of Dodd-Frank, there remains some stubborn facts indicating that industry practices that enabled the financial meltdown are not likely be self-correcting.

First, I would note that the three largest credit rating agencies, that issue about 98% of the total credit ratings in the U.S.,[8] continue to operate under a fundamentally conflicted system that was a significant factor responsible for the

[8] Staff of S. Permanent Subcomm. on Investigations, 112th Cong, Rep. on Wall Street and The Financial Crisis: Anatomy of a Financial Collapse 247 (Apr. 13, 2011), http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf.

inaccurate credit ratings leading up to the financial crisis.[9] As the Senate Permanent Subcommittee on Investigations explained:

> The Subcommittee's investigation uncovered a host of factors responsible for the inaccurate credit ratings . . . . One significant cause was the inherent conflict of interest arising from the system used to pay for credit ratings. Credit rating agencies were paid by the Wall Street firms that sought their ratings and profited from the financial products being rated. Under this "issuer pays" model, the rating agencies were dependent upon those Wall Street firms to bring them business, and were vulnerable to threats that the firms would take their business elsewhere if they did not get the ratings they wanted. The ratings agencies weakened their standards as each competed to provide the most favorable rating to win business and greater market share. The result was a race to the bottom.[10]

Second, I would note that that the three largest credit rating agencies continue to be run by the same chief executive officer or president that was in charge of those respective organizations through all or much of the housing boom, the bust and the entire financial crisis.[11] Those individuals managed organizations that despite record revenues had serious operational problems that contributed to their inaccurate ratings.[12] Those problems included: (1) rating models that failed to include relevant mortgage performance data, (2) unclear and

---

[9] *Id.* at 7.
[10] *Id.*
[11] Deven Sharma was named President of Standard & Poor's in 2007. Standard & Poor's, About S&P, Americas, http://www.standardandpoors.com/about-sp/management-profiles/en/us (last visited July 22, 2011); Raymond W. McDaniel has served as the Chief Executive Officer of Moody's Corporation since 2005. Forbes.com, http://people.forbes.com/profile/raymond-w-mcdaniel/46481 (last visited July 22, 2011). Stephen W. Joynt has been the Chief Executive Office of Fitch Ratings since 2001. Algorithmics, Executive Management, http://www.algorithmics.com/EN/company/executivemanagement/1-executive.cfm (last visited July 22, 2011).
[12] Staff of S. Permanent Subcomm. on Investigations at 7.

subjective criteria used to produce ratings, and (3) inadequate staffing to perform rating and surveillance services.[13]

Whether credit rating agencies are held to a sufficient level of liability under Dodd-Frank

It is widely recognized that credit rating agencies play a gatekeeper role in the financial markets, exerting influence over the ability of corporations to raise capital and the investment options of many institutional investors.[14] We agree with the findings of the Committee on Banking, Housing, and Urban Affairs that the credit rating agencies' gatekeeper role in the financial markets "justifies the same level of . . . accountability that applies to securities analysts, auditors, and investments banks."[15] The result of those findings, in part, led the U.S. Congress to include two complimentary liability related provisions in Dodd-Frank.[16]

The first provision, Section 933, establishes a private right of action under the federal securities laws for material misstatements made by credit rating agencies in informational reports that they are required to file with the SEC.[17] For example, if a credit rating agency makes a material misstatement in their required conflict of interest disclosures to the SEC, the material misstatement

---

[13] *Id.*
[14] *See, e.g.,* Frank Partnoy at 1.
[15] Comm. on Banking, Hous., and Urban Affairs, 111th Cong., Rep. on S.3217, at 94 (Mar. 22, 2010), http://banking.senate.gov/public/_files/RAFSAPostedCommitteeReport.pdf.
[16] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376, at §§ 933, 939G (July 21, 2010), http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.
[17] Council of Institutional Investors, Dodd Frank Issue Brief: Requirements Affecting Credit Rating Agencies 2 (Apr. 2011) (on file with Council).

could be actionable by an investor under the federal securities laws. Thus, Section 933 generally subjects credit rating agencies to the same level of liability as other gatekeepers such as certain registered accounting firms and security analysts that are required to file reports with the SEC.[18]

The second provision, Section 939G, eliminates a special exemption for NRSROs from liability for material misstatements or omissions of fact relating to credit rating opinions included in issuers' registration statements.[19] The SEC originally put the special exemption in place in 1982, in part, to encourage the disclosure of credit ratings in registered offering documents.[20]

Section 939G's elimination of the special exemption for NRSROs places NRSROs in essentially the same position as auditors, investment bankers, non-NRSRO credit rating agencies, and other financial gatekeepers when they include their reports or opinions in registered offering documents.[21] In response to the implementation of Section 939G, the major NRSROs collectively refused to provide consent to issuers to reference their credit rating opinions in registration statements.[22] In addition, the SEC staff suspended indefinitely the requirement that asset-backed securities offerings include credit rating disclosures.[23] As a result, credit ratings are generally no longer included in issuer offering statements. We note that this result has to-date had little

---

[18] *See* Comm. on Banking, Hous., and Urban Affairs at 99.
[19] *See* Investors' Working Group at 21.
[20] Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933, Securities Act Release No. 33-9071, at 9 (Oct. 7, 2009), http://www.sec.gov/rules/concept/2009/33-9071.pdf.
[21] Issue Brief at 2.
[22] *Id.*
[23] *Id.*

impact on debt offerings, principally because NRSROs publish their ratings widely and contemporaneously.[24] We also note the result is generally consistent with the intent of the previously referenced requirement in Section 939A of Dodd-Frank to remove references to credit ratings in order to reduce the perceived over-reliance on ratings by both regulators and investors.[25]

In any event, in our view, Section 939G, like Section 933 of Dodd-Frank, simply holds rating agencies to the same level of accountability to investors as other financial gatekeepers that serve similar roles in the financial markets.[26] Thus, Colorado PERA, like many other investors, strongly supports these two provisions of Dodd-Frank.

Whether the provisions of Dodd-Frank intended to improve transparency of credit rating agencies are likely to be effective

As directed by the U.S. Congress through the passage of the Credit Rating Agency Reform Act of 2006 (Act), the SEC established a formal registration system and rules for credit rating agencies seeking certification as NRSROs. While the Act substantially increased the SEC's oversight of credit raters, the rating agencies' role in the recent financial crisis demonstrated the need for additional reform. In response, Congress included a number of provisions in Dodd-Frank designed to strengthen the SEC's oversight authority, address conflicts of interest and increase the transparency and accountability of rating

[24] *Id.*
[25] *Id.* at 3.
[26] *See, e.g.*, Frank Partnoy at 16.

agencies. Implementation of a large majority of those provisions is still in progress. We note that recently the SEC issued a proposed rule to implement many of those requirements.

Colorado PERA believes that the following three provisions intended to improve transparency of credit ratings and the ratings industry are likely to be most effective so long as the SEC is fully able and willing to exercise its oversight authority: (1) increased disclosure about individual ratings and the methodologies used; (2) enhanced and standardized disclosure of information about rating agency performance; and (3) a report on internal controls. The following is a brief discussion of each of those three provisions and why we believe they are likely to be effective for investors.

Individual Ratings and the Methodologies Used

Colorado PERA strongly believes that all financial gatekeepers, including NRSROs, should be transparent in their methodologies and avoid or tightly manage conflicts of interest.[27] Moreover, as recommended by the IWG, we believe more complete, prominent and consistent disclosures of conflicts are needed.[28] For those and other reasons, we strongly support Section 932 of Dodd-Frank, which directs the SEC to adopt rules to require NRSROs to publish a form with each credit rating that includes additional details about the rating and the methodology used to determine it. Under the SEC's current proposed rule, an NRSRO would be required to disclose along with a rating

---

[27] Council Statement on Financial Gatekeepers at 1.
[28] Investors' Working Group at 21.

(including an expected or preliminary rating, initial rating, upgrade, downgrade, placement on watch, affirmation or withdrawal) the version of the methodology used to determine the rating; main assumptions underlying the methodology; potential limitations of the rating, including the types of risks excluded (such as liquidity); information on the reliability, accuracy and quality of the data used; a statement on the extent to which data essential to the determination of the rating were reliable or limited; the findings of a third-party due diligence service, if used; and information relating to conflicts of interest associated with the rating.

In addition to unchecked conflicts of interest, flawed methodologies and inadequate, inaccurate data were core reasons some NRSROs continued to issue inflated ratings for complex structured finance instruments leading up to and during the financial crisis.[29] Colorado PERA firmly believes that if fully implemented, the proposed rule would provide a disincentive for rating agencies from knowingly issuing ratings based on inaccurate models using insufficient, outdated data.[30] The transparency that would result from the robust disclosure provided by this provision would allow investors the opportunity to analyze the assumptions and methodologies an NRSRO used to develop a particular rating, and evaluate whether the rating may be based on insufficient data or influenced by conflicts of interest. Disclosure of information of this sort would also promote more prudent use of credit ratings by investors.

[29] Staff of S. Permanent Subcomm. on Investigations at 244.
[30] *See, e.g.,* Staff of S. Permanent Subcomm. on Investigations at 289.

Finally, the proposed disclosures would serve as a vital market-based check on NRSROs' processes and quality of ratings.

Information about Rating Agency Performance

Section 932 of Dodd-Frank also requires the SEC to develop rules to require credit rating agencies to disclose publicly information on their initial credit ratings and subsequent changes to such ratings. The SEC's current proposed rule standardizes the way NRSROs calculate and present information about the performance of their initial ratings over time and how often a rated entity or product defaulted. The proposal was designed to result in disclosures that are simply presented, easy to understand, uniform in appearance and comparable across credit rating agencies.

The proposed enhancements to current performance disclosure rules will allow users of credit ratings to easily evaluate the accuracy of ratings over time and compare the performance of different credit rating agencies. Without quality data, investors have been unable to judge the performance of an NRSRO in terms of its ability to accurately assess the creditworthiness of issuers and obligors. The new rule will also assist both credit rating users and NRSROs by drawing attention to those rating agencies that demonstrate they have superior methodologies and competence, thus attracting new clients and enhancing competition within the industry.

Report on Internal Controls

Section 932 of Dodd-Frank builds on the current requirement that credit rating agencies have an effective internal control structure and requires each NRSRO to submit an annual report to the SEC containing, among other things, an assessment of the effectiveness of its internal control structure and its compliance with securities laws and the NRSRO's policies and procedures. The SEC's recent proposed rule addresses this provision and requests comment on whether the internal control report should be disclosed to the public.

We believe that it is necessary for the protection of investors and the U.S. financial system as a whole that NRSROs' compliance reports be publicly disclosed. Investors and other users of credit ratings would greatly benefit from access to this information, in that it would allow users of credit ratings the ability to evaluate the effectiveness of a rating agency's internal control structure and consider what impact, if any, it may have on the quality of the credit ratings issued.

Dodd-Frank also creates a new Office of Credit Ratings within the SEC charged with conducting annual examinations of each NRSRO (we note that due to budgetary uncertainties, the formation of this vital office has been postponed). Through this office, the Commission must make public an annual report summarizing the findings of all NRSRO examinations conducted that year and include the responses of NRSROs to identified regulatory deficiencies and whether previous SEC recommendations have been addressed. So long as the contents of the report are comprehensive, we expect the publication of this report to serve as a deterrent to credit rating agencies from allowing conflicts to unduly influence their ratings. The annual examination report would also provide investors with valuable information that would help them evaluate the independence and value of a rating agency's ratings.

That completes my testimony. Colorado PERA and the Council look forward to continuing to work closely with this Subcommittee, the SEC and other interested parties to ensure that credit rating agencies post Dodd-Frank will effectively and efficiently serve the needs of investors and all participants in the U.S. financial system.

Thank you, Mr. Chairman and Ranking Member Capuano for inviting me to participate at this important hearing. I look forward to the opportunity to respond to any questions.

COLORADO PERA

Testimony of
Gregory W. Smith
General Counsel & COO
Public Employees' Retirement Association of Colorado
before the
Subcommittee on Oversight and Investigations
of the
Committee on Financial Services
on
Oversight of the Credit Rating Agencies Post Dodd-Frank
July 27, 2011

Attachment 1

Council of Institutional Investors, Statement on Financial Gatekeepers

Council of Institutional Investors
The Voice of Corporate Governance

Statement on Financial Gatekeepers

The Council of Institutional Investors believes financial gatekeepers should be transparent in their methodology and avoid or tightly manage conflicts of interest. Robust oversight and genuine accountability to investors are also imperative. Regulators should remain vigilant and work to close gaps in oversight. Continued reforms are needed to ensure that the pillars of transparency, independence, oversight and accountability are solidly in place.

Auditors, financial analysts, credit rating agencies and other financial "gatekeepers" play a vital role in ensuring the integrity and stability of the capital markets. They provide investors with timely, critical information they need, but often cannot verify, to make informed investment decisions. With vast access to management and material non-public information, financial gatekeepers have an inordinate impact on public confidence in the markets. They also exert great influence over the ability of corporations to raise capital and the investment options of many institutional investors.

In recent years, the global financial crisis and financial scandals on Wall Street and at operating companies from Enron to Tyco have cast a harsh light on flawed structures and practices of gatekeepers. In many cases, poor disclosure, conflicts of interest, minimal oversight and lack of accountability helped mislead many market participants into making investment decisions that ultimately yielded huge losses. The crisis of confidence in the markets that followed spurred regulators and lawmakers to scrutinize and rein in gatekeepers.

The Sarbanes-Oxley Act of 2002 and the "global settlement" with Wall Street firms in 2003 bolstered the transparency, independence, oversight and accountability of accounting firms and equity analysts, respectively. For example, accounting firms now are barred from providing many consulting services to companies whose books they audit. And banks are not allowed to include analysts in investment banking "roadshows" and must make analysts' historical ratings and price target forecasts publicly available.

Credit rating agencies largely escaped meaningful oversight until the passage of the Credit Rating Agency Reform Act of 2006. While the act has improved disclosure and competition in the rating industry, more transparency, stronger regulation and genuine accountability are still needed. Investigations by Congress and the Securities and Exchange Commission (SEC) have uncovered repeated instances where credit raters inflated ratings on structured financial products to win business from firms that issued the debt. And rating agencies continue to face minimal accountability for the fairness or quality of their ratings. The Council welcomes further examination of financial gatekeepers by regulators, lawmakers, academics and others, to determine what changes, including new rules and stronger oversight, are needed.

(Adopted April 13, 2010)

COLORADO PERA

Testimony of
Gregory W. Smith
General Counsel & COO
Public Employees' Retirement Association of Colorado
before the
Subcommittee on Oversight and Investigations
of the
Committee on Financial Services
on
Oversight of the Credit Rating Agencies Post Dodd-Frank
July 27, 2011

Attachment 2

Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective

U.S. Financial Regulatory Reform:

The Investors' Perspective

A Report by the Investors' Working Group

An Independent Taskforce Sponsored by
CFA Institute Centre for Financial Market Integrity
and
Council of Institutional Investors

July 2009

U.S. Financial Regulatory Reform:

The Investors' Perspective

A Report by the Investors' Working Group

An Independent Taskforce Sponsored by
CFA Institute Centre for Financial Market Integrity
and
Council of Institutional Investors

July 2009

About the Investors' Working Group

During the summer of 2008, the CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors began exploring the idea of commissioning a study on financial regulatory reform. Both organizations were concerned that investor views were missing in the ongoing national debate about overhauling the U.S. system of financial regulation. The U.S. Treasury Department's "Blueprint for a Modernized Financial Regulatory Structure," released in March 2008, largely ignored investor considerations, focusing instead on making U.S. markets more globally "competitive" by reducing costs for public companies and financial institutions.

The result was the launch in February 2009 of the Investors' Working Group (IWG). This independent, non-partisan panel was formed to provide an investor perspective on ways to improve the regulation of U.S. financial markets. The IWG worked collaboratively to seek agreement on the recommendations. This report fairly reflects the consensus views of the group on myriad reforms. However, not all IWG members agreed with every recommendation in the report.

Our report could not be more timely. Over the past year, the worst financial crisis since the Great Depression has brought markets to the brink of collapse, toppled iconic financial institutions and forced repeated government bailouts. The debacle has wiped out retirement savings for millions of Americans and crippled the economy. It also has changed fundamentally the terms of the debate about regulation. Calls to unshackle Wall Street and let markets police themselves no longer dominate. Instead, the focus of the discussion now is on making the U.S. system of regulation more comprehensive, effective and responsive to the needs of investors, consumers and the broader financial system.

This report offers an essential roadmap to that destination. It suggests practical, near-term improvements and longer-term, aspirational reforms, some of which may require further study. But all of our recommendations are guided by a profound commitment to restoring confidence in our markets by ensuring that regulation serves the needs of investors. Strong investor safeguards are a prerequisite for market stability and integrity and a vibrant U.S. financial system.

William H. Donaldson, CFA
Co-Chair,
Investors' Working Group

Arthur Levitt, Jr.
Co-Chair,
Investors' Working Group

MEMBERS OF THE INVESTORS' WORKING GROUP

Co-Chairs:
William H. Donaldson, CFA, Chair, Donaldson Enterprises and former Chair, U.S. Securities and Exchange Commission
Arthur Levitt Jr., Senior Advisor, The Carlyle Group and former Chair, U.S. Securities and Exchange Commission

Members:
Mark Anson, CFA, President and Executive Director of Investment Services, Nuveen Investments
Brooksley Born, Retired Partner, Arnold & Porter and former Chair, U.S. Commodity Futures Trading Commission
Joe Dear, Chief Investment Officer, CalPERS and Chair, Council of Institutional Investors
David Fisher, Chair, The Capital Group International
Harvey J. Goldschmid, Dwight Professor of Law, Columbia Law School and former Commissioner, U.S. Securities and Exchange Commission
Jeremy Grantham, Co-Founder and Chair, GMO, LLC
William R. Hambrecht, Founder, Chair and CEO, WR Hambrecht + Company
John D. Markese, President, American Association of Individual Investors
Bill Miller, CFA, Chair and Chief Investment Officer, Legg Mason Capital Management, Inc.
Ira Millstein, Senior Partner, Weil, Gotshal & Manges LLP and Senior Associate Dean for Corporate Governance, Yale School of Management
Nell Minow, Editor and Co-Founder, The Corporate Library
Peter Montagnon, Chair, International Corporate Governance Network and Director of Investment Affairs, Association of British Insurers
Jane Bryant Quinn, Director and Personal Finance Columnist, Bloomberg LP
Barbara Roper, Director of Investor Protection, Consumer Federation of America
Kurt Schacht, CFA, Managing Director, CFA Institute Centre for Financial Market Integrity
Ellen Seidman, Senior Fellow, New America Foundation, Executive Vice President, ShoreBank Corporation and former Director, Office of Thrift Supervision

*Note: Affiliations are for identification purposes only. IWG members participated as individuals; the report reflects their own views and not those of organizations with which they are affiliated.

ACKNOWLEDGEMENTS

The Investors' Working Group wishes to acknowledge and express its great appreciation to the many outside contributors who helped produce this report. Our deepest thanks go to Professor Lawrence A. Cunningham, Henry St. George Tucker III Research Professor of Law at the George Washington University School of Law, and Professor Donald C. Langevoort, Thomas Aquinas Reynolds Professor of Law at Georgetown University Law Center. Professor Cunningham was instrumental in helping the IWG organize its initial thoughts regarding financial regulatory reform. Professor Langevoort provided technical advice and assistance during the report's development and final drafting. The IWG is also grateful to Susan Trammell for her assistance in framing the initial draft report and Paul Beswick, John Brinkley, Peter R. Fisher, Steve Harris, Bob Herz, Gene Ludwig, Mark Radke, Marc A. Siegel, David F. Swensen and Lynn Turner for their contributions.

The IWG also would like to thank the staff of the CFA Institute Centre for Financial Market Integrity (CFA Centre) and the Council of Institutional Investors (CII) for their assistance in keeping the project moving. The IWG would like to especially thank Don Marlais (CII) and Linda Rittenhouse (CFA Centre) for their hard work and dedication in managing this project. Other staffers who contributed to the report included Amy Borrus, Marie Brodmerkel, Justin Levis, Jeff Mahoney, Jonathan Urick and Ann Yerger at CII and Jim Allen, Patrick Finnegan, Debra Palmore and Kathy Valentine at CFA Centre.

OVERVIEW

The credit crisis has exposed the faulty underpinnings of the U.S. financial services sector. The fundamental flaws are glaring: gaps in oversight that let purveyors of abusive mortgages, complex over-the-counter (OTC) derivatives and convoluted securitized products run amok; woefully underfunded regulatory agencies; and super-sized financial institutions that are both "too big to fail" and too labyrinthine to regulate or manage effectively. Too often, the complexities of the regulatory system and the institutions it is supposed to police benefit institutions, dealers and traders at the expense of investors and consumers.

Designing a more rational financial services sector will take time, thoughtful analysis and political will. The findings of the Financial Crisis Inquiry Commission, which is to report to the U.S. Congress on the origins of the market meltdown and measures to ensure that such catastrophes do not happen again, are critical to that effort. What is at stake—the integrity of the U.S. financial system—is too important to rush the review.

In the near term, there are critical, practical steps that the federal government can take to put the U.S. financial regulatory system on a sounder footing and make it more responsive to the needs of investors. The Obama Administration's regulatory reform plan, announced on June 17, 2009, is a start. The Investors' Working Group (IWG) supports many of these recommendations but advocates a bolder set of near-term measures to strengthen investor and consumer protections and check systemic risks that threaten the health of the financial system.

The IWG believes that the U.S. needs a process for dealing with threats to the broader financial system, but we also believe that bolstering investor and consumer protection is paramount. The lack of sufficient authority, resources and will on the part of regulators helped fuel the financial meltdown at least as much as the absence of systemic-risk oversight.

To address these shortcomings, reform in the near term should focus on:

Strengthening and reinvigorating existing federal agencies responsible for policing financial institutions and markets and protecting investors and consumers. To achieve this goal, the will to regulate must be restored. Light-touch federal regulation has met with disastrous results, as has starving agencies of needed resources. For example, the U.S. Securities and Exchange Commission's (SEC) funding has not kept pace with the explosive growth of the securities markets over the past two decades. Today, the agency monitors 30,000 entities, including more than 11,000 investment advisers, up 32 percent in only the last four years. Even so, in the three years from 2005 to 2007, the SEC's budgets were flat or declining.

Filling the gaps in the regulatory architecture and in authority over certain investment firms, institutions and products. For example, OTC derivatives contracts should be subject to comprehensive regulation; credit rating agencies should be subject to more meaningful oversight and greater accountability for their ratings; investment managers, including managers of hedge funds and private equity, should be required to register with the SEC; originators of asset-backed securities (ABS) should have some "skin in the game"; and regulators should be given resolution authority, analogous to the Federal Deposit Insurance Corporation's (FDIC) authority for failed banks, to wind down or restructure troubled systemically significant non-banks.

Improving corporate governance. The financial crisis represents a massive breakdown in oversight at many levels, including at corporate boards. Investors need better tools to hold directors accountable so they will be motivated to challenge executives who pursue excessively risky strategies. Measures to make it easier for shareowners to nominate and elect directors are a good place to start.

Since the financial crisis erupted, fear that the failure of large financial institutions could have devastating repercussions throughout the U.S. financial system has prompted unprecedented government intervention in the markets and the private sector. Consequently, much of the debate about financial reform has focused on the need to monitor and address future systemic risks. The U.S. regulatory framework was not designed to monitor and respond to risks to the entire financial system posed by large, complex and interconnected institutions, practices and products.

The IWG believes that the appropriate way to address this immediate need is for Congress and the Administration to authorize the creation of an independent Systemic Risk Oversight Board (SROB). Ideally, the SROB would have the authority and highly skilled staff to 1) collect and analyze financial institutions' exposures, practices and products that could threaten the stability of the financial system and 2) recommend steps that existing regulators should take to reduce those risks.

This approach represents a middle ground between the systemic risk regulator advocated by the Administration and the "college of cardinals" model of oversight by the heads of existing federal regulators that some leading lawmakers propose. The IWG views both approaches with skepticism. A council of regulators would have blurred lines of authority—ultimately no one would be in charge or accountable—and could be hamstrung by the usual jurisdictional disputes. The Administration's approach, which envisions the U.S. Federal Reserve Board as systemic risk regulator, has more serious drawbacks. The Fed has other, potentially competing responsibilities—from guiding monetary policy to managing the vast U.S. payments system. Its credibility has been tarnished by the easy credit policies it pursued and the lax regulatory oversight that let institutions ratchet higher their balance sheet leverage and amass huge concentrations of risky, complex securitized products. Other serious concerns stem from the Fed's regulatory failures—its refusal to police mortgage underwriting or to impose suitability standards on mortgage lenders—and the heavy influence that banks have on the Fed's governance.

The Systemic Risk Oversight Board's collection and analysis of data, with an eye on emerging systemic risks, would be informed by the Financial Crisis Inquiry Commission's parallel efforts to understand the root causes of the current crisis. The tandem investigations would help guide policymakers as they consider overall regulation of the financial services sector, including the eventual locus, scope and powers of a systemic risk regulator. Until then, the oversight board would monitor systemic threats and refer appropriate steps to existing regulatory agencies–the Treasury, the Fed and Congress.

While our report focuses on near-term needs, we recognize that there is a larger, long-term agenda. Restructuring the hodge-podge of financial regulators and key financial institutions is clearly an imperative, regardless of how politically arduous the task. Policymakers need to map out a path toward a more rational, less conflicted financial system. Steps they should consider include:

Designating a systemic risk regulator, with appropriate scope and powers. One option would be for the Systemic Risk Oversight Board to evolve into a full-fledged regulator.

Adopting new regulations for financial services that will prevent the sector from becoming dominated by a few giant and unwieldy institutions. New rules are needed to address and balance concerns about concentration and competitiveness.

Strengthening capital adequacy standards for all financial institutions. Too many financial institutions have weak capital underpinnings and excessive leverage.

Imposing careful constraints on proprietary trading at depository institutions and their holding companies. Proprietary trading creates potentially hazardous exposures and conflicts of interest, especially at institutions that operate with explicit or implicit government guarantees. Ultimately, banks should focus on their primary purposes, taking deposits and making loans.

Consolidating federal bank regulators and market regulators. Regulation of banks and other depository institutions may be streamlined through the appropriate consolidation of prudential regulators. Similarly, efficiencies may be obtained through the merger of the SEC and the Commodity Futures Trading Commission (CFTC).

Studying a federal role in the oversight of insurance companies. The current state-based regulation makes for patchwork supervision that has proven inadequate to the task.

The IWG believes that the goal of the longer-term effort should be a simpler yet more comprehensive regulatory net, stronger overseers and manageable, better-governed financial institutions that will not pose "too big to fail" threats. The new financial order that emerges must ensure appropriate safeguards for investors. Investors, in turn, must focus on sustainable, risk-adjusted performance, recognizing that pressing investment advisers and executives of portfolio companies for quick returns can spur out-on-a-limb behavior in pursuit of fast but often ephemeral profits.

The regulatory overhaul should not stop at the water's edge. Financial markets are increasingly global. U.S. financial institutions generate a growing share of their revenues and assets overseas. Washington policymakers must lead a fresh effort to forge international consensus on key elements of the regulation of global markets, players and products. U.S. leaders should also press for greater sharing of information among national regulators and harmonization of rules and practices. In contrast to other recent global initiatives, however, the focus should be on *raising* standards, not weakening them.

This report is intended to ensure that policymakers fully consider and reflect on making regulatory changes that serve investors, consumers and the broader financial system. A balance is needed among many interests. In particular, building a U.S. financial system that correctly balances efficiency, global competitiveness, and investor and consumer protection is enormously challenging. It is also an opportunity, however, to put the U.S. financial system on a firmer, more rational footing and ensure that it serves the needs of investors. Strong investor protections are integral to restoring trust, stability and vibrancy to U.S. financial markets. The IWG believes this plan of action is the best way forward toward that goal.

OUTLINE OF RECOMMENDATIONS

I. INVESTOR AND CONSUMER PROTECTIONS

A. Strengthening Existing Federal Regulators

- Congress and the Administration should nurture and protect regulators' commitment to fully exercising their authority.
- Regulators should have enhanced independence through stable, long-term funding that meets their needs.
- Regulators should acquire deeper knowledge and expertise.

B. Closing the Gaps for Products, Players and Gatekeepers

OTC Derivatives

- Standardized derivatives should trade on regulated exchanges and clear centrally.
- OTC trading in derivatives should be strictly limited and subject to robust federal regulation.
- The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) should improve accounting for derivatives.
- The SEC and the CFTC should have primary regulatory responsibility for derivatives trading.
- The United States should lead a global effort to strengthen and harmonize derivatives regulation.

Securitized Products

- New accounting standards for off-balance-sheet transactions and securitizations should be implemented without delay and efforts to weaken the accounting in those areas should be resisted.
- Sponsors should fully disclose their maximum potential loss arising from their continuing exposure to off-balance-sheet asset-backed securities.
- The SEC should require sponsors of asset-backed securities to improve the timeliness and quality of disclosures to investors in these instruments and other structured products.
- ABS sponsors should be required to retain a meaningful residual interest in their securitized products.

Hedge Funds, Private Equity and Investment Companies, Advisers and Brokers

- All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers and be subject to oversight.
- Existing investment management regulations should be reviewed to ensure they are appropriate for the variety of funds and advisers subject to their jurisdiction.
- Investment managers should have to make regular disclosures to regulators on a real-time basis, and to their investors and the market on a delayed basis.

Hedge Funds, Private Equity and Investment Companies, Advisers and Brokers (cont.)

- Investment advisers and brokers who provide investment advice to customers should adhere to fiduciary standards. Their compensation practices should be reformed, and their disclosures should be improved.
- Institutional investors—including pension funds, hedge funds and private equity firms—should make timely, public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, and members of their governing bodies and report annually on holdings and performance.

Non-Bank Financial Institutions

- Congress should give regulators resolution authority, analogous to the Federal Deposit Insurance Corporation's authority for failed banks, to wind down or restructure troubled, systemically significant non-banks.

Mortgage Originators

- Congress should create a new agency to regulate consumer financial products, including mortgages.
- Banks and other mortgage originators should comply with minimum underwriting standards, including documentation and verification requirements.
- Mortgage regulators should develop suitability standards and require lenders to comply with them.
- Mortgage originators should be required to retain a meaningful residual interest in all loans and outstanding credit lines.

Nationally Recognized Statistical Rating Organizations (NRSROs)

- Congress and the Administration should consider ways to encourage alternatives to the predominant issuer-pays NRSRO business model.
- Congress and the Administration should bolster the SEC's position as a strong, independent overseer of NRSROs.
- NRSROs should be required to manage and disclose conflicts of interest.
- NRSROs should be held to a higher standard of accountability.
- 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.

C. Corporate Governance

- In uncontested elections, directors should be elected by a majority of votes cast.
- Shareowners should have the right to place director nominees on the company's proxy.
- Boards of directors should be encouraged to separate the role of chair and CEO or explain why they have adopted another method to assure independent leadership of the board.
- Securities exchanges should adopt listing standards that require compensation advisers to corporate boards to be independent of management.
- Companies should give shareowners an annual, advisory vote on executive compensation.
- Federal clawback provisions on unearned executive pay should be strengthened.

II. Systemic Risk Oversight Board

- Congress should create an independent governmental Systemic Risk Oversight Board.
- The board's budget should ensure its independence from the firms it examines.
- All board members should be full-time and independent of government agencies and financial institutions.
- The board should have a dedicated, highly skilled staff.
- The board should have the authority to gather all information it deems relevant to systemic risk.
- The board should report to regulators any findings that require prompt action to relieve systemic pressures and should make periodic reports to Congress and the public on the status of systemic risks.
- The board should strive to offer regulators unbiased, substantive recommendations on appropriate action.
- Regulators should have latitude to implement the oversight board's recommendations on a "comply or explain" basis.

I. INVESTOR AND CONSUMER PROTECTIONS

The Investors' Working Group believes that strengthening existing regulatory agencies, closing gaps in the regulatory structure, enhancing consumer and investor protections and improving corporate governance are the most important steps Congress and the Obama Administration can take to restore the integrity of the financial system and the stability of financial markets.

Background

When the financial meltdown began, regulators for the most part had enough information and should have recognized the signs but did not, or could not, stop the downward spiral. One reason is that regulators lacked the requisite will, resources and expertise. Another is that the web of regulatory supervision that covers the U.S. financial services industry is riddled with holes. Some are intentional. For example, the OTC derivatives market has been expressly exempted from virtually all federal oversight. But even in regulated parts of the markets, the oversight fabric is not knit tightly enough.

A. Strengthening Existing Federal Regulators

While the IWG acknowledges that regulatory failures were a major contributing cause of the financial debacle, we believe that the right solution is to reinforce, rather than abandon, the existing regulatory framework.

Above all, regulators must be committed to promoting policies that are good for consumers, investors and the financial markets. Although the will to regulate cannot be legislated, Congress can encourage vigorous regulation through general oversight and its specific role in providing advice and consent regarding nominees to lead financial regulatory agencies. Structural and financial changes can also help strengthen regulatory agencies by making them more independent of the industries they supervise and allowing them to hire staff with deep knowledge of complex products and rapid financial innovation. Consolidating agencies as appropriate can help bolster and streamline financial regulation so long as mergers are crafted with a keen understanding of the differences between existing regulators and the markets and institutions they supervise.

Background

Since 1980, a dramatic shift in the financial regulatory system has occurred. Vigorous governmental oversight was abandoned as regulators placed their faith in the ability of markets to self-police and self-correct. Even as the credit crisis unfolded in early 2008, the prevailing view in the industry and among many agency chiefs and government leaders was that too much regulation, rather than too little, was eroding the competitiveness of U.S. markets.

The IWG believes that this view is misguided. The financial crisis has revealed that insufficient and ineffective oversight, not over-regulation, paved the way to financial turmoil.

Beyond a misplaced faith in markets, regulators lacked the will, knowledge and resources to flexibly respond to rapid financial innovation and market expansion. Poor funding and a lack of independence allowed an anti-regulatory ideology to permeate regulatory agencies. The Congressional appropriations process helped to undermine robust oversight. Fearful of political budgetary retaliation, agencies grew reluctant to exercise their authority fully in certain areas. It is no coincidence that these pockets of poor oversight proved to be sources of great risk.

Specific Recommendations

1. Congress and the Administration should nurture and protect regulators' commitment to fully exercising their authority. Congress and the Administration should amend statutory language establishing various financial regulators to prominently include provisions requiring that the President consider potential appointees' determination to exercise vigorous oversight and their commitment to the regulatory mission. Congress should be vigilant in exercising its general supervisory authority and thoughtfully carry out its obligation to provide advice and consent to ensure that nominees possess the resolve to regulate effectively.

The President, Congress and agency leaders must work to foster a culture of regulatory professionalism that rewards high-quality work and instills a community of purpose. Such a culture is rooted in steadfast devotion to vigorous oversight and enforcement. Regulators should be encouraged to exercise the greatest supervision where the need is greatest, including over the most complex and rapidly expanding institutions, products and markets. Resistance to regulation in these often highly lucrative areas is likely to be intense. Staff should be rewarded for asking tough questions, pursuing difficult cases and thinking outside the bounds of conventional wisdom. A healthy tension and skepticism between regulators and those they oversee should be promoted as a hallmark of exemplary regulation.

2. Regulators should have enhanced independence through stable, long-term funding that meets their needs. All federal financial regulators should have the resources and independence to fulfill their mission effectively without political interference or dependence on the firms they oversee. The IWG encourages Congress and the Administration to consider ways to develop mechanisms for stable, long-term funding. To ensure that funding keeps pace with rapid market changes and financial innovation, Congress, the Administration and regulators should periodically reevaluate the resources each agency needs to fulfill its mission. To the extent possible, agencies should have funding flexibility to respond to these changes on their own.

3. Regulators should acquire deeper knowledge and expertise. The speed with which financial products and services have proliferated and grown more complex has outpaced regulators' ability to monitor the financial waterfront. Staffing levels failed to keep pace with the growing work load, and many agencies lack staff with the necessary expertise to grapple with emerging issues. Political appointees and senior civil service staff should have a wide range of financial backgrounds. Compensation should be sufficient to attract top-notch talent. In addition, continuing education and training should be dramatically expanded and officially mandated to help regulators keep pace with innovation. Although we recognize that the "revolving door" between regulatory agencies and the private sector can lead to abuse, we believe that both the public sector and the private sector can benefit from people with experience in both. In particular, agencies should explore ways of recruiting individuals from the private sector to improve the regulators' ability to understand and keep up with complex financial and market innovations. And those who have served in regulatory agencies can assist market players in understanding the perspective of regulators and the need for regulations.

B. Closing the Gaps for Products, Players and Gatekeepers

The nation's regulatory umbrella should be comprehensive. Specifically, it should be broadened to cover important financial products, players and gatekeepers that lack meaningful oversight. Critical gaps that urgently need attention include OTC derivatives, securitized products, investment managers, mortgage finance companies and credit rating agencies.

OTC Derivatives

All standardized (and standardizable) derivative contracts currently traded over the counter should be required to be traded on regulated exchanges and cleared through regulated clearinghouses. Any continuing OTC derivatives trading should be limited strictly to truly customized contracts between highly sophisticated parties, at least one of which requires a customized contract in order to hedge business risk. What remains of the OTC derivatives market should be subject to a robust federal regulatory regime, including reporting, capital and margin requirements.

Background

OTC derivatives generally are bilateral contracts between sophisticated parties. They include interest rate swaps, foreign exchange contracts, equity swaps, commodity swaps and the now-infamous credit default swaps (CDS), along with other types of swaps, contracts and options. It is widely acknowledged that OTC derivatives contracts, and particularly CDS, played a significant role in the current financial crisis. For December 2008, the Bank for International Settlements reported a notional amount outstanding of $592 trillion and a gross market value outstanding of $34 trillion for global OTC derivatives. This enormous financial market was exempted from virtually all federal oversight and regulation by the Commodity Futures Modernization Act of 2000 (CFMA).

Although OTC derivatives have been justified as vehicles for managing financial risk, they have also spread and multiplied risk throughout the economy in the current crisis, causing great financial harm. Warren Buffett has dubbed them "financial weapons of mass destruction." Problems plaguing the market include lack of transparency and price discovery, excessive leverage, rampant speculation and lack of adequate prudential controls.

Specific Recommendations

1. Standardized derivatives should trade on regulated exchanges and clear centrally. Congress and the Administration should enact legislation overturning the exemptive provisions of the CFMA and requiring standardized (and standardizable) derivatives contracts to be traded on regulated derivatives exchanges and cleared through regulated derivatives clearing operations. Legal requirements based on those established in the Commodity Exchange Act for designated contract markets and derivatives clearing operations should apply to such trading and clearing. These requirements would allow effective government oversight and enforcement efforts, ensure price discovery, openness and transparency, reduce leverage and speculation and limit counterparty risk. Although requiring central clearing alone would mitigate counterparty risk, it would not provide the essential price discovery, transparency and regulatory oversight provided by exchange trading.

2. OTC trading in derivatives should be strictly limited and subject to robust federal regulation. An OTC market is necessarily much less transparent and much more difficult to regulate than an exchange market. If trading OTC derivatives is permitted to continue, such trading should be strictly limited to truly customized contracts between highly sophisticated parties, at least one of which requires such a customized contract in order to hedge business risk. Congress and the Administration should enact legislation limiting the eligibility requirement for OTC derivatives trades to highly sophisticated and knowledgeable parties and requiring that at least one party to each OTC contract should certify and be prepared to demonstrate that it is entering into the contract to hedge an actual business risk. This limitation to trading on the OTC market would permit entities to continue to hedge actual business risks but would reduce the current pervasive speculation in the market.

A federal regulatory regime is needed for any continuing OTC market. OTC derivatives dealers should be required to register, maintain records and report transaction prices and volumes to the federal regulator. They should be subject to adequate capital requirements and business conduct standards, including requirements to disclose contract terms and risks to their customers. All OTC trades should be subject to federally imposed margin requirements, and all large market participants should be subject to capital requirements. In addition, transaction prices and volumes of OTC derivatives should be publicly reported on a timely basis.

All market participants should be subject to federal fraud and manipulation prohibitions, recordkeeping and reporting requirements, and position limits if imposed by the federal regulator. The regulator should have broad powers to oversee the market and all its participants, including powers to require additional reporting and inspection of records and to order positions to be eliminated or reduced. Federal legal prohibitions should be enacted to prohibit the use of OTC derivatives to misrepresent financial condition or to avoid federal laws.

3. The FASB and IASB should improve accounting for derivatives. A thorough and comprehensive review of accounting rules related to derivative instruments is needed. The goals of this review should be to ensure consistent reporting about these instruments and to ensure full disclosure for the benefit of investors, counterparties and regulators. To make informed decisions, investors and those entering into counterparty relationships need information about these positions.

4. The SEC and the CFTC should have primary regulatory responsibility for derivatives trading. Currently, the SEC and the CFTC each have regulatory responsibilities for certain portions of derivatives trading, depending on the nature of the derivatives product and/or the type of exchange on which it is traded. Those agencies have the experience and sophistication to oversee derivatives markets and should act as the primary regulators of both exchange trading and any continuing OTC market. It is important that federal standards for derivatives trading be comprehensive and consistent and that agency jurisdiction over such trading be clearly delineated. For this reason, the SEC and the CFTC must agree on appropriate regulatory standards and on their respective regulatory responsibilities, and the terms of such agreement should be enacted into law.

5. The United States should lead a global effort to strengthen and harmonize derivatives regulation. Because the OTC derivatives market is global, U.S. financial regulators should work with foreign authorities to strengthen and harmonize standards for derivatives regulation internationally and to enhance international cooperation in enforcement and information sharing.

Securitized Products

Investors have had a difficult time understanding securitized instruments because of the lack of information about them and the confusing manner in which this information is reported, both to the shareowners of the issuing company (or sponsor), and to investors in these often complex products. This opacity stems in part from securitized products' absence from sponsors' balance sheets. Moreover, securitized products are sold before investors have access to a comprehensive and accurate prospectus.

The IWG believes that accounting standards setters should improve the quality, appropriateness and transparency of reporting related to off-balance-sheet transactions and securitizations by sponsoring institutions. The SEC should develop new rules for the sale of asset backed securities that give investors in these products a reasonable opportunity to review disclosures before making a decision to invest. Sponsors of ABS and structured products should have to retain a meaningful interest in the underlying assets they securitize. Lastly, while the status of government-sponsored enterprises (GSEs) is currently in limbo, the IWG believes the GSEs or their successor enterprises should be subject to the same securities regulations that apply to all other sponsors when they issue ABS.

Background

Beginning in the 1980s, banks and other lenders began repackaging mortgage loans and other predictable cash flows into asset-backed securities. Some $3 trillion were outstanding by year-end 2008.

Both investors in these securities and the shareowners of their sponsoring organizations lack crucial information needed to judge their true risk. The off-balance-sheet accounting treatment of securitizations masks from shareowners of the sponsoring company the potential costs of deterioration in the quality of the assets underlying the instruments. Consequently, shareowners of a sponsoring company may not appreciate the impact on the company of deterioration in the quality of the underlying loans. In addition, the off-balance-sheet treatment allows the sponsor to reduce the amount of capital supporting the underlying loans by as much as 90 percent. Significant capital shortfalls can thus occur when a sponsor chooses to support these securitizations (whether according to or beyond the terms of the securitization) by bringing them back onto its balance sheet.

Beyond poor accounting and disclosures by the sponsors of securitized products, institutions that invest directly in these securities have been ill-served by existing disclosures. In particular, investors often have to decide whether to invest in an ABS issuance based not upon a detailed prospectus but rather on a basic term sheet with limited information. Although these investors could choose not to invest under such terms, doing so would lock them out of many ABS transactions. Institutions feared that this lockout would be inconsistent with their fiduciary duty to find the best investments for their clients. Investing before reviewing a prospectus, however, limits the ability of investors to perform adequate due diligence.

Accounting and disclosure problems were even more severe at the GSEs. As government-chartered corporations, the GSEs were able to operate as major sponsors of mortgage-backed securities, even though they were not subject to the same regulations as other participants. As recent events have shown, an implicit government guarantee does not protect investors from systemic failure. Consequently, investors need to have relevant information that will help them review, analyze and make reasoned and informed investment decisions about securities and firms that might be affected by the financial performance and condition of GSEs. Although the GSEs' future is uncertain at this time, the IWG believes that they or their successors should have to adhere to the same regulations as other securities issuers.

Notwithstanding the serious lack of crucial information about securitized products, the IWG recognizes that investors need to be more diligent. Some investors effectively outsourced their investment due diligence to third parties, such as credit rating agencies, without fully understanding the nature of the collateral underlying the bonds, the purpose of the rating or the rating agency's conflicts of interest that may have colored its ratings. Investors must pay more attention to these details, which are critical to understanding the risks and opportunities of ABS investments.

Specific Recommendations

1. New accounting standards for off-balance-sheet transactions and securitizations should be implemented without delay and efforts to weaken the accounting in those areas should be resisted. The IWG applauds the recent action by the FASB finalizing accounting standards that limit exemptions for consolidating off-balance-sheet entities and require more information about securitization transactions. Efforts to water down or delay the implementation of those new requirements should be vigorously resisted.

2. Sponsors should fully disclose their maximum potential loss arising from their continuing exposure to off-balance-sheet asset-backed securities. Sponsoring companies with off-balance-sheet exposure to ABS that they sponsored and/or are servicing should be required to provide full disclosure about how these exposures could affect shareowners if the firm returns the related assets and liabilities to their balance sheets. More transparent disclosure would permit investors to better understand the amount and type of loans that sponsors are originating and the amount of leverage they could create. The disclosure would also provide investors with information about ongoing changes in loan quality and underwriting standards and the potential risks those changes may create in the future. In particular, such disclosure also should describe how those actions could affect the sponsoring firm's capital and liquidity positions, earnings and future business prospects if the firm repurchases the loans onto its balance sheet.

3. The SEC should require sponsors of asset-backed securities to improve the timeliness and quality of disclosures to investors in these instruments and other structured products. Current rules allowing sponsors to issue asset-backed securities via shelf registration provide for woefully inadequate disclosures to potential investors in these products. Because each ABS offering involves a new and unique security, the IWG does not believe the SEC should allow such issuances to be eligible for its normal shelf-registration procedures. Instead, the SEC should develop a regulatory regime for such asset-backed securities that would require issuers to make prospectuses available for potential investors in advance of their purchasing decisions. These prospectuses should disclose important information about the securities, including the terms of the offering, information about the sponsor, the issuer and the trust, and details about the collateral supporting the securities. Such new rules would give investors critical information they need to perform due diligence on offerings prior to investing. It would also create better opportunities for due diligence by the underwriters of such securities, thus adding additional levels of oversight of the quality and appropriateness of structured offerings.

4. ABS sponsors should be required to retain a meaningful residual interest in their securitized products. Having "skin in the game" would make sponsors more thoughtful about the quality of the assets they securitize. Sponsors should have to retain a meaningful residual interest in ABS offerings. Hedging these retained exposures should be prohibited.

Hedge Funds, Private Equity and Investment Companies, Advisers and Brokers

All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers so that they are subject to federal scrutiny. All registered fund managers should have to make periodic disclosures to regulators about the current positions of their funds, and should make regular, delayed public disclosures of their funds' positions to help their investors and other market participants understand the associated risks. Regulators should conduct a full review of rules governing investment managers and their funds to ensure that they adequately address the different types of investment vehicles and practices subject to those rules. In order to improve the quality of advice provided to retail investors and to protect them from abusive practices, the SEC should be empowered to reform compensation practices that create unacceptable conflicts of interest, improve pre-sale disclosures, and subject all those who provide personalized investment advice, including broker-dealers, to a fiduciary duty.

Regulators should also be empowered to oversee new participants and products as they emerge and have adequate resources for timely and careful examinations.

Background

Many hedge funds, funds of hedge funds and private equity funds operate within the "shadow" financial system of unregulated non-bank financial entities. These funds and their managers have been exempt from regulation because of a combination of factors related to the number and relative sophistication of investors they serve and the size of assets under management.

Unencumbered by leverage limits, compliance examinations or full disclosure requirements, many hedge funds and private equity funds operate under the radar. Their ability to take on enormous leverage, in particular, enables them to hold huge positions that can imperil the broader market. If market trends move against a hedge fund or a private equity fund and it is forced to liquidate at fire-sale prices, prime brokers, banks and other counterparties could be subject to significant losses. Even market participants who have no direct dealings with the fund could be battered by the resulting plunge in asset prices and liquidity squeeze. Registration would afford a degree of transparency and oversight for these systemically important market players. It would at least ensure disclosure of basic information about the managers and funds and make them eligible for examination by the SEC.

Oversight of the intermediaries that investors rely on in making investment decisions has failed to keep pace with dramatic changes in the industry. These changes include the development and rapid growth of the financial planning profession and changes in the full-service brokerage business model to one that is, or is portrayed as being, largely advisory in nature. Nevertheless, a series of decisions by regulators over the years allowed brokerages to call their sales representatives "financial advisers," offer extensive personalized investment advice and market their services based on the advice offered, all without regulating them as advisers.

As a result, investors are forced to choose among financial intermediaries who offer services that appear the same to unsophisticated eyes, but who are subject to very different standards of conduct and legal obligations to the client. Most significantly, investment advisers are required to act in their clients' best interest and disclose all material information, including information about conflicts of interest, whereas brokers are subject to the less rigorous suitability standard and do not have to provide the same extensive disclosures.

Meanwhile, although investors are encouraged to place their trust in "financial advisers," compensation practices in the industry are riddled with conflicts of interest that may encourage sales of products that are not in clients' best interests. The disclosures that investors are supposed to rely on in making investment decisions are often inadequate and overly complex and typically arrive after the sale–long past the point when they could have been useful to investors in analyzing their investment options.

As innovation produces new institutions, products and practices, federal regulators must be able to bring them under their jurisdiction, too. One important lesson of the recent crisis is that as financial products and services proliferate and become more complex, they often fall through the regulatory cracks. Extending the scope of examinations will require additional funding for regulators and ultimately result in more effective regulation.

Specific Recommendations

1. All investment managers of funds available to U.S. investors should be required to register with the SEC as investment advisers and be subject to oversight. All investment advisers and brokers offering investment advice should have to meet uniform registration requirements, regardless of the amount of assets under management, the type of product they offer or the sophistication of investors they serve. Exemptions from registration should not be permitted, although smaller advisory firms should continue to be overseen by state regulators.

2. Existing investment management regulations should be reviewed to ensure they are appropriate for the variety of funds and advisers subject to their jurisdiction. The frequency and extent of regulatory examinations should be determined by the nature and size of the firm. The exam process should be augmented by independent third-party reviews and reporting. Regulators should be empowered to extend their jurisdictional reach to cover emerging participants and products.

3. Investment managers should have to make regular disclosures to regulators on a real-time basis and to their investors and the market on a delayed basis. Because of the potential systemic risks associated with investment managers, and their interconnections with other systemically important financial institutions, the IWG believes that all investment managers should have to disclose their positions to regulators on a confidential but real-time basis. This would allow regulators to recognize large and growing exposures and take steps to limit their impact.

The IWG also believes that hedge funds and other private pools of capital should make regular but delayed public disclosures about their positions. Delayed disclosure would provide investors a window on the fund manager's investment strategies while preventing other investors from "front-running" those game plans. It would also give the market at large an understanding of the degree of risk inherent in the investment strategies. In light of new trading techniques and products available, regulators should reexamine how often investment companies are required to report their holdings to investors and the market.

4. Investment advisers and brokers who provide investment advice to customers should have to adhere to fiduciary standards. Their compensation practices should be reformed and their disclosures improved. All investment professionals, including broker-dealers who provide personalized investment advice, should be subject to a fiduciary duty to act in their clients' best interests and to disclose material information. Compensation practices that encourage investment professionals to make recommendations that are not in their clients' best interests should be reformed. Disclosures should also be improved to ensure that investors receive pre-engagement disclosure to aid them in selecting an investment professional and clear, plain English, pre-sale disclosure of key information about recommended investments. This would provide an added level of protection to both retail and institutional clients.

5. Institutional investors—including pension funds, hedge funds and private equity firms—should make timely public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, and members of their governing bodies and report annually on holdings and performance. Investors who champion best disclosure practices at portfolio companies have a responsibility to play by similar rules. Best disclosure practices for institutional investors would foster transparency and accountability throughout the capital markets, thus enhancing confidence in the markets. They would also strengthen fiduciary ties between fund beneficiaries and trustees and guard against misuse of fund assets and abuses of the power inherent in large pools of capital. Specifically, institutional investors should make timely, public disclosures about their proxy voting guidelines, proxy votes cast, investment guidelines, members of their governing bodies and report annually on holdings and performance.

Non-Bank Financial Institutions

Congress should enact legislation granting appropriate regulators resolution authority for faltering non-bank financial institutions. Such authority should include explicit powers to seize, wind down and restructure troubled institutions deemed "too big to fail." The IWG generally supports the Administration's proposal for this new authority but does not take a position on where it should be vested and how it should be implemented.

Background

In the 1930s, chaotic and costly bank failures motivated Congress and President Roosevelt to empower federal regulators to seize and wind down, in an orderly fashion, illiquid and insolvent banks. The financial crisis of 2008 included, in particular, a run on several large firms operating in the non-bank financial system. No mechanism existed, however, to deal with the failure of large, complex, interconnected non-bank institutions, such as Bear Stearns, Lehman Brothers or American International Group (AIG). As a result, federal bailouts were ad hoc and inconsistent, fueling further market chaos that threatened the entire financial system.

Specific Recommendation

Congress should give regulators resolution authority, analogous to the FDIC's authority for failed banks, to wind down or restructure troubled, systemically significant non-banks. Banks are no longer the primary systemically significant players in our financial system. The disorderly failure of large, interconnected investment banks, insurers and other institutions could also trigger cascading failures throughout the financial system. A carefully designed resolution regime for large non-banks would provide much needed market stability by ensuring that the essential functions of failed institutions continue relatively uninterrupted. Consideration also should be given to expanded use of the Bankruptcy Code. An orderly liquidation or restructuring would also help minimize the cost to taxpayers over the long run.

Mortgage Originators

All banks and other mortgage lenders should be required to meet minimum underwriting standards. They should also adhere to baseline standards for documenting and verifying a borrower's ability to repay and for ensuring that loans and credit lines they issue are appropriate for particular borrowers. A new consumer product oversight agency could help ensure that mortgage lenders adhere to such standards and requirements. Mortgage lenders should be required to retain a meaningful residual interest in all loans and credit lines they originate.

Background

Over the past 20 years, the link between mortgage underwriting and origination and retention of the risk of repayment has become increasingly attenuated. Although mortgage bankers and brokers, as well as some bank loan officers, have always been paid on the basis of the size of the loan and its characteristics, it has become common for brokers and others to be paid more for loans with higher interest rates or other characteristics (such as prepayment penalties) that in fact make it harder for borrowers to repay. The practice encouraged steering borrowers to loans for which they were not qualified and falsifying income and other data so borrowers could get loans they could not afford. Lenders that quickly sold loans to packagers of securitized products had little or no interest in the borrowers' ability to repay. Ultimately, investors who purchased mortgage-backed securities shouldered the credit risk.

The lack of meaningful federal oversight of consumer credit product providers exacerbated the off-loading of risk to investors. Without minimum standards and oversight applied consistently to all mortgage lenders, many of the largest mortgage originators "regulated" themselves—and competition drove down standards. The consequences were disastrous for borrowers, lenders, communities and the economy as a whole.

Specific Recommendations

1. Congress should create a new agency to regulate consumer financial products, including mortgages. The financial crisis has demonstrated that mortgage originators cannot exercise necessary market self-discipline and that current regulatory structures, where they exist, have failed to provide appropriate protection for both consumers and investors. The IWG supports the Administration's call for a new federal agency to regulate consumer financial products and payment systems. The agency should have broad rulemaking, oversight and enforcement authority.

2. Banks and other mortgage originators should comply with minimum underwriting standards, including documentation and verification requirements. Mortgage originators will make more responsible lending decisions if they face minimum underwriting standards that are subject to review by federal and state regulators. These standards should be based on a realistic appraisal of the borrower's ability to repay the debt, taking into account any features that would increase the payments in the future. Such standards should also require mortgage originators to obtain and verify key financial information from all borrowers and to obtain and retain evidence that the borrower has seen and agreed with this information before a loan is closed. Federal and state regulators should monitor all mortgage originators for compliance with these practices. These changes should reduce the "race to the bottom" that characterized the last decade.

3. Mortgage regulators should develop suitability standards and require lenders to comply with them. This will help ensure that mortgage companies consider carefully whether a particular credit product is appropriate for a particular borrower. Innovative features in mortgage products can help certain borrowers. But these should be tailored to each borrower's needs and ability to repay, and originators should be required to offer consumers the best possible mortgage rates, fees and terms for which they qualify.

4. Mortgage originators should be required to retain a meaningful residual interest in all loans and outstanding credit lines. Having "skin in the game" would make lenders more thoughtful about the credit-worthiness of potential borrowers. Mortgage lenders should be required to retain a meaningful interest in all loans and outstanding credit lines they generate. Federal and state regulators should be empowered to determine the minimum holding period and related terms and conditions. Lenders should be prohibited from hedging these exposures.

Nationally Recognized Statistical Rating Organizations

The failure of Nationally Recognized Statistical Ratings Organizations to alert investors to the risks of many structured products underscores the need for significant change in the regulation of credit rating agencies. Congress should grant the SEC greater authority to scrutinize NRSROs. Congress and the Administration should consider steps to encourage alternatives to the predominant, issuer-pays NRSRO business model. Congress also should eliminate the safe harbor in Section 11 of the Securities Act of 1933 that shields rating agencies from liability for due diligence failures. And to deter investors from relying too heavily on rating agencies, lawmakers and regulators should remove or diminish provisions in laws and regulations that designate minimum NRSRO ratings for specific kinds of investments.

Background

Credit ratings issued by NRSROs are widely embedded in federal and state laws, regulations and private contracts. Ratings determine the net capital requirements of financial institutions globally under the Basel II capital accords. They also dictate the primary types of investment securities that money market funds and pension funds may hold. Partly as a result, many institutional investors have come to rely on credit rating agencies as a basic investment screen, a problem that is exacerbated by the lack of adequate disclosures in the sale of asset-backed securities.

Despite the semi-official status of NRSROs as financial gatekeepers, the rating agencies face minimal federal scrutiny. The Credit Rating Agency Reform Act of 2006 did not much alter that "light-touch" oversight. Although it standardized the process for NRSRO registration and gave the SEC new oversight powers, those powers were limited. It also expressly ruled out any private right of action against an NRSRO.

The central role that rating agencies played in the financial crisis makes such limited oversight untenable. The leading NRSROs— Fitch Ratings, Moody's Investors Service and Standard & Poor's Ratings Services—maintained high investment-grade ratings on many troubled financial institutions until they were on the brink of failure or collapse. And well into the credit crisis, NRSROs maintained triple-A ratings on complex structured financial instruments despite the poor and deteriorating the quality of the sub-prime assets underlying those securities.

The conflicted issuer-pays model of many NRSROs contributed to their poor track record. Most NRSROs are paid by companies and securitizers whose debt they rate. With their profitability dependent on the rapidly growing business of rating structured finance products, rating agencies appear to have been all too willing to assign the high ratings that originators and underwriters demanded. Questions about the quality of their ratings continued to rise in recent years even as they rated more and more complicated instruments.

But credit rating agencies' statutory exemption from liability also keeps NRSROs from having to answer for their shoddy performance and poorly managed conflicts of interest. Credit rating agencies have long maintained that their ratings are merely opinions that should be afforded the same protection as the opinions of newspapers and other publishers. Judicial rulings have tended to support their claim to protected status.

To be sure, some investors relied too heavily on NRSRO ratings, ignoring warning signs such as the rating agencies' notorious failure to downgrade ratings on Enron and other troubled companies until they were on the brink of bankruptcy. And some investors ignored or failed to comprehend the fundamental differences between ratings on structured securities and ratings on traditional debt instruments.

Statutory and regulatory reliance on ratings encourages investors to put more faith in the rating agencies than they should. If the rating agencies cannot dramatically improve their rating performance, they should be weaned from such official seals of approval. At the very least, legal references to ratings should make clear that reliance on them does not satisfy the requirement that investors perform appropriate due diligence to determine the appropriateness of the investments. In other words, ratings should be seen not as a seal of approval for certain investments but as defining the investments that should not be considered for a particular purpose.

The IWG recognizes that it is not practical to abolish the concept of NRSROs and erase references to NRSRO ratings in laws and regulations, at least not with one stroke. Mandates to use ratings are embedded in many financial rules. The more practical course for the near term is to reform credit rating agency regulation and to work toward reducing or removing references to credit ratings in laws and regulations.

Specific Recommendations

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

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. They should not be permitted to rate any product where they cannot disclose the specifics of the underlying assets. Credit rating agencies should 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 safe harbors 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.

C. Corporate Governance

Investors need better tools to hold managers and directors accountable for their actions. Improved corporate governance requirements would also help restore trust in the integrity of U.S. financial markets. In particular, shareowners' ability to hold an advisory vote on the compensation of senior executives, as well as their ability to nominate and elect directors, must be enhanced. Board independence should also be strengthened.

Background

The global financial crisis represents a massive failure of oversight. Vigorous regulation alone cannot address all of the abuses that paved the way to financial disaster. Shareowner-driven market discipline is also critical. Too many CEOs pursued excessively risky strategies or investments that bankrupted their companies or weakened them financially for years to come. Boards were often complacent, failing to challenge or rein in reckless senior executives who threw caution to the wind. And too many boards approved executive compensation plans that rewarded excessive risk-taking.

But shareowners currently have few ways to hold directors' feet to the fire. The primary role of shareowners is to elect and remove directors, but major roadblocks bar the way. Federal proxy rules prohibit shareowners from placing the names of their own director candidates on proxy cards. Shareowners who want to run their own candidates for board seats must mount costly full-blown election contests. Another wrinkle in the proxy voting system is that relatively few U.S. companies have adopted majority voting for directors. Most elect directors using the plurality standard, by which shareowners may vote for, but not against, a nominee. If they oppose a particular nominee, they may only withhold their votes. As a consequence, a nominee only needs one "for" vote to be elected and unseating a director is virtually impossible.

Poorly structured pay plans that rewarded short-term but unsustainable performance encouraged CEOs to pursue risky strategies that hobbled one financial institution after another and tarnished the credibility of U.S. financial markets. To remedy this situation, stronger governance checks on runaway pay are needed.

Specific Recommendations

1. In uncontested elections, directors should be elected by a majority of votes cast. At many U.S. public companies, directors in uncontested elections are elected by a plurality of votes cast. An uncontested election occurs when the number of director candidates equals the number of available board seats. Plurality voting in uncontested situations results in "rubber stamp" elections. Majority voting in uncontested elections ensures that shareowners' votes count and makes directors more accountable to shareowners. Plurality voting for *contested* elections should be allowed because investors have a more meaningful choice in those elections.

2. Shareowners should have the right to place director nominees on the company's proxy. In the United States, unlike most of Europe, the only way that shareowners can run their own candidates is by waging a full-blown election contest, printing and mailing their own proxy cards to shareowners. For most investors, that is onerous and prohibitively expensive. A measured right of access would invigorate board elections and make boards more responsive to shareowners, more thoughtful about whom they nominate to serve as directors and more vigilant in their oversight of companies. Federal securities laws should be amended to affirm the SEC's authority to promulgate rules allowing shareowners to place their nominees for directors on the company's proxy card.

3. Boards of directors should determine whether the chair and CEO roles should be separated or whether some other method, such as lead director, should be used to provide independent board oversight or leadership when required. Boards of directors should be encouraged to separate the roles of chair and CEO or explain why they have adopted another method to assure independent leadership of the board.

4. Exchanges should adopt listing standards that require compensation advisers to corporate boards to be independent of management. Compensation consultants play a key role in the pay-setting process. But conflicts of interest may lead them to offer biased advice. Most firms that provide compensation consulting services to boards also provide other kinds of services to management, such as benefits administration, human resources consulting and actuarial services. These other services can be far more lucrative than advising compensation committees. Conflicts of interest contribute to a ratcheting-up effect for executive pay. They should be minimized and disclosed.

5. Companies should give shareowners an annual advisory vote on executive compensation. Nonbinding shareowner votes on pay would make board compensation committees more careful about doling out rich rewards to underperforming CEOs, and thus would avoid the embarrassment of shareowner rejection at the ballot box. So-called "say on pay" votes would open up dialogue between boards and shareowners about pay concerns.

6. Federal clawback provisions on unearned executive pay should be strengthened. Clawback policies discourage executives from taking questionable actions that temporarily lift share prices but ultimately result in financial restatements. Senior executives should be required to return unearned bonus and incentive payments that were awarded as a result of fraudulent activity, incorrectly stated financial results or some other cause. The Sarbanes-Oxley Act of 2002 required boards to go after unearned CEO income, but the Act's language is too narrow. It applies only in cases where misconduct is proven—which occurs rarely because most cases result in settlements where charges are neither admitted nor denied—and only covers CEO and CFO compensation. Many courts, moreover, have refused to allow this provision to be enforced via private rights of action.

II. SYSTEMIC RISK OVERSIGHT BOARD

The Investors' Working Group believes there is an immediate need to monitor and respond to risks to the entire financial system posed by large, complex, interconnected institutions, practices and products and supports the creation of an independent Systemic Risk Oversight Board to supplement, not supplant, the functions of existing federal financial regulators. The mission of the board should include collecting and analyzing the risk exposure of bank and non-bank financial institutions, as well as those institutions' practices and products that could threaten the stability of the financial system and the broader U.S. economy; reporting on those risks and any other systemic vulnerabilities; and recommending steps regulators should take to reduce those risks.

The Systemic Risk Oversight Board would fill an immediate void on systemic issues, and its future would be shaped by the findings of the Financial Crisis Inquiry Commission.

Background

The current U.S. system of financial regulation was not designed to monitor and respond to risks to the entire financial system posed by the interconnectedness of complex institutions, practices and products. To properly address the range of significant threats to the broader financial system, we need better and more coordinated information about a wide range of exposures. Mechanisms to identify and assess information on rapidly expanding markets and products also are critical.

Many factors contributed to the financial crisis, including excessive leverage, lax mortgage underwriting standards and a weak understanding of the risk profiles of complex securitized products. Just as devastating, however, was the absence of any oversight mechanism to track and sound early warnings about the extent to which financial institutions had taken on excessive leverage or held dangerously large concentrations of specific securities.

Individual exposures and the interconnections between institutions with significant exposures were misunderstood or not recognized and, in many cases, hidden from view. AIG was widely recognized as the king of credit-default swaps. But few appreciated that AIG's activities in the CDS market could not just produce catastrophic losses for the company; they imperiled dozens of AIG's counterparties too. The failure to count and connect the dots applied to highly regulated entities as well as those, such as hedge funds and private equity firms, which were lightly or not at all supervised. Even now, regulators world-wide are still sorting out the number and interrelations of many structured financial instruments.

One clear lesson of the financial crisis is the need for an ongoing effort to aggregate and analyze relevant risk exposure information across firms, securities instruments and markets. This oversight must keep up with financial innovation and be able to coordinate with regulators outside the United States. And it must suggest corrective steps before particular risks grow big or concentrated enough to threaten entire markets or economic sectors.

By taking a panoramic view, a Systemic Risk Oversight Board would be quicker to recognize emerging threats than would regulators that tend to focus more narrowly on the safety and soundness of individual institutions or on conduct that harms consumers and investors. In particular, the board would be able to identify practices designed to escape regulatory attention and other efforts by firms or individuals to exploit the cracks between various agencies' jurisdictions.

Much of the discussion surrounding systemic risk oversight has focused on two alternative approaches. One is to set up a strong systemic regulator in the more traditional sense: an agency with statutory authority that permits it to analyze and take direct action to contain or defuse emerging systemic risks before they wreak havoc. The other approach envisions a hybrid advisory council that would be a research- and information-sharing body with formal regulatory powers to address systemic imbalances. This "college of cardinals," as Senator Mark Warner (D-VA) has dubbed it, would have regulatory and enforcement authority and perhaps consist of the heads of key financial regulators.

The IWG believes both of these approaches have major drawbacks. First, the Administration and others in favor of a macro regulator with expansive, plenary authority over systemic risk regulation envision the Federal Reserve playing that role. But that would vest far too much authority in an agency whose credibility has been damaged by its own part in the financial cataclysm. The Fed's easy credit policies, pursued with the aim of stimulating the economy, enabled financial firms to lever up to sky-high levels and amass large concentrations of risky complex securitized products. The potential for conflict between monetary policy, the Fed's primary responsibility, and systemic oversight also argues against making the Fed the systemic risk regulator.

The Federal Reserve's existing duties are daunting enough. Besides crafting monetary policy, the Fed also supervises bank holding companies and the U.S. activities of foreign-owned banks and manages the vast U.S. payments system. Regulating systemic risk would heap too much responsibility on the Fed's already-full plate. Finally, the Federal Reserve's tendency to favor secrecy over public disclosure could undermine transparency and crucial consumer and investor protections.

The IWG also is concerned about systemic oversight via a coordinating council of existing financial regulators. Such a council would add a layer of regulatory bureaucracy without closing the gaps that regulators currently have in skills, experience and authority needed to track systemic risk comprehensively.

The IWG believes that a Systemic Risk Oversight Board would strike an appropriate balance between the two models. We advocate immediate creation of an independent board vested with broad powers to examine information from both bank and non-bank financial institutions and their regulators. The board would also have the authority to make recommendations to the appropriate regulators about how to address potential systemic threats. Regulators would either have to comply or justify an alternative course of action. In this way, existing regulators would still have the primary role in addressing systemic risk but could not ignore the board's findings or advice.

The long-term approach to systemic risk issues and the role of the Systemic Risk Oversight Board should hinge on the results of the Financial Crisis Inquiry Commission. One option would be for the Systemic Risk Oversight Board to evolve into a full-fledged regulator, if that is what policymakers determine is best.

Specific Recommendations

1. Congress should create an independent governmental Systemic Risk Oversight Board. To function efficiently, the board should consist of a chair and no more than four other members. All should be presidential appointees confirmed by the U.S. Senate. The board would be accountable primarily to Congress.

2. The board's budget should ensure its independence from the firms it examines. Funding should be adequate and sustainable to attract and retain highly competent board members and staff. Appropriate funding options include an industry assessment fee similar to that of the Public Company Accounting Oversight Board (PCAOB).

3. All board members should be full-time and independent of government agencies and financial institutions. Members should possess broad financial market knowledge and expertise. Collectively, the members should have backgrounds in investment practice, risk management and modeling, market operations, financial engineering and structured products, investment analysis, counterparty matters and forensic accounting.

4. The board should have a dedicated, highly skilled staff. Staffers should have a range of key skills and experiences and work exclusively for the board. They should be experts who understand the components and complexities of systemic risk and how to fully examine critical interconnections between firms and markets. To attract and retain top-notch individuals, staff and board member salaries should be commensurate with those of the PCAOB.

5. The board should have the authority to gather all information it deems relevant to systemic risk. The IWG believes that federal regulators do not currently have the full scope and depth of information they need to understand systemic risks in the U.S. financial system, much less the behavior of those risks in the context of global markets. For the Systemic Risk Oversight Board to have that capability, it should develop a timely way to identify a broad range of threats emanating from institutions, markets, practices, financial instruments and emerging products. Therefore, the board should have the legal authority to gather all the financial information it deems necessary to assess systemic vulnerabilities.

Defining such threats is not a static process. Systemic risks do not lurk only in systemically significant institutions. Highly concentrated market segments or critical financial instruments can threaten the health of the financial system. Risk may be baked into regulation in ways that are not well understood. For example, the financial crisis has revealed the danger to the markets of rules that make credit rating agencies gatekeepers for issuing debt without ensuring that they are independent and accountable for the accuracy of their ratings.

The board would need to develop appropriate procedures for determining which entities to examine and what information to review. It would need a degree of flexibility so that its focus and examinations could adjust to shifts in market conditions. The board and staff should be able to use their professional judgment to determine the scope of analysis for financial institutions, products or practices. The board should also have the authority to hire consultants and other experts as needed.

6. The board should report to regulators any findings that require prompt action to relieve systemic pressures and should make periodic reports to Congress and the public on the status of systemic risks. If appropriate, the board would also report its findings to specific companies and other institutions. The board should take steps to mitigate any severe market reactions or disruptions that could occur as a result of its reports. How the board reports its activities and findings should take into consideration the confidential nature of much of the information it will gather and the potential for market mayhem if information is not dealt with properly.

The board should also provide comprehensive, periodic reports on the state of systemic risks to all relevant regulators and Congress or committees designated by Congress as well as the public. As appropriate, the board should consult with systemic risk overseers outside the United States. The board should consult with regulators and Congress about the nature of any information it releases publicly.

7. The board should strive to offer regulators unbiased, substantive recommendations on appropriate action. As an independent monitor, the board should identify firms and markets that are at risk before significant damage is done. This might entail identifying exposures, modeling potential solutions and communicating those recommendations fully and clearly to regulators. Regulators should determine whether and how to implement the board's recommendations. Where appropriate, the board should coordinate its recommendations with those of overseas systemic risk overseers.

8. Regulators should have latitude to implement the oversight board's recommendations on a "comply or explain" basis. Regulators are generally better positioned to understand the operational and practical implications of a proposed regulatory action, and a regulator may believe that it would be appropriate to refine or modify a recommendation of the board. For this reason, the IWG does not believe that the Systemic Risk Oversight Board should have regulatory authority or other powers to force a regulator to implement a recommendation.

Instead, the recommendations would shift the onus of systemic risk mitigation onto regulators, by requiring them either to 1) adopt and implement the recommendation(s) as suggested, 2) refine and modify the recommendations as they deem necessary, or 3) reject them and take no further action or follow another course. In the case of options 2 or 3 above, the regulator would provide the board a detailed explanation of its response. This should include a discussion of any alternative approach to address the systemic risk the board identified. The regulator should also address any concerns or issues that could emerge if its alternative approach is not consistent with the coordinated response of other regulators. If the board is not satisfied with the regulator's response, it should communicate its concerns to the President and appropriate Congressional authorities.

About the Sponsoring Organizations

About the CFA Institute Centre for Financial Market Integrity

The CFA Institute Centre for Financial Market Integrity develops timely, practical solutions to global capital market issues, while advancing investors' interests by promoting the highest standards of ethics and professionalism within the investment community worldwide. It builds upon the 40-year history of standards and advocacy work of CFA Institute, especially its Code of Ethics and Standards of Professional Conduct for the investment profession, which were first established in the 1960s. In 2007, the CFA Institute Centre published *Self-Regulation in Today's Securities Markets: Outdated System or Work in Progress?*, a report that explored the failure of the current system of self-regulation to keep pace with the dramatic evolution of the global economy.

About the Council of Institutional Investors

The Council of Institutional Investors is a nonprofit association of public, union and corporate pension funds with combined assets exceeding $3 trillion. Member funds are major long-term shareowners with a duty to protect the retirement assets of millions of American workers. The Council strives to educate its members, policymakers and the public about good corporate governance, shareowner rights and related investment issues, and to advocate on our members' behalf. Corporate governance involves the structure of relationships between shareowners, directors and managers of a company. Good corporate governance is a system of checks and balances that fosters transparency, responsibility, accountability and market integrity.

For further details about the **Investors' Working Group** or this report:

contact:
Linda Rittenhouse
CFA Institute Centre for Financial Market Integrity
linda.rittenhouse@cfainstitute.org
434.951.5333

contact:
Amy Borrus
Council of Institutional Investors
amy@cii.org
202.822.0800

Testimony of
Gregory W. Smith
General Counsel & COO
Public Employees' Retirement Association of Colorado
before the
Subcommittee on Oversight and Investigations
of the
Committee on Financial Services
on
Oversight of the Credit Rating Agencies Post Dodd-Frank
July 27, 2011

Attachment 3

Frank Partnoy, Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective

Council of Institutional Investors
The Voice of Corporate Governance

Rethinking Regulation of Credit Rating Agencies:

An Institutional Investor Perspective

Prepared by Frank Partnoy
George E. Barrett Professor of Law and Finance
Director of the Center on Corporate and Securities Law
University of San Diego School of Law
April 2009

This white paper was commissioned by the Council of Institutional Investors to educate its members, policymakers and the general public about proposals to regulate credit rating agencies and their potential impact on investors. The views and opinions expressed in the paper are those of Professor Partnoy and do not necessarily represent views or opinions of Council members, board of directors or staff.

Contents

Council of Institutional Investors
The Voice of Corporate Governance

SECTION I

Executive Summary

Credit ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs) are used to fulfill a wide range of regulatory and contractual requirements in the United States and abroad. Over time, NRSRO ratings have become woven into federal and state laws, regulations, and private contracts. Ratings dictate the net capital requirements of banks and broker-dealers, the securities money market funds may hold, and the investment options of pension funds. As legal requirements for ratings have proliferated, the rating agencies have evolved from information providers to purveyors of "regulatory licenses." A regulatory license is a key that unlocks the financial markets. Credit rating agencies profit from providing ratings that unlock access to the markets, regardless of the accuracy of their ratings.

The global credit crisis has called into question this role of rating agencies as financial gatekeepers. The debacle was fueled in part by credit rating agencies "licensing" complex, risky financial instruments with triple-A ratings they did not deserve. Both regulators and institutional investors relied on those ratings, to their peril.

In response, policymakers in the United States and abroad are considering measures to make rating agencies more accountable and rating processes more transparent. Proposals to overhaul credit rating agency regulation run the gamut, from increased disclosure requirements to removing references to credit ratings in rules and regulations.

Given the abysmal performance of rating agencies, widespread reliance on ratings is no longer warranted. However, it is not feasible or practical for regulators and investors simply to stop using ratings. Mandates to use ratings have become part of the fabric of financial markets, and cannot be unwoven instantaneously.

There is an immediate need, however, to revamp the regulatory framework surrounding credit rating agencies. This paper offers an institutional investor perspective of the pros and cons of several proposals for redesigning credit rating agency regulation. It focuses on two areas of primary importance — oversight and accountability — and offers specific recommendations in both areas.

> **Oversight:** Congress should create a new Credit Rating Agency Oversight Board (CRAOB) with the power to regulate rating agency practices, including disclosure, conflicts of interest, and rating methodologies, as well as the ability to coordinate the reduction of reliance on ratings. Alternatively, Congress could enhance the authority of the Securities and Exchange Commission (SEC) to grant it similar power to oversee the rating business.
>
> **Accountability:** Congress should eliminate the effective exemption of rating agencies from liability and make rating agencies more accountable by treating them the same as banks, accountants, and lawyers.

As financial gatekeepers with little incentive to "get it right," credit rating agencies pose a systemic risk. Creating a rating agency oversight board and strengthening the accountability of rating agencies is thus consistent with the broader push by U.S. policymakers for greater systemic risk oversight. Over the long term, other measures for assessing credit risk may become more acceptable and accessible to regulators and investors. Meanwhile, a more powerful overseer and broader accountability would help reposition credit rating agencies as true information intermediaries.

SECTION II

Background

Three players have long dominated the credit rating business: Fitch Ratings, Moody's Investor Service, and Standard & Poor's Ratings Services. Fitch's market share, however, is significantly smaller than its two main rivals. Despite the presence of seven additional NRSROs, this trio is responsible for 98 percent of all outstanding ratings issued by NRSROs. And because only NRSRO ratings can be used to fulfill certain regulatory requirements, these three rating agencies wield immense, quasi-governmental power.

NRSROs have been the subject of intense criticism because of the part they played in the financial crisis. Just months ago, S&P, Moody's, and Fitch gave high investment grade ratings to 11 big financial institutions that later faltered or failed. They rated AIG in the double-A category. They rated Lehman Brothers single-A a month before it collapsed. Until recently, the NRSROs maintained triple-A ratings on thousands of nearly worthless subprime-related instruments.

In June 2008, the SEC reported that its examination of the three dominant agencies had uncovered serious deficiencies in their ratings and rating processes. For example, one analyst expressed concern that her firm's model did not capture "half" of a deal's risk, and that "it could be structured by cows and we would rate it."[1] Legislators have held hearings criticizing the agencies, and regulators have recommended reforms.

Yet these credit rating agencies continue to play a central role as powerful and influential gatekeepers in global financial markets. It is hard to overstate the importance of the role of credit rating agencies and their letter ratings. Thomas Friedman, the *New York Times* columnist, expressed the prominence of credit rating agencies succinctly in 1996, well before the significant increase in the prominence of ratings and ratings-driven deals:

> "There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful."[2]

Given the central role of ratings, it is worth rethinking a basic paradoxical question: Why are credit ratings and rating agencies so important if they are often so unreliable? This background section addresses this question. Then, the two following sections address the pros and cons of two major areas of reform: oversight and accountability.

From Information Intermediaries to Regulatory Licensors

Rating agencies began as information intermediaries, entities that step in to assess product quality when sellers cannot credibly make claims about product quality themselves. Information intermediaries function best when they have reputational capital at stake and will suffer a loss if their assessments are biased, negligent, or false.

In the early debt markets, credit rating agencies helped to bridge information gaps between bond buyers and sellers. In 1909, John Moody published his first *Manual of Railroad Securities*, in which he rated 200 railroads companies and their securities. Moody's insight was that he could profit by selling to the public a synthesis of complex bond data in the form of single letter ratings: Aaa, Aa, A, Baa, Ba, B, Caa, Ca, C, in declining order of credit quality. These letter ratings were not designed to have any specific meaning, as might be the case for modern financial analysis. They were not, for example, designed to mark categories of percentages of expected probability of default or of recovery in the event of default. Instead, they were a rough compilation of disparate information about bonds that investors found difficult or costly to assess on their own.

Over time, however, rating agencies have shifted from selling information to selling "regulatory licenses," keys that unlock the financial markets. This shift began after the 1929 crash, when regulators turned to the rating agencies, primarily Moody's and S&P, for measures of bond quality in banking and insurance guidelines. Federal Reserve examiners proposed a system for weighting the value of a bank's portfolio based on credit ratings. Bank and insurance regulators expressed the "safety" or "desirability" of portfolios in letter ratings, and used such ratings in bank capital requirements and bank and insurance company investment guidelines. States relied on rating agencies to determine which bonds were "legal" for insurance companies to hold. The Comptroller of the Currency made similar determinations for federally chartered banks.

The SEC's introduction of the NRSRO concept in the mid-1970s further encouraged regulators to increase their reliance on ratings.[3] During that same period, the NRSROs stopped selling ratings to investors and began charging the companies that issue the debt they rate. The issuer-pay model introduced significant new conflicts of interest — chiefly, the challenge for credit raters of impartially rating securities of companies that generate their revenues. But the rating agencies believed that they could manage these conflicts internally.

Regulators now mandate that institutions of all types pay heed to NRSRO credit ratings as a necessary step for regulatory compliance. Some rules require that certain investors can only buy bonds with high ratings. Other rules reduce capital requirements for institutions that purchase highly rated bonds. Without high ratings, bond issuers cannot access certain markets because they do not have a "license" from the NRSROs to comply with NRSRO-dependent regulations.

Regulatory dependence on ratings created higher demand for ratings and increasingly higher profits for NRSROs, even when their ratings proved spectacularly inaccurate. Too often, rating changes lagged the revelation of public information about rated issuers and instruments. Prominent examples included California's Orange County and Enron, both of which received high credit ratings until just before they filed for bankruptcy protection. Even so, the rating agencies have been shielded from liability by their insistence that their ratings were merely opinions protected by First Amendment free speech privileges.

Rating agencies also began rating substantially greater numbers of issuers and increasingly complex instruments. But the resources expended per rating declined. As they expanded ratings to cover large numbers of structured finance products, including tranches of various collateralized debt obligations, some NRSROs neglected to divert resources to update rating models and methodologies or recruit additional staff needed to ensure quality. As a senior analytical manager at one of the big three rating agencies put it in a February 2007 e-mail: "We do not have the resources to support what we are doing now."[4]

The Paradox of Credit Ratings

Paradoxically, the leading NRSROs have become more profitable even as the quality of their ratings has declined. Operating margins for some in recent years topped 50 percent; Moody's profit margins were higher than the margins of any other company in the S&P 500 for five consecutive years during the early 2000s. Moody's market capitalization was nearly $20 billion at its peak; S&P was similarly profitable and large. The companies that owned NRSROs drew savvy investors, looking to profit from the reliable returns associated with the sale of regulatory licenses. Warren Buffet is a major investor in Moody's, and as of Dec. 31, 2008, held more than 20 percent of its outstanding common shares.

One explanation of this paradox is that profits from the sale of regulatory licenses do not depend greatly on the informational value of ratings. If regulators and private actors defer to private standard setters, those private standard setters will earn profits from that deference even if their standards are not useful. Over time, both regulators and private actors might decide to shift to alternative sources of information and analysis. However, to the extent they do not shift, the private standard setters will continue to prosper, even if their standards lack informational value.

Another explanation is that rating agencies have been effectively exempt from civil liability. With rare exceptions, rating agencies have not suffered damages from litigation even when they were negligent or reckless in issuing overly optimistic ratings. To some extent, the rating agencies' success in avoiding liability is due to legislative policy, such as the explicit statutory exemption from liability under Section 11 of the Securities Act of 1933 or the limitations on private rights of action in the Credit Rating Agency Reform Act of 2006. But the exemption also is due to a handful of judicial decisions accepting the rating agencies' assertion that ratings are merely "opinions," which, under the First Amendment, should be afforded the same protection as opinions of publishers.

The accountability of NRSROs has deteriorated so much that institutional investors now are vulnerable if they rely on credit ratings in making investment decisions. To the extent rating agencies are not subject to liability, an institutional investor's defense of reliance on ratings is weakened, because constituents can argue that ratings are less reliable when rating agencies are not accountable for fraudulent or reckless ratings.

Overall, this lack of accountability has impeded the ability and willingness of rating agencies to function as information intermediaries because they do not credibly pledge reputational and economic capital in the event they fail to perform their core function. But it also partially explains the paradox: Rating agencies that are insulated from liability have a more profitable, dominant franchise.

The paradox of credit ratings has persisted during the recent financial crisis. Even though ratings have plummeted in informational value, since portions of the U.S. government rescue efforts rely on them, ratings are more important than ever. Specifically, the Federal Reserve's $1 trillion Term Auction Lending Facility (TALF) plan, which lends money to investors to purchase new securities backed by consumer debt, mandates that only securities rated by two or more major NRSROs are eligible for government support.

Moreover, when government officials anticipated the potential negative impact of AIG's announcement of quarterly earnings in March 2009, they implemented a fourth rescue package for the insurer and consulted privately with representatives of the dominant NRSROs, to be sure the plan would be attractive enough to avoid a downgrade of AIG, which would have killed the company. Because of overdependence on NRSROs, both regulators and investors were in a ratings trap.

Recent Efforts by Regulators

In response to several market crises over the last decade, regulators have tried to remedy some of the problems in the credit rating industry. The SEC and the International Organization of Securities Commissions (IOSCO), an organization representing dozens of global regulators that focuses on establishing standards of financial regulation, produced reports assessing the role of rating agencies in the markets.

After a series of hearings, Congress adopted the Credit Rating Agency Reform Act of 2006. While this act standardized the process for NRSRO registration and gave the SEC new oversight powers, it prohibited the SEC from regulating "the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings." The act also stated that it "creates no private right of action." The rating agencies supported this act, in part because its scope was so narrowly circumscribed.

More recently, many federal and state legislators and regulators have lambasted the rating agencies for their part in the financial crisis. Even the President's Working Group on Financial Markets, long a champion of deregulation and financial innovation, sharply criticized the flaws in the rating agencies' assessments of complex products and called them a "principal underlying cause" of the crisis.[5] Lawmakers in the European Union have continued to push for the development of a new European credit rating agency regulatory authority.

In June 2008, the SEC released a report outlining serious deficiencies in the ratings process. It subsequently adopted new rules designed to increase the transparency of NRSRO rating methodologies, strengthen NRSRO disclosures of ratings performance, prohibit certain conflicted NRSRO practices, and enhance NRSRO recordkeeping. These rules reflected much political compromise. For example, regulatory review and scrutiny of NRSRO procedures were limited. Even the NRSROs' obligation to make publicly available their ratings histories was limited to a random sample of 10 percent of issuer-paid ratings for each class of ratings.

In December 2008 the SEC re-proposed rules governing the conduct of NRSROs. Specifically, the SEC proposed barring NRSROs from issuing ratings for structured finance products unless the information related to those securities was published on a password-protected Web site that other NRSROs could access, under certain conditions; other NRSROs would have to agree to provide and maintain ratings on 10 percent of the securities for which they tapped the Web site. The proposals also included a provision requiring complete disclosure of issuer-paid ratings and ratings histories.

The SEC shelved its proposal to eliminate requirements for NRSRO ratings in some of its own regulations. The proposal had received mixed views from investors. Many preferred a more incremental approach. This idea is discussed in more detail later in this paper.

SECTION III

Oversight

It is now widely accepted that the architecture of credit rating agency regulation needs reform. SEC Chairman Mary L. Schapiro recently stated: "To this end, allow me to highlight a few of the initiatives that I hope to pursue as priorities: Improving the quality of credit ratings by addressing the inherent conflicts of interest credit rating agencies face as a result of their compensation models and limiting the impact of credit ratings on capital requirements of regulated financial institutions."[6]

These improvements require both a change in regulatory structure and new regulatory powers. Like other areas of financial regulation, the regulation of credit ratings has been piecemeal and is spread throughout numerous state and federal governing bodies, including securities, banking, and insurance. Ideally, improvements in regulatory structure would entail consolidation of credit rating regulation within one umbrella organization with additional responsibilities and new powers.

Regulatory Structure

One approach would be to create a single independent Credit Rating Agency Oversight Board (CRAOB), with a structure and mission similar to that of the Public Company Accounting Oversight Board (PCAOB). It could be a free-standing entity created by statute to oversee registration, inspections, standards, and enforcement actions related to NRSROs, just as the PCAOB oversees audit firms. The board also could encourage and facilitate the development of alternatives to NRSRO ratings among market participants. Congress should make this mission to facilitate the eventual removal of "regulatory licenses" explicit in authorizing the board.

Two alternative options to a free-standing rating agency oversight board would be to establish an office within the SEC strictly dedicated to the regulation of NRSROs, with enhanced powers, or to house oversight of credit rating agencies within the PCAOB. The functions and duties of a rating agency overseer are somewhat consistent with the mandate of the PCAOB, which was created to protect investors and the public interest by promoting informative, fair, and independent audit reports. Under the PCAOB approach, Congress would simply authorize additional funds for the PCAOB to establish these new functions, and pass legislation creating new PCAOB authority. However, integrating credit rating agency oversight duties into the PCAOB could present organizational and legislative challenges.

Ideally, a consolidated credit rating agency overseer would have two overriding characteristics: independence and specialized expertise. A free-standing board would require independent funding so that it would not depend on Congress or other agencies for frequent funding or decision-making. Initial funding could be in the form of an endowment. Alternatively, funding could be provided through required, periodic NRSRO user fees or transaction fees.

Securing reliable funding would be particularly important in order to offer salaries sufficient to attract high caliber board members. Board members should have specific expertise in assessing credit risk and, more generally, an understanding of financial markets, asset pricing, and alternative information sources and intermediaries.

Members of the board should be independent and appointed for limited terms. The appointment process should be designed to limit the potential for influence by the credit rating agencies, and board members should not be permitted to join NRSROs after their service.

Proponents acknowledge that the SEC recently has stepped up its oversight of the rating business. But many believe that the agency is not likely ever to be a bold enough regulator. They say the SEC has been reluctant to use its existing authority or request additional power from Congress and often has been captive to the ratings industry, which has lobbied strenuously against proposals to strengthen accountability and disclosure rules.

In addition, regulatory reliance on NRSROs beyond the SEC's authority limits the commission's ability to implement a coordinated approach to credit rating agency regulation. For example, even the SEC's proposal to eliminate ratings references in some of its own rules would have applied narrowly, and would not have affected regulatory reliance on ratings in banking and insurance regulations.

Critics of a free-standing rating agency oversight board, however, counter that more fragmentation of financial regulation would add more layers to the already complex web of financial market regulation in the United States. They also believe that the SEC already has the staff, expertise, and contacts to regulate rating agencies; they say it simply needs greater authority and resources from Congress.

Adding New Oversight Authority

Whatever structure the overseer takes, it will need additional legislative authority to implement its objectives. Although the SEC recently has adopted new rules for credit ratings, the scope of its legislative authority is limited.

Below are several specific areas of oversight authority that could be expanded immediately. One approach would be to enumerate each of these areas in the adopting legislation. Alternatively, Congress might grant the board general oversight authority over NRSRO practices, and let the board adopt rules in each area. Again, the rating agencies might contend that such authority would infringe their free speech privileges; they frequently have made veiled threats to assert such a claim.[7]

Disclosure of Credit Rating Actions. A rating agency overseer should have the statutory authority to require significantly more extensive NRSRO disclosure, including a complete record of rating history, such as initial rating, upgrades, downgrades, placements on watch for upgrade or downgrade, and withdrawals.

Current disclosure proposals are more limited, in part because of questions about the scope of regulatory authority granted by the Credit Rating Agency Reform Act of 2006. For example, the SEC finalized new rules in February 2009 that require NRSROs to make available to the commission individual records for each of their outstanding credit ratings showing all rating actions. In addition, the rules require NRSROs to publicly disclose rating action histories in eXtensible Business Reporting Language (XBRL) format. However, they can delay disclosures for six months and must disclose rating action histories only for a randomly selected 10 percent of issuer-paid ratings. Similarly, in February, the SEC proposed requiring disclosure, on a 12-month delay, of all issuer-paid credit ratings issued on or after June 26, 2007. Under the rules adopted in February and proposals still pending, unsolicited ratings and subscriber-paid ratings are exempt from disclosure.

SECTION III

Congress should authorize the board to require that NRSROs disclose complete records to the public, not merely to the regulator. In addition, disclosure should extend to unsolicited ratings and subscriber-paid ratings. Current rules do not provide investors with the level of information necessary to assess and compare ratings and rating agencies. Securities included in one NRSRO's 10 percent disclosure pool are not necessarily included in other NRSROs' pools, thus making a true comparison between rating agencies impossible. Moreover, excluding unsolicited and subscriber-paid ratings from public analysis eliminates valuable data from market scrutiny.

Critics argue that requiring full disclosure for subscriber-paid ratings would undermine the business model of agencies that issue them. The rationale for bottling up information inside a regulatory authority, however, is not persuasive. Investors need greater transparency to be able to compile and analyze ratings and rating changes. Effective oversight of the credit rating business must include market oversight, which requires that investors have access to complete data regarding credit ratings.

Symbology. Symbology is a contentious topic. Although the oversight board should have the power to assess different categories of ratings and require NRSROs to use alternative symbology (e.g., numbers instead of letters, or letter subscripts) for ratings in different categories, it should take extreme caution before exercising that power.

In June 2008, the SEC proposed amendments to current regulations to require NRSROs to distinguish ratings on structured products by either 1) attaching a report to the rating itself describing the unique rating methodologies used in establishing the rating and how the security's risk characteristics differ from others (i.e., corporate bonds) or 2) using symbols unique to structured products only (i.e., numbers rather than letters). The SEC's intent was to spur investors to perform more rigorous internal risk analysis on structured products, thereby reducing undue reliance on ratings in making investment decisions. Although the commission has not addressed the proposals yet, in March 2009, the European Union moved forward on a proposal to require that rating agencies identify ratings on structured products, as well as unsolicited ratings, by different symbols.

Proponents suggest that alternative symbology could benefit investors in a number of ways. Particular letter ratings mean different things when applied to structured finance issuers vs. corporate issuers vs. municipal issuers. Different symbols for structured products could serve as a flashing light for investors, signaling that the securities' risk characteristics are more volatile than those of other securities. And at a basic level, different symbols for different classes of securities would notify users that the agencies used different methodologies to generate the ratings.

An additional advantage to requiring that NRSROs use letter ratings only for corporate bonds is that most regulations and investment guidelines then would refer only to corporate bonds. Securities rated using a new symbology would fall outside the scope of those rules. Thus, symbology reform could force a wholesale rewrite of the rules governing investments other than corporate bonds. It could remove "regulatory licenses."

Critics assert that if NRSROs were required to use different symbols to rate different categories of securities, the investing public would be more confused than informed. The rating agencies also contend that mandating different nomenclature for different classes of securities would violate their First Amendment protection.

A vital function of the board would be to consider market participants' diverse positions, evaluate the positive and negative consequences relating to credit rating symbols (including which classes of securities could or should be identified by unique symbols), and work with international regulators to mitigate confusion over inconsistencies in symbol regulation.

Methodologies. The board should have the authority to require greater disclosure of NRSRO methodologies. Flawed methodologies were a core reason NRSROs gave overly high ratings to complex structured finance instruments. Allowing investors the opportunity to analyze rating agencies' methodologies would serve as a vital market-based quality check.

Current SEC registration rules require minimal disclosure. Rating agencies' registrations are stale, and their descriptions of methodologies and procedures are opaque. It is not helpful for the rating agencies to release their general statistical methods and models if they do not also specify the assumptions in those models.

The board should focus on disclosures that would enable institutional investors to assess key underlying variables, such as expected probability of default. Letter ratings alone are not helpful. Indeed, the rating agencies admit that letter ratings are ordinal, not cardinal, in that they rank issues in order of relative credit risk, but do not specify any particular expected default. For example, according to S&P: "The definitions of each rating category also make clear that we do not attach any quantified estimate of default probability to any rating category."[8] Yet the rating agencies use default probabilities in their models, and ratings reflect implied default probabilities, which can vary substantially from those implied by market prices.

Rating agencies contend that their methodologies are proprietary and that requiring detailed disclosure of their methodologies would promote free-riding, remove incentives for innovation, and leave the market with a smaller number of similarly derived credit ratings rather than a larger pool of ratings based on different methods of analysis. On balance, however, the likely benefits of enhanced disclosure far outweigh such objections.

Some critics assert that the board also should have substantive oversight of rating agency methodologies, as a quid pro quo for the benefits NRSROs enjoy from regulatory reliance on their ratings. The rating agencies might fiercely resist such authority and argue it would violate their First Amendment rights. Under pressure from the leading NRSROs, Congress explicitly excluded from the SEC's regulatory authority the ability to oversee rating methodologies.

Others believe NRSRO ratings are systemically important enough to the global market to warrant giving the board this authority. With such authority, the board could sanction rating agencies whose ratings consistently failed to meet or exceed an acceptable level of accuracy. The board could bar NRSROs from issuing ratings on new types of securities for which there is little historical data. It also could require NRSROs to use third-party due diligence services to ensure the accuracy of data used to establish ratings on complex securities. Such powers should be exercised cautiously and only after the regulator has investigated the potential costs and benefits.

Conflicts of Interest. New legislative authority also is needed to police NRSRO conflicts of interests and to investigate the extent to which conflicts of interest differ for issuer-pay NRSROs vs. investor-pay NRSROs (also referred to subscriber-pay NRSROs). Section 15E(h)(1) of the Exchange Act requires an NRSRO to establish, maintain, and enforce policies and procedures reasonably designed to address and manage conflicts of interest. Although Congress directed the commission in 2006 to issue final rules to prohibit or require the management and disclosure of conflicts of interest, the SEC has been reluctant to take full advantage of its power.

Some market participants have urged Congress to prohibit issuer-pay NRSROs altogether. This approach would eliminate the conflicts of interest associated with rating agencies receiving compensation from issuers of the securities they rate. But investor-pay NRSROs are subject to potential pressure from clients to slide ratings one way or another.

For example, institutions that can only invest in highly rated instruments might pressure a rater to guarantee a particular security gets an investment-grade rating. Others might press the rating agencies for lower ratings in hopes of receiving higher returns.

An alternative to a blanket prohibition of the issuer-pay business model would be to require disclosure of business relationships and to prohibit NRSROs from engaging in business activities other than issuing ratings. Auditors face similar restrictions. Both the SEC and the rating agencies recognize that conflicts of interest are endemic in the rating process and the SEC has stated that "NRSROs that are compensated by subscribers appear less likely to be susceptible to 'ratings shopping' or reducing quality for initial ratings to induce revenues."[9] The new board should consider whether increased disclosure rules and prohibitions on ancillary business activities should apply equally to all NRSROs.

Fees. Many investors believe the overseer should require rating agencies to disclose their fees. They also call for a reexamination of the compensation structure of NRSROs.

At a minimum, the board should have the power to require NRSROs to publicly disclose fee schedules and individual rating fees for every rated deal. The rating agencies currently disclose only summary information regarding fees, and they do not make data available for fees on individual deals. Fee transparency would increase incentives for ratings accuracy by creating a new method of competition in the ratings business. Ratings "shopping" based on fee levels would not present the same conflicts and challenges as ratings shopping based on rating levels. Moreover, such disclosure could also reveal potential conflicts of interest arising from an issuer's heavy use of one particular agency.

Alternative pay structures, and the power to reform those structures, should also be considered. Some critics have suggested that issuers could pay a small percentage of any fees upfront, with the remaining fee being "earned out" in the following years, until the maturity of the rated instrument. In order to motivate NRSROs to update their outstanding ratings regularly, fees could depend on certain contingencies or milestones, and might even be related to the accuracy of the rating, as assessed by comparison to other measures of credit risk, including market measures. Over time, such performance-based compensation could discipline NRSROs to strive for greater accuracy. Alternatively, rating agencies might be required to hold stakes in certain instruments that they rate highly.

Fee-for-service style payment also should be considered. Incentives are better aligned if both parties are in a pay-as-you-go situation. Under such a regime, if the credit rating agency breached its arrangement with the issuer (for example, by ceasing its ratings or by changing its assumptions in a way that renders the ratings inaccurate), the issuer would no longer be obligated to pay the agency. Staggering pay in this way might avoid some of the perverse incentives in the ratings process.

Access to Inside Information. For years rating agencies have enjoyed an exemption from Regulation Full Disclosure, or Regulation FD, which allows the rating agencies to receive inside information from issuers that is not shared with the market.[10] The agencies contend that the exemption is needed in order to fully evaluate credit risk. NRSROs say the Regulation FD exemption allows them to alert the public to any substantial changes in the status of a security more quickly and clearly through rating upgrades, downgrades, and watches. Moreover, some argue that credit rating agencies should be able to receive material non-public information from arrangers for the purpose of developing unsolicited credit ratings.

But a strong case can be made for removing this exemption. Rating actions, without a substantial increase in transparency, can cause confusion and speculation. And unsolicited credit ratings are rare. Unless that practice becomes common, there is scant justification for giving credit rating agencies access to inside information through a Regulation FD exemption. Moreover, it is far from apparent that credit rating agencies have incorporated inside information in their ratings. Most notoriously, even though Enron made non-public credit rating agency presentations, information about the risks described in those presentations was not reflected in Enron's credit ratings. The same has been true of structured finance ratings. For these reasons, the board should have the power to limit the subsidy given to credit rating agencies to obtain, and act upon, material non-public information.

Regulators also should set governance standards for NRSROs more broadly. It is worth noting that federal overseers have become more involved in governance of other financial institutions as the government's interest in those institutions has increased during the crisis. Rating agencies, too, played a key role in the debacle, and their quasi-governmental powers need stronger checks and balances.

SECTION IV

Accountability

Although inaccurate and unreasonable credit ratings from NRSROs were a primary cause of the recent crisis, the agencies remain largely unaccountable. As noted above, in order for credit rating agencies to function properly as gatekeepers, they must be able to credibly pledge a loss of reputational capital in the event they fail to perform their functions. Yet the rating agencies vehemently resist any assignment of liability for their ratings, hewing to the dictum that they merely provide "opinions," and that no one should rely on ratings in making investment decisions. But ratings are more than opinions, and rating agencies must become more accountable.

Critics offer two approaches to improving the accountability of credit rating agencies: litigation and competition. A credible threat of civil liability would force credit rating agencies to be more vigilant in guarding against negligent, reckless, and fraudulent practices. A credible threat that both regulators and market actors will switch to alternatives to credit ratings could force rating agencies to behave more like information intermediaries than providers of regulatory licenses. Both accountability measures are consistent with oversight reforms. A stronger regulator could help to ensure that credit rating agencies are more accountable to private market actors and subject to competition.

Eliminating the Rating Agency Exemption from Liability

Historically, the threat of liability has been an effective tool in encouraging gatekeeper accountability. In general, gatekeepers are less likely to engage in negligent, reckless, or fraudulent behavior if they are subject to a risk of liability.

Although most financial market gatekeepers have been subject to serious threats of civil liability, credit rating agencies have not. Some market observers believe that, with appropriate changes in policy, litigation could become a viable tool for ensuring NRSRO accountability.

Rating agencies have been sued relatively infrequently, and rarely have been held liable. As rational economic actors, rating agencies factor in the expected costs of litigation, including the cost of defending lawsuits as well as any damage awards or settlements. Given the litigation track record, the fact that the rating agencies have published unreasonably high ratings should not be surprising.

Litigation against the credit rating agencies often is deterred by statutory provisions and judicial precedent that limit the liability of NRSROs. NRSROs are immune from liability for misstatements in a registration statement under Section 11 of the Securities Act of 1933. Securities Act Rule 436 explicitly provides that NRSRO are exempt from liability as an expert under Section 11.[11]

In addition, courts have not been willing to impose liability on rating agencies for other alleged federal and state violations, and the threat of NRSRO liability is limited given judicial precedent in the area. Rating agencies were sued following a number of defaults, including class action litigation related to the Washington Public Power Supply System default in 1983; claims related to the Executive Life bankruptcy in 1991; a suit by the Jefferson County, Colorado, School District against Moody's in 1995; and claims by Orange County, California, based on professional negligence, against S&P in 1996. However, the only common element in these cases was that the rating agencies won. The suits were dismissed or settled on favorable terms to the rating agencies. For example, Orange County's $2 billion suit against S&P nettled a paltry settlement of $140,000, roughly 0.007 percent of the claimed damages.

A more recent example was the portion of the consolidated Enron litigation involving claims brought by the Connecticut Resources Recovery Authority.[12] Consider the following statement from the Houston federal district court hearing that case:

> "After reviewing the case law regarding credit rating agencies and a number of reports and law review articles, this Court finds that generally the courts have not held credit rating agencies accountable for alleged professional negligence or fraud and that plaintiffs have not prevailed in litigation against them. Moreover, there is even a statutory exemption under the Securities Act of 1933 for Section 11 claims against credit rating agencies like the three Defendants here that have been designated 'nationally recognized statistical rating agencies' or 'NRSROs.'"[13]

The Enron court, like some other courts, extended a qualified First Amendment protection to credit rating agencies. Ironically, in doing so, the judicial decision cited the Senate Committee on Governmental Affairs report, "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs" and its statement that "It is difficult not to wonder whether lack of accountability — the agencies' practical immunity to lawsuits and nonexistent regulatory oversight — is a major problem."[14]

Recently, however, a few courts have exhibited some skepticism about judicial protection of credit rating agencies from liability. One plaintiff has had success alleging that Moody's made misrepresentations regarding its independence and ratings methodologies.[15] Another court indicated skepticism of the rating agency's First Amendment argument in the context of private placements, because the rating is not published generally to the public.[16]

Such modest pushback against the rating agencies' free speech assertions is strongly rooted in the economics of ratings, and the fact that ratings agencies are compensated for their "opinions" by the same issuers they are opining about. Rating agencies' profit margins have exceeded 50 percent, whereas more traditional publishing companies' profit margins have been less than 10 percent. Given the high profile nature of the problems with rating agencies and the continuing profitability of the ratings business, judges in future cases may be less inclined to view rating agencies' "opinions" as on par with opinions of publishers.

Indeed, given the dearth of rating agency employees compared to rated issues, rating agencies hardly act like publishers. In 2005, before the beginnings of the recent crisis, Moody's provided ratings for roughly 745,000 different securities; even the largest publishing companies publish only a fraction of that number of stories or opinions.

Moreover, in one important context — the compensation of their senior executives — rating agencies behave more like financial service companies than publishers. Compensation of NRSRO senior management is much higher than executive pay at publishing companies.

Moody's peer group for compensation purposes, as disclosed in its most recent Compensation Discussion and Analysis, was dominated by financial services firms, including AllianceBernstein, BlackRock, CME Group, Eaton Vance, Federated Investors, Franklin Resources, Invesco, Morningstar, NASDAQ OMX Group, NYSE Euronext, Union Bank California, and other financial firms.[17] Only a handful of publishing companies were on the list. If NRSROs are not comparable to publishers for compensation purposes, they should not be comparable to publishers in litigation for First Amendment purposes. Firms like BlackRock and Union Bank of California are not immune from securities fraud claims.

Perhaps most important, judicial immunity for rating agencies creates challenges for institutional investors, particularly those that rely, at least in part, on credit ratings in their investment process. If judges find that NRSROs are not accountable for negligent, reckless, or fraudulent behavior, it is riskier for investors to rely on NRSRO ratings. Indeed, investors who rely exclusively or primarily on NRSRO ratings may have an increased risk of liability regarding claims that they unreasonably relied on ratings from unaccountable NRSROs.

Moreover, there is judicial precedent that investor reliance on NRSRO ratings is not reasonable. For example, in one dispute involving the purchase of A-rated collateralized mortgage obligations which were downgraded to CCC and defaulted soon thereafter, the court said: "While it is unfortunate that [the investor] lost money, and we take him at his word that he would not have bought the bonds without the S&P 'A' rating, any reliance he may have placed on that rating to reassure himself about the underlying soundness of the bonds was not reasonable."[19] Thus, investors who rely on unaccountable NRSRO ratings are exposing themselves to liability.

In order to make NRSROs properly accountable, critics contend, there must be a real threat of liability. Many believe that Congress should amend Section 11 of the Securities Act of 1933 to add NRSROs as potential defendants. Further, they say lawmakers also should adopt legislation indicating that NRSROs are subject to private rights of action under the anti-fraud provisions of the securities laws. That legislation should include a description of the pleading standard for cases against rating agencies, to indicate that it would be sufficient for a plaintiff to plead the required state of mind by stating that the credit rating agency failed to conduct a reasonable investigation of the rated security or to have obtained reasonable verification from other sources independent of the issuer.

One final advantage to imposing accountability on rating agencies through liability is that it would obviate the need for regulators to provide parameters upfront governing when NRSROs have satisfied their responsibilities as part of the oversight process. In other words, ex ante oversight does not need to be as specific or draconian if regulators and investors can rely on ex post adjudication of rating agency negligence, recklessness, and fraud. Through an evolutionary approach, judges and private litigants could develop a common law understanding of appropriate rating agency behavior.

Enhancing Accountability through Competition and Reduced Reliance on Ratings

Finally, critics assert that competition in the credit rating business has not been effective. Some say the problem is due to insufficient industry competition and that the solution is to designate more NRSROS. Others contend that opening the NRSRO designation to more rating agencies fails to change the fundamental feature of the rating business, which is that ratings are driven by regulatory licenses. Instead of a supply-side solution, they argue that the demand side — regulators and market participants — should broaden and deepen their reliance on alternative measures of credit risk.

Credit ratings are an important, and sometimes mandated, tool for many categories of market participants. Today, references to ratings are incorporated in investment guidelines, swap documentation, loan agreements, collateral triggers, and other important documents and provisions.

Most institutional investors do not rely exclusively on ratings. While credit ratings are part of the mosaic of information considered as part of the investment process, they are generally not an appropriate sole source for making decisions.

A variety of alternative measures may be used to evaluate credit risk and supplement or even replace credit ratings. They include the following:

- Investors might use the variables underlying ratings, such as expected probability of default, recovery in the event of default, and default correlation, when relevant. For example, an investor might amend its investment guidelines to state it would only purchase bonds with an expected probability of default of 1 percent or less during maturity. The decision about expected probability of default then could be made based on a wide range of information.

  A "first cut" filter might be based on the market-wide expectation of default, as reflected in a bond's price. Most bond underwriters can provide this information for a range of issues; relatively inexpensive information services, such as Bloomberg and Reuters, also provide such information. Professor Edward Altman also has published extensive data in this area. In addition, credit default swap data is available from services, such as Markit, for numerous fixed income issues. Credit default swaps have been criticized in various ways, but abundant evidence suggests that credit default swap spreads more quickly and accurately reflect underlying credit risks than do NRSRO ratings.

- Investors might use the default probability implied by a bond's price, not only at the time of purchase but over time, as part of their portfolio management process. Many services provide such information. Indeed, NRSROs increasingly incorporate such market measures into their own ratings, though on a lagged basis. Investors concerned about the volatility of market prices could use 30-day or 90-day rolling averages.

  Rolling averages of market prices at least potentially reflect a wider range of available information than credit ratings, and may be a more timely and accurate measure of credit risk. Rolling averages also more accurately reflect available information than credit ratings and are not likely to be subject to manipulation or abuse.

  Basing investment decisions on a rolling average of market measures may motivate investors to assess early on the risks associated with investments and to limit their exposure in the event of a market downturn. Some institutions might be forced to sell during periods of price declines, but those that do may avoid more sustained declines that occur when stale ratings permit investors to continue to hold and to deny that investments have declined in value. Moreover, to the extent forced sales occur relatively early, these new policies may help deter prolonged crises.

- Investors might revise their guidelines to reflect a blended standard of information sources used to make investment decisions based in part on professional judgment. For example, investors might rely on: 1) private information obtained through due diligence, 2) publicly available "soft" information, and 3) market-based measures and prices. The blended information might include credit ratings.

Liquidity risk is also becoming a more important part of investment decision making. NRSRO ratings do not cover liquidity risk. As a result, the market for information about liquidity risk does not suffer from the same regulatory license distortions as the market for credit risk. Many relatively new information intermediaries, such as Markit, Kamakura, and some investor-pay NRSROs, have developed competing analytic systems for assessing both credit and liquidity risk. As investor guidelines evolve to focus more on assessments of liquidity risk, this focus may apply market pressure to NRSROs, making them more accountable.

SECTION IV

Ultimately, institutional investors vary in the amount of time and money they can afford to spend on the analysis of credit and liquidity risks. Accordingly, they have mixed views on whether references to credit ratings should be immediately removed from regulations. Some say ratings are meaningless and useless; they are comfortable with an immediate abolition of regulatory references to credit ratings. They argue that new intermediaries will come forward to fill the gaps left by the dominant NRSROs. Others say credit ratings remain an important tool. They argue that a sweeping removal of regulatory references to credit ratings would leave a gap for certain investment processes, would harm investors by removing a minimal floor for some investment decisions, and would disrupt the credit markets. In order to reduce private reliance on ratings, credible alternatives and substitutes must be developed, particularly for institutions that lack the resources to assess independently the huge number of available fixed income instruments.

Over the longer term, institutional investors at large are likely to grow more comfortable with a regulatory move away from credit ratings. And as institutional investors continue to encourage the formation and development of alternative information markets, market pressures from the demand side should motivate the NRSROs to improve their performance and accountability. Given the lack of accountability of NRSROs, this approach may be more effective and efficient than an approach that explicitly incorporates NRSRO ratings.

SECTION V

Conclusion

Many credit rating agencies have ventured far from their original role as reliable financial gatekeepers. They no longer provide consistently dependable information about credit risk. This has put many institutional investors in a box because they are still required to use ratings, regardless of the accuracy of the ratings. Stung by losses on investments in a string of once highly rated companies, from Enron to Lehman Brothers, investors are seeking ways to strengthen oversight and accountability of rating agencies, as well as new tools to evaluate credit risk.

Alternatives are emerging but may be out of reach for some investors for some time. For that reason, it is the author's view that Congress should step in to ensure that rating agencies are motivated to be more diligent in their assessment of credit risk. Toward that end, lawmakers should create a new Credit Rating Agency Oversight Board with the power to regulate rating agencies. At a minimum, Congress should provide the SEC with the financial and statutory resources to be an effective regulator of the industry. Secondly, it is time to take away the rating agencies' liability shield. Exemption from liability is not justified or tolerable, given the enormous clout that rating agencies now wield.

Ultimately, as institutional investors become more comfortable with alternative sources of credit information, competitive pressure could spur credit rating agencies to improve their performance and accountability. "Regulatory licenses" should disappear. Meanwhile, more vigorous oversight and accountability measures can improve the performance of NRSROs.

Endnotes

[1] Summary Report of Issues Identified in the Staff's Examinations of Select Credit Rating Agencies (July 2008), http://www.sec.gov/news/studies/2008/craexamination070808.pdf, at 12.

[2] Interview with Thomas L. Friedman, The NewsHour with Jim Lehrer (PBS television broadcast, Feb. 13, 1996).

[3] More precisely, the regulatory dependence on credit ratings began in 1973, when the SEC proposed amending broker-dealer "haircut" requirements, which set forth the percentage of a financial asset's market value a broker-dealer was required to deduct for the purpose of calculating its net capital requirement. Rule 15c3-1, promulgated two years later, required a different "haircut" based on the credit ratings assigned by NRSROs. See 17 C.F.R. 240.15c3-1. Since the mid-1970s, statutes and regulations increasingly have come to depend explicitly on NRSRO ratings.

[4] Summary Report of Issues Identified in the Staff's Examinations of Select Credit Rating Agencies (July 2008), http://www.sec.gov/news/studies/2008/craexamination070808.pdf, at 21.

[5] The President's Working Group on Financial Markets, Policy Statement on Financial Market Developments, March 2008, at 1.

[6] Address to Practising Law Institute's "SEC Speaks in 2009," Program, February 6, 2009, http://www.sec.gov/news/speech/2009/spch020609mls.htm.

[7] For example, in S&P's comment on the SEC's proposal to eliminate some regulatory reliance on ratings, S&P reminded the SEC of its limited statutory authority and said "the Commission should carefully consider" unintended side effects of its proposal. See S&P Letter, Sep. 5, 2008. Although Moody's historically has favored elimination of regulatory licenses, it backed down somewhat from that position in its recent comment letter on the SEC's proposed rules regarding regulatory reliance. See Moody's Letter, at 5.

[8] See S&P, Fundamentals of Structured Product Ratings, at 9.

[9] 2008 SEC NRSRO Report, at 41.

[10] 17 CFR 243.100-243.103.

[11] See also Item 10(c) of Regulation S-K.

[12] See Newby v. Enron Corporation, 511 F. Supp. 2d 741 (S.D. Tex. Feb. 16, 2005).

[13] Id. at 815-17.

[14] Newby at 817 (citing Report at 116).

[15] See In re Moody's Corporation Securities Litigation, 2009 U.S. Dist. LEXIS 13894 (S.D.N.Y. Feb. 23, 2009).

[16] See In re National Century Financial Enterprises, Inc., Investment Litigation, 580 F. Supp. 2d 630 (S.D. Ohio. Jul. 22, 2008).

[17] Moody's Corporation Schedule 14A, March 18, 2009, at 19.

[18] Quinn v. McGraw-Hill, 168 F.3d 331, 336 (7th Cir. 1999).

Council of Institutional Investors
The Voice of Corporate Governance

About the Council of Institutional Investors

The Council of Institutional Investors (CII) is a nonprofit association of public, union and corporate pension funds with combined assets that exceed $3 trillion. Member funds are major long-term shareowners with a duty to protect the retirement assets of millions of American workers.

The Council strives to educate its members, policymakers and the public about good corporate governance, shareowner rights and related investment issues, and to advocate on its members' behalf. Corporate governance involves the structure of relationships between shareowners, directors and managers of a company. Good corporate governance is a system of checks and balances that fosters transparency, responsibility, accountability and market integrity.

Council of Institutional Investors
The Voice of Corporate Governance

888 17th Street, NW ■ Suite 500
Washington, DC 20006
202.822.0800 ■ www.cii.org

For release on delivery
10:00 a.m. EDT
July 27, 2011

Statement by

Mark E. Van Der Weide

Senior Associate Director

Division of Banking Supervision and Regulation

Board of Governors of the Federal Reserve System

before the

Subcommittee on Oversight and Investigations

of the

Committee on Financial Services

U.S. House of Representatives

July 27, 2011

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee, thank you for the opportunity to discuss section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). To help achieve the important objective of reducing governmental and private sector reliance on credit ratings, section 939A requires all federal agencies to review their regulations for references and requirements related to credit ratings, remove such credit rating references and requirements from their regulations, and replace them with appropriate alternative standards of creditworthiness.

In my testimony, I will first describe how the Board has used credit ratings in its regulations. I will then discuss the problems associated with credit ratings that were observed during the recent financial crisis and how section 939A of the Dodd-Frank Act attempts to address those problems. Lastly, I will discuss the most important considerations in developing alternative standards of creditworthiness and describe the Board's efforts to develop these standards.

A credit rating is an assessment by a third-party rating firm of the credit risk of a financial instrument--that is, whether the issuer of the instrument (the borrower) will meet its contractual obligations to pay principal and interest to the holder of the instrument (the creditor). As detailed in the report the Board submitted to the Congress last week, in accordance with section 939A,[1] the Board has reviewed its regulations for references to and requirements regarding the use of credit ratings. In all, we identified 46 references to or requirements regarding credit ratings in our regulations.

[1] See Board of Governors of the Federal Reserve System (2011), *Report to the Congress on Credit Ratings* (Washington: Board of Governors, July), www.federalreserve.gov/publications/other-reports/files/credit-ratings-report-201107.pdf.

Most of these references to credit ratings are in the Board's risk-based capital rules for state member banks and bank holding companies. For example, under the Board's risk-based capital rules, a banking firm's capital requirements for certain securitization positions and trading positions are in whole or in part a function of the position's credit rating.[2] Other references appear in regulations governing transactions between banks and their affiliates, in regulations on international banking operations, and in regulations governing state member bank investments in financial subsidiaries. For example, whether a foreign branch of a U.S. bank may invest in a foreign government debt obligation may depend on the credit rating of the obligation.[3]

For many years before the introduction of credit ratings in banking regulations, investors had used credit ratings to assist them in making investment decisions. Credit ratings provided a uniform, market-driven, third-party assessment of the creditworthiness of countries, state and local governments, and companies. Federal agencies later incorporated credit ratings into their regulatory frameworks in part because of these same positive attributes.

The recent financial crisis, however, made manifest serious flaws associated with the methodologies and processes used to determine credit ratings, particularly ratings for structured finance positions. For example, the rating agencies used untested models that were revealed to be based on flawed assumptions and that relied on limited and unverified data about underlying asset pools to predict default frequencies of structured finance positions. The rating agencies also provided insufficient transparency to market participants about those models and about how their ratings of structured finance positions differed from ratings of unstructured debt. In addition, the rating agencies suffered from potential conflicts of interest due to their "issuer pays" compensation arrangements and other factors.

---

[2] See 12 CFR parts 208 and 225, Appendix A, § III, and Appendix E.
[3] See 12 CFR 211.4.

These flaws contributed to the issuance of credit ratings that severely underestimated the credit risk of many mortgage- and asset-backed securities. Investors, for their part, relied too heavily and uncritically on these ratings in making investment decisions. Indeed, downward revaluations of many of these securities by market participants between 2007 and 2009, and the resulting loss of confidence in the accuracy of credit ratings, contributed meaningfully to the destabilizing dynamics of the recent financial crisis.

Section 939A of the Dodd-Frank Act is one of a number of provisions in title IX of the statute intended to address the various problems associated with credit ratings and the rating agencies that became evident during the crisis. Section 939A was intended to help address these problems by removing credit ratings from federal regulations, thereby helping eliminate any government-induced demand for, and reliance on, ratings. In place of ratings, under section 939A, the Board (and each other federal agency) generally must substitute appropriate alternative standards of creditworthiness that are as uniform as possible.

The level of difficulty associated with removing credit ratings from the Board's regulations varies considerably from regulation to regulation. Complete removal of credit ratings from the Board's risk-based capital rules for banking firms poses the greatest challenge. To protect the safety and soundness of individual banking firms and of financial stability more broadly, we are striving to develop alternative standards of creditworthiness for use in our risk-based capital rules that possess the virtues of credit ratings but not the vices.

There are several key characteristics of a good alternative creditworthiness standard. Most importantly, the standard should be reliably risk-sensitive; it should effectively measure the relative credit risk of various types of financial instruments and counterparties. Reducing the risk sensitivity of the risk-based capital rules would make a banking firm's risk-based capital ratios less informative of the firm's capital adequacy and would make the capital rules easier to arbitrage. In addition, the standard should result in a consistent and transparent application across different types of financial instruments and counterparties. Moreover, the standard ideally should auto-adjust on a timely basis to reflect changes in the credit-risk profile of an instrument or counterparty and should auto-adapt to cover new financial market practices. Finally, the standard should be relatively simple to implement and should not increase the regulatory burden for banking firms, especially small banks. Obviously, credit ratings themselves do not meet all these criteria, and developing good replacements for credit ratings is a particularly difficult task.

Since the Dodd-Frank Act was signed into law last July, the Board has been working with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) to carry out the 939A mandate. To further this effort, in August 2010, the Board and the other banking agencies issued an advance notice of proposed rulemaking requesting public comment on alternative standards of creditworthiness to be used in the risk-based capital rules. In addition, in November 2010, the Board hosted a roundtable discussion with the other banking agencies, academics, and industry experts to solicit views on how to replace credit ratings in our capital rules.

Public commenters on our 939A efforts have expressed concern about the statutory mandate of section 939A and have suggested it could lead to competitive distortions across the global banking system and the domestic banking landscape. Most commenters have emphasized the need for alternative standards of creditworthiness to be risk-sensitive. In addition, commenters representing less complex banking firms have indicated that any alternative standard should be reasonably easy to implement, should allow banks of varying size and complexity to arrive at the same assessment of creditworthiness for similar exposures, and should take into account the costs and burdens imposed on small firms. We are particularly sensitive to the difficulties of constructing effective, low-burden replacement standards for smaller banks, which have less credit-risk assessment resources than large banks.

The Board continues to work closely with the other banking agencies to develop appropriate alternative standards for banking firms to use to meet regulatory requirements for assessing the credit risk of financial instruments and counterparties. We are considering a number of approaches, including approaches that rely on market-based indicators, such as bond spreads; approaches that rely on balance-sheet financial ratios; and approaches that rely on internal assessments of credit risk by banking firms. Each of these approaches, like the use of credit ratings, has strengths and weaknesses. The Board anticipates that it will propose amendments to remove references to credit ratings from its regulations in the near future, including through proposals to implement recent international agreements on capital by the Basel Committee on Banking Supervision.

The Board also has been active in the international efforts to encourage reduced dependence on credit ratings across the global financial system. Such efforts include the development and publication of principles by the Financial Stability Board in 2010 for reducing reliance on credit ratings by supervisors and market participants as well as work that is currently being conducted by the Basel Committee to revise the Basel capital framework to reduce reliance on ratings.[4] Although the international financial regulatory community is working to reduce reliance on credit ratings, the Basel capital framework (including several components of the recent Basel III agreement) continues to incorporate credit ratings in material ways.

---

[4] See Financial Stability Board (2010), *Principals for Reducing Reliance on CRA Ratings* (Basel, Switzerland: Financial Stability Board, October), www.financialstabilityboard.org/publications /r_101027.pdf.

Accordingly, we will need to find ways to synchronize our 939A changes with the global bank-capital accords.

The Board welcomes input from the public and from members of the Subcommittee on this important issue of public policy. Thank you for the opportunity to describe the Board's efforts to date to implement section 939A of the Dodd-Frank Act. I am happy to answer any questions.

TESTIMONY

Lawrence J. White
Professor of Economics, Stern School of Business
New York University

Before the
Subcommittee on Oversight and Investigations
Committee on Financial Services
United States House of Representatives
Hearing on
"Oversight of the Credit Rating Agencies Post-Dodd-Frank"
July 27, 2011

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee: My name is Lawrence J. White. I am a Professor of Economics at the NYU Stern School of Business. During 1986-1989 I served as a Board Member on the Federal Home Loan Bank Board; in that capacity I was also one of the three board members of Freddie Mac. I have written extensively on the credit rating agencies; a chronological list of these writings is at the end of this statement, as is my short biographical summary. I represent solely myself at this hearing.

Thank you for the opportunity to testify today on this important topic. I have appended to this statement for the Committee a longer article on the credit rating agencies that appeared in the Spring 2010 issue of the Journal of Economic Perspectives, which is published by the American Economic Association and which I would like to have incorporated for the record into the statement that I am presenting today.

The three large U.S.-based credit rating agencies – Moody's, Standard & Poor's, and Fitch – and their excessively optimistic ratings of subprime residential mortgage-backed securities (RMBS) in the middle years of the past decade played a central role in the financial debacle of the past two years. Given this context and history, it is understandable that there would be strong political sentiment – as expressed in Sec. 932 of the Dodd-Frank Act – for more extensive regulation of the credit rating agencies in hopes of forestalling future such debacles. The advocates of such regulation want (figuratively) to grab the rating agencies by the lapels, shake them, and shout "Do a better job!"

This urge for greater regulation is understandable and well-intentioned – but it is misguided and potentially quite harmful. The heightened regulation of the rating agencies is likely to discourage entry, rigidify a specified set of structures and procedures, and discourage innovation in new ways of gathering and assessing information, new technologies, new methodologies, and new models (including new business models) – and may well not achieve the goal of inducing better ratings from the agencies. Ironically, it will also likely create a protective barrier around the incumbent credit rating agencies and is thus likely to make them even more central to and important for the bond markets for the future.

There is a better route. That route is also embodied in the Dodd-Frank Act: in Secs. 939 and 939A. These are the sections that remove statutory references to ratings (Sec. 939) and that instruct federal agencies to review and modify their regulations so as "to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness … as appropriate…" (Sec. 939A).

An understanding of why this is a better route requires some background:

Let's start with the basics: The fundamental question of finance for lenders (and for bond investors who are, in essence, lenders) is: "Will I be paid back?"; or, in a slightly more elaborate form, "What is the likelihood that I will be paid back?"

To answer this question, lenders gather information about prospective borrowers (so as to try to figure out who are likely to be the more creditworthy borrowers, and who are less so) and also about existing borrowers (so as to try to forestall any potential problems as to repayment and to be able to intervene early if repayment problems do begin to arise). In many instances – e.g., loans by banks to households and small businesses – financial institutions do their own (in-house) credit analyses, although they may still outsource the collection of data (as in the use of FICO scores for loans to households). In the case of bonds, there are clearly some financial institutions that are large enough and sophisticated enough that they can gather their own information and do their own (in-house) credit analyses; however, smaller financial institutions are more likely to rely on third-party creditworthiness information services as major inputs for their decisions with respect to buying or selling bonds.

In essence, a lender's analysis of and decision with respect to a borrower's creditworthiness is a process that involves information: gathering information, analyzing information, forming judgments about the lending implications of that information.

There are many potential sources of creditworthiness information: As was just discussed, lenders can rely on their own internal information gathering and creditworthiness assessments; or they can rely on third-party creditworthiness information services. The three large credit rating agencies – Moody's, Standard & Poor's, and Fitch – are frequently described in the media as if they were the only third-party sources of such information for the bonds in which many financial institutions invest. But that is a false impression. There are many other third-party sources of such information (as well as the in-house sources in large financial institutions), such as smaller credit rating agencies or other creditworthiness information firms that may not describe themselves as "credit rating agencies" but are nevertheless providing similar types of creditworthiness information. In addition, most securities firms have "fixed income analysts," who perform similar types of analyses on bonds, which become the basis for the creditworthiness advice that these securities firms offer to their clients.[1]

How then did the three major credit rating agencies attain such a central place in the bond creditworthiness information process? At least part of the answer can be found in the history of U.S. prudential ("safety-and-soundness") regulation of regulation of financial institutions, beginning with banks. In 1936, bank regulators mandated that banks could not hold "speculative" bonds – as determined by the ratings of the major credit rating agencies. (This requirement is still in place today.) In the following decades, similar mandates were applied to insurance companies, pension funds, broker-dealers, and money market mutual funds.

[1] It is worth noting that fixed income analysts are a sizable and substantial enough group that they have their own professional society: the Fixed Income Analysts Society, Inc. (FIASI; see www.fiasi.org).

In essence, regulatory reliance on these specific rating agencies' ratings imbued these third-party judgments about the creditworthiness of bonds *with the force of law!* The regulators had outsourced or delegated this specific safety judgment. This problem was compounded when the SEC created the category of "nationally recognized statistical rating organization" (NRSRO) in 1975 and subsequently became a barrier to entry into the rating business. As of year-end 2000 there were only three NRSROs: Moody's, Standard & Poor's, and Fitch.[2]

It should therefore come as no surprise that when this (literal) handful of rating firms stumbled badly in their excessively optimistic ratings of the subprime RMBS, the consequences were quite serious.

This recognition of the longstanding role of financial regulation in forcing the centrality of the major rating agencies then leads to the alternate prescription, which is embodied in Dodd-Frank's Secs. 939 and 939A: *Eliminate regulatory reliance on ratings – eliminate the ratings' force of law – and bring market forces to bear.* Since the bond markets are primarily institutional markets (and not a retail securities market, where retail customers are likely to need more help), market forces can be expected to work – and the detailed regulation that is embodied in Dodd-Frank's Sec. 932 is unnecessary (as well as ill-advised). Indeed, with the elimination of regulatory reliance on ratings, the entire NRSRO regulatory superstructure should be dismantled, and the NRSRO category should be eliminated. This elimination could well cause the major rating agencies to be *less important* for the future.

As Secs. 939 and 939A recognize, the regulatory requirements that prudentially regulated financial institutions must maintain safe bond portfolios should remain in force. But financial regulators – especially the U.S. banking regulators – have been having difficulties determining how to ensure that their regulated entities maintain safe bond portfolios without continuing the automatic reliance on ratings of the past 75 years.

[2] Because of subsequent prodding by the Congress, and then the specific barrier-reduction provisions of the Credit Rating Agency Reform Act of 2006 (CRARA), there are now ten NRSROs.

The proper approach in this regard is, fundamentally, to approach the safety of a financial institution's bond portfolio in the same way that bank regulators approach the safety of banks' loan portfolios more generally: First, regulators should place the burden directly on the regulated institutions to demonstrate and justify to their regulators that their bond portfolios are safe and appropriate – either by doing the creditworthiness research and analysis themselves, or by relying on third-party creditworthiness information firms. Larger financial institutions might well choose the former route, while smaller financial institutions might well choose the latter. In the latter case, the financial institutions might choose to continue to rely on the judgments of the existing large credit agencies and their ratings, but they could instead select other creditworthiness information firms whose forms of judgments and opinions might be described in different terms from "ratings."[3]

Under either route, the regulators must then check carefully that the regulated entity has been competent in its processes of doing its research/analysis or of choosing reliable third-party creditworthiness information firms.[4]

This process will require more effort on the part of regulators and on the part of the regulated institutions than has been required under the system of regulatory reliance on NRSRO ratings. It is understandable that regulators and their regulated financial institutions would be reluctant to move away from an "easy" system of outsourcing safety judgments, with which they have been familiar for as long as 75 years. However, the alternative approach that I have suggested is, as discussed above, fundamentally no different from what bank regulators already do through their "examination and supervision" processes with respect to other types of loans in banks'

[3] As was discussed above, included in these other sources of creditworthiness information are the fixed income analysts at securities firms. These sources may be considered to be too "conflicted" (e.g., they might be considered to be advocates for the securities that their firms want to sell or buy) to be a trustworthy source of creditworthiness information. However, if the barriers to entry that were created by the NRSRO system and the regulatory reliance on NRSRO ratings were removed, these individuals might be more inclined to "hang out their own shingles" and establish themselves as freestanding creditworthiness information services – thereby increasing the availability of such services.

[4] Even if a regulated financial institution does not have the expertise to do the research and analysis itself, it should be expected to have the necessary competence with respect to its selection of third-party creditworthiness information firms. However, because a regulated financial institution always has an incentive to take on excessive risk unless restrained by regulators, the latter must check to make sure that the institution has not chosen a third-party creditworthiness information firm that will provide a cover for excessive risk taking (e.g., by indicating that risky securities are safe and appropriate for the institution).

portfolios. It should be readily applicable to bonds as well, whether in the portfolios of banks or in the portfolios of other financial institutions. And the consequences of persisting with the system of regulatory reliance on NRSRO ratings are too perverse.

Under the alternative approach that I have outlined, financial institutions could then call upon a wider array of sources of advice on the safety of their bond portfolios, and the bond information market would be opened to innovation and entry in ways that have not been possible since the 1930s.

My appended JEP article provides greater elaboration on many of these points. Since that article preceded the enactment of the Dodd-Frank Act July 2010 and specifically the enactment of Sec. 932 and its further regulation of the NRSROs, I will expand here on the drawbacks of that approach.

The provisions of Sec. 932 are devoted primarily to efforts to increase the transparency of ratings and to address issues of conflicts of interest of the NRSROs. The latter arise largely from the major rating agencies' business model of relying on payments from the bond issuers in return for rating their bonds.[5] These provisions expand and elaborate on a set of NRSRO regulations that the SEC had previously implemented.

Again, the underlying urge to "do something" in the wake of the mistakes of the major credit rating agencies during the middle years of this decade is understandable. Further, the "issuer pays" business model of those rating agencies presents an obvious set of potential conflict-of-interest problems that appear to be crying out for correction.[6]

[5] It is worth noting that three smaller U.S.-based NRSRO rating agencies have "investor pays" business models and that the "investor pays" model was the original model for John Moody and for the industry more generally, until the major rating agencies switched to the "issuer pays" model in the late 1960s and early 1970s.

[6] It is important to remember, however, that the major credit rating agencies switched to the "issuer pays" model in the late 1960s and early 1970s, and that the serious problems only arose three decades later, and also arose only in the area of RMBS and not in the areas of "plain vanilla" corporate bonds or municipal bonds. Apparently, the agencies' concerns for their long-run reputations and the transparency and multiplicity of issuers prior to the current decade all served to keep the potential conflict-of-interest problems in check during those three intervening decades. See my appended JEP article for more discussion of why the "issuer pays" model broke down in the area of RMBS but didn't do so in the other areas.

Nevertheless, the dangers of Sec. 932 are substantial: They ask the SEC to delve ever deeper into the processes and procedures and methodologies of credit ratings. In so doing, these provisions are likely to rigidify the industry along the lines of the specific implementing regulations that the SEC devises, as well as raising the costs of being a credit rating agency. Sec. 932 will thereby discourage entry and innovation in new ways of gathering and assessing information, in new methodologies, in new technologies, and in new models – including new business models.[7]

Further, it is far from clear that the Sec. 932 provisions will actually achieve the goal of improving ratings. One common complaint against the large credit rating agencies is that they are slow to adjust their ratings in response to new information.[8] But this appears to be a business culture phenomenon for the rating agencies (which was present, as well, in the pre-1970s era when the rating agencies had an "investor pays" business model). As for the kind of over-optimism about the RMBS in the decade of the 2000s that subsequently created such serious problems, the rating agencies were far from alone in "drinking the Kool-Aid" that housing prices could only increase and that even subprime mortgages consequently would not have problems. It is far from clear that, had they been in effect, the Sec. 932 regulations would have curbed such herd behavior. Also, the three large credit rating agencies are quite aware of the damage to their reputations that have occurred and have announced measures – including increased transparency and enhanced efforts to address potential conflicts – to repair that damage.

In sum, the provisions of Sec. 932 are deeply flawed and wrongheaded.

There is a better overall route, which is embodied in Secs. 939 and 939A: Eliminate <u>all</u> regulatory reliance on ratings, by the U.S. financial regulatory agencies – eliminate the force of law that has been accorded to these third-party judgments. The institutional participants in the bond

---

[7] Although the provisions of Sec. 932 and of the SEC's regulation under the CRARA apply only to NRSROs, the maintenance of this category clearly imbues the NRSROs with a greater status and prominence; also, there is always the possibility – which was included in an early Obama Administration proposal, which (fortunately) was subsequently dropped – that all creditworthiness information firms should be required to become NRSROs and would thereby become subject to the SEC's regulation.

[8] This complaint has been present for decades. It surfaced strongly in the wake of the Enron bankruptcy in November 2001, with the revelation that the major rating agencies had maintained "investment grade" ratings on Enron's debt until five days before that company's bankruptcy filing. More recently, the major agencies had "investment grade" ratings on Lehman Brothers' debt on the morning that it filed for bankruptcy.

markets could then more readily (with appropriate oversight by financial regulators) make use of a wider set of providers of information, and the bond information market would be opened to new ideas and new entry in a way that has not been possible for 75 years.

Thank you again for the opportunity to appear before this Committee; I would be happy to respond to your questions.

Publications by Lawrence J. White on the Credit Rating Agencies

"Don't Like the 'Power' of the Bond Rating Firms? Basel 2 Will Only Make It Worse," in Bumps on the Road to Basel: An Anthology of Views on Basel 2, Centre for the Study of Financial Innovation, 2002.

"The Credit Rating Industry: An Industrial Organization Analysis," in R.M. Levich, G. Majnoni, and C.M. Reinhart, eds. Ratings, Rating Agencies and the Global Financial System, Kluwer, 2002.

"An Industrial Organization Analysis of the Credit Rating Industry," in M.K. Ong, ed., Credit Ratings: Methodologies, Rationale and Default Risk, Risk Books, 2002.

"The SEC's Other Problem," Regulation, Winter 2002-2003; reprinted in C.H. Rajeshwer and S. Jutur, eds., Credit Rating Agencies: Emerging Issues, ICFAI University Press, 2005.

"The Bond-Rating Game," SternBusiness, Fall 2003.

"Good Intentions Gone Awry: A Policy Analysis of the SEC's Regulation of the Bond Rating Industry," Policy Brief #2006-PB-05, Networks Financial Institute, Indiana State University.

"A New Law for the Bond Rating Industry" Regulation, Spring 2007; reprinted in V.V.L. Gayathri, ed., Credit Rating Agencies: Regulatory Road-Map, Amicus Books, 2009.

"The Rating Agencies: Is Regulation the Answer?" in V. Acharya and M. Richardson, eds., Restoring Financial Stability: How to Repair a Failed System, Wiley, 2009 (with M. Richardson).

"The Credit Rating Agencies and the Subprime Debacle," Critical Review, Nos. 1-2, 2009; reprinted in J. Friedman, ed., Causes of the Financial Crises, Univ. of Pennsylvania Press, forthcoming 2010.

"A Brief History of Credit Rating Agencies: How Financial Regulation Entrenched This Industry's Role in the Subprime Mortgage Debacle of 2007-2008," Mercatus on Policy, No. 57, October 2009.

"Wrong on Ratings," Financial World, December-January 2009-2010.

"Credit Rating Agencies & Regulation: Why Less Is More," in R. Johnson and E. Payne, eds., Make Markets Be Markets. Roosevelt Institute, 2010.

"Credit Rating Agencies and the Financial Crisis: Less Regulation is a Better Response," Journal of International Banking Law and Regulation, 2010.

"Markets: The Credit Rating Agencies," Journal of Economic Perspectives, Spring 2010.

"Regulation of Rating Agencies," in V.V. Acharya, T.F. Cooley, M.P. Richardson, and I. Walter, eds., Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance. Wiley, 2011 (with E.I. Altman, T.S. Oncu, M. Richardson, and A. Schmeits).

BIOGRAPHICAL SUMMARY

Lawrence J. White

Lawrence J. White is Robert Kavesh Professor of Economics at New York University's Stern School of Business and Deputy Chair of the Economics Department at Stern. During 1986-1989 he was on leave to serve as Board Member, Federal Home Loan Bank Board, in which capacity he also served as Board Member for Freddie Mac; and during 1982-1983 he was on leave to serve as Director of the Economic Policy Office, Antitrust Division, U.S. Department of Justice. He is the General Editor of The Review of Industrial Organization and formerly Secretary-Treasurer of the Western Economic Association International.

Prof. White received the B.A. from Harvard University (1964), the M.Sc. from the London School of Economics (1965), and the Ph.D. from Harvard University (1969). He is the author of The Automobile Industry Since 1945 (1971); Industrial Concentration and Economic Power in Pakistan (1974); Reforming Regulation: Processes and Problems (1981); The Regulation of Air Pollutant Emissions from Motor Vehicles (1982); The Public Library in the 1980s: The Problems of Choice (1983); International Trade in Ocean Shipping Services: The U.S. and the World (1988); The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation (1991); and articles in leading economics, finance, and law journals. He is the co-author of Guaranteed to Fail: Fannie Mae, Freddie Mac, and the Debacle of Mortgage Finance, Princeton University Press, 2011 (with V.V. Acharya, M. Richardson, and S. Van Nieuwerburgh).

He is editor or coeditor of eleven volumes: Deregulation of the Banking and Securities Industries (1979); Mergers and Acquisitions: Current Problems in Perspective (1982); Technology and the Regulation of Financial Markets: Securities, Futures, and Banking (1986); Private Antitrust Litigation: New Evidence, New Learning (1988); The Antitrust Revolution (1989); Bank Management and Regulation (1992); Structural Change in Banking (1993); The Antitrust Revolution: The Role of Economics, 2nd edn. (1994); The Antitrust Revolution: Economics, Competition, and Policy, 3rd edn. (1999); The Antitrust Revolution: Economics, Competition, and Policy, 4th edn. (2004); and The Antitrust Revolution: Economics, Competition, and Policy, 5th edn. (2009). He was the North American Editor of The Journal of Industrial Economics, 1984-1987 and 1990-1995.

Prof. White served on the Senior Staff of the President's Council of Economic Advisers during 1978-1979, and he was Chairman of the Stern School's Department of Economics, 1990-1995.

Prof. White's webpage is found at http://pages.stern.nyu.edu/~Lwhite/. His e-mail address is Lwhite@stern.nyu.edu.

Journal of Economic Perspectives—Volume 24, Number 2—Spring 2010—Pages 211–226

Markets
The Credit Rating Agencies

Lawrence J. White

This feature explores the operation of individual markets. Patterns of behavior in markets for specific goods and services offer lessons about the determinants and effects of supply and demand, market structure, strategic behavior, and government regulation. Suggestions for future columns and comments on past ones should be sent to James R. Hines Jr., c/o *Journal of Economic Perspectives*, Department of Economics, University of Michigan, 611 Tappan St., Ann Arbor, Michigan 48109-1220.

Introduction

In 1909, John Moody published the first publicly available bond ratings, focused entirely on railroad bonds. Moody's firm was followed by Poor's Publishing Company in 1916, the Standard Statistics Company in 1922, and the Fitch Publishing Company in 1924. These firms' bond ratings were sold to bond investors in thick manuals. These firms evolved over time. Dun & Bradstreet bought Moody's in 1962, but then subsequently spun it off in 2000 as a free-standing corporation. Poor's and Standard merged in 1941; Standard & Poor's was then absorbed by McGraw-Hill in 1966. Fitch merged with IBCA (a British firm, which was a subsidiary of FIMILAC, a French business services conglomerate) in 1997. At the end of the year 2000, at about the time that the market for structured securities that were based on subprime residential mortgages began growing rapidly, the issuers of these securities had only these three credit-rating agencies to whom they could turn to obtain their all-important ratings: Moody's, Standard & Poor's (S&P), and Fitch.

■ *Lawrence J. White is Professor of Economics, Stern School of Business, New York University, New York. His e-mail address is ⟨Lwhite@stern.nyu.edu⟩.*

doi=10.1257/jep.24.2.211

Favorable ratings from these three credit agencies were crucial for the successful sale of the securities based on subprime residential mortgages and other debt obligations. The sales of these bonds, in turn, were an important underpinning for the financing of the self-reinforcing price-rise bubble in the U.S. housing market. When house prices ceased rising in mid 2006 and then began to decline, the default rates on the mortgages underlying these securities rose sharply, and those initial ratings proved to be excessively optimistic. The price declines and uncertainty surrounding these widely-held securities then helped to turn a drop in housing prices into a widespread crisis in the U.S. and global financial systems.

This paper will explore how the financial regulatory structure propelled these three credit rating agencies to the center of the U.S. bond markets—and thereby virtually guaranteed that when these rating agencies did make mistakes, those mistakes would have serious consequences for the financial sector. We begin by looking at some relevant history of the industry, including the series of events that led financial regulators to outsource their judgments to the credit rating agencies (by requiring financial institutions to use the specific bond creditworthiness information that was provided by the major rating agencies) and when the credit rating agencies shifted their business model from "investor pays" to "issuer pays."[1] We then look at how the credit rating industry evolved, and how its interaction with regulatory authorities served as a barrier to entry. We then show how these ingredients combined to contribute to the subprime mortgage debacle and associated financial crisis. Finally, we consider two possible routes for public policy with respect to the credit rating industry: One route would tighten the regulation of the rating agencies, while the other route would reduce the required centrality of the rating agencies and thereby open up the bond information process in way that has not been possible since the 1930s.

A History of Outsourcing Regulatory Judgment

A central concern of any lender—including the lenders/investors in bonds—is whether a potential or actual borrower is likely to repay the loan. Along with collecting their own information about borrowers, and imposing requirements like collateral, co-signers, and restrictive covenants in bond indentures or lending agreements, those who lend money may also seek outside advice about creditworthiness. The purpose of credit rating agencies is to help pierce the fog of asymmetric information by offering judgments—they prefer the word "opinions"[2]—about

[1] Overviews of the credit rating industry can be found in, for example, Cantor and Packer (1995), Langohr and Langohr (2008), Partnoy (1999, 2002), Richardson and White (2009), Sinclair (2005), Sylla (2002), and White (2002a, 2002b, 2006, 2007, 2009).

[2] The rating agencies favor that term "opinion" because it supports their claim that they are "publishers." One implication is that the credit rating agencies thus enjoy the protections of the First Amendment of the U.S. Constitution when they are sued by investors and by issuers who claim that they have been injured by the actions of the agencies.

the credit quality of bonds that are issued by corporations, U.S. state and local governments, "sovereign" government issuers of bonds abroad, and (most recently) mortgage securitizers.

In the early years of Moody's, Standard, Poor's, and Fitch, they earned revenue by selling their assessments of creditworthiness to investors. This occurred in the era before the Securities and Exchange Commission (SEC) was created in 1934 and began requiring corporations to issue standardized financial statements. These judgments come in the form of "ratings," which are usually a letter grade. The best-known scale is that used by Standard & Poor's and some other rating agencies: AAA, AA, A, BBB, BB, and so on, with pluses and minuses as well.

However, a major change in the relationship between the credit rating agencies and the U.S. bond markets occurred in the 1930s. Bank regulators were eager to encourage banks to invest only in safe bonds. They issued a set of regulations that culminated in a 1936 decree that prohibited banks from investing in "speculative investment securities" as determined by "recognized rating manuals." "Speculative" securities (which nowadays would be called "junk bonds") were below "investment grade." Thus, banks were restricted to holding only bonds that were "investment grade"—in modern ratings, this would be equivalent to bonds that were rated BBB– or better on the Standard & Poor's scale. With these regulations in place, banks were no longer free to act on information about bonds from any source that they deemed reliable (albeit within oversight by bank regulators). They were instead forced to use the judgments of the publishers of the "recognized rating manuals"—which were *only* Moody's, Poor's, Standard, and Fitch. *Essentially, the creditworthiness judgments of these third-party raters had attained the force of law.*

In the following decades, the insurance regulators of the 48 (and eventually 50) states followed a similar path. State insurance regulators established minimum capital requirements that were geared to the ratings on the bonds in which the insurance companies invested—the ratings, of course, coming from the same small group of rating agencies. Once again, an important set of regulators had delegated their safety decisions to the credit rating agencies. In the 1970s, federal pension regulators pursued a similar strategy.[3]

The Securities and Exchange Commission crystallized the centrality of the three rating agencies in 1975, when it decided to modify its minimum capital requirements for broker-dealers, who include major investment banks and securities firms. Following the pattern of the other financial regulators, the SEC wanted those capital requirements to be sensitive to the riskiness of the broker-dealers' asset portfolios and hence wanted to use bond ratings as the indicators

[3] Other countries have also incorporated ratings into their regulation of financial institutions, though not as extensively as in the United States. For an overview, see Sinclair (2005, pp. 47–49), Langohr and Langohr (2008, pp. 431–34), and Joint Forum (2009). The "New Basel Capital Accord" (often described as "Basel II"), which is being adopted internationally (albeit with modifications due to the financial crisis), uses ratings on the debt held by banks as one of three possible frameworks for determining those banks' capital requirements.

of risk. But it worried that references to "recognized rating manuals" were too vague and that a bogus rating firm might arise that would promise AAA ratings to those companies that would suitably reward it and "DDD" ratings to those that would not.

To deal with this potential problem, the Securities and Exchange Commission created a new category—"nationally recognized statistical rating organization" (NRSRO)—and immediately grandfathered Moody's, Standard & Poor's, and Fitch into the category. The SEC declared that only the ratings of NRSROs were valid for the determination of the broker-dealers' capital requirements. Other financial regulators soon adopted the NRSRO category and the rating agencies within it. In the early 1990s, the SEC again made use of the NRSROs' ratings when it established safety requirements for the commercial paper (short-term debt) held by money market mutual funds.

Taken together, these regulatory rules meant that the judgments of credit rating agencies became of central importance in bond markets. Banks and many other financial institutions could satisfy the safety requirements of their regulators by just heeding the ratings, rather than their own evaluations of the risks of the bonds. Because these regulated financial institutions were such important participants in the bond market, other players in the market—both buyers and sellers—needed to pay particular attention to the bond raters' pronouncements as well. The irony of the regulators' reliance on the judgments of credit rating agencies is powerfully revealed by a line in Standard & Poor's standard disclaimer at the bottom of its credit ratings: "[A]ny user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision." (Moody's ratings have a similar disclaimer.)

From Investor Pays to Issuer Pays

One other piece of history is important: In the early 1970s, the basic business model of the large rating agencies changed. In place of the "investor pays" model that had been established by John Moody in 1909, the credit rating agencies converted to an "issuer pays" model, whereby the entity issuing the bonds also pays the rating firm to rate the bonds. The reasons for this change of business model have not been established definitively. Several candidates have been proposed.

First, the rating firms may have feared that their sales of rating manuals would suffer from the consequences of the high-speed photocopy machine (which was just entering widespread use), which would allow too many investors to free ride by obtaining photocopies from their friends.

Second, the bankruptcy of the Penn-Central Railroad in 1970 shocked the bond markets and made debt issuers more conscious of the need to assure bond investors that they (the issuers) really were low risk, and they were willing to pay the credit rating firms for the opportunity to have the latter vouch for them (Fridson, 1999). However, this argument cuts both ways, because the same shock should have also made investors more willing to pay to find out which bonds were really safer, and which were not.

Third, the bond rating firms may have belatedly realized that the financial regulations described above meant that bond issuers needed their bonds to have the "blessing" of one or more rating agencies in order to get those bonds into the portfolios of financial institutions, and the issuers should be willing to pay for the privilege.

Fourth, the bond rating business, like many information industries, involves a "two-sided market," where payments can come from one or both sides of the market (as discussed in this journal by Rysman, 2009). For example, in the two-sided markets of newspapers and magazines, business models range from "subscription revenues only" (like *Consumer Reports*) to "a mix of subscription revenues plus advertising revenues" (most newspapers and magazines) to "advertising revenues only" (like *The Village Voice*, some metropolitan "giveaway" daily newspapers, and some suburban weekly "shoppers"). Information markets for the quality of bonds have a similar feature, in that the information can be paid for by issuers of debt, buyers of debt, or some mix of the two[4]—and the actual outcome may sometimes shift in idiosyncratic ways.

Regardless of the reason, the change to the "issuer pays" business model opened the door to potential conflicts of interest: A rating agency might shade its rating upward so as to keep the issuer happy and forestall the issuer's taking its rating business to a different rating agency.[5]

However, the rating agencies' concerns about their long-run reputations apparently kept the actual conflicts in check for the first three decades of experience with the new business model (Smith and Walter, 2002; Caouette, Altman, Narayanan, and Nimmo, 2008, chap. 6). There were two important and related characteristics of the bond issuing market that helped: First, there were thousands of corporate and government bond issuers, so that the threat by any single issuer (if it was displeased by an agency's rating) to take its business to a different rating agency was not potent. Second, the corporations and governments whose "plain vanilla" debt was being rated were relatively transparent, so that an obviously incorrect rating would quickly be spotted by others and would thus potentially tarnish the rater's reputation.

[4] Or the information might be given away as a "loss leader" to attract customers to other paying services of the information provider. For example, in December 2009, Morningstar, Inc. (which is primarily a mutual fund information company) began issuing corporate bond ratings with no fees directly charged to anyone.

[5] Skreta and Veldkamp (2009) develop a model in which the ability of issuers to choose among potential raters leads to overly optimistic ratings, even if the raters are all trying honestly to estimate the creditworthiness of the issuers. In their model, the raters can only make *estimates* of the creditworthiness of the issuers, which means that their estimates will have errors. If the estimates are (on average) correct and the errors are distributed symmetrically (that is, the raters are honest but less than perfect) but the issuers can choose which rating to purchase, the issuers will systematically choose the most optimistic. (This model thus has the same mechanism that underlies the operation of the "winner's curse" in auction markets.) In an important sense, it is the issuers' ability to select the rater that creates the conflict of interest.

Indeed, the major complaint about the rating agencies during this era was not that they were too compliant to issuers' wishes but that they were too tough and too powerful. This view was epitomized by the *New York Times* columnist Thomas L. Friedman's remarks in a PBS "News Hour" interview on February 13, 1996: "There are two superpowers in the world today in my opinion. There's the United States, and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful." In October 1995, a Colorado school district sued Moody's, claiming that the rating agency deliberately underrated the school district's bonds, in retaliation for the district's decision not to solicit a rating from Moody's;[6] and other issuers apparently were also fearful of arbitrarily low ratings (Partnoy, 2002, p. 79; Fridson, 2002, p. 82; Sinclair, 2005, pp. 152–54, 172).

How the Credit Rating Industry Evolved and Barriers to Entry

Although there appear to be roughly 150 local and international credit rating agencies worldwide (Basel Committee on Banking Supervision, 2000; Langohr and Langohr, 2008, p. 384), Moody's, Standard & Poor's, and Fitch are clearly the dominant entities. All three operate on a worldwide basis, with offices on six continents; each has ratings outstanding on tens of trillions of dollars of securities. Only Moody's is a free-standing company, so the most information is known about that firm: Its 2008 annual report listed the company's total revenues at $1.8 billion, its net revenues at $458 million, and its total assets at year-end at $1.8 billion (Moody's, 2009). Fifty-two percent of its total revenue came from the United States; as recently as 2006 that fraction was two-thirds. Sixty-nine percent of the company's revenues comes from ratings; the rest comes from related services. At year-end 2008, the company had approximately 3,900 employees, with slightly more than half located in the United States.

Because Standard & Poor's and Fitch's ratings operations are components of larger enterprises that report on a consolidated basis, comparable revenue and asset figures are not possible. But Standard & Poor's rating operations are roughly the same size as Moody's, while Fitch is somewhat smaller. Table 1 provides a set of roughly comparable data on each company's analytical employees and numbers of issues rated. All three companies employ about the same numbers of analysts; however, Moody's and Standard & Poor's rate appreciably more corporate and asset-backed securities than does Fitch. The market shares (based on revenues or issues rated) of the three firms are commonly estimated to be approximately 40, 40, and 15 percent

[6] The suit was eventually dismissed. *See Jefferson County School District No. R-1 v. Moody's Investor's Services, Inc.*, 175 F.3d 848 (1999). After the suit was filed, the U.S. Department of Justice's Antitrust Division opened an investigation to determine whether Moody's alleged threats of low unsolicited ratings constituted an illegal exercise of market power; the investigation was eventually closed, with no charges filed (Partnoy, 2002, p. 79).

Table 1
Data from Form NRSRO for 2009 for Moody's, Standard & Poor's, and Fitch

	Moody's	*Standard & Poor's*	*Fitch*
Number of analyst employees:			
Credit analysts	1,126	1,081	1,057.5
Credit analyst supervisors	126	228	305
Number of bond issues rated of:			
Financial institutions	84,773	47,300	83,649
Insurance companies	6,277	6,600	4,797
Corporate issuers	31,126	26,900	14,757
Asset-backed securities	109,281	198,200	77,480
Government securities	192,953	976,000	491,264

Sources: Form NRSRO 2009, for each company, as found on each company's website.
Note: Table 1 provides a set of roughly comparable data on each company's analytical employees and numbers of issues rated. The large numbers of bonds that are rated partly derive from the fact that many bonds represent multiple issues from the same issuer, which usually involve little marginal effort from the rating agency.

for Moody's, Standard & Poor's, and Fitch, respectively (Smith and Walter, 2002, p. 290; Caouette, Altman, Narayanan, and Nimmo, 2008, p. 82).

During the 25 years that followed the Securities and Exchange Commission's 1975 creation of the "nationally recognized statistical rating organization" category, the SEC designated only four additional firms as NRSROs: Duff & Phelps in 1982; McCarthy, Crisanti & Maffei in 1983; IBCA in 1991; and Thomson BankWatch in 1992. However, mergers among the entrants and with Fitch caused the number of NRSROs to return to the original three by year-end 2000.

Of course, the credit rating industry was never going to be a commodity business with hundreds of small-scale producers. The market for bond information is one where potential barriers to entry like economies of scale, the advantages of experience, and brand name reputation are important features. Nevertheless, in creating the NRSRO designation, the Securities and Exchange Commission had become a significant barrier to entry into the bond rating business in its own right. Without the benefit of the NRSRO designation, any would-be bond rater would likely remain small-scale. New rating firms would risk being ignored by most financial institutions (the "buy side" of the bond markets); and since the financial institutions would ignore the would-be bond rater, so would bond issuers (the "sell side" of the markets).

In addition, the Securities and Exchange Commission was remarkably opaque in its designation process. It never established formal criteria for a firm to be designated as a "nationally recognized statistical rating organization," never established a formal application and review process, and never provided any justification or explanation for why it "anointed" some firms with the designation and refused to do so for others.

However, it is important to note that while the major credit rating agencies are a major source of creditworthiness for bond investors, they are far from the only potential source. A few smaller rating firms—notably KMV, Egan-Jones, and Lace Financial, all of which had "investor pays" business models—were able to survive, despite the absence of NRSRO designations (although KMV was absorbed by Moody's in 2002). Some bond mutual funds do their own research, as do some hedge funds. "Fixed income analysts" at many financial services firms offer recommendations to those firms' clients with respect to bond investments.[7]

Controversy Arrives for Credit Rating Agencies

The "nationally recognized statistical rating organization" system remained one of the less-well-known features of federal financial regulation until the Enron bankruptcy of November 2001. In the wake of the Enron bankruptcy, however, the media and Congress noticed that the three major rating agencies had maintained "investment grade" ratings on Enron's bonds until five days before that company declared bankruptcy. This notoriety led to Congressional hearings in which the Securities and Exchange Commission and the rating agencies were repeatedly asked how the latter could have been so slow to recognize Enron's weakened financial condition. The rating agencies were similarly slow to recognize the weakened financial condition of WorldCom, and were subsequently grilled about that as well. Indeed, the major agencies' tardiness in changing their ratings has continued up to the present. The major rating agencies still had "investment grade" ratings on Lehman Brothers' commercial paper on the morning that Lehman declared bankruptcy in September 2008.

Why does this sluggishness in adjusting credit ratings persist? According to the credit rating agencies, they profess to provide a long-term perspective—to "rate through the cycle"—rather than providing an up-to-the-minute assessment. This strategy implies that credit rating agencies will always have a delay in perceiving that any particular movement isn't just the initial part of a reversible cycle, but instead is the beginning of a sustained decline or improvement.

This practice of rating through the cycle may well be a response to the rating agencies' institutional investor constituency. Investors clearly desire stability of ratings, so as to reduce the need for frequent (and costly) adjustments in their portfolios (for example, Altman and Rijken, 2004, 2006; Loffler, 2004, 2005; Beaver, Shakespeare, and Soliman, 2006; Cheng and Neamtu, 2009), which might well be mandated by the regulatory requirements discussed above. Prudentially regulated investors (such as banks, insurance companies, and others that are regulated for safety) may not mind inaccurate ratings—indeed, they may prefer bonds that carry

[7] There is a professional society for fixed income analysts—the Fixed Income Analysts Society, Inc. (FIASI)—and even a Fixed Income Analysts Society Hall of Fame! Johnston, Markov, and Ramnath (2009) document the importance of fixed income analysts for the bond markets.

ratings that the market believes to be inflated, since those bonds will carry higher yields relative to the rating and the institution's bond manager can thereby obtain higher yields (by taking greater risks) and yet still appear to be within regulatory safety limits (Calomiris, 2009). In addition, issuers of securities, who pay the fees of credit rating agencies, would certainly prefer not to be downgraded. However, as Flandreau, Gaillard, and Packer (2009) document, the rating agencies' sluggishness extends back at least to the 1930s, long before the switch to the "issuer pays" business model. Also, the absence of frequent changes allows the agencies to maintain smaller staffs.

The sluggishness of these changes raises an even more central question: whether the three major credit rating agencies actually provide useful information about default probabilities to the financial markets (and, indeed, whether they have done so since the 1930s). As evidence of their value, the rating agencies themselves point to the generally tight relationship over the decades between their rankings and the likelihoods of defaults. Moody's (2009, p. 13) annual report, for example, states: "The quality of Moody's long-term performance is illustrated by a simple measure: over the past 80 years across a broad range of asset classes, obligations with lower Moody's ratings have consistently defaulted at greater rates than those with higher ratings." But this correlation could equally well arise if the rating agencies arrived at their ratings by, say, observing the financial markets' separately determined spreads on the relevant bonds (over comparable Treasury bonds), in which case the agencies would not be providing useful information to the markets.

More sophisticated empirical approaches, summarized in Jewell and Livingston (1999) and Creighton, Gower, and Richards (2007), have noted that when a major rating agency *changes* its rating on a bond, the markets react. But this reaction by the financial markets might be due to the concomitant change in the implied regulatory status of the bond. For example, if a rating moves a bond from "investment grade" to "speculative," or vice-versa—or even if it just moves the bond closer to, or farther away from, that regulatory "cliff"—many financial institutions must then reassess their holdings of that bond, rather than reacting to any truly new information about the default probability of the bond. The question of what true value the major credit rating agencies bring to the financial markets remains open and difficult to resolve.[8]

Finally, the post-Enron notoriety for the credit rating agencies exposed their "issuer pays" business model—and its potential conflicts—to a wider public view.

[8] It is difficult for research concerning the effects of ratings changes on the securities markets to avoid this ambiguity. Creighton, Gower, and Richards (2007) claim that bond rating changes provide new information to the securities markets in Australia, where the regulatory reliance on ratings is substantially less than in the United States; but there is nevertheless some regulatory reliance in Australia, and U.S. investors in Australian bonds may be affected by the rating changes. Jorion, Liu, and Shi (2005) find that the consequences of rating downgrades were larger after a SEC regulatory change in 2000 ("Regulation Fair Disclosure") that placed the rating agencies in a favored position vis-à-vis other potential sources of information about companies; but Jorion et al. do not adequately control for a possible increase in the severity of the downgrades after the regulatory change.

Although the rating agencies' reputational concerns had kept the potential conflicts in check, the possibility that the conflicts might get out of hand loomed (Smith and Walter, 2002; Caouette, Altman, Narayanan, and Nimmo, 2008, chap. 6).

Fueling the Subprime Debacle

The problems with outsourcing regulatory judgments to three entrenched credit rating agencies—all of whom had "issuer pays" business models—became even more apparent with the unfolding of the boom and bust in housing prices, and the financial crisis that followed. The U.S. housing boom that began in the late 1990s and ran through mid 2006 was fueled, to a substantial extent, by subprime mortgage lending.[9] In turn, the underlying finance for these subprime mortgage loans came through a process of securitization. The subprime mortgage loans were combined into mortgage-related securities, which in turn were divided into a number of more-senior and less-senior tranches, such that junior tranches would bear all losses before the senior tranches bore any. Senior tranches of these mortgage-backed securities ended up being owned by many financial firms, including banks. Many financial institutions also created "structured investment vehicles," which borrowed funds by issuing short-term "asset-backed" commercial paper and then used the funds to purchase tranches of the collateralized debt obligations backed by subprime mortgages. If these mortgage-backed securities received high credit ratings, then the asset-backed commercial paper could also receive a high credit rating—thus making it cheaper to borrow.

The securitization of these subprime mortgages was only able to succeed—that is, the resulting securities were only able to be widely marketed and sold—because of the favorable ratings bestowed on the more-senior tranches. First, recall that the credit ratings had the force of law with respect to regulated financial institutions' abilities and incentives (via capital requirements) to invest in these bonds.[10] Second, the generally favorable reputations that the credit rating agencies had established in their corporate and government bond ratings meant that many bond purchasers—regulated and nonregulated—were inclined to trust the agencies' ratings on the mortgage-related securities.

During their earlier history, the credit rating agencies rated the bonds that were issued by corporations and various government agencies. But in rating of mortgage-related securities, the rating agencies became highly involved in their design. The credit rating agencies consulted extensively with the issuers of these

[9] The debacle is discussed extensively in Gorton (2008), Acharya and Richardson (2009), Brunnermeier (2009), Coval, Jurak, and Stafford (2009), and Mayer, Pence, and Sherlund (2009).

[10] For banks and savings institutions, mortgage-backed securities—including collateralized debt obligations—that were issued by nongovernmental entities and rated AA or better qualified for the same reduced capital requirements (1.6 percent of asset value) that applied to the mortgage-backed securities issued by Fannie Mae and Freddie Mac, instead of the higher (4 percent) capital requirements that applied to mortgages and lower-rated mortgage securities.

securities on what kinds of mortgages (and other kinds of debt) would earn what levels of ratings for what sizes of tranches of these securities (Mason and Rosner, 2007). For any given package of underlying mortgages to be securitized, the securitizers made higher profits if they attained higher ratings on a larger percentage of the tranches of securities that were issued against those mortgages.

It is not surprising, then, that the securitizers would be prepared to pressure the rating agencies to deliver favorable ratings. Unlike the market for rating corporate and government debt, where there were thousands of issuers, the market for rating mortgage-related securities involved only a relatively small number of investment banks as securitizers with high volumes (U.S. Securities and Exchange Commission, 2008, p. 32); and the profit margins on these mortgage-related securities were substantially larger as well. An investment bank that was displeased with an agency's rating on any specific security had a more powerful threat—to move all of its securitization business to a different rating agency—than would any individual corporate or government issuer.[11] In addition, these mortgage-related securities were far more complex and opaque than were the traditional "plain vanilla" corporate and government bonds, so rating errors were less likely to be quickly spotted by critics (or arbitragers).

Thus, in calculating appropriate ratings on the tranches of securities backed by subprime mortgages, the credit rating agencies were operating in a situation where they had essentially no prior experience, where they were intimately involved in the design of the securities, and where they were under considerable financial pressure to give the answers that issuers wanted to hear. Furthermore, it is not surprising that the members of a tight, protected oligopoly might become complacent and less worried about the problems of protecting their long-run reputations (Mathis, McAndrews, and Rochet, 2009).

The credit ratings for the securities backed by subprime mortgages turned out to be wildly optimistic—especially for the securities that were issued and rated in 2005–2007. Then, in keeping with past practice, the credit rating agencies were slow to downgrade those securities as their losses became apparent. Here is one stark indicator of the extent of the initial overoptimism: As of June 30, 2009, 90 percent of the collateralized debt obligation tranches that were issued between 2005 and 2007 and that were originally rated AAA by Standard & Poor's had been downgraded, with 80 percent downgraded below investment grade; even of the simpler residential mortgage-backed securities that were issued during these years and originally rated AAA, 63 percent had been downgraded, with 52 percent below investment grade (International Monetary Fund, 2009, pp. 88, 93).

[11] Informed commentary at the time acknowledged that rating shopping was occurring (Adelson, 1997). Econometric evidence that supports the likelihood of ratings shopping can be found in Benmelech and Dlugosz (2009), He, Qian, and Strahan (2009), and Morkotter and Westerfeld (2009). When some of the downgraded tranches were resecuritized in 2009, the securitizers shunned Moody's, because of its more stringent rating methodology for these securitizations (IMF, 2009, pp. 86–87). And in a similar market—rating commercial mortgage-backed securities—Moody's found that it lost market share in 2007 after it tightened its ratings standards (Dunham, 2007).

Policy Responses

The main policy responses to the growing criticism of the three large bond raters—over the sluggishness in downgrading Enron and WorldCom debt, on through the recent errors in their initial, excessively optimistic ratings of the complex mortgage-related securities—have involved attempts to increase entry, to limit conflicts of interest, and to increase transparency.

The Sarbanes–Oxley Act of 2002 included a provision that required the Securities and Exchange Commission to send a report to Congress on the credit rating industry and the "nationally recognized statistical rating organization" system. The SEC duly did so (U.S. Securities and Exchange Commission, 2003); but the report only raised a series of questions rather than directly addressing the issues of the SEC as a barrier to entry and the enhanced role of the three incumbent credit rating agencies.

However, the Securities and Exchange Commission did begin to allow more entry. In early 2003 the SEC designated a fourth "nationally recognized statistical rating organization": Dominion Bond Rating Services, a Canadian credit rating firm. In early 2005 the SEC designated a fifth NRSRO: A.M. Best, an insurance company rating specialist. The SEC's procedures remained opaque, however, and there were still no announced criteria for the designation of a NRSRO.

Tiring of this situation, Congress passed the Credit Rating Agency Reform Act, which was signed into law in September 2006. The Act instructed the SEC to cease being a barrier to entry, specified the criteria that the SEC should use in designating new "nationally recognized statistical rating organizations," insisted on transparency and due process in these SEC's decisions, and provided the SEC with limited powers to oversee the incumbent NRSROs—but specifically forbade the SEC from influencing the ratings or the business models of the NRSROs. The SEC responded by designating three new NRSROs in 2007: Japan Credit Rating Agency; Rating and Information, Inc. (of Japan); and Egan-Jones—and another two in 2008, Lace Financial and Realpoint. Thus by early 2010, the total number of NRSROs has reached ten. However, to this point the SEC's belated efforts to allow wider entry during the current decade have had little substantial effect. The inherent advantages of the "Big Three's" incumbency could not quickly be overcome by the subsequent NRSRO entrants—three of which were headquartered outside the United States, one of which was a U.S. insurance company specialist, and three of which were small U.S.-based firms.

To address issues of conflict of interest and transparency, the Securities and Exchange Commission in December 2008 and again in November 2009 promulgated regulations on the "nationally recognized statistical rating organizations" that placed restrictions on the conflicts of interest that can arise under their "issuer pays" business model. For example, these rules require that the credit rating agencies not rate complex structured debt issues that they have also helped to design, they require that analysts for credit rating agencies not be involved in fee negotiations, and so on. These rules also require greater transparency, for example, by requiring that the rating agencies reveal details on their methodologies, assumptions, and track records in the construction of ratings (*Federal Register*, vol. 74, February 9, 2009, pp. 6456–84; and *Federal Register*, vol. 74, December 4, 2009, pp. 63832–65). Similarly, in April 2009 the European Union adopted a set of rules that address the conflict-of-interest and transparency issues (European Central Bank, 2009). Political pressures to require further, more stringent efforts on the part of the rating agencies to deal with agency conflicts and enhance transparency—and possibly even to ban the "issuer pays" model—have remained strong.

This regulatory response—the credit rating agencies made mistakes; let's try to make sure that they don't make such mistakes in the future—is understandable. But it would not alter the rules that have pushed the judgments of the credit rating agencies into the center of the bond information process. Moreover, regulatory efforts to fix problems, by prescribing specified structures and processes, unavoidably restrict flexibility, raise costs, and discourage entry and innovation in the development and assessment of information for judging the creditworthiness of bonds. Ironically, such efforts are likely to increase the importance of the three large incumbent rating agencies. Finally, although efforts to increase transparency of credit rating agencies may help reduce problems of asymmetric information, they also have the potential for eroding a rating firm's intellectual property and, over the longer run, discouraging the creation of future intellectual property.

Alternatively, public policy with regard to credit rating agencies could proceed in a quite different direction. This approach would begin with the withdrawal of all of those delegations of safety judgments by financial regulators to the rating agencies. Indeed, the Securities and Exchange Commission has withdrawn some of its delegations (*Federal Register*, vol. 74, October 9, 2009, pp. 52358–81) and has proposed withdrawing more (*Federal Register*, vol. 74, October 9, 2009, pp. 52374–81). Under such rules, the rating agencies' judgments would no longer have the force of law. However, no other financial regulator has similarly withdrawn its delegations.[12] And even the SEC appears to be two-minded about this matter, since the SEC has also proposed regulations that would increase money market mutual funds' reliance on ratings (*Federal Reserve*, vol. 74, July 8, 2009, pp. 32688–32741).

The withdrawal of these delegations need not mean an "anything goes" attitude toward the safety of the bonds that are held by prudentially regulated financial institutions. Instead, financial regulators should persist in their goals of having safe bonds in the portfolios of their regulated institutions (or that, as in the case of insurance companies and broker-dealers, an institution's capital requirement would be geared to the riskiness of the bonds that it holds); but those

[12] In October 2009, the Federal Reserve announced that it would be more selective with respect to which ratings it would accept in connection with the collateral provided by borrowers under the Fed's "Term Asset-Backed Securities Lending Facility" (TALF) and would also conduct its own risk assessments of proposed collateral; and in November 2009, the National Association of Insurance Commissioners (NAIC) announced that it had asked the Pacific Investment Management Company (PIMCO) to provide a separate risk assessment of residential mortgage-backed securities that were held by insurance companies that are regulated by the 50 state insurance regulators.

safety judgments should remain the responsibility of the regulated institutions themselves, with oversight by regulators.

Under this alternative public policy approach, banks and other financial institutions would have a far wider choice as to where and from whom they could seek advice as to the safety of bonds that they might hold in their portfolios. Some institutions might choose to do the necessary research on bonds themselves, or rely primarily on the information yielded by the credit default swap market. Or they might turn to outside advisers, which might include the incumbent credit rating agencies but might also include the fixed income analysts at investment banks or industry analysts or upstart advisory firms that are currently unknown. Regulators would—and should—continue to oversee the safety of the institution's bond portfolio, and this oversight might also include a review of how the institution evaluates the risks of its bond holdings (including its choice of adviser). Nevertheless, it seems highly likely that the bond information market would be opened to new ideas—about ratings business models, methodologies, and technologies—and to new entry in ways that have not been possible since the 1930s. Perhaps the "issuer pays" business model would survive in this new approach; perhaps not. That outcome would be determined by the competitive process.

If this second route is pursued, then the first route—the expansion of conflict-of-interest and transparency regulations, as well as the continued existence of the NRSRO system—would no longer be needed. The bond manager of a bank or other financial institution should have sufficient market sophistication to be able to figure out who is a reliable advisor—subject, of course, to the prudential oversight of regulators. (If these markets were instead dominated by household transactors, then a different answer would be appropriate.)

Conclusion

Those who are interested or involved in this public policy debate concerning the credit rating agencies should ask themselves the following questions: Is a regulatory system that delegates important safety judgments about bonds to third parties in the best interests of the regulated financial institutions and of financial markets more generally? To what extent will more extensive regulation of the rating agencies succeed in pressing the rating agencies to make better judgments in the future? To what extent would such regulation limit flexibility, innovation, and entry in the bond information market? Can financial institutions instead be trusted to seek their own sources of information about the creditworthiness of bonds, so long as financial regulators oversee the safety of those bond portfolios?

■ *I am grateful to David Autor, James Hines, Charles Jones, and Timothy Taylor for helpful comments.*

References

Acharya, Viral, and Matthew Richardson, eds. 2009. *Restoring Financial Stability: How to Repair a Failed System.* New York: Wiley.

Adelson, Mark. 2007. "The Role of the Credit Rating Agencies in the Structured Finance Market," Testimony before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, September 27, 2007.

Altman, Edward I., and Herbert A. Rijken. 2004. "How Rating Agencies Achieve Rating Stability." *Journal of Banking & Finance,* 28(11): 2679–2714.

Altman, Edward I., and Herbert A. Rijken. 2006. "A Point-in-Time Perspective on Through-the-Cycle Ratings," *Financial Analysts Journal,* 62(1): 54–70.

Basel Committee on Banking Supervision. 2000. "Credit Ratings and Complementary Sources of Credit Quality Information." Bank for International Settlements, Basel Committee on Banking Supervision, Working Paper 3. http://www.bis.org/publ/bcbs72a.pdf?noframes=1.

Beaver, William H., Catherine Shakespeare, and Mark T. Soliman. 2006. "Differential Properties in the Ratings of Certified versus Non-Certified Bond-Rating Agencies." *Journal of Accounting and Economics,* 42(3), pp. 303–34.

Benmelech, Efraim, and Jennifer Dlugosz. 2009. "The Credit Rating Crisis." NBER Working Paper 15045.

Brunnermeier, Markus K. 2009. "Deciphering the Liquidity and Credit Crunch 2007–2008." *Journal of Economic Perspectives,* 23(1): 77–100.

Calomiris, Charles W. 2009. "A Recipe for Ratings Reform." *The Economists' Voice,* vol. 6, no. 11, Article 5.

Cantor, Richard, and Frank Packer. 1995. "The Credit Rating Industry." *Journal of Fixed Income,* 5(3): 10–34.

Caouette, John B., Edward I. Altman, Paul Narayanan, and Robert Nimmo. 2008. *Managing Credit Risk: The Great Challenge for the Global Financial Markets,* 2nd ed. New York: Wiley.

Cheng, Mei, and Monica Neamtu. 2009. "An Empirical Analysis of Changes in Credit Rating Properties: Timeliness, Accuracy and Volatility." *Journal of Accounting and Economics,* 47(1–2): 108–130.

Coval, Joshua, Jakub Jurek, and Erik Stafford. 2009. "The Economics of Structured Finance." *Journal of Economic Perspectives,* 23(1): 3–25.

Creighton, Adam, Luke Gower, and Anthony J. Richards. 2007. "The Impact of Rating Changes in Australian Financial Markets." *Pacific-Basin Finance Journal,* 15(1): 1–17.

Dunham, Kemba J. 2007. "Real Estate Finance: Moody's Says It Is Taking Hit; Ratings Firm Loses Business as Tougher CMBS Stance Spurs Issuers to 'Rate Shop.'" *Wall Street Journal,* July 18, p. B-7.

European Central Bank. 2009. "Credit Rating Agencies: Developments and Policy Issues." *Monthly Bulletin,* May, pp. 107–117.

Flandreau, Marc, Norbert Gaillard, and Frank Packer. 2009. "Ratings, Performance, Regulation and the Great Depression: Lessons from Foreign Government Securities." CEPR Discussion Paper No. DP7328. (June).

Fridson, Martin S. 1999. "Why Do Bond Rating Agencies Exist?" *Extra Credit* (Merrill Lynch), November/December.

Fridson, Martin S. 2002. "Discussion," in *Ratings, Rating Agencies, and the Global Financial System,* ed. Richard M. Levich, Carmen Reinhart, and Giovanni Majnoni, 85–88. Boston: Kluwer.

Gorton, Gary B. 2008 "The Panic of 2007." NBER Working Paper 14358.

He, Jie, Jun Qian, and Philip E. Strahan. 2009. "Credit Ratings and the Evolution of the Mortgage-Backed Securities Market." Unpublished paper, November.

International Monetary Fund. 2009. "Global Financial Stability Report: Navigating the Financial Challenges Ahead." http://www.imf.org/external/pubs/ft/gfsr/2009/02/index.htm.

Jewell, Jeff, and Miles Livingston. 1999. "A Comparison of Bond Ratings from Moody's S&P and Fitch." *Financial Markets, Institutions, & Instruments,* 8(4): 1–45.

Johnston, Rick, Stanimir Markov, and Sundaresh Ramnath. 2009. "Sell-side Debt Analysts." *Journal of Accounting and Economics,* 47(1–2): 91–107.

Joint Forum. 2009. "Stocktaking on the Use of Credit Ratings." Bank for International Settlements, Basel Committee on Banking Supervision. June.

Jorion, Philippe, Zhu Liu, and Charles Shi. 2005. "Informational Effects of Regulation FD: Evidence from Rating Agencies." *Journal of Financial Economics,* 76(2): 309–330.

Langohr, Herwig, and Patricia Langohr. 2008. *The Rating Agencies and Their Credit Ratings: What They Are, How They Work, and Why They Are Relevant.* Chichester: Wiley.

Loffler, Gunter. 2004. "An Anatomy of Rating through the Cycle." *Journal of Banking & Finance,* 28(3): 695–720.

Loffler, Gunter. 2005. "Avoiding the Rating

Bounce: Why Rating Agencies Are Slow to React to New Information." *Journal of Economic Behavior & Organization*, 56(3): 365–81.

Mason, Joseph, and Joshua Rosner. 2007. "Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions." Available at SSRN: http://ssrn.com/abstract=1027475.

Mathis, Jerome, James McAndrews, and Jean-Charles Rochet. 2009. "Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?" *Journal of Monetary Economics*, 56(5): 657–74.

Mayer, Christopher, Karen Pence, and Shane M. Sherlund. 2009. "The Rise in Mortgage Defaults." *Journal of Economic Perspectives*, 23(1): 27–50.

Moody's Corporation. 2009. *Annual Report 2008*. New York: Moody's.

Morkotter, Stefan, and Simone Westerfeld. 2009. "Rating Model Arbitrage in CDO Markets: An Empirical Analysis." *International Review of Financial Analysis*, 18(5): 21–33.

Partnoy, Frank. 1999. "The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies." *Washington University Law Quarterly*, 77(3): 619–712.

Partnoy, Frank. 2002. "The Paradox of Credit Ratings." In *Ratings, Rating Agencies, and the Global Financial System*, ed. Richard M. Levich, Carmen Reinhart, and Giovanni Majnoni, 65–84. Boston: Kluwer.

Richardson, Matthew C., and Lawrence J. White. 2009. "The Rating Agencies: Is Regulation the Answer?" In *Restoring Financial Stability: How to Repair a Failed System*, ed. Viral Acharya and Matthew C. Richardson, 101–115. New York: Wiley.

Rysman, Marc. 2009. "The Economics of Two-Sided Markets." *Journal of Economic Perspectives*, 23(3): 125–43.

Sinclair, Timothy J. 2005. *The New Masters of Capital: American Bond Rating Agencies and the Politics of Creditworthiness*. Ithaca: Cornell University Press.

Skreta, Vasiliki, and Laura Veldkamp. 2009. "Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation." *Journal of Monetary Economics*, 56 (5): 678–95.

Smith, Roy C., and Ingo Walter. 2002. "Rating Agencies: Is There an Agency Issue?" In *Ratings, Rating Agencies, and the Global Financial System*, ed. Richard M. Levich, Carmen Reinhart, and Giovanni Majnoni, 289–318. Boston: Kluwer.

Sylla, Richard. 2002. "An Historical Primer on the Business of Credit Ratings." In *Ratings, Rating Agencies, and the Global Financial System*, ed. Richard M. Levich, Carmen Reinhart, and Giovanni Majnoni, 19–40. Boston: Kluwer.

U.S. Securities and Exchange Commission. 2003. "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets." January.

U.S. Securities and Exchange Commission. 2008. "Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies." July.

White, Lawrence J. 2002a. "The Credit Rating Industry: An Industrial Organization Analysis." In *Ratings, Rating Agencies, and the Global Financial System*, ed. Richard M. Levich, Carmen Reinhart, and Giovanni Majnoni, 41–63. Boston: Kluwer.

White, Lawrence J. 2002b. "The SEC's Other Problem." *Regulation*, 25(Winter 2002–2003): 38–42.

White, Lawrence J. 2006. "Good Intentions Gone Awry: A Policy Analysis of the SEC's Regulation of the Bond Rating Industry." Policy Brief No. 2006-PB-05. Networks Financial Institute, Indiana State University.

White, Lawrence J. 2007. "A New Law for the Bond Rating Industry." *Regulation*, 30(Spring): 48–52.

White, Lawrence J. 2009. "The Credit-Rating Agencies and the Subprime Debacle." *Critical Review*, 21(2–3): 389–99.

For Release Upon Delivery

10 a.m., July 27, 2011

TESTIMONY OF

DAVID K. WILSON
SENIOR DEPUTY COMPTROLLER BANK SUPERVISION POLICY
AND CHIEF NATIONAL BANK EXAMINER

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Before the

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
COMMITTEE ON FINANCIAL SERVICES

U. S. HOUSE OF REPRESENTATIVES

July 27, 2011

Statement Required by 12 U.S.C. § 250:
The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

I. Introduction

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee, I appreciate the opportunity to testify about the initiatives the Office of the Comptroller of the Currency (OCC) has undertaken, and the challenges we are facing, in working to implement section 939A of the Dodd-Frank Act.

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) requires each federal agency, within one year of enactment, to review regulations that require the use of an assessment of the creditworthiness of a security or money market instrument, and any references to, or requirements in, those regulations regarding credit ratings. Each agency must then modify its regulations to remove any reference to, or requirement for, reliance on credit ratings and substitute alternative standards of creditworthiness that the agency determines are appropriate. Upon conclusion of the review, the Act requires each federal agency to transmit a report to Congress containing a description of any modification of any regulation made pursuant to section 939A. The OCC will be submitting its report today. My testimony today is based on the content of our report.

The OCC has reviewed its regulations and identified those that require the use of an assessment of the creditworthiness of a security or money market instrument and that reference or require the use of credit ratings. These regulations include interagency risk-based capital regulations, as well as OCC-specific regulations pertaining to national bank investment securities activities, securities offerings, and international banking activities. My testimony describes the use of credit ratings in these regulations and our efforts to develop alternative creditworthiness standards pursuant to section 939A.[1] I will also discuss some of the challenges that the OCC and the other federal banking agencies face in developing appropriate alternatives. The difficulties presented in this regard include developing alternatives that do not add undue regulatory burdens and still appropriately measure credit risk, that provide for timely and accurate updates as the quality of a particular asset deteriorates or improves, and that are transparent and replicable so that banks of varying size and complexity, as well as supervisors, can arrive at the same assessment for similar assets.

II. Risk-Based Capital Regulations

A. References to Credit Ratings

The federal banking agencies' risk-based capital standards reference credit ratings issued by nationally recognized statistical ratings organizations (NRSROs)[2] to determine appropriate capital requirements in four general areas:

- The assignment of risk weights to securitization exposures under the general risk-based capital rules and advanced approaches rules. Both approaches include provisions that differentiate among exposures by referencing credit ratings. As a general matter, highly-rated exposures receive lower capital requirements than

[1] Pursuant to the Dodd-Frank Act, effective July 21, 2011, the OCC assumed responsibility for the on-going examination, supervision, and regulation of federal savings associations and for the rulemaking authority of the OTS relating to all savings associations, both state and federal. Currently, the OTS rules include references to credit ratings related to lending and investment in 12 CFR Part 560, and regulatory capital requirements in 12 CFR Part 567. The OTS issued an advance notice of proposed rulemaking addressing lending and investment on October 14, 2010 (75 Fed. Reg. 63107), and it joined the other federal banking agencies in issuing an advanced notice of proposed rulemaking addressing the regulatory capital requirements on August 25, 2010 (75 Fed. Reg. 52283). Going forward, the OCC's efforts pursuant to section 939A will cover both OCC and OTS rules and will take into account comments received in response to the OTS notices.

[2] An NRSRO is an entity registered with the U.S. Securities and Exchange Commission (SEC) as an NRSRO under section 15E of the Securities Exchange Act of 1934. See, 15 U.S.C. 78o-7, as implemented by 17 CFR 240.17g-1.

lower-rated exposures.[3]

- The assignment of risk weights to claims on, or guaranteed by, qualifying securities firms under the general risk-based capital rules. Under the general risk-based capital rules, a lower risk weight is applied to most claims on, or guaranteed by, a securities firm, provided the firm has a credit rating that is in one of the three highest investment-grade categories used by the NRSRO.[4]
- The assignment of certain standardized specific risk add-ons under the agencies' market risk rule. As a general matter, debt instruments that are rated investment grade by one or more NRSROs are considered "qualifying" and receive a lower specific risk add-on under the standard option.[5]
- The determination of eligibility of certain guarantors and collateral for purposes of the credit risk mitigation framework under the advanced approaches rules. Under the advanced approaches risk-based capital rule, the definition of financial collateral includes various types of securities that have external ratings of at least investment grade and, in certain instances, recognition of guarantees are based on NRSRO ratings assigned to a guarantor.[6]

The federal banking agencies' risk-based capital regulations are based on a framework published by the Basel Committee on Banking Supervision (Basel Committee), a committee of banking supervisory authorities,[7] which was established by

---

[3] *See* 12 CFR Part 3, appendices A (general risk-based capital rules) and C (advanced approaches rules).

[4] *See* 12 CFR Part 3, Appendix A, section 3(a)(2)(xiii).

[5] *See* 12 CFR Part 3, Appendix B, section 5.

[6] *See* the definition of "eligible double default guarantor," "eligible securitization guarantor," and "financial collateral" in the agencies advanced approaches rules. 12 CFR Part 3, Appendix C, section 2.

[7] The Basel Committee's members include Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands,

the central bank governors of the G–10 countries in 1975. The Basel Committee formulates broad supervisory standards and guidelines, including risk-based capital standards, to encourage convergence toward rigorous common approaches and standards.

In addition to affecting existing rules, Section 939A will also significantly affect future rulemaking by the U.S. banking agencies to conform our capital standards to recent changes and enhancements to the Basel Accord capital standards.

In 2008, the agencies issued a notice of proposed rulemaking[8] that sought comment on implementation in the U.S. of certain aspects of the standardized approach in the Basel Accord. The Basel standardized approach for credit risk is a more risk-sensitive approach than our current general risk-based capital rule and relies extensively on credit ratings to assign risk weights to various exposures.

In 2009, in response to the financial crisis, the Basel Committee published the following documents that revise and strengthen the Basel risk-based capital framework: Revisions to the Basel II Market Risk Framework (*Revisions* Document); Enhancements to the Basel II Framework (*Enhancements* Document); and Strengthening the Resilience of the Banking Sector.[9] The *Enhancements* Document introduced operational criteria to require banking organizations[10] to undertake independent analyses of their securitization exposures. These operational criteria require a bank to have a comprehensive understanding of the risk characteristics of its individual securitization exposures; to be

---

Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

[8] 73 FR 43982.

[9] *See,* "Revisions to the Basel II Market Risk Framework" (July 2009, Basel Committee); "Guidelines for Computing Capital for Incremental Risk in the Trading Book" (July 2005, joint publication of the Basel Committee and International Organization for Securities Commissioners); "Enhancements to the Basel II Framework" (July 2009, Basel Committee); and "Strengthening the Resilience of the Banking Sector" (December 2009, Basel Committee).

[10] For simplicity, and unless otherwise indicated, the term "banking organization" includes banks, savings associations, and bank holding companies.

able to access performance information on the underlying pools on an on-going basis in a timely manner; and to have a thorough understanding of all structural features of a securitization transaction.[11] The *Enhancements* document also introduced higher risk-based capital requirements for re-securitization exposures. Moreover, the *Revisions* document increases capital charges for bank securitization exposures held for trading. The Basel Committee expects the standards under the *Enhancements* document and the *Revision* document, which still rely partially on credit ratings, to become effective in January 2012.

U.S. regulators cannot conform our capital standards to those agreed to internationally if section 939A precludes any reference to or reliance on credit ratings.

B. Interagency Advance Notice of Proposed Rulemaking

On August 25, 2010, the OCC and the other federal banking agencies published an advance notice of proposed rulemaking (interagency ANPR) seeking comment on several approaches of varying complexity and risk-sensitivity, for developing alternative creditworthiness standards for the provisions of the risk-based capital regulations that reference credit ratings.

At one end of the spectrum, the agencies requested comment on a relatively simple approach to measuring and differentiating risk using broad risk categories with limited risk sensitivity. For example, the approach would require all corporate exposures to receive the same risk weight, regardless of the variation in risks that exist across corporate exposures.

At the other end of the spectrum, the agencies suggested permitting a banking organization to assign risk weights to individual exposures using specific qualitative and

[11] *Enhancements* document, paragraphs 565(i)–(iv).

quantitative credit risk measurement standards that could be established for various exposure categories based on broad creditworthiness metrics. For example, exposures could be assigned a risk weight using certain market-based measures, such as credit spreads, or obligor-specific financial data, such as debt-to-equity ratios or other sound underwriting criteria. Alternatively, a banking organization could assign exposures to one of a limited number of risk weight categories based on an internally-developed assessment of the exposure's probability of default or expected loss. Although this approach is risk sensitive, it likely would be difficult to achieve relatively consistent assessments of risk across exposure categories and across banking organizations.

Overall, commenters on the interagency ANPR expressed substantial concerns with the removal of credit ratings from the risk-based capital regulations and asserted that credit ratings can be a valuable tool for assessing creditworthiness. Commenters stated that any alternative creditworthiness standard used to determine risk-based capital requirements should be risk sensitive so as to not incent banks to engage in risk arbitrage.

A number of commenters noted that credit ratings are useful for measuring creditworthiness when appropriately used as a supplement to prudent due diligence processes. They observed that although easy-to-use alternatives have obvious appeal, such tools could create incentives to transform more robust credit analysis and due diligence into a simple compliance exercise. Simple alternatives could also fail to promote well-informed markets. A few of these commenters stated that the federal banking agencies should pursue other options, such as a legislative change, that would permit the agencies to continue using credit ratings in their regulations. These commenters stated that developing a suitable alternative to credit ratings would be impossible without creating undue regulatory burden, which would be particularly acute for community banks, competitive inequities with international banking institutions, and inconsistencies with the international capital standards established by the Basel Committee.

Several commenters stated that exclusive reliance on credit ratings is inappropriate, especially for securitization exposures where measuring risk requires consideration of specific cash structures and collateral. However, instead of completely eliminating the use of credit ratings, these commenters suggested that the regulators should ensure that firms have sufficient information and conduct adequate due diligence to understand their risk exposure.

Many commenters especially stressed that risk-sensitive rules that require extensive modeling capabilities would place a disproportionate burden on community and regional banks. These banks generally do not have in-house the systems and staff capable of performing a level of analysis similar to that performed by credit rating agencies, and thus would have to hire third-party vendors. Further, rating services performed by third-party vendors would likely be similar to the services of NRSROs.

C. Interagency Roundtable

On November 10, 2010, the Federal Reserve Board hosted a roundtable discussion attended by staff and principals of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the OCC, as well as bankers, academics, asset managers, staff of credit rating organizations, and others to discuss alternate measures of creditworthiness.

Roundtable participants reiterated many of the concerns expressed and suggested by commenters in response to the interagency ANPR. These included concerns about the burden placed on community and regional banks to perform analyses similar to those conducted by credit rating organizations and larger banks. These participants asserted that any alternative standard should be easy to understand and use and allow for quick decision making. However, some participants also expressed concern that many creditworthiness measures that would be relatively simple to apply, such as credit default spreads, could introduce procyclicality. These participants suggested that a more complex multifactor analysis would be necessary to appropriately measure credit risk.

With regard to complex structured finance products, such as securitization positions, participants generally agreed that many banks needed to better understand the positions in which they invested. Several roundtable participants favored the use of cash flow analysis – which could be produced internally or provided by qualified third parties – to help determine risk-based capital requirements for securitization exposures. According to one panelist, the key components for conducting such an analysis would include an understanding of securitization structure and underlying loan characteristics, as well as timely surveillance. One participant favored a treatment for community banks that relied on observable inputs, such as bond spreads, rather than cash flow analysis that requires modeling.

III. OCC Non-Capital Regulations

A. References to Credit Ratings

In addition to the federal banking agencies' risk-based capital regulations, the OCC's regulations regarding permissible investment securities, securities offerings, and international activities each reference or rely on NRSRO credit ratings.[12] In some instances, these regulations also use credit ratings as proxies for factors other than creditworthiness.

Investment Securities

The OCC's investment securities regulations at 12 CFR Part 1 use credit ratings as a factor for determining the credit quality, marketability, and appropriate concentration levels of investment securities purchased and held by national banks. Under the OCC rules, an investment security must not be "predominantly speculative in nature." The OCC rules provide that an obligation is not "predominantly speculative in nature" if it is rated investment grade or, if unrated, is the credit equivalent of investment grade. "Investment grade," in turn, is defined as a security rated in one of the four highest rating categories by two or more NRSROs (or one NRSRO if the security has been rated by only one NRSRO).

Credit ratings also are used to determine marketability in the case of a security that is offered and sold pursuant to Securities and Exchange Commission Rule 144A. Under Part 1, a 144A security is deemed to be marketable if it is rated investment grade or the credit equivalent of investment grade. The purpose of the investment grade rating requirement is to ensure that the security is of high credit quality <u>and</u> can be sold with reasonable promptness in the secondary market.

In addition, credit ratings are used to determine concentration limits for certain investment securities. For example, OCC rules limit holdings of "Type IV" securities of any one obligor that are rated in the third highest investment grade rating categories to

[12] *See generally,* 12 CFR Part 1 (investment securities), 12 CFR Part 16 (securities offerings), and 12 CFR Part 28 (international banking activities).

25 percent of the bank's capital and surplus.[13] However, there is no concentration limit for small business-related securities that are rated in the highest or second highest investment grade categories.

Securities Offerings

Securities issued by national banks are not covered by the registration provisions and several other SEC regulations that govern other issuers under the Securities Act of 1933. However, the OCC has adopted regulations at 12 CFR Part 16 to require disclosures related to national bank-issued securities. Part 16 includes references to "investment grade" ratings.

For example, section 16.6 provides an optional abbreviated registration system for nonconvertible bank-issued debt securities that meet certain criteria. The OCC designed the criteria, in part, to ensure that potential purchasers of nonconvertible debt have access to necessary information on the issuing bank and commonly controlled depository institutions, as well as the appropriate knowledge and experience to evaluate that information. Among the criteria required for abbreviated registration, a security must be rated investment grade.

International Banking Activities

Pursuant to section 4(g) of the International Banking Act (IBA),[14] foreign banks with federal branches or agencies must establish and maintain a capital equivalency deposit (CED) with a member bank located in the state where the federal branch or agency is located. The IBA authorizes the OCC to prescribe regulations describing the

---

[13] A Type IV investment security includes certain small business related securities, commercial mortgage related securities, or residential mortgage related securities. See, 12 CFR 1.2(m).

[14] 12 U.S.C. 3102(g).

types and amounts of assets that qualify for inclusion in the CED, "as necessary or desirable for the maintenance of a sound financial condition, the protection of depositors, creditors, and the public interest."[15] At 12 CFR 28.15, OCC regulations set forth the types of assets eligible for inclusion in a CED. Among these assets are certificates of deposit payable in the U.S., and bankers' acceptances, provided that, in either case, the issuer or the instrument is rated investment grade by an internationally recognized rating organization, and neither the issuer nor the instrument is rated lower than investment grade by any such rating organization that has rated the issuer or the instrument.

B. OCC Advance Notice of Proposed Rulemaking

On August 13, 2010, the OCC published an advance notice of proposed rulemaking (OCC ANPR) that described the references to credit ratings in its regulations at 12 CFR Parts 1, 16, and 28 and requested comment on alternative creditworthiness standards.[16] The OCC's ANPR described and requested comment on three general options for defining the term "investment grade."

First, the OCC requested comment on an option that would permit a bank to determine that a security is investment grade by conducting its own internal credit analysis.

Second, the OCC outlined an alternative "investment grade" standard that would focus solely on a broader set of criteria than the current creditworthiness standard. The current standard focuses primarily on the timely repayment of principal and interest and the probability of default. A broader standard would recite many of the expectations described in OCC guidance materials, which emphasize that national banks must

[15] 12 U.S.C. 3102(g)(4).

[16] 75 Fed. Reg. 49,423 (Aug. 13, 2010).

consider, as appropriate, credit, liquidity, and market risk, as well as any other risks presented by proposed securities activities.

Finally, the OCC proposed to permit banks to use internal loan classification systems to rate investment securities. This option would leverage off of the federal banking agencies' existing common risk-rating scale used to identify problem credits.

A majority of the commenters said that the OCC should continue to use credit ratings in its regulations. Most commenters argued that credit ratings are a valuable tool for banks – especially small banks – for measuring credit risk. Several commenters expressed doubt that any of the suggested alternatives for measuring creditworthiness would yield results that would be as useful and cost-effective as credit ratings, particularly after the passage of Dodd-Frank Act, which included measures adding to the SEC's oversight authority over NRSROs and requiring the SEC to draft new regulations governing NRSROs. A number of commenters stated that the OCC either should interpret the statute in a manner that would permit the continued use of credit ratings as one factor in the evaluation, or seek a legislative change that would permit banks to consider credit ratings as one of several factors when measuring credit risk.

Commenters on the OCC ANPR focused largely on two issues: competitive equity and compliance burden. Community and regional bank commenters argued that the inability to use credit ratings in evaluating investments could disadvantage them when compared with larger institutions that have advanced analytical capabilities. Larger internationally active banks expressed concern that they will be disadvantaged when compared to their foreign counterparts who may continue to use external credit ratings. Commenters also stated that developing internal rating systems to replace the longstanding use of NRSRO credit ratings would involve costs greater than those under the current regulation, without a corresponding benefit to risk management. While commenters noted that cost and burden would be a factor for all banks, it is likely to be more pronounced for community and regional banks that may not have in-house the systems and staff capable of adopting and meeting new standards. If smaller financial institutions lack the staff and systems to comply with the new standard, commenters noted that they effectively would be prevented from purchasing many of the investment securities they currently are permitted to hold and which have not been a source of problems, including many types of municipal bonds. Thus, commenters stated that a cost-effective, simple standardized approach to measuring credit risk would be particularly important for community and regional banks.

IV. Rulemaking Efforts and Challenges

Section 939A directs the agencies both to remove references to and requirements of reliance on credit ratings from their regulations and to substitute in their place new standards of creditworthiness that the agencies determine to be appropriate. As many of the ANPR commenters and roundtable participants noted, developing such appropriate alternative standards of creditworthiness to replace references to credit ratings is proving an exceptionally challenging task.

In order to further safety and soundness, appropriate alternatives need to meet several objectives. They must appropriately measure credit risk, provide a basis for timely and accurate updates as the quality of a particular asset deteriorates or improves, and be transparent and replicable so that banks of varying size and complexity, as well as supervisors, can arrive at the same assessment for similar assets. In addition, appropriate alternatives must be useable by banks of all sizes; they must not be so complex and burdensome that they are impractical and unduly burdensome for community and regional banks to use.

Finding appropriate substitutes for references to credit ratings is proving particularly challenging in connection with the risk-based capital standards. As previously noted, the federal banking agencies, in conjunction with other global supervisors through the Basel Committee, have sought to enhance the risk sensitivity of the risk-based capital standards. This is because less risk-sensitive rules may tend to encourage financial institutions to take on riskier, higher yielding assets to improve return on equity, without a corresponding increase in capital to offset the higher risk. However, absent the incorporation of third-party credit ratings, a more refined differentiation of credit risk may be achievable only at the expense of greater implementation burden – a burden that is likely to fall disproportionately on smaller banking institutions that do not have the resources to conduct credit analyses with the same level of detail as a credit rating organization or larger banking organizations.

The federal banking agencies have been reviewing the comments received in response to the interagency ANPR and have been examining ways in which they may implement the recent revisions to the international standards adopted by the Basel Committee, consistent with section 939A. If the U.S. agencies are unable to implement the Basel Committee changes that reference credit ratings, other jurisdictions may infer a lessening of the U.S. commitment to the Basel framework and the goal of a level playing field internationally.

Additionally, the OCC is continuing to work toward developing appropriate amendments to its regulations at 12 CFR Parts 1, 16, and 28.

We are proceeding thoroughly and carefully. To date, the use of credit ratings generally has provided a uniform, efficient, and reasonably transparent standard for assessing creditworthiness for most corporate and municipal exposures. Moreover, important steps have been taken to address areas where credit ratings were a factor in the recent financial crisis. Dodd-Frank has mandated major reforms for NRSROs; the SEC is setting new standards; and the OCC issued guidance in May 2009 re-emphasizing key principles of diligence and avoiding overreliance on NRSRO ratings, especially for more complex structured products.[17]

V. Conclusion

Issues surrounding credit ratings, primarily with respect to complex structured products, were a significant factor in market overconfidence that contributed to subsequent losses in the markets for mortgage-backed securities in 2008-2009. The Dodd-Frank Act includes a number of important remedial measures to address this problem, including structural changes at the rating agencies, greater SEC oversight of the ratings process, and loan-level disclosure requirements to investors in asset-backed securities. Additionally, the OCC has issued guidance addressing the inappropriate overreliance on ratings.

In this context of enhanced regulation and oversight, the OCC believes the absolute prohibition against any references to ratings under section 939A goes further than is reasonably necessary. With appropriate operational and due diligence requirements, credit ratings can be a valuable factor to consider when evaluating the

[17] OCC Bulletin 2009-15 (May 22, 2009).

creditworthiness of money market instruments and other securities. Precluding undue or exclusive reliance on credit ratings – rather than imposing an absolute prohibition to their use – would strike a more appropriate balance between the need to address the problems created by overreliance on credit ratings with the need to enact sound regulations that do not adversely affect credit availability or impede economic recovery.

Notwithstanding these concerns, we are continuing our work to revise our regulations to replace references to credit ratings with appropriate substitutes, as required by section 939A. As we undertake our revisions, we will be careful that the result is not a step backward in assuring that banks of all sizes conduct their activities in a safe and sound manner that reflects sound credit judgment and adequate capital for the risks they take.

I appreciate the opportunity to update the Subcommittee on the work we have done to date to implement section 939A of the Dodd-Frank Act, and to discuss the challenges we continue to face. I am happy to answer your questions.

Written Statement for the Hearing Record
by the
FEDERAL DEPOSIT INSURANCE CORPORATION

on

OVERSIGHT OF THE CREDIT RATING AGENCIES POST- DODD-FRANK

Subcommittee on Oversight and Investigations
Committee on Financial Services
Washington, D.C.

July 27, 2011
10:00 a.m.

The Federal Deposit Insurance Corporation appreciates this opportunity to submit a statement for the record for the hearing on "Oversight of the Credit Rating Agencies Post-Dodd-Frank." The Subcommittee has asked for an update on the FDIC's rulemaking to implement the credit rating reforms in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), as well as other rulemakings under Title IX of the Act.

The recent financial crisis highlighted the markets' over-reliance on credit ratings. Banking organizations and other investors suffered significant losses from once highly-rated securities – especially certain structured finance products – which experienced rapid and severe downgrades of their external credit ratings. A major cause of these downgrades was an overly optimistic assessment of risk by Nationally Recognized Statistical Rating Organizations (NRSROs) in their assignments of initial credit ratings for structured products and certain mortgage backed securities. As initial credit ratings migrated lower, credit rating agencies were criticized for possible bias in the structure of the rating process and for the presence of conflicts of interest among credit rating agencies, investors, and issuers. Many investors, including banking organizations, placed undue reliance on external credit ratings by failing to perform an independent analysis of the credit-worthiness of externally-rated exposures.

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires federal financial regulatory agencies to review their regulations that (1) require an assessment of the credit-worthiness of a security or money market instrument and (2) contain references to or requirements regarding credit ratings. In addition, agencies are required to remove such references to or reliance upon credit ratings, and to substitute in their place uniform standards of credit-worthiness.

FDIC actions pursuant to Section 939A of the Dodd-Frank Act

Generally, FDIC regulations reference credit ratings for four purposes. First, credit ratings are used as an input for calculating minimum risk-based capital requirements. Second, credit ratings are incorporated in permissibility standards to determine if investments are appropriate for financial institutions to purchase. Third, banking organization credit ratings have been used as an input to the FDIC's deposit insurance assessment system. Finally, in certain instances credit ratings or the lack of a credit rating are required to be disclosed to customers or other market participants.

Capital Requirements. Under the FDIC's existing risk-based capital guidelines, credit ratings are used to assign a capital charge for securitization exposures, including structured finance products, under the general risk-based capital rules and advanced approaches rules. Under the current rules, the rating of a structured finance product corresponds to a specific risk weight or capital charge that banks may use to determine minimum capital requirements. Additionally, the market risk rule uses credit ratings to assign standardized specific risk add-ons. Eligibility requirements for certain guarantors and collateral also reference credit ratings. Finally, the Basel II and Basel III international agreements rely on credit ratings in certain instances to determine minimum capital requirements.

On August 25, 2010, the FDIC, together with the Federal Reserve Board and the Office of the Comptroller of the Currency, issued the *Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of External Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies* (ANPR). The ANPR solicited comment on various alternative credit-worthiness standards that may be used for risk-based capital purposes. When considering different approaches, the agencies noted that they would evaluate the extent to which any alternative standard of credit-worthiness would: appropriately distinguish the credit risk associated with a particular exposure within an asset class; be sufficiently transparent, unbiased, replicable, and defined to allow banking organizations of varying size and complexity to arrive at the same assessment of credit-worthiness for similar exposures and to allow for appropriate supervisory review; provide for the timely and accurate measurement of negative and positive changes in credit-worthiness; minimize opportunities for regulatory capital arbitrage; be reasonably simple to implement and not add undue burden on banking organizations; and foster prudent risk management.

The FDIC received 23 comment letters from various sources, including industry associations, banks, and rating agencies. Generally, comments received did not concretely identify or suggest alternative standards of credit-worthiness. Most commenters expressed concern that credit ratings would no longer be permitted as an input into the risk-based capital rules, and argued that credit ratings are valuable tools in evaluating credit risk. Commenters generally argued that alternative standards of credit-worthiness need not only be risk-sensitive, but also internationally consistent to ensure a level playing field across jurisdictions.

On November 10, 2010, the agencies also hosted a roundtable discussion with industry participants and credit assessment experts to discuss alternatives to credit ratings. Roundtable panelists presented their views on factors and methodologies that the agencies should consider in formulating alternative standards of credit-worthiness. While there was no clear solution developed that could meet the agencies' standards for determining risk based capital requirements, panelists' comments generally mirrored those received from the ANPR. Broadly, panelists asserted that in order to be implemented by banking organizations of all sizes and levels of complexity, alternative standards of credit-worthiness need to be simple and risk-sensitive without adding undue burden.

Identifying suitable alternatives to credit ratings is challenging for a number of reasons and involves a balancing of important policy tradeoffs. Ideally, alternative standards of credit ratings would appropriately distinguish the credit risk of a given exposure. Developing objective and risk-sensitive regulatory credit risk assessments, however, may result in heightened complexity and data requirements for banks. Conversely, using a simple risk-bucket approach may be appropriate for some type of exposures but may not satisfy objectives for risk-sensitivity. Balancing the goals of risk-sensitivity on the one hand, and not placing undue burden on banks on the other, will be important for a successful implementation of Section 939A.

A contrasting approach that would not involve the use of objective formulas or risk buckets would be to allow capital requirements for rated instruments to be set by banks' own estimates of risk. This approach would pose a number of difficult issues. One is that models and risk estimates across banks could differ, resulting in inconsistent capital requirements across institutions. Another issue is that this approach would, in effect, allow banks to set their own capital requirements for the exposures covered by this approach. Over time, this could result in a significant decline in capital requirements and opportunities for banks to engage in capital arbitrage.

Ensuring international consistency has also proved to be challenging. Under international agreements, credit ratings can drive both very high and very low capital requirements. Regulators and banks in other countries are closely monitoring the U.S. regulatory process to see how we will implement these international agreements without using credit ratings.

The FDIC, in conjunction with the other banking agencies, is working to strike an appropriate balance among these potentially competing objectives. Our objective continues to be to seek public comment on concrete proposals to revise our capital regulations to meet the requirements of Section 939A.

We note that Section 939A does not prevent financial institutions from using credit ratings as a means of evaluating the credit risk of exposures as part of their own management of risk. Credit ratings should be supported by an appropriate level of due diligence, but will likely remain a widely accepted, standardized evaluation tool that banks and other market participants will use as part of their efforts to assess the risks of their exposures.

Permissibility Standards. Under the FDIC's permissible investments regulation, banks are generally prohibited from investing in certain types of securities. This regulation makes reference to "investment grade" credit ratings as the criteria for permissible investment activity. The FDIC will modify its permissible investments regulation in conjunction with the other banking agencies to develop uniform standards of credit-worthiness.

Deposit Insurance assessments. The FDIC's deposit insurance assessment rules referenced credit ratings as one of the criteria to stratify the risks posed by financial institutions to the deposit insurance fund. The FDIC has removed the references to credit ratings in this regulation and substituted a scorecard approach that relies on confidential financial and supervisory information. The FDIC approved the final rule making this change on February 7, 2011, and changes were effective on April 1, 2011.

Disclosures. To ensure that purchasers of securities in transactions with FDIC regulated banks are provided adequate information, FDIC regulations require certain disclosures. Included in these disclosures is the requirement for banks to notify customers that a given security is unrated by a NRSRO, if that is the case. This regulation is intended to foster accountability and suitability of the transaction for the customer and is unrelated to the credit-worthiness standard of the underlying security. The FDIC is considering whether the reference to credit ratings in this regulation constitutes a prohibited reference to credit-worthiness that falls under the scope of Section 939A.

Other Dodd-Frank Act Title IX Rulemakings

In addition to Section 939 of the Dodd-Frank Act, the FDIC participated in two other rulemakings pursuant to Title IX. On April 14, 2011, the FDIC issued a NPR titled *Incentive-Based Compensation Arrangements* to implement section 956 of the Dodd-Frank Act. The proposed rule would require the reporting of incentive-based compensation arrangements by certain financial institutions and prohibit incentive-based compensation arrangements that provide excessive compensation. The agencies are now reviewing the comments on that proposed rule. In addition, on April 29, 2011, the FDIC published a NPR titled *Credit Risk Retention* to implement the credit risk retention requirements of section 941 of the Dodd-Frank Act. The proposed rule generally requires the securitizer of asset-backed securities to retain not less than five percent of the credit risk of the assets collateralizing the asset-backed securities unless the assets adhere to defined underwriting standards. The comment period for that proposed regulation ends August 1, 2011.

Conclusion

As required by Section 939A, the FDIC is submitting its report today to Congress describing FDIC regulations that reference credit ratings and the status of efforts to replace such references. Consistent with this testimony, the report will indicate that the work needed to replace credit ratings in most of these regulations is not complete. The FDIC is working with the other federal banking agencies to develop uniform alternative standards of credit-worthiness for capital standards, permissibility, and other purposes.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

June 13, 2011

The Honorable Randy Neugebauer
Chairman
Subcommittee on Oversight and Investigations
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Neugebauer:

I am writing in response to your letter regarding recent actions taken by the credit rating agency Standard & Poor's ("S&P"). Your letter raises important issues related to the fiscal challenges facing the Nation. As you know, on April 18, S&P affirmed the AAA credit rating of the United States, but lowered its rating outlook to negative. While we disagree with S&P's conclusion, these events highlight the importance of timely, bipartisan cooperation on fiscal reform. As Deputy Secretary Wolin expressed to you in person shortly after we received your letter, we are firmly committed to working with Congress to strengthen the long-term fiscal position of the United States.

President Obama has emphasized his strong commitment to restoring balance to our fiscal position and to working with both parties to put the Nation on a responsible path to address the national debt. This will require difficult choices and a comprehensive approach. Nonetheless, as the President noted last month, addressing these issues is well within our capacity as a country. To this end, he has initiated a bipartisan process to help restore fiscal sustainability.

In its April 18 research report, S&P questioned whether government leaders would be able to reach an agreement on how to address our long-term budget challenges. This was a political judgment, which we believe is incorrect. We expect that America's leaders will come together—as both parties have done at key moments in the past—to meet and to overcome these challenges. The President is committed to this, and so am I. In fact, both parties agree on the broad parameters of the scale and timing of deficit reduction that is necessary to begin decreasing our national debt as a share of GDP. Our challenge now is to implement such a plan and to demonstrate to the world that the United States is serious about improving its long-term fiscal position. It is the right and necessary thing to do for America's future.

Your letter asks us to provide a better understanding of Treasury's engagement with S&P in regard to its recent action. As you know, S&P provides an independent rating for the sovereign debt of the United States. We do not solicit the rating, and we do not regulate or oversee the company. S&P periodically reviews its ratings; and, in connection with that process, it often reaches out to the U.S. government for information. In fact, S&P recently stated—in a report dated February 24, 2011—that its sovereign ratings "may involve the participation of government officials." In February 2011, S&P followed that practice, reached out to Treasury, and asked for information. In response, our staff met with S&P personnel and discussed publicly available information. We understand that S&P also met with the Office of Management and Budget, the Federal Reserve, Congress, and perhaps others. At the conclusion of the February review, S&P expressed some concern about the long-term fiscal position of the United States.

In early April, S&P contacted Treasury again and stated that its sovereign ratings committee was scheduled to meet to review the U.S. credit rating. In response, we emphasized that S&P should have the benefit of additional relevant information before making any significant decisions. In particular, we understood that S&P intended to make a judgment informed by its views of the Administration's intentions and objectives regarding fiscal reform, as well as the prospects for legislative action. In that context, we felt it was important to address those issues and to provide our views.

Shortly thereafter, on April 13, Administration officials met with S&P personnel. Deputy Secretary Wolin and I attended the meeting, along with Jacob Lew, the Director of the Office of Management and Budget; Bruce Reed, the Chief of Staff to Vice President Biden; Jason Furman, the Deputy Director of the National Economic Council; and several other Treasury officials. We discussed President Obama's plan for restoring fiscal responsibility, which the President had announced in a speech earlier the same day. And we discussed our firm belief that government leaders will come together and will reach an agreement to address our long-term budget challenges. We believe these communications were entirely appropriate. In fact, we believe it would have been irresponsible *not* to engage with S&P, as the Administration has a responsibility to the American taxpayers to minimize the cost of credit for the United States.

Finally, you ask us to provide materials related to the communications between Treasury officials and S&P personnel. We have identified a series of e-mail communications between Treasury and S&P in advance of the April 13 meeting, which we have enclosed. In addition, Treasury staff prepared an internal briefing deck that I used for general reference during the April 13 meeting. This deck is a confidential internal document, it was not shared with S&P, and I did not discuss all the information contained therein during the meeting. Nonetheless, we appreciate your interest in this issue, and we want to foster a collaborative working relationship with the Committee. Therefore, we would be happy to arrange a briefing, at which time you and/or your staff can review the deck and discuss it with Treasury personnel.

Thank you for your letter. Again, we look forward to working with you to address the Nation's fiscal challenges.

Sincerely,

Timothy F. Geithner

Timothy F. Geithner

Enclosure

From: Chambers, John [john_chambers@[redacted]]
Sent: Tuesday, March 22, 2011 5:27 PM
To: Rutherford, Matthew
Cc: Swann, Nikola
Subject: RE: Standard & Poor's

Matt,

Sure. How does your Friday afternoon look?

John

============================
John B. Chambers, CFA
Managing Director
Chairman, Sovereign Rating Committee
Standard & Poor's

phone [redacted]
fax [redacted]
============================

-----Original Message-----
From: Matthew.Rutherford@treasury.gov
[mailto:Matthew.Rutherford@treasury.gov]
Sent: Tuesday, March 22, 2011 5:26 PM
To: Chambers, John
Cc: Swann, Nikola; Beers, David
Subject: RE: Standard & Poor's

Thank you all. I am in Asia next week. Anyway we can do it later this week?

Best,
Matt

-----Original Message-----
From: Chambers, John [mailto:john_chambers@[redacted]]
Sent: Tuesday, March 22, 2011 5:10 PM
To: Rutherford, Matthew
Cc: Swann, Nikola; Beers, David
Subject: Standard & Poor's

Matt,

Thanks again for all of your help earlier this month. We greatly appreciate it.

We're making progress with our analysis. Can we chat on the phone in the next few days to go over a couple of open items? Next Tuesday would be a good day for us, but we could also do it beforehand.

UST000001

Thanks & best regards,

John

==========================

John B. Chambers, CFA

Managing Director

Chairman, Sovereign Rating Committee

Standard & Poor's

phone [redacted]

fax [redacted]

==========================

From: Rutherford, Matthew
Sent: Wednesday, March 30, 2011 3:27 AM
To: 'john_chambers@[redacted]'
Cc: 'nikola_swann@[redacted]'
Subject: Re:

Ok. Let's talk Monday. Just shoot me times.....thanks.

----- Original Message -----
From: Chambers, John <john_chambers@[redacted]>
To: Rutherford, Matthew
Cc: Swann, Nikola <Nikola_Swann@[redacted]>
Sent: Wed Mar 30 03:15:00 2011
Subject: RE:

Matt,

I'm in London this week. Probably the easiest thing is for the three of us to try to talk Monday. It's just to get any last update on the administration's budget strategy. The call can be short. We just want to be sure we have all the pieces before we go to committee.

Thanks

John

-----Original Message-----
From: Matthew.Rutherford@treasury.gov
[mailto:Matthew.Rutherford@treasury.gov]
Sent: 30 March 2011 07:53
To: Chambers, John
Subject:

John:

I am in Asia. Do you want to talk?

I am back Friday.

Matt

From: Rutherford, Matthew
Sent: Tuesday, April 05, 2011 9:56 PM
To: 'john_chambers@[redacted]
Subject: Re: S&P

Thx. Sent an email to you guys....

----- Original Message -----
From: Chambers, John <john chambers@[redacted]>
To: Rutherford, Matthew; Swann, Nikola <Nikola Swann@[redacted]
Sent: Tue Apr 05 21:52:29 2011
Subject: RE: S&P

Matt,

My cell is [redacted] but I'll be in & out tomorrow, first with the lecture and then with an investor call elsewhere in the state. Can I call her? If so, what number shall I use?

John

Sent with Good (www.good.com)

-----Original Message-----
From: Matthew.Rutherford@treasury.gov [mailto:Matthew.Rutherford@treasury.gov]
Sent: Tuesday, April 05, 2011 09:35 PM Eastern Standard Time
To: Chambers, John; Swann, Nikola
Subject: Re: S&P

Great. John - FYI - Mary is going to reach out to you tomorrow. Is there a # to reach you on?

Thx,
Matt

----- Original Message -----
From: Chambers, John <john chambers@[redacted]
To: Rutherford, Matthew; Swann, Nikola <Nikola Swann@[redacted]>
Sent: Tue Apr 05 21:32:18 2011
Subject: S&P

Matt,

Greetings from UVA, where I'm giving a lecture tomorrow.

Nikola will send you tomorrow our last full analysis on the USA and our ratings list. A dozen plus sovereigns have a AAA rating.

Best regards

John

Sent with Good (www.good.com)

-----Original Message-----
From: Matthew.Rutherford@treasury.gov [mailto:Matthew.Rutherford@treasury.gov]
Sent: Tuesday, April 05, 2011 08:12 PM Eastern Standard Time
To: Chambers, John; Swann, Nikola
Subject:

Hi gentlemen:

A couple questions:

1) Can you fwd me your latest ratings piece on the us? I cannot find it and I am away from my desktop.

2) Out of curiosity, how many sovereigns that you rate have aaa?

Thanks,
Matt

From: Chambers, John [john_chambers@[redacted]
Sent: Wednesday, April 06, 2011 8:36 AM
To: Miller, Mary; Rutherford, Matthew; Hester, Barrett (Bret)
Subject: RE: Re:

Mary,

You can reach me at [redacted] room 422 up until 9.

John

Sent with Good (www.good.com)

-----Original Message-----
From: Mary.Miller@treasury.gov [mailto:Mary.Miller@treasury.gov]
Sent: Tuesday, April 05, 2011 10:14 PM Eastern Standard Time
To: Matthew.Rutherford@treasury.gov; Chambers, John; Barrett.Hester@treasury.gov
Subject: Re:

Thanks Matt. I am free between 8:30 and 9, 9:45 to 10, and can clear something between 2 and 3. John, please let me know if any of these times work for you.

Mary Miller

----- Original Message -----
From: Rutherford, Matthew
To: Miller, Mary; 'john_chambers@[redacted]' <john_chambers@[redacted]>; Hester, Barrett (Bret)
Sent: Tue Apr 05 21:55:16 2011
Subject:

Mary:

John is out of the office tomorrow, but he is able to connect with you if you set up a time. His cell is [redacted]

I have cc'ed him on this email so you all can set up a time.

Matt

----

information to McGraw-Hill e-mail addresses you, as the sender, are consenting to McGraw-Hill processing any of your personal data therein.

From: Beers, David [david_beers@[redacted]
Sent: Wednesday, April 06, 2011 7:49 PM
To: Miller, Mary
Subject: Re: Re:

Yes. That's fine.
DTB

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Mary.Miller@treasury.gov <Mary.Miller@treasury.gov>
To: Beers, David
Cc: Chambers, John
Sent: Thu Apr 07 00:43:42 2011
Subject: RE: Re:

David - I think there has been a mix up. We are going to reach John Chambers tonight to discourage him from coming to DC tomorrow. We would like to have a telephone call with you tomorrow and if John can join that would be great. I would like to suggest 8am for a call tomorrow, which would be 1pm your time. Does that work?

-----Original Message-----
From: Beers, David [mailto:david_beers@[redacted]
Sent: Wednesday, April 06, 2011 7:34 PM
To: Miller, Mary
Subject: Re: Re:

Mary, a new develoment. John Chambers, in Richmond today, is now enroute to DC. He spoke to Matt R. who promised to pull together a meeting tomorrow. We're hoping our colleague Marie Cavanaugh, an MD in the group in NY, can fly down to join. As for me, if telephone security is a concern (I understand that you all want to share with us some confidential information), I'm supposing I could participate via a secure phone line in the American Embassy in London.
Regards,
DTB

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Mary.Miller@treasury.gov <Mary.Miller@treasury.gov>
To: Beers, David
Sent: Thu Apr 07 00:28:02 2011
Subject: RE: Re:

Yes, that makes sense. I will coordinate with Jeffery Goldstein. What times are you available? Morning on our end would work best.

-----Original Message-----
From: Beers, David [mailto:david_beers@[redacted]
Sent: Wednesday, April 06, 2011 6:34 PM
To: Miller, Mary
Subject: Re: Re:

Mary, I understand from my president, Deven Sharman, that Under Secretary Goldstein also wants to talk to me tomorrow. I'm supposing that it would be sensible if I called the two of you together.
Regards,
DTB

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Mary.Miller@treasury.gov <Mary.Miller@treasury.gov>
To: Beers, David
Sent: Wed Apr 06 22:40:36 2011
Subject: RE: Re:

Certainly. I get in at 7:30 U.S. time. Thanks

-----Original Message-----
From: Beers, David [mailto:david_beers@[redacted]
Sent: Wednesday, April 06, 2011 5:17 PM
To: Miller, Mary
Subject: Re:

Mary, I'm on a train at the moment. Could I call you tomorrow?
Regards,
DTB

Sent from my BlackBerry Wireless Handheld

From: Mary.Miller@treasury.gov <Mary.Miller@treasury.gov>
To: Beers, David
Sent: Wed Apr 06 21:27:09 2011
Subject:

Just left you a message at the office and on your cell. Please call if you have a moment.
Thanks

Mary J. Miller

Assistant Secretary for Financial Markets

[redacted]

The information contained in this message is intended only for the recipient, and may be a confidential attorney-client communication or may otherwise be privileged and confidential and protected from disclosure. If the reader of this message is not the intended recipient, or an employee or agent responsible for delivering this message to the intended recipient, please be aware that any dissemination or copying of this communication is strictly prohibited. If you have received this communication in error, please immediately notify us by replying to the message and deleting it from your computer. The McGraw-Hill Companies, Inc. reserves the right, subject to applicable local law, to monitor, review and process the content of any electronic message or information sent to or from McGraw-Hill e-mail addresses without informing the sender or recipient of the message. By sending electronic message or information to McGraw-Hill e-mail addresses you, as the sender, are consenting to McGraw-Hill processing any of your personal data therein.

From: Rutherford, Matthew
Sent: Wednesday, April 06, 2011 9:47 PM
To: 'nikola_swann@[redacted]
Cc: 'john_chambers@[redacted]
Subject: Re: S&P

Thank you Nikola. Hope you are recovering.

----- Original Message -----
From: Swann, Nikola <Nikola_Swann@[redacted]>
To: Rutherford, Matthew
Cc: Chambers, John <john_chambers@[redacted]>
Sent: Wed Apr 06 21:37:53 2011
Subject: RE: S&P

Matt,

Apologies for not getting this to you earlier in the day. Our last Full Analysis is attached.

The sovereigns we currently rate AAA are: Australia; Austria; Canada; Denmark; Finland; France; Germany; Guernsey; Hong Kong; Isle of Man; Liechtenstein; Luxembourg; Netherlands; Norway; Singapore; Sweden; Switzerland; UK; US.

Let us know if you have further questions.

Best regards,

Nikola.

-----Original Message-----
From: Chambers, John
Sent: Tuesday, April 05, 2011 9:32 PM
To: 'Matthew.Rutherford@treasury.gov'; Swann, Nikola
Subject: S&P

Matt,

Greetings from UVA, where I'm giving a lecture tomorrow.

Nikola will send you tomorrow our last full analysis on the USA and our ratings list. A dozen plus sovereigns have a AAA rating.

Best regards

John

Sent with Good (www.good.com)

-----Original Message-----
From: Matthew.Rutherford@treasury.gov
[mailto:Matthew.Rutherford@treasury.gov]
Sent: Tuesday, April 05, 2011 08:12 PM Eastern Standard Time
To: Chambers, John; Swann, Nikola
Subject:

Hi gentlemen:

A couple questions:

1) Can you fwd me your latest ratings piece on the us? I cannot find it and I am away from my desktop.

2) Out of curiosity, how many sovereigns that you rate have aaa?

Thanks,
Matt

From: Rutherford, Matthew
Sent: Thursday, April 07, 2011 11:04 AM
To: 'john_chambers@[redacted]
Subject: Re: S&P

Thank you John. I look forward to hearing how you plan to proceed.

Best,
Matt

----- Original Message -----
From: Chambers, John <john chambers@[redacted]
To: Rutherford, Matthew
Sent: Thu Apr 07 10:00:14 2011
Subject: RE: S&P

Matt,

Again, no problem. Thanks for arranging the call. David will get back to the Under Secretary shortly.

John

Sent with Good (www.good.com)

-----Original Message-----
From: Matthew.Rutherford@treasury.gov [mailto:Matthew.Rutherford@treasury.gov]
Sent: Wednesday, April 06, 2011 09:05 PM Eastern Standard Time
To: Chambers, John
Cc: Beers, David
Subject: Re: S&P

Gentlemen. My apologies again - I think there was some miscommunication in a short period of time. John, thank you for understanding. The call is tomorrow at 8 am.

[redacted], password [redacted]

Talk tomorrow.

Matt

----- Original Message -----
From: Chambers, John <john chambers@[redacted]>
To: Rutherford, Matthew
Cc: Beers, David <david beers@[redacted]>
Sent: Wed Apr 06 19:57:41 2011
Subject: S&P

Matt

No problem,

I see that Mary asked for an 8 a.m. call.

Let's work with that time. Shall we set up a toll free dial in number?

John

Sent with Good (www.good.com)

-----Original Message-----
From: Matthew.Rutherford@treasury.gov [mailto:Matthew.Rutherford@treasury.gov]
Sent: Wednesday, April 06, 2011 07:49 PM Eastern Standard Time
To: Chambers, John
Subject:

John:

I am so sorry. Please accept my apologies.

Matt

From: Rutherford, Matthew
Sent: Friday, April 08, 2011 4:28 PM
To: 'Chambers, John'
Cc: Brown, Amy
Subject: RE: S&P

Unclear. Will let you know.

Thanks much, Matt

-----Original Message-----
From: Chambers, John [mailto:john_chambers@[redacted]
Sent: Friday, April 08, 2011 3:02 PM
To: Rutherford, Matthew
Cc: Brown, Amy
Subject: S&P

Matt,

Sure. We'll send the bios, the dates of birth, and the social security numbers (or passport numbers).

When do you think you will have a firm date and time?

John

==========================
John B. Chambers, CFA
Managing Director
Chairman, Sovereign Rating Committee
Standard & Poor's

phone [redacted]
fax [redacted]
==========================

-----Original Message-----
From: Matthew.Rutherford@treasury.gov [mailto:Matthew.Rutherford@treasury.gov]
Sent: Friday, April 08, 2011 2:42 PM
To: Chambers, John
Subject:

Hi John:

Can you send me the bios of everyone attending next week?

Thanks,
Matt

The information contained in this message is intended only for the recipient, and may be a confidential attorney-client communication or may otherwise be privileged and confidential

From: Goldstein, Jeffrey
Sent: Friday, April 08, [redacted]
To: 'deven_sharma@[redacted]
Subject: Re: Background documents

Deven:

Many thanks.

Jeffrey

----- Original Message -----
From: Sharma, Deven <deven_sharma@[redacted]>
To: Goldstein, Jeffrey
Sent: Fri Apr 08 17:02:20 2011
Subject: Background documents

Jeff

Attached are two documents that you may find helpful. The second document outlines our current approach to sovereign ratings. We have recently taken worked on clarifying our approach to make our criteria more transparent and we have sought market feedback. The approach is essentially the same though our intent is to make it much more clear.

Best, deven

Attached:

(i) Criteria | Governments | Request for Comment: Sovereign Government Rating Methodology And Assumptions

(ii) Criteria | Governments | Sovereigns: Sovereign Credit Ratings: A Primer

Deven Sharma
[redacted]
deven_sharma@[redacted]

From: Brown, Amy [amy_brown@[redacted]
Sent: Friday, April 08, 2011 6:10 PM
To: Rutherford, Matthew; Chambers, John
Subject: S&P - visitor data for security pre-clearance
Attachments: Cavanaugh_Marie_BioPic.pdf; Beers_David_BioPic.pdf; Swann,_Nikola_05-25-10_GAa.pdf; Chambers_John Bio Pic 6 10.pdf

Importance: High

Dear Matt,

Please find below the data that you'll need for security pre-clearance in advance of next week's meeting, along with the requested bios.
Should you need anything else, please let me know.

David Beers
Date of Birth: [redacted]
SS#: [redacted]

Marie Cavanaugh
Date of Birth: [redacted]
SS#: [redacted]

John Chambers
Date of Birth: [redacted]
SS#: [redacted]

Nikola Swann
Date of Birth: [redacted]
Canadian Passport #: [redacted]

Thank you,
Amy

Amy M. Brown
Administrative Assistant
Sovereign Ratings Group
Standard & Poor's
55 Water Street
New York, NY 10041-0003
[redacted]
amy_brown[redacted]

-----Original Message-----
From: Matthew.Rutherford@treasury.gov [mailto:Matthew.Rutherford@treasury.gov]
Sent: Friday, April 08, 2011 4:28 PM
To: Chambers, John
Cc: Brown, Amy
Subject: RE: S&P

Unclear. Will let you know.

Thanks much, Matt

-----Original Message-----
From: Chambers, John [mailto:john chambers@[redacted]
Sent: Friday, April 08, 2011 3:02 PM
To: Rutherford, Matthew
Cc: Brown, Amy
Subject: S&P

Matt,

Sure. We'll send the bios, the dates of birth, and the social security numbers (or passport numbers).

When do you think you will have a firm date and time?

John

============================
John B. Chambers, CFA
Managing Director
Chairman, Sovereign Rating Committee
Standard & Poor's

phone [redacted]
fax [redacted]
============================

-----Original Message-----
From: Matthew.Rutherford@treasury.gov
[mailto:Matthew.Rutherford@treasury.gov]
Sent: Friday, April 08, 2011 2:42 PM
To: Chambers, John
Subject:

Hi John:

Can you send me the bios of everyone attending next week?

Thanks,
Matt

From: Rutherford, Matthew
Sent: Monday, April 11, 2011 12:13 PM
To: 'john_chambers@[redacted]
Subject: Re: S&P

Great. Look forward to seeing you.

Matt

----- Original Message -----
From: Chambers, John <john_chambers@[redacted]>
To: Rutherford, Matthew; Gathers, Shirley
Cc: Brown, Amy <amy_brown@[redacted]
Sent: Mon Apr 11 11:58:21 2011
Subject: RE: S&P

Matt,

Amy just responded a couple of minutes ago. We're set for 2:30 p.m. on Wednesday at Treasury. On our side, we will be David Beers, Marie Cavanaugh, Nikola Swann, and me. We are all members of the committee.

In case of need on Wednesday, please take note of my cell phone number below.

Best regards,

John

==========================
John B. Chambers, CFA
Managing Director
Chairman, Sovereign Rating Committee
Standard & Poor's

phone [redacted]
cell [redacted]
==========================

-----Original Message-----
From: Matthew.Rutherford@treasury.gov [mailto:Matthew.Rutherford@treasury.gov]
Sent: Monday, April 11, 2011 11:49 AM
To: Shirley.Gathers@treasury.gov
Cc: Chambers, John
Subject: S&P

John:

Shirley is trying to set up a meeting for you with The Secretary and OMB Director. She has emailed Amy and has not heard back from her.

Thanks,
Matt

From: Beers, David [david_beers@[redacted]
Sent: Thursday, April 14, 2011 6:44 PM
To: Miller, Mary; Chambers, John
Cc: Rutherford, Matthew
Subject: Re: Follow Up

Dear Mary,
Thanks for your e-mail, and our thanks again for your efforts to pull together yesterday's meeting. My colleagues and I certainly benefited from the discussions, both as they related to the President's proposals as well on the politics of finding cross-party agreement on the fiscal strategy.
At this point, my colleagues are finalizing their work on tomorrows committee, which will be held in the morning EDT. Hence the logistics won't work for additional meeting between now and then. We do feel, though, that the discussions yesterday gave us insight into the Administration's strategy on the political front.
I'll be back in touch tomorrow.
Regards,
DTB

Sent from my BlackBerry Wireless Handheld

From: Mary.Miller@treasury.gov <Mary.Miller@treasury.gov>
To: Chambers, John; Beers, David
Cc: Matthew.Rutherford@treasury.gov <Matthew.Rutherford@treasury.gov>
Sent: Thu Apr 14 22:21:47 2011
Subject: Follow Up

David and John,

Thanks once again for your time here yesterday. We hope that you found the meeting useful. I wanted to follow up to ask if there were further questions, particularly on the political front. If so, we could try to arrange a meeting with others in the Administration.

Mary J. Miller

Assistant Secretary for Financial Markets

[redacted]

The information contained in this message is intended only for the recipient, and may be a confidential attorney-client communication or may otherwise be privileged and confidential and protected from disclosure. If the reader of this message is not the intended recipient,

From: Sharma, Deven [deven_sharma@[redacted]
Sent: Friday, April 15, 2011 1:34 AM
To: Goldstein, Jeffrey

Categories: Yellow Category

Jeff

I got your message. I am out of the country, so I will give you a call.

Thks. Deven.

From: Goldstein, Jeffrey
Sent: Friday, April 15, 2011 3:25 PM
To: 'Beers, David'; Miller, Mary; Rutherford, Matthew
Subject: RE: Standard & Poor's

We can call you shortly if there is a convenient number to reach you.

-----Original Message-----
From: Beers, David [mailto:david_beers@[redacted]
Sent: Friday, April 15, 2011 3:18 PM
To: Goldstein, Jeffrey; Miller, Mary; Rutherford, Matthew
Subject: Standard & Poor's
Importance: High

Undersecretary Goldstein, Mary, Matt,

When would it be convenient to call you to let you know today's committee outcome?

Regards,

DTB

From: Goldstein, Jeffrey
Sent: Friday, April 15, 2011 3:38 PM
To: 'Beers, David'; Miller, Mary; Rutherford, Matthew
Subject: RE: Standard & Poor's

Yes, we are together now in my office.

-----Original Message-----
From: Beers, David [mailto:david_beers@[redacted]
Sent: Friday, April 15, 2011 3:37 PM
To: Goldstein, Jeffrey; Miller, Mary; Rutherford, Matthew
Subject: RE: Standard & Poor's

We can call you now, if you like, at your number. Will Mary and Matt join?

-----Original Message-----
From: Jeffrey.Goldstein@treasury.gov
[mailto:Jeffrey.Goldstein@treasury.gov]
Sent: 15 April 2011 20:27
To: Beers, David; Mary.Miller@treasury.gov; Matthew.Rutherford@treasury.gov
Subject: RE: Standard & Poor's

Alternatively, please call my office at [redacted].

-----Original Message-----
From: Beers, David [mailto:david_beers@[redacted]]
Sent: Friday, April 15, 2011 3:18 PM
To: Goldstein, Jeffrey; Miller, Mary; Rutherford, Matthew
Subject: Standard & Poor's
Importance: High

Undersecretary Goldstein, Mary, Matt,

When would it be convenient to call you to let you know today's committee outcome?

Regards,

DTB

From: Miller, Mary
Sent: Friday, April 15, 2011 6:45 PM
To: 'Beers, David'
Subject: RE: RE:

Got it. Thanks

-----Original Message-----
From: Beers, David [mailto:david_beers@[redacted]]
Sent: Friday, April 15, 2011 6:24 PM
To: Miller, Mary
Subject: RE:
Importance: High

Mary, a thousand apologies. We've been having McGraw-Hill system problems that prevented me getting on e-mail and attaching this file.

Anyway, here it is.

One other thing to bear in mind. This draft is presently receiving internal legal review (standard operating procedure in S&P these days), so what gets published on Monday may show some small editorial changes compared to what you see here.

Please get back to me over the weekend if you want have any comments.

Regards,

DTB

From: Mary.Miller@treasury.gov [mailto:Mary.Miller@treasury.gov]
Sent: 15 April 2011 22:19
To: Beers, David
Subject:

Were you planning to send a draft press release today? It would be helpful to take a look at that in advance. Thanks

Mary J. Miller

Assistant Secretary for Financial Markets

[redacted]

From: Rutherford, Matthew
Sent: Friday, April 15, 2011 10:35 PM
To: 'john_chambers@[redacted]; 'nikola_swann@[redacted]
Subject: Re: Question

Excellent - thank you.

----- Original Message -----
From: Chambers, John <john chambers@[redacted]>
To: Rutherford, Matthew; Swann, Nikola <Nikola Swann@[redacted]>
Sent: Fri Apr 15 22:27:50 2011
Subject: RE: Question

Matt,

S&P has rated the USA since the inception of the firm with the merger of Standard Statistics and Poor's Publishing in 1941. The predecessor institutions also rated the USA with their highest rating.

John

Sent with Good (www.good.com)

-----Original Message-----
From: Matthew.Rutherford@treasury.gov [mailto:Matthew.Rutherford@treasury.gov]
Sent: Friday, April 15, 2011 10:01 PM Eastern Standard Time
To: Chambers, John; Swann, Nikola
Subject: Re: Question

One more q: did you start rating the us in 1941? Thx...

----- Original Message -----
From: Chambers, John <john chambers@[redacted]
To: Rutherford, Matthew; Swann, Nikola <Nikola Swann@[redacted]
Sent: Fri Apr 15 22:00:51 2011
Subject: RE: Question

Matt,

No. We started assigning outlooks in 1989. It has always been stable.

John

Sent with Good (www.good.com)

-----Original Message-----
From: Matthew.Rutherford@treasury.gov [mailto:Matthew.Rutherford@treasury.gov]
Sent: Friday, April 15, 2011 09:58 PM Eastern Standard Time
To: Swann, Nikola; Chambers, John
Subject: Question

Hi guys:

Question: has the US ever been on negative outlook in your ratings history?

Thanks,
Matt

From: Chambers, John [john_chambers@[redacted]
Sent: Saturday, April 16, 2011 11:11 AM
To: Beers, David; Rutherford, Matthew; Goldstein, Jeffrey; Miller, Mary
Subject: RE: Call

Matt

I could do 12 too

John

Sent with Good (www.good.com)

-----Original Message-----
From: Beers, David
Sent: Saturday, April 16, 2011 10:51 AM Eastern Standard Time
To: 'Matthew.Rutherford@treasury.gov'; Chambers, John; 'Jeffrey.Goldstein@treasury.gov'; 'Mary.Miller@treasury.gov'
Subject: Re: Call

Matt,

I have nother call at that time.

12 would be possible for me.

DTB

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Matthew.Rutherford@treasury.gov <Matthew.Rutherford@treasury.gov>
To: Beers, David; Chambers, John; Jeffrey.Goldstein@treasury.gov <Jeffrey.Goldstein@treasury.gov>; Mary.Miller@treasury.gov <Mary.Miller@treasury.gov>
Sent: Sat Apr 16 15:40:45 2011
Subject: Call

David and John:

I tried to reach you on your cell phones just now.

We were hoping to set up a call with you at 11.

Please advise if you are available.

Matt

From: Rutherford, Matthew
Sent: Saturday, April 16, 2011 11:11 AM
To: 'david_beers@[redacted]; 'john_chambers@[redacted]; Goldstein, Jeffrey; Miller, Mary
Subject: Re: Call

Great - here is the dial in:

[redacted]

----- Original Message -----
From: Beers, David <david_beers@[redacted]>
To: Rutherford, Matthew; Chambers, John <john_chambers@[redacted]; Goldstein, Jeffrey; Miller, Mary
Sent: Sat Apr 16 10:51:42 2011
Subject: Re: Call

Matt,

I have nother call at that time.

12 would be possible for me.

DTB

Sent from my BlackBerry Wireless Handheld

----- Original Message -----
From: Matthew.Rutherford@treasury.gov <Matthew.Rutherford@treasury.gov>
To: Beers, David; Chambers, John; Jeffrey.Goldstein@treasury.gov <Jeffrey.Goldstein@treasury.gov>; Mary.Miller@treasury.gov <Mary.Miller@treasury.gov>
Sent: Sat Apr 16 15:40:45 2011
Subject: Call

David and John:

I tried to reach you on your cell phones just now.

We were hoping to set up a call with you at 11.

Please advise if you are available.

Matt

From: Rutherford, Matthew
Sent: Saturday, April 16, 2011 2:02 PM
To: 'john_chambers@[redacted]
Subject: Re: S&P

Perfect thx

----- Original Message -----
From: Chambers, John <john_chambers@[redacted]
To: Rutherford, Matthew; LeCompte, Jenni; Swann, Nikola <Nikola_Swann@[redacted]
Sent: Sat Apr 16 14:00:48 2011
Subject: S&P

Matt,

I don't know the protocol. I don't recall such a request ever came up before.

I'll check and revert

John

Sent with Good (www.good.com)

-----Original Message-----
From: Matthew.Rutherford@treasury.gov [mailto:Matthew.Rutherford@treasury.gov]
Sent: Saturday, April 16, 2011 01:57 PM Eastern Standard Time
To: Jenni.LeCompte@treasury.gov; Chambers, John; Swann, Nikola
Subject:

Nikola and John:

Later today is there a communications director that our press people can connect with? I have cc'ed Jenni Lecompte here.

I am not sure what protocol is here. We just want to be prepared on timing, logistics, etc.

Thanks,
Matt

From: Chambers, John [john_chambers@[redacted]
Sent: Saturday, April 16, 2011 2:34 PM
To: Rutherford, Matthew; LeCompte, Jenni; Swann, Nikola
Cc: Beers, David; Mathis, Catherine; Wargin, David
Subject: S&P

Dear Ms LeCompte,

Catherine Mathis is in charge of our Communications Department. I've cc'd her. Either she or her colleague, David Wargin, also cc'd, would be your best point of contact. If you'd like to speak today, I suggest dropping them a note with a proposed time.

Regards

John Chambers

Sent with Good (www.good.com)

-----Original Message-----
From: Matthew.Rutherford@treasury.gov [mailto:Matthew.Rutherford@treasury.gov]
Sent: Saturday, April 16, 2011 01:57 PM Eastern Standard Time
To: Jenni.LeCompte@treasury.gov; Chambers, John; Swann, Nikola
Subject:

Nikola and John:

Later today is there a communications director that our press people can connect with? I have cc'ed Jenni Lecompte here.

I am not sure what protocol is here. We just want to be prepared on timing, logistics, etc.

Thanks,
Matt

From: Rutherford, Matthew
Sent: Saturday, April 16, 2011 2:35 PM
To: 'nikola_swann@[redacted]; 'john_chambers@[redacted]
Subject: Re: S&P articles

Thanks Nikola...

----- Original Message -----
From: Swann, Nikola <Nikola_Swann@[redacted]>
To: Rutherford, Matthew; Chambers, John <john_chambers@[redacted]>
Sent: Sat Apr 16 14:29:43 2011
Subject: Re: S&P articles

Matt,

I had some initial problems connecting to AMTRAK wi-fi, but it is working now. As long as the connection holds up, you wil receive these shortly.

Nikola.

Nikola G. Swann, CFA, FRM

----- Message d'origine -----
De : Matthew.Rutherford@treasury.gov <Matthew.Rutherford@treasury.gov> À : Chambers, John; Swann, Nikola Envoyé : Sat Apr 16 13:53:58 2011 Objet : Re: S&P articles

Thank you much guys...

----- Original Message -----
From: Chambers, John <john_chambers@[redacted]>
To: Swann, Nikola <Nikola_Swann@[redacted]
Cc: Rutherford, Matthew
Sent: Sat Apr 16 13:53:00 2011
Subject: S&P articles

Nikola,

Could you do me a favor? If you can access RatingsDirect, Could you e mail Matt the media release when we assigned the UK a negative outlook (around May 2009, click the tab 'rating action' or 'rating news' and not 'analysis' I believe), the last FAQ on the USA (2009 I believe), and the article "Outlooks: The Sovereign Credit Weathervane (April 2010).

.....

Matt,

Since I started this e mail, Nikola checked in. He's boarding a train at Union Station & he'll be able to send you the articles as soon as he can pull them down after the train departs.

John

Sent with Good (www.good.com)

From: Swann, Nikola [Nikola_Swann@[redacted]
Sent: Saturday, April 16, 2011 3:49 PM
To: Rutherford, Matthew
Cc: Chambers, John
Subject: Re: S&P articles

Hi Matt, The connection is poor quality, slowing everything down, but it is working. It won't be long, now.

Nikola.

Nikola G. Swann, CFA, FRM

----- Message d'origine -----
De : Matthew.Rutherford@treasury.gov <Matthew.Rutherford@treasury.gov> À : Swann, Nikola Envoyé : Sat Apr 16 15:23:55 2011 Objet : Re: S&P articles

Hi Nikola - no luck huh?

----- Original Message -----
From: Swann, Nikola <Nikola_Swann@[redacted]
To: Rutherford, Matthew; Chambers, John <john_chambers@[redacted]
Sent: Sat Apr 16 14:29:43 2011
Subject: Re: S&P articles

Matt,

I had some initial problems connecting to AMTRAK wi-fi, but it is working now. As long as the connection holds up, you wil receive these shortly.

Nikola.

Nikola G. Swann, CFA, FRM

----- Message d'origine -----
De : Matthew.Rutherford@treasury.gov <Matthew.Rutherford@treasury.gov> À : Chambers, John; Swann, Nikola Envoyé : Sat Apr 16 13:53:58 2011 Objet : Re: S&P articles

Thank you much guys...

----- Original Message -----
From: Chambers, John <john_chambers@[redacted]
To: Swann, Nikola <Nikola_Swann@[redacted]
Cc: Rutherford, Matthew
Sent: Sat Apr 16 13:53:00 2011
Subject: S&P articles

Nikola,

Could you do me a favor? If you can access RatingsDirect, Could you e mail Matt the media release when we assigned the UK a negative outlook (around May 2009, click the tab 'rating action' or 'rating news' and not 'analysis' I believe), the last FAQ on the USA (2009 I believe), and the article "Outlooks: The Sovereign Credit Weathervane (April 2010).

.....

Matt,

Since I started this e mail, Nikola checked in. He's boarding a train at Union Station & he'll be able to send you the articles as soon as he can pull them down after the train departs.

John

Sent with Good (www.good.com)

From: Chambers, John [john_chambers@[redacted]
Sent: Saturday, April 16, 2011 5:33 PM
To: Rutherford, Matthew; Swann, Nikola
Subject: RE: S&P articles

Matt,

No. Not at that time.

Our articles take different formats, depending in the audience.

I think the FAQ we have in the hopper will address some of the concerns you & Mary expressed today.

John

Sent with Good (www.good.com)

-----Original Message-----
From: Matthew.Rutherford@treasury.gov [mailto:Matthew.Rutherford@treasury.gov]
Sent: Saturday, April 16, 2011 05:21 PM Eastern Standard Time
To: Swann, Nikola
Cc: Chambers, John
Subject: Re: S&P articles

Thank you Nikola. So there was no faq that followed the December 2009 release?

Thx..

----- Original Message -----
From: Swann, Nikola <Nikola Swann@[redacted]>
To: Rutherford, Matthew
Cc: Chambers, John <john chambers@[redacted]>
Sent: Sat Apr 16 16:21:34 2011
Subject: Re: S&P articles

Matt,

The prior publications John mentioned are attached.

I added in two more, in case it might be helpful for you to have these close at hand: the one from January, about the debt ceiling; and the one we published last winter about our views on the sustainability of global demand for the U.S. dollar.

Let me know if you need anything else. By 7PM I should be at my next hotel, with a better Internet connection.

Regards,

Nikola.

Nikola G. Swann, CFA, FRM

De : Nikola Swann <[redacted]>
À : Swann, Nikola
Envoyé : Sat Apr 16 16:08:44 2011
Objet :

From: Chambers, John [john_chambers@[redacted]
Sent: Monday, April 18, 2011 9:07 AM
To: Rutherford, Matthew; Swann, Nikola
Subject: ratings update
Attachments: ResearchUpdateUnitedStatesofAmericaAAAA1RatingAffirmedOutlookRevisedToNegative.pdf

Matt

Here is the ratings update.

The media release is coming shortly.

John

==========================

John B. Chambers, CFA

Managing Director

Chairman, Sovereign Rating Committee

Standard & Poor's

phone [redacted]

fax [redacted]

==========================

From: Chambers, John [john_chambers@[redacted]
Sent: Monday, April 18, 2011 9:16 AM
To: Rutherford, Matthew; Swann, Nikola
Subject: FW: Media Release PDF
Attachments: 0108458N.pdf

Matt

Here is the media release.

John

=========================

John B. Chambers, CFA

Managing Director

Chairman, Sovereign Rating Committee

Standard & Poor's

phone [redacted]

fax [redacted]

=========================

From: Chambers, John [john_chambers@[redacted]
Sent: Monday, April 18, 2011 11:08 AM
To: Rutherford, Matthew
Subject: FAQ / S&P
Attachments: CreditFAQACloserLookAtTheRevisionOfTheOutlookOnTheUSGovernmentRating.pdf

Matt,

Here is the FAQ.

It looks like the commentary will go out shortly after lunch.

I'll give you a call later today.

John

==========================

John B. Chambers, CFA

Managing Director

Chairman, Sovereign Rating Committee

Standard & Poor's

phone [redacted]

fax [redacted]

==========================

From: Chambers, John [john_chambers@[redacted]
Sent: Monday, April 18, 2011 5:43 PM
To: Rutherford, Matthew
Subject: S&P
Attachments: FiscalChallengesWeighingOnTheAAASovereignCreditRatingOnTheGovernmentOfTheUnitedStates.pdf

Matt,

Here's the fourth article.

We just published it.

John

==========================

John B. Chambers, CFA

Managing Director

Chairman, Sovereign Rating Committee

Standard & Poor's

phone [redacted]

fax [redacted]

==========================

----

information to McGraw-Hill e-mail addresses you, as the sender, are consenting to McGraw-Hill processing any of your personal data therein.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

DIVISION OF
TRADING AND MARKETS

August 12, 2011

The Honorable Steve Stivers
U.S. House of Representatives
1007 Longworth House Office Building
Washington, D.C. 20515

Dear Representative Stivers:

I am writing to follow up on my testimony at the July 27, 2011 hearing entitled "Oversight of the Credit Rating Agencies Post Dodd-Frank" before the Subcommittee on Oversight and Investigations of the House Committee on Financial Services. At that hearing you asked me whether credit ratings disclosure is still required to be provided in prospectuses of asset-backed securities (ABS) offerings. In addition, you asked whether there is a pending rule proposal relating to the ratings disclosure in prospectuses for ABS offering. Finally, you asked about the application of an SEC staff no-action letter to credit rating disclosure (specifically, the impact of the no-action letter as it relates to Section 939G of the Dodd-Frank Wall-Street Reform and Consumer Protection Act).

After consulting with my colleagues in the Division of Corporation Finance, I would like to clarify and correct my response to your questions for the record. Under the current SEC rules for ABS offerings, ABS registration statements must include information regarding the rating if the sale is conditioned on the issuance of a rating. As you know, Section 939G of the Dodd-Frank Act repealed Rule 436(g) under the Securities Act, which resulted in requiring issuers to file the consent of an NRSRO named in a registration statement, when that registration statement includes the credit rating of the security being offered and sold. Because the current rules for ABS offerings require ABS registration statements to include credit ratings information, the immediate impact of the repeal of Rule 436(g), which was effective one day after the date of enactment of the Dodd-Frank Act, was in the area of public offerings of asset-backed securities. As a result of the repeal, without further staff action, any registered offering of ABS that is conditioned on receiving a rating would have been required to include consent by the rating agency that issued the rating for the securities.

We were advised by the rating agencies, both at enactment of the Dodd-Frank Act and more recently, that they would not be willing to provide such consent, which, in turn, would have caused issuers to be unable to register ABS offerings. In July and November 2010, the staff of the Division of Corporation Finance issued staff no-action letters to Ford Credit as temporary measures to enable ABS issuers to continue to conduct registered offerings while we and market participants determine an appropriate long-term solution. Thus, under the current staff no-action letter to Ford Credit, pending further notice, the Division will not recommend enforcement action to the Commission if an asset-backed issuer omits the ratings disclosure that is currently

The Honorable Steve Stivers
August 12, 2011
Page 2

required by SEC rules from a prospectus that is part of a registration statement relating to an offering of asset-backed securities.

During the hearing, I stated that on July 26, 2011, the Commission issued a release proposing rules relating to credit ratings ("July 26 Proposing Release" or "July 26 Proposal"). I would like to clarify for the record that the July 26 Proposal does not relate to credit ratings disclosure. Instead, on July 26, the Commission proposed revisions to rules that apply when asset-backed issuers seek to use an expedited registration process known as shelf registration. The proposed rules would eliminate the ratings requirement from the SEC's conditions to shelf registration; it would not change the disclosure requirements about ratings in ABS offerings. The July 26 Proposing Release also contains additional requests for comments on other aspects of a previous SEC proposal relating to asset-backed securities issued in April 2010.

The Commission, however, did issue a proposal regarding credit ratings disclosure in October 2009. In that proposal, the Commission proposed amendments to our rules that would require disclosure of information regarding credit ratings used by registrants in connection with a registered offering of securities. The Commission also issued a concept release at that time asking whether the Commission should propose to repeal Rule 436(g). This rule proposal and concept release were issued before enactment of the Dodd-Frank Act and its repeal of Rule 436(g). Staff currently plans to work through the more recently proposed ABS and NRSRO rules before determining what recommendations to make to the Commission on the October 2009 proposal. Each of the July 26 Proposal, the October 2009 Proposal and the Rule 436(g) concept release can be found on the SEC's Web site.

Thank you for this opportunity to clarify the record. Please do not hesitate to contact me at (202) 551-2100 or have a member of your staff contact Eric Spitler, Director of the Office of Legislative and Intergovernmental Affairs, at (202) 551-2010, if we can be of further assistance.

Sincerely,

John Ramsay
Deputy Director
Division of Trading and Markets

O