Testimony before
The Oversight and Investigations Subcommittee of the House Financial Services Committee on
"Oversight of the Credit Rating Agencies Post-Dodd-Frank"

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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.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Jules Kroll	Kroll Bond Rating Agency
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☒ No	☐ Yes ☒ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
NA.	
7. Signature: Jules Kroll	

Please attach a copy of this form to your written testimony.