RATING THE RATING AGENCIES: THE STATE OF TRANSPARENCY AND COMPETITION

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

APRIL 2, 2003

Printed for the use of the Committee on Financial Services

Serial No. 108–18

U.S. GOVERNMENT PRINTING OFFICE

89–083 PDF WASHINGTON : 2003

For sale by the Superintendent of Documents, U.S. Government Printing Office
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Wednesday, April 2, 2003

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RATING THE RATING AGENCIES: THE STATE OF TRANSPARENCY AND COMPETITION

Wednesday, April 2, 2003

U.S. House of Representatives,
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:02 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Ose, Shays, Oxley (ex-officio), Ney, Ryun, Capito, Hart, Tiberi, Brown-Waite, Feeney, Kanjorski, Hooley, Sherman, Inslee, Capuano, Hinojosa, Lucas, Clay, McCarthy, Baca, Matheson, Miller, Emanuel and Scott.

Chairman Baker. [Presiding.] I would like to call this meeting of the Subcommittee on Capital Markets to order this morning.

We are here today to celebrate the birthday of my ranking member, Mr. Paul Kanjorski.

[Laughter.]

And secondarily, to take up another small matter relating to the performance of our rating agencies, the regulation and oversight of those agencies by the SEC.

The hearing today actually represents the next logical step in the committee's work and in examining all sectors in the performance of our capital markets.

Most recently the committee received comment concerning mutual fund performance and are awaiting the response from the SEC on matters of particular interest before our next hearing. But today, it is the issue of the nationally recognized statistical rating organization known as the NRSROs. And there are only at this moment four such organizations currently recognized in that capacity.

It is my hope that we can examine in some detail the manner by which these organizations are designated, the adequacy of our current regulatory oversight methodologies and the basis for which such organization is either to be given approval or the methodology for revocation of such authority.

It is also important, I think, to understand how the system works. As committee members will recall, in our examination of the analyst investment banking world, many were surprised to learn of the relationships and the revenues generated between the various parties in transactions relating to analytical opinions. It appears that the NRSROs do receive a significant amount of revenue from the parties they are assigned for public purposes to rate.

Then there is the real issue of bottom line performance. NRSROs do have access to more information than any other market participant other than the officials or the corporation which they are examining. Shouldn't we expect as a result their performance to exceed that of any other analyst or observer of corporate conduct?

These are all questions of great significance and concern. It has been sometime since the Congress has reviewed the NRSRO system in any detail. And it is my expectation that today's hearing will provide us with a broad scope of information, very helpful in understanding whether any further actions may be warranted or not.

And I certainly welcome all of those who have agreed to participate here this morning.

Mr. Birthday Boy?

[Laughter.]

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

Mr. Chairman, for nearly a century, rating agencies like Moody's, Standard & Poor's and Fitch have published their views about the creditworthiness of issuers of debt securities. The importance of these opinions has grown significantly in recent decades as a result of increases in the number of issues and issuers, the globalization of our financial markets, and the introduction of complex financial products like asset-backed securities and credit derivatives.

I believe that strong regulation helps to protect the interests of American investors, but regulation in itself may fail to accomplish this goal, and the private market may not necessarily be responsible for the burdens. So somewhere in there, we have to ascertain whether there is a responsibility of the SEC and the Congress to reexamine the need for regulatory activity on behalf of or regarding the credit-rating agencies.

Accordingly, I am pleased we have worked diligently over the last year to augment the resources available to the Securities and Exchange Commission and enacted sweeping reforms of auditing and accounting practices, restored accountability to investment backing and analyst research, and improved the conduct of business executives and corporate boards.

Although rating agencies received some scrutiny after the recent spate of corporate scandals, we have not yet mandated any substantive change in their practices.

At hearings before our committee last year, however, one witness noted that rating agencies played a significant role in Enron's failure. Additionally, a recent Senate investigative report found that the monitoring and review of Enron's finances, quote, fell far below the careful efforts one would have expected from organizations whose ratings hold so much importance, unquote.

I wholeheartedly agree. Outside of Arthur Andersen, the rating agencies probably had the greatest access to comprehensive nonpublic information about Enron's complicated financial arrangements, and they exhibited a disappointing lack of diligence in their coverage of the company.

Furthermore, the rating agencies have missed a number of other large-scale financial debacles over the last several decades. They failed to sound appropriate alarms before New York City's debt crisis in 1975 and the Washington Public Power Supply System's default in 1983. They have also floundered before when First Executive Life collapsed in early 1990s and during Orange County's bankruptcy of 1994. The failure of rating agencies to lower the ratings in these cases ultimately resulted in the loss of billions of dollars of American investors who little understood the true credit risks.

As a result of the concerns about the role that the rating agencies played in recent downfalls of Enron, WorldCom and other companies, we called upon the Securities and Exchange Commission to study these issues and report back to us. In reviewing this report, it has become clear to me that while our capital markets and the rating agencies have evolved considerably in recent decades, the Commission's oversight and regulations in this area have changed little.

Moreover, it disturbs me that the Commission has studied these issues for more than a decade without reaching any firm conclusion. In 1992, for example, then SEC Commissioner Richard Roberts first noted that rating agencies, despite their importance and influence, remained the only participants in the securities markets without any real regulation.

In 1994, the Commission also solicited public comment on the appropriate role of ratings in our federal securities laws and the need to establish formal procedures for recognizing and monitoring the activities of the nationally recognized statistical rating organizations.

This release led in 1997 to a rule proposal that the Commission never finalized. In releasing its latest rating agency report to the Congress, the Commission stated that it would issue within 60 days a concept paper asking questions about rating agency regulation. Sixty days have now passed.

It is therefore my expectation that the SEC will publish its concept release as quickly as possible and that it will move with due diligence to finally resolve this issue and publish regulations regarding agencies.

As we proceed today, it is also my hope that we will carefully examine the many issues raised in the recent SEC report on rating agencies. We must discern how the Commission should oversee rating agencies in a systematic way. We should also explore the conflicts of interest that rating agencies encounter like their reliance on payment by issuers, and their provision of consulting services to issuers. Last year, accountants came under fire for similar problems. We should additionally discuss the competitiveness of the credit rating industry. In particular, many critics have raised concerns about the ability of participants to enter the market.

Furthermore, I think that we should evaluate the ability of investors to understand credit ratings. In studying the recommendations of investment analysts two years ago, we heard stories about "buy" meaning "hold" and "hold" meaning "sell." With respect to credit ratings, investors may well understand that triple A is an excellent credit risk with little probability of default and that triple B+ means an acceptable credit risk with some chance of default. But they may not know that B-, a passing grade on their child's report card, signifies junk bond status. Average American investors need help in deciphering this convoluted code.

In closing, Mr. Chairman, I expect the Commission to take prompt and prudent action on rating-agency regulatory issues. I also look forward to working with you on these matters as we move forward deliberatively.

Chairman BAKER. I thank the gentleman.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 69 in the appendix.]

Chairman BAKER. Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman.

And I want to thank you and commend you and thank you for holding this important hearing to study the role and function of credit rating agencies in the securities markets.

Over the past two years, this committee has lead the way on investor protection beginning with an examination of Wall Street analysts and continuing with a review of accountants, corporate officers and boards, investment banks, mutual funds and corporate governance practices generally.

Our inquiries resulted in the Sarbanes-Oxley Act and other regulatory reforms and now we turn to credit rating agencies.

Sarbanes-Oxley required the SEC to submit to the committee report on rating agencies and that report was issued in January. I am pleased that the SEC's top market regulator is here this morning to discuss its content.

Ms. Nazareth, welcome to the committee. We are glad to have you back with your valued experience at the SEC.

I know that members of this committee have questions about the Commission's oversight for this industry. Some commentators have called for greater transparency in the rating process and have raised questions about potential conflicts of interest that arise because agencies collect fees from and sell other services to the companies that they rate.

We have seen to many instance where greater transparency has led to better functioning markets and more informed investors.

The similarities between the potential conflicts of interest presented in this area and those that were addressed in the area of accounting firms in Sarbanes-Oxley are impossible to ignore. I look forward to our panel's views on the need for more disclosure and clarity in the rating process. Beyond the potential conflicts and the lack of transparency, some of questioned the real liability of the ratings themselves, particularly in light of the rating agencies failure to warn investors about the impending bankruptcies at Enron, WorldCom, Global Crossing and other major companies.

There are also concerns regarding the openness of the industry and whether anti-competitive barriers to entry exist for ratings firms seeking recognition by the SEC. We are all familiar with the accounting scandals which turned the big five into the final four and resulting concerns that have been raised.

Somehow the fact that until very recently, there were only three SEC-recognized credit ratings agencies does not seem to garner the same level of scrutiny. The Commission has recognized only one new firm in well over a decade.

I am concerned that the Commission may have allowed an oligopoly to exist. And I hope and expect to hear from the SEC on how they plan to clarify and improve the application for firms striving to qualify as recognized rating agencies.

Thank you, Chairman Baker, for holding this hearing. Focusing attention on the role of rating agencies and examining the current levels of disclosure, competition, accuracy and regulatory oversight in the industry will surely benefit investors and the market.

And I yield back.

[The prepared statement of Hon. Michael G. Oxley can be found on page 64 in the appendix.]

Chairman BAKER. Thank you, Mr. Chairman.

Mr. Miller? No opening statement?

Mr. Emanuel?

Mr. EMANUEL. Thank you very much.

Obviously a number of questions, Mr. Chairman, that we need to hear have already been raised. So rather than repeat them, I think like every member of this body and of this committee and subcommittee, we have state funds, teachers' funds, police funds, all who lost money in WorldCom and Enron.

And although the Sarbanes-Oxley bill correctly started to realign the walls that exist in the accounting industry, the investment banking, commercial banking, the credit agencies to date have been immune from that oversight. And we need to obviously take a look at what those agencies do, whether there is a conflict of interest that exists, whether there is in fact more of the debt market they should cover rather than limit it.

So I submit my full remarks to the committee. And then look forward to the testimony and the question and answer period.

Thank you.

[The prepared statement of Hon. Rahm Emanuel can be found on page 66 in the appendix.]

Chairman BAKER. Mr. Shays?

Mr. SHAYS. Thank you, Mr. Chairman.

I thank you for conducting this hearing. And just to say to you that when we had the hearing on Enron there was not one profession that looked good. The managers did not manage. The directors did not direct. The employees did not speak out, not withstanding Ms. Watkins who spoke out internally. The lawyers were on a gravy train. The accountants did not do their job of auditing. But what to me was most alarming was how the rating agencies just broke down.

And it seemed very clear to me that they broke down in measure because they also were part of the renumeration this incredible amount of opportunity to make money at the public's, I think, unfortunate expense.

So delighted we are having this hearing, and I hope that we hear some very convincing information from the regulators as to how we are dealing with this issue.

Chairman BAKER. Thank you, sir.

Other Members wanting opening statements?

Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman. I too want to thank you Chairman Baker and Ranking Member Kanjorski for holding this important hearing today regarding the Securities and Exchange Commission's oversight of the credit rating agencies. I certainly want to thank the distinguished panel of witnesses today for your testimony.

This is indeed a very, very important hearing. As we know last year the Senate Governmental Affairs Committee held a hearing on Enron's scandal and questioned why Enron's credit rating was high until just before the company filed for bankruptcy.

Due to the development of complex financial products and the globalization of the financial markets, credit ratings have been given increased importance. The credit ratings effect the security markets in many ways. But the SEC has not performed any significant oversight over rating agencies.

And perhaps this lack of oversight has led to what the Senate Governmental Affairs Committee in their hearing, to be incredulous that they had that good credit risk until just before the bankruptcy.

I think there are several areas we certainly need to focus on—information flow, potential conflicts of interest, alleged anti-competitive or unfair practices, reducing potential regulatory barriers to entry and ongoing oversight.

And there are some questions that I certainly would want to get some answers to. For example, I would like to know whether there is general agreement about whether greater regulatory oversight of credit agencies is indeed warranted.

The Senate Governmental Affairs Committee staff report recommended that the SEC monitor credit agency compliance with performance and training standards. I mean, is it time for that change?

Again, a very important hearing. I look forward to hearing from the panel and the recommendations for the SEC review of the credit agencies.

Thank you Mr. Chairman.

Chairman BAKER. Thank you, Mr. Scott.

Mr. Tiberi? No opening statement?

Mr. Ryun? Mr. Ryun has excused himself.

Mr. Matheson?

Mr. Sherman?

Mr. SHERMAN. As we explore the financial world, we find a world where the referees are paid by one of the teams. We find this among auditors and around credit creating agencies or bond rating agencies.

What insulated bond rating agencies from the same pressures that accountants faced was first an absence of competition. The vast majority of bonds being rated by the two major agencies. So even if you call them as you see them, they still have to hire you for the next game.

But the absence of competition is not an enshrined value of American free enterprise. And it probably is a good thing that we are going to get some more competition in this area.

If the competition is to serve investors either by reducing the fees charged to corporations or to provide better insight that is good. My fear is that competition will be best expressed in the sense of who will give you a better a grade.

If you were to—if a rating agency were to cut its fees by half, it would be nothing in terms of value to the corporation as if it were increase its grade by the slightest denomination available.

I will look forward to learning in these hearings what we are doing to providing a disclosure of all of the relationships between the rating agencies and the issuer in terms of is there consulting services being provided? What services and what cost? And what are the fees being charged for the basic rating services?

The thing that would concern me the most as a bond buyer is if I ever saw that a corporation was paying more than the standard fee to the entity providing its grade.

One advantage we have in bonds is that most of the decisions are being made by highly sophisticated bond purchasers and that the individual investor plays a smaller role. But even there often it is a fund that invests in bonds and then competes for the highest rate of return saying, "All of our bonds are at least single A or double A.

And so even bond managers should they fear that a rating agency's results may not be strong, the pressure on them is to buy the highest yield with the best grade whether they like that grade or not.

So I look forward to seeing what we can do to prevent the increase in competition from being a competition for who will provide the best grade and to provide investors with the best way for them to decide whether it is a grade they can trust.

Thank you.

Chairman BAKER. Thank you, Mr. Sherman.

If there are no members seeking recognition, then at this time I would like to welcome our first panelist this morning, Ms. Annette Nazareth, who appears here in her capacity as the Director of the Division of Market Regulation for the Securities and Exchange Commission.

Welcome, Ms. Nazareth. And I do not know if your mike is on. Try that little button.

Ms. NAZARETH. Can you hear me now?

Chairman BAKER. Very well.

STATEMENT OF ANNETTE NAZARETH, DIRECTOR, DIVISION OF MARKET REGULATION, SECURITIES AND EXCHANGE COMMISSION

Ms. NAZARETH. Thank you, Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee.

On behalf of the Securities and Exchange Commission, I appreciate the opportunity to testify today before you regarding credit rating agencies and their role and function in the operation of the securities markets.

As you know, this past January, the Commission submitted to Congress a detailed report on credit rating agencies in response to the congressional directive contained in the Sarbanes-Oxley Act of 2002.

In my testimony this morning, I would like to highlight for you some of the key points in the Commission's report and give you a sense of some of the areas we intend to explore in more depth.

During the past 30 years, regulators, including the Commission, have increasingly used credit ratings to help monitor the risk of investments held by regulated entities and to provide an appropriate disclosure framework for securities of differing risks.

Since 1975, the Commission has relied on ratings by market-recognized credible rating agencies for distinguishing among grades of creditworthiness in various regulations under the federal securities laws.

These nationally recognized statistical rating organizations or NRSROs, are recognized as such by Commission staff through a no-action letter process.

Recently, the Commission has pursued several approaches, both formal and informal to conduct a thorough and meaningful study of the use of credit ratings in the federal securities laws, the process of determining which credit ratings should be used for regulatory purposes, and the level of oversight to apply to recognized rating agencies.

Commission efforts included informal discussions with credit rating agencies and market participants, formal examinations of each of the NRSROs, and public hearings that offered a broad cross-section of market participants the opportunity to communicate their views on credit rating agencies and their role in the capital markets.

These Commission initiatives coincided with the requirement of the Sarbanes-Oxley Act that the Commission conduct a study of credit rating agencies and submit a report of that study to Congress.

Our report identified a number of important substantive issues relating to credit rating agencies that the Commission would be exploring in more depth. And the Commission plans to issue a concept release that would seek public comment on these matters in the very near future.

Among other things, the concept release would ask a wide range of questions regarding possible approaches the Commission could develop to address various concerns regarding credit rating agencies.

I will devote the remainder of my testimony to a synopsis of some of these complex issues.

One important group of issues the Commission staff has been reviewing relates to the information flow surrounding the credit rating process.

First, we are exploring the current amount of disclosure that rating agencies provide regarding their ratings decisions. At the Commission's credit rating agency hearings representatives of the users of securities ratings, particularly the buy side firms, stressed the importance of transparency in the rating process.

In their view the marketplace needs to more fully understand the reasoning behind the ratings decision and the types of information relied upon by the rating agencies in their analysis.

Better information about ratings decisions they assert would reduce the uncertainty and accompanying market volatility that frequently surrounds a ratings change.

Second, the Commission staff is reviewing the implications of direct contacts between rating analysts and subscribers. Some have expressed concern regarding the special access subscribers have to rating agency information and personnel. And questions have been raised as to whether this direct access creates the potential for inappropriate selective disclosure of information.

Finally, the Commission staff is assessing the extent and quality of disclosure by issuers. At the Commission's credit rating agency hearings several specific areas for improved issuer disclosure were mentioned, including the need for additional detail regarding an issuer's short term credit facilities and, particularly in light of the Enron experience, better disclosure of the existence and nature of ratings triggers in contracts that are material to an issuer.

Another set of issues the Commission staff has been examining is the potential conflicts of interest faced by credit rating agencies.

First, the Commission staff is reviewing potential conflicts of interest that could arise when issuers pay for ratings. Arguably, the dependence of rating agencies on revenues from the companies they rate could induce them to rate issues more liberally and temper their diligence in probing for negative information.

Rating agencies on the other hand assert that their processes, procedures and market competition sufficiently address these concerns.

Second, the Commission staff is assessing the potential for conflicts of interest to arise when rating agencies develop ancillary fee-based businesses. The large credit rating agencies recently have begun to develop ancillary businesses such as ratings assessment services and risk management and consulting services to compliment their core ratings business.

Concerns have been expressed, for example, that credit rating decisions might be impacted by whether or not the issuer purchases additional services offered by the credit rating agency.

The Commission staff also has been exploring the extent to which allegations of anti-competitive or unfair practices by large credit rating agencies have merit.

In the course of the Commission's study, there were a few allegations that the largest credit rating agencies have abused their dominant position by engaging in certain aggressive competitive practices.

Some allege, for example, that rating agencies may have used what critics term strong-arm tactics to induce payment for a rating that an issuer did not request.

A fourth set of issues under review by the Commission staff is whether the Commission's historical approach to the NRSRO designation has created potential regulatory barriers to entry into the credit rating business.

For many years, market participants have voiced concerns about the concentration of credit rating agencies in the U.S. securities markets and whether inordinate barriers to entry exist.

Most agree that significant natural barriers exist, particularly given the long standing dominance of the credit rating business by a few firms, essentially the NRSROs, as well as the fact that the marketplace may not demand ratings from more than two or three rating agencies.

There also has been substantial debate regarding the extent to which any natural barriers to entry are augmented by the regulatory use of the NRSRO concept and the process of Commission recognition of NRSROs.

One obvious way to avoid potential regulatory barriers to entry is to eliminate the regulatory use of the NRSRO concept. And the Commission staff is exploring this possibility.

The Commission staff also is reviewing steps short of eliminating the NRSRO concept that would reduce potential regulatory barriers including possible clarifications of the current process and criteria for regulatory recognition of rating agencies. Instituting timing goals for the evaluation of applications for regulatory recognition, and considering whether rating agencies that cover a limited sector of the debt market or confine their activity to a limited geographical area could be recognized for regulatory purposes.

Finally, the Commission staff is assessing whether more direct ongoing oversight of rating agencies is warranted and possible and if so, the appropriate means of doing so.

This oversight could include, among other things, record keeping requirements designed for the credit rating business and a program of regular Commission inspections and examinations.

As part of this analysis, we are examining the scope of the Commission's present oversight as well as the potential impact on the credit rating market of any action the Commission may take.

In addition, I should note that the rating agencies have asserted that their ratings activities are at least to some extent protected by the First Amendment.

Another aspect of possible ongoing Commission oversight is whether rating agencies should and can be required to incorporate general standards of diligence in performing their rating analysis and develop standards for training and qualification of credit rating analysts.

In the aftermath of the Enron situation and the recent corporate failures, some have criticized the performance of the credit rating agencies and questioned whether they are conducting sufficiently thorough analysis of issuers, particularly given their special position in the marketplace.

Concerns have also been raised regarding the training and qualifications of credit rating agency analysts. Whether and how such standards might be incorporated into the Commission's oversight of credit rating agencies likely will be explored more deeply in the forthcoming concept release.

As you can see, credit rating agencies raise a wide range of complex regulatory and policy issues. I expect you will get a sense of some of the diverse perspectives on these matters from the witnesses who will be testifying later this morning.

The Commission has made substantial progress in its review of credit rating agencies as I hope is evident from our recent report to Congress. And I expect our analysis to be focused further based on comments received in response to the planned concept release.

Thank you for the opportunity to testify.

[The prepared statement of Annette Nazareth can be found on page 128 in the appendix.]

Chairman BAKER. Thank you very much. I do appreciate, Ms. Nazareth, not only your work but the apparent openness having read your written testimony, of the SEC to consider a number of alternative directions to take with regard to current market performance.

Is there at the current time a written set of standards if one complies with, would lead to a designation as an NRSRO that could be printed in a form and handed to someone? And if you meet these guidelines, you can be assured of approval?

Ms. NAZARETH. The process is not that formal at this time. I believe that in general the standards for national recognition are understood to the extent that the 1997 proposal basically talked about codifying what was the staff's approach to national recognition.

But certainly what the Commission has been talking about more recently is taking those general standards and were it to decide to continue to use the NRSRO designation to apply more objective criteria and further list criteria to obtain the NRSRO designation.

Chairman BAKER. In response to the 1997 rule proposal, in which the SEC had a considerable number of suggestions, the response from the NRSRO group was that the SEC concerns were addressed by their existing policies, meaning the SEC's, procedures and competition.

Now if there are only four of them, and there were three at the time, doesn't it seem that the competitive argument was at best a little disingenuous? How does one allege that a government granted authority to do a public function and you only have three of you in the country, leads one to conclude that that is a competitive environment? But yet they were saying this strong competition is what keeps us on our toes.

Ms. NAZARETH. I understand the position that you are taking. You know, there is a question as to whether or not there really is sort of a natural oligopoly in this business. And——

Chairman BAKER. I think that is a great answer.

Ms. NAZARETH. Yes, I think our concern is we certainly do not want to be in a position where we are adding to any impediments to entry into the business through the regulatory process.

Chairman BAKER. Let me jump to the next level because my time is going to expire here. And we do have members with a lot of interest.

Let's assume for the moment that I have been designated. What is the normal regulatory oversight process that exists today from your perspectives to my conduct? What is it that I could expect? Do I have an SEC audit? Are there analysts coming through and looking at how I perform my day-to-day? Do you have to present a business plan? What is the formal relationship between this public regulatory authority and the SEC?

Ms. NAZARETH. The SEC's oversight on an ongoing basis is very limited. These entities are registered as investment advisers, but the Adviser's Act does not really specifically contemplate much of this type of business.

So there is not sort of a regular examination process or——

Chairman BAKER. Well, let's assume for the moment that tomorrow we read where one of the four is engaging in their inappropriate conduct, there is a capital adequacy question, whatever the reason. But it is a national in scope issue.

Is there a process by which the designation can be withdrawn?

Ms. NAZARETH. The designation has never been withdrawn, but certainly it could be withdrawn. I mean, there is not a formal process, but there is a process in general for no action letters that they could be withdrawn.

Chairman BAKER. Well, you can hopefully understand that the concern is that we do not have clinical standards by which someone gets approved. There is not a formal set of standards for continual oversight, and there is not a published methodology for withdrawing the designation once granted.

Would it at least be advisable to consider having this process subject to the Administration Procedures Act where that requires certain printed notices to the public, public hearings where interested parties could come and make comment?

At least opening it up to that extent where market participants at the very least and the general public on a large scope would have an ability to express the views of the market to the SEC because one of the principles on which the SEC basis its judgment is national recognition and market acceptance of whoever it is that is to be designated.

It seems to be difficult to obtain without a formally structured process to get that information. Is that something would or would not be advisable?

Ms. NAZARETH. It is certainly something that is along the lines of what a number of participants at the credit rating agency hearings that we had, had raised as well. Greater transparency with respect to the process as well as solicitation of more data from the public at large about the national recognition. So that is certainly something that the Commission could consider.

Chairman BAKER. And let me again, I do not want to end on a negative note. I appreciate your appearance and recognize that this is not a circumstance that has occurred in the last six months. This is an environment, which frankly has existed the first designation. And this is just the appropriate for a review of all aspects of market conduct. And I certainly have more questions, but my time has long expired.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

Ms. Nazareth, your testimony raises some questions about the rating agencies. I am more interested in what is your personal valuation or opinion of the rating agencies? Because you know, there is no reason to go along to set standards and an awful lot of paperwork and a lot of hoops and things to jump through just to make us look like we are closing the door after the horse got out of the barn.

The question really should go: In your opinion, do the agencies open up the door to allow the horse to get out of the barn?

Ms. NAZARETH. Well, I do not know who much weight my personal opinion should have on this particularly since I am not familiar with all of the factors, you know, surrounding this. But I can say that, in general what makes this area so difficult and the reason that we never seem to come to closure on how to address these issues is that, fundamentally what is occurring here is financial analysis.

Mr. KANJORSKI. Yes.

Ms. NAZARETH. Which is why we certainly need to be sure it is being done in a manner that has integrity and that is free to the fullest extent of conflicts——

Mr. KANJORSKI. Well, are there any questions concerning——

Ms. NAZARETH. ——but you do not know whether or in general it is an opinion.

Mr. KANJORSKI. Well, you mean after all of this time of studying it and the requests that we made under the Sarbanes-Oxley Act, the Commission still has not made a judgment?

I think it is about time somebody steps up to resolve the problem, rather than spending a lot of time studying it. Look, we have had some startling failures—Enron, WorldCom—and all of us are trying to prove that we did not have anything to do with it. Certainly the Congress is not responsible for it.

And the Commission probably is saying, "Well, we are not responsible for it." And the rating agencies I would assume are saying, "Well, we are not responsible for it either."

I do not think that we should concentrate necessarily on finding fault. Those are days gone by. But, do you see any way that we are going to improve analysis, limit conflicts of interest, or restore integrity if we do put into effect some regulatory control over these rating agencies?

Ms. NAZARETH. Well, what the Commission is going to examine in the concept release is whether or not additional regulatory oversight would be appropriate and whether, you know, it might help in this area. I think——

Mr. KANJORSKI. I thought that was what the concept release that we are waiting to receive would do.

Ms. NAZARETH. That is right, in the concept release. That is——

Mr. KANJORSKI. When is that going to happen? I mean, maybe we should have postponed this hearing until we obtain the concept release.

Ms. NAZARETH. Well, we suggested that. No, the concept release will be coming out shortly. There are drafts circulating internally now.

Mr. KANJORSKI. Can you give us a peek preview as to what you are talking about?

Ms. NAZARETH. Well, I think where it currently stands, and again I cannot say where the Commission will come out, but it could potentially be very broad in its scope in raising as Chairman Baker had mentioned, you know, all manner of issues——

Mr. KANJORSKI. I understand all of that, and you know, I think we do not get to that level unless we find that rating agencies have either failed or scored very poorly.

I guess what I am simply asking you is as a teacher, grade them, A, B, C, D, or F.

Ms. NAZARETH. You know, I think in general the credit rating agencies have done remarkably well. I think the problem is that you have some colossal failures, and we can—and it is interesting what you have——

Mr. KANJORSKI. Would you attribute any of these failures of Enron, WorldCom or any of these other organizations to either the conflict of interest that the agencies may or may not have been in, or their failure of analysis, or their failure of due diligence?

Do you see a problem? I mean, there was not any question when we examined the accountants. There was a very definite link between the accountants who were getting involved in carrying out the fraud. I mean that was very clear as far as testimony.

Are these people directly involved in any of this or is it a failure of one out what 17,000 publicly traded corporations and they have missed three or four of them. Is that all?

Ms. NAZARETH. You know, I am personally not aware of all of the facts. I can tell you that the rating agencies certainly take the view that they were defrauded in the same manner as the rest of the investing public was.

Mr. KANJORSKI. Well, then, shouldn't we——

Ms. NAZARETH. On the other hand, they may have been privy to more information than others were. So I really do not know.

Mr. KANJORSKI. Well, I am wondering, rather than concentrate a lot of our time on process and particularly new regulations of an existing business that is doing fairly well, I mean, until preparing for this hearing, over the years, I have always had a great deal of respect for the rating agencies. I have always thought that they have done a pretty good job. The failures also are minute when you really look at them over the scheme of how many papers they are rating.

Should we have more transparency on the corporate side? Is it that? There was some mention here on Enron—that they could not pierce the veil of some of these off-shore things because they just did not know about it. Should we be up here arguing for total disclosure of everything a corporation does and then put some rule into effect that the agencies have to be an arm of the government in some way directly or indirectly, to examine that?

Should the SEC be out there even examining that? I mean, it sort of seems unfair for me to suggest that we are all up here trying to burden this system all over again. Boy, as a Democrat I should not be talking this way.

[Laughter.]

Democrats are supposed to be for more regulation, but you know, I do not want to be a party to adding expense to the securities market, driving the credit situations into a jeopardized position because of actions we take that are not really going to accomplish the one thing I am interested in.

Maybe I should say it: How many unsophisticated investors are the ones that are reading these ratings or is it a fact that the people that read these ratings and understand these ratings are because they are expert in the field? And what we are trying to do is prepare something that mom and pop can decide over a kitchen table discussion, but when it in fact they do not decide on bond ratings or other ratings made by these agencies?

Ms. NAZARETH. Well, the ratings are used primarily by the sophisticated financial users. And the reason that we consider it important is because it does have great influence on the financial markets and people's ability to raise funds and the like. It is important to——

Mr. KANJORSKI. Let me come to a conclusion——

Ms. NAZARETH. ——the——

Mr. KANJORSKI. ——I know my time is almost gone. Can you attribute any of the financial failures that have occurred over the last year in the American economy to a large extent, not a total extent, but to a large extent or as to the extent of the accountant problem that we have to the rating agencies?

Do see them as the——

Ms. NAZARETH. I personally do not see that level of——

Mr. KANJORSKI. So we are at a much lower position and——

Ms. NAZARETH. I would assume so.

Mr. KANJORSKI. ——therefore our regulations or statutory authority for regulations should be more constricted? Is that——

Ms. NAZARETH. Again, what we have to analyze is what will additional regulation bring to the process? The Commission is not only going to have to decide if it engages in more regulation, but what additional benefits would that regulation bring? And two, are there limits to the Commission's current authority? And would the Commission need——

Mr. KANJORSKI. Now——

Ms. NAZARETH. ——additional authority from Congress to do that?

Mr. KANJORSKI. In some of our opening statements, we referred to this conflict of interest problem. It is potentially an alleged conflict of interest because we do not know whether there is one where payments are coming from the issuers and/or paying to the rating agencies that may cloud their judgment.

Have you ever seen anything like that happen? I mean, are we dealing here with conflicts of interest that are rampant or even evident in some of these failures? Or is that just a misstatement of fact and we should apologize to the rating companies.

Ms. NAZARETH. I think there are always potential conflicts of interest——

Mr. KANJORSKI. Have you seen any? I know there is a potential conflict of interest in every step we take in life.

Ms. NAZARETH. That is right.

Mr. KANJORSKI. But have we seen any conflict problem or do we know of any or have any evidence that they have had any impact on any of these failures?

Ms. NAZARETH. I am not aware of their being systemic conflict problems.

Mr. KANJORSKI. Thank you.

Chairman BAKER. Mr. Oxley?

Mr. OXLEY. Thank you.

Mr. Chairman, in the absence of marketplace competition, the SEC really is the only agency that determines the qualifications of a ratings agency in place of the normal checks and balances a marketplace has. And in the case of other oligopoly or monopolies regulated by the SEC, there are regulations, public interest obligations and the like that tend to provide some balance. But in the case of the rates charged by the agencies, the SEC really has no authority over those rates. Is that correct?

Ms. NAZARETH. That is right.

Mr. OXLEY. And what would prevent the—any of the agencies from exercising monopoly power or pricing for their services?

Ms. NAZARETH. Well, there are a few of them obviously, and I would think that market forces have, you know, prevented that from happening because there is some limited competition there. And I would also assume that were there inappropriate tactics being exercised by these agencies, we would have heard about it. But——

Mr. OXLEY. So you think there is some marketplace——

Ms. NAZARETH. I think there is some marketplace competition. Usually the number of ratings required for an issue is one or two ratings. And they do have some choice here.

Mr. OXLEY. I know that there are—at least I have been told that there is one agency that is considering tripling its price even though they apparently are adding no value, extra value.

If that were the case and they were indeed to triple their price, what would be the—what would be the outcome? What would be the view of the SEC in that situation?

Ms. NAZARETH. Normally we would not exercise authority over the prices that these entities would charge. We do not do that with the broker dealers either.

Mr. OXLEY. Well, and I am not here to advocate the government regulation of pricing. Far be it for a conservative Republican to advocate that. But obviously our goal is to—our goal is to try to get more competition, more entries into the market. And you have obviously heard from Chairman Baker, Ranking Member Kanjorski and myself, that that clearly is I think what we are aiming at.

And so to that extent we want to work with the SEC to encourage market entry. It may very well be potential growth industry given the past history of ratings agencies and some of the problems that developed with failure to recognize some of the major business failures that we had over the last several months. And clearly that is what we are aiming at.

We appreciate your constant efforts in that—and I know you have been at the Commission for a number of years and have always had the best interests of the public at heart. And this is no exception. And we are looking forward to your leadership, working with us to provide a more competitive marketplace in this area.

And I thank you and I yield back.

Ms. NAZARETH. Thank you.

Chairman BAKER. Thank you, Mr. Chairman.

Mr. Miller, do you have a question?

Mr. MILLER. I do, a few. They are along the lines of Mr. Sherman's opening statement. We have heard both concerns for conflicts of interest and a lack of competition. And I know that reliability has to be one basis of competition for these agencies, at least sequentially because no issuer is going to want any agent—if every issuer is going to want a rating that is accepted in the marketplace as reliable.

But what will be the basis of the competition? Is it going to be price only to the issuer, what the agency would charge if there were more agencies? And are we going to have to worry about the more of what we saw with the accounting firms becoming willing partners in Enron, WorldCom, et cetera?

Ms. NAZARETH. What our focus has been all along is that the marketplace ultimately would decide through their use of these rating that the issuers of these ratings were credible and were issuing the ratings in an appropriate way without conflict and side agreements with the issuers.

So basically, we have used that process to try to recognize or mimic how the marketplace viewed what these agencies were doing.

Mr. MILLER. What we want these agencies to be is detached. We want detachment from the agencies. That is—isn't that right?

Ms. NAZARETH. Yes.

Mr. MILLER. Is it—if there is a proliferation of these agencies, and I know that there are natural barriers to entry, there is not going to be 400 agencies. But is—is there not going to be some push for more favorable ratings as Mr. Sherman suggested in his opening remarks? Is that not a concern?

Ms. NAZARETH. Well, certainly from our limited perspective—you know, originally we started using this national recognition process because we wanted to ensure that our regulated entities that were using these ratings for regulatory purposes were not in fact doing what you are suggesting, which is sort of buying a rating, you know.

Because the ratings were used to determine things like capital requirements for the broker dealers and the like. And you did not want to have a situation where there was any issue that the credibility of the rating was called into question.

And so there is a concern there if we are going to continue to use this designation because we have become somewhat attached to it for regulatory purposes, we really do have to ensure that all of the appropriate procedures are in place so that you do not have what you are suggesting which is a race to the bottom based on people coming in and competing on basis other than the credibility of their ratings.

Mr. MILLER. The suggestion is that having essentially three firms is oligolistic.

Ms. NAZARETH. Yes.

Mr. MILLER. What would be the appropriate size of the market?

Ms. NAZARETH. I do not know what the perfect size of the market would be but I do note that in Europe where they do not have this designation process, they likewise have a somewhat limited number of major firms that are operating in the marketplace.

I think we had a staff person from the Financial Services Authority in London testify at our hearing, who said that they generally have I think south of 10. So I do not think we are talking about a situation here where there are hundreds of new entrants trying to come into this marketplace.

Mr. MILLER. Okay. Has Europe had any of the kind of problems that we have had or that we fear or agencies missing it?

Ms. NAZARETH. Well, I think that they feel that they have had a very comparable experience. And they are very much looking to what we are doing in this area. There is a lot of interest in Europe as there has been here to looking into further regulation of the credit rating agencies. So they are very much looking to us for the analysis that we undertake in this regard.

Mr. MILLER. Okay. Thank you.

Chairman BAKER. I thank the gentleman.

Mr. Shays?

Mr. SHAYS. I would like to ask you what your reaction was when the whole debacle of Enron unfolded. I would like you to tell me what you thought and why you thought what you thought.

Ms. NAZARETH. I cannot really speak for the agency in that regard. So I am not sure it is appropriate or how helpful it would be to just say what my own personal views are. I do not think in this regard I am necessarily——

Mr. SHAYS. Well, you were in office at the time, correct?

Ms. NAZARETH. Yes.

Mr. SHAYS. Well, then describe——

Ms. NAZARETH. Well, we——

Mr. SHAYS. Describe to me what you felt as a Commissioner.

Ms. NAZARETH. And——

Mr. SHAYS. And what that, you know, made you think you might need to do.

Ms. NAZARETH. I think——

Mr. SHAYS. I do not think it is a difficult question.

Ms. NAZARETH. We do not oversee the activities of these credit rating agencies. There may be people in other areas of the Commission involved in Enron enforcement action who have be privy to more detailed information.

But in the Division of Market Regulation, we are not privy to the specific information that the credit rating agencies reviewed with respect to the Enron situation.

I think—there is no question that looking at the situation, there are two distinct possibilities. One is that, as I said earlier, the fraud that was perpetrated on the public was likewise perpetrated on the credit rating agencies, and that they were given answers that were not truthful with respect to questions that they raised.

The other possibility is that because of their unique role there may have been information that had they probed further might have caused them to realize that things basically did not add up.

What would be my personal question is—on which side of the line did it fall? But I personally am not aware of which was the case.

Mr. SHAYS. The—you know, all of us when we had to examine that, I do not think that—since I do not believe there was a professional that did their job or looked good, any one of us in any profession would—I would think have instinctively have said, "My gosh, what role should or could we have played?"

And so we as legislators had to look at, you know, whether our oversight was proper and whether we needed to take action.

I do not think it would be surprising for me to expect that your agency ultimately while you do not regulate a rating agency, you are the that has given them authenticity, correct?

Ms. NAZARETH. Certainly we have some involvement because of this designation process.

Mr. SHAYS. So if you believe that maybe the rating agencies did not do their job, do not you have the ability to—in other words, dedesignate them?

Ms. NAZARETH. Well, that is one issue. I do not think that we have considered in this instance that they were subject to designation but I think that——

Mr. SHAYS. Why not, why not?

Ms. NAZARETH. Because in general, I think, as we said earlier, ultimately—if we believed that there was a systemic issue, clearly that is something that the Commission or the staff should consider. I think if you look—there have been some, there is no question about it, colossal failures.

And we have discussed many of them here today, WHOPPS, Orange County, New York City, but you know the track record in general. It is public—they publish it. It is quite admiral in terms of the track record and in terms of predicting the repayments on debt securities. And I think nobody is a guarantor in this area. This is an area of you know, financial analysis and opinion.

So——

Mr. SHAYS. Do you believe that the rating agencies adequately serve the public in continuing to rate Enron's investment grade four days before bankruptcy rating the California utilities A-2 weeks before it default, in rating WorldCom investment grades three months before bankruptcy and rating Global Crossing investment grade four months before defaulting on loans?

Ms. NAZARETH. What was your question—did they serve the pubic?

Mr. SHAYS. Yes.

Ms. NAZARETH. I do not think it was their finest hour.

Mr. SHAYS. Would you say that is an understatement?

Ms. NAZARETH. In this case, I said I am not sure the reasons for their inability to detect the problems, but certainly the result was extremely problematic. And we all know what the affects of that were.

Mr. SHAYS. I would just say Mr. Chairman, that the challenge I am having is that I think you wrote a very thorough statement of all the things you are reviewing, but I do not feel any passion in your voice. I do not feel any sense of responsibility in your position. And it makes me tremendously concerned.

I thought I was giving you a softball that you could have knocked out of the park. I thought I was basically giving you the opportunity to say, "I was horrified. It caused us to look at what we are doing and how we might make a better contribution. It got us thinking of recommendations we might make to the legislative body on ways that we could protect the public interest to make sure things were done better."

I get the feeling that basically you all are pretty much asleep. That is the feeling I get from the way you responded to me.

Chairman BAKER. Your question is, "Did you know that all of those things?" That is your question. I was just framing it for you as a question instead of a statement.

Mr. SHAYS. I would like you to do it. That is your question.

[Laughter.]

Chairman BAKER. Thank you, Mr. Shays.

If I may, Mr. Scott, you are next.

Mr. SCOTT. Thank you very much. Ms. Nazareth let me ask you this, could you explain to me why three credit rating agencies are exempt from the SEC rules on corporate disclosure?

Ms. NAZARETH. I am glad you asked that question, because there is some misunderstanding about how reg FD works. All credit rating agencies that publicly disseminate their views, whether or not they are NRSROs—have an exemption from reg FD.

At the time that reg FD was promulgated I think the belief was and continues to be that you want credit ratings to be as knowing and be based on as much information as possible. And to the extent that there is some information that issuers might feel free to share with the rating agency, that could be factored into the rating and therefore, have the rating be to some extent more accurate and timely, that that was an appropriate exception, particularly since the rating then is widely disseminated.

So it was within keeping of the spirit of reg FD whether or not the full basis on which the rating was promulgated was known. The fact of the matter is that there would be wide dissemination of a rating that included this information. And that therefore you would have a better more fulsome rating than you would have had without it.

That was the logic.

Mr. SCOTT. But as you look at it, do not you think that this lack of disclosure has a harmful effect on the decision making process?

Ms. NAZARETH. It's not a lack of—it is a question of whether or not something is not required to be disclosed at the time. If you recall, reg FD said if the issuer were determined to disclose something you had that was material that you had to widely disseminate to every one. It could not be selective discloser.

In this case again, if it is something that the issuer is not obligated at that moment in time to publicly disseminate, but feels that it would be important for the credit rating agency to know, reg FD would not be an impediment to sharing that information.

It does not require that he share it. If he does share it, it is not a violation of the regulation.

Mr. SCOTT. These credit rating agencies are sort of like an exclusive club. I mean, they cannot get a foothold in the industry, in the business without the SEC's approval. Is that right?

Ms. NAZARETH. Well, I think credit rating agencies in general, you know, there are many of them and they can—and many of them are quite successful. I think the issue is the designation as a nationally recognized statistical rating organization which is more selective.

Mr. SCOTT. Can't get that without the SEC approval?

Ms. NAZARETH. Yes.

Mr. SCOTT. Well, why have there not been any new rating agencies designed in the last 10 years? Do you see that as a problem?

Ms. NAZARETH. I guess I have to put it in the context of how many have applied as well.

Again, we think there are some natural barriers to entry here. There have not been that many applications. As you may know, at one point we were up to seven and because of consolidation in the industry, those seven who had been designated went down to three.

And I would say in the last ten years we probably had about four or five additional rating agencies who had applied who did not receive the designation. We have currently three or four that are pending.

So we are not talking about scores of people who have come in who we have turned down. There has been a limited number, obviously some of them have received the designation and I think we took action in 1999, on Thompson Bank Watch, which had had a limited designation. And so we expanded their NRSRO designation to cover a wider variety or products in 1999. And then as you know, recently we had Dominion approved. So we are now up to four.

Mr. SCOTT. Are there artificial barriers?

Ms. NAZARETH. Well, that is what we want to be sure that we are not creating. I think we are trying to ensure that there is some discipline on this process because we use the designation for regulatory purposes. But I think the Commission is very interested in ensuring that they are not creating artificial barriers that exacerbate any competitive issues.

Mr. SCOTT. So there are barriers, but you would say they are more natural market forces?

Ms. NAZARETH. Well, there certainly are a lot of natural market barriers.

The question is, are there things that the Commission could do to ensure that their regulatory process does not make it worse.

Chairman BAKER. Mr. Scott, your time is winding up. If you could make this your last one, sir.

Mr. SCOTT. Well, I just would like to say that I think that there is a challenge here for the SEC to move forthrightly to make for better competitiveness as an—just—is there—is there general agreement on whether greater regulatory oversight of these credit agencies is warranted? Is it pretty much agreed?

Ms. NAZARETH. No. I think that the Commission has an open mind about it and is seeking comment on that through the concept release—which explains my lack of passion in my testimony. I think that the Commission is truly open minded about what inputs it gets back in the context of the concept release.

And I think we will also carefully look at the authority issues and determine if additional regulation is warranted, in which case we may also seek further authority from Congress.

Mr. SCOTT. Thank you Ms. Nazareth.

Chairman BAKER. Thank you Mr. Scott.

Mr. Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman.

Ms. Nazareth, do not confuse me with Mr. Shays. I have no softballs to throw at you.

Ms. NAZARETH. Oh, great.

Mr. CAPUANO. I have to tell you that I came to this hearing today because I wanted to make sure that I was on record as telling the SEC that think you have done a minimal job at best in reaction to this crisis that has been facing us now for almost two years. If it was not for the state attorney general in New York, I think that you would have done even less than you have done.

So I am not a happy camper. I do not that the investing confidence has come back. I do think that today's situation or today's hearing relative to rating agencies is just another part of it.

But it amazes me, absolutely amazes me that average people can see the potential conflict in the private end in what the agencies do. Every single one of them, just like auditors, are afraid that the people they are rating are going to go to another rating agency if they rate them too harshly. How is that not seeable? How is that not clearly understood?

And when you have that situation, I think there is no answer other than relatively strict regulation or at least oversight from somebody. And the only somebody is the SEC.

That is who the public looks to. They look to the SEC.

And for the SEC to sit back and say, "Well, we are not sure. We have been thinking about this for—well, since 1994. We are going to continue to think about it. We have a lot of questions."

To me is, well, why bother. Why bother? Forget your concern or anybody's concerns for the general public's faith in the system. The credit rating agencies, just like the auditors, have a financial push to not anger their clients.

Very simple. Having been involved with credit rating agencies in the past, their desire to delve deeply into the numbers underwhelmed me every time I ever dealt with them.

Cookie cutter stuff, did not fit into the cookie cutter, fine if it did, fine. Very little—very few questions. And here is the rating.

And you know as well as I do that the average investor, that includes the small investor who might just wonder what their mutual fund is doing, they may not read the credit report but they certainly will know that it is an A or double AA or a triple BBB or whatever it is going to be. They know that.

And the individual companies themselves use those ratings as advertising. You know that. "Oh, we got an A. We got a B."

That is what it is all about. And to worry about or to take, I do not know, I think I read somewhere since 1994, if you want to certify a group, do it and make it count. If you do not, then do not."

These people are walking around and that does not mean that everybody is doing a bad job. I do not mean to imply that. But the ones who do not do their job, clearly there have been many, but the ones who do not do their job are walking around with their CC certification which tells the investing public, "It is fine."

How is it that you do not see a problem with that? How is that there is still debate in the SEC to do something? How is that possible at this point in time after the crisis that we continue to suffer from?

Ms. NAZARETH. I do not think that there is any question that the Commission considers it a very important issue. I think—you actually stated it quite clearly. I think where we are is that given that we do give this NRSRO designation—we either have to be in or out.

We either have to stop giving the designation and basically say we have no oversight responsibility over these entities. And clearly the statute does not specifically say that we are supposed to be overseeing credit rating agencies, or if we are going to continue to designate these entities, there has to be certainly more transparency to the process. And it will raise further issues of what additional oversight is necessary.

I think we are in a difficult position right now because once you designate an entity, I think it does leave the impression that there is more being done on any ongoing basis. And I think that is the challenge that the Commission has and we are hoping that in the next few months once they basically analyze more current feedback that they get from the soon-to-be-released concept release, that they will make a determination.

Mr. CAPUANO. The last time they asked for feedback and they analyzed it, they basically decided to do nothing. Do I have any faith whatsoever—should I have any faith that something will be done, anything will be done?

Ms. NAZARETH. I would think so. I also think that the concept release of the time was probably somewhat more limited than the issues that we are looking at now.

So, I think there is much more focus on the issue how.

But suffice it to say, as others have said here, that it is a very complicated issue. But——

Mr. CAPUANO. I understand that it is a complicated issue. Everything is complicated in life. I understand that, but at the same time for me, I do not care. The SEC gets paid and now hopefully gets paid more than they used to——

Ms. NAZARETH. We thank you for that.

Mr. CAPUANO. Well, happy to do that. I think it was worthwhile. But it gets paid to deal with complicated issues.

Ms. NAZARETH. Uh, huh.

Mr. CAPUANO. My mother relies on your goodwill and your positive action to do your best within reason obviously, to make sure that her investment is reasonably safe. We need some speed here. I need some speed here.

Ms. NAZARETH. Right.

Chairman BAKER. Speaking of speed, Mr. Capuano, your time has expired but——

Mr. CAPUANO. Thank you.

Chairman BAKER. Thank you, Mr. Capuano.

I would like to suggest for members, because everybody has a sincere interest in this, as opposed to going to a second round with five minutes for everybody, that everybody who chooses can ask—well, we have members who have not yet—do you have questions?

Okay. Mr. Ney?

Let me recognize Mr. Ney for his five minutes, and then we will go to a second round with each member having the option to ask two more questions just to make sure we have vetted everything.

Mr. Ney?

Mr. NEY. Thank you, Mr. Chairman. One question I wanted to ask is about the rating firms. You know, the rating firms are essentially private research firms. They have been granted a government benefit in the form of a monopoly power they enjoy as a result of receiving an NRSRO status from the Commission's staff.

Why should they also get special access to information that reg full disclosure restricts from the public?

Ms. NAZARETH. They do not have a unique benefit under regulation FD. All credit rating agencies whether or not they are designed as an NRSRO have an exception under reg FD.

Mr. NEY. So they do not have special access to information?

Ms. NAZARETH. They do not. They do not. NRSROs alone do not have special access.

Mr. NEY. Okay. The other question, Mr. Chairman, I had is Standard & Poor and Moody's control about 80 percent of the credit ratings market. In light of the fact that a rating from two different firms is typically needed for issuing new debt, the two firms do not actually compete against each other.

Even though S&P and Moody'ss have failed repeatedly to warn investors, their revenues have not suffered because there are few alternatives.

What do you think could be done to counter what I consider unhealthy conditions?

Ms. NAZARETH. Well, I think there is some issue as to whether or not there are natural barriers to entry, but one of the things that the Commission is interested in ensuring is that it is not sort of adding to the competitive problems through its regulations. So that is something that is the subject of great Commission focus right now and will be hopefully addressed through the concept release, the questions.

Mr. NEY. So this subject is under internal discussion——

Ms. NAZARETH. It is under internal discussion, yes.

Mr. NEY. Is there a timeframe or guesstimate or——

Ms. NAZARETH. Well, we are hoping that the concept release will be issued within the next few weeks and then from there, we will take the data and the Commission will determine what further steps it wishes to take.

Mr. NEY. Thank you.

Thank you.

Chairman BAKER. Thank you, Mr. Ney. And starting our second round now, we would recognize any member for a couple of additional questions. I just want again reiterate my appreciation for your appearance.

I have two questions that are not troubling, but of interest. S&P for example, is a publicly owned corporation that has its stock traded in the public market.

Who rates them?

Ms. NAZARETH. Who rates S&P? I do not know.

[Laughter.]

Chairman BAKER. Because it would seem that if—if we have only four them and they are all publicly traded stock——

Ms. NAZARETH. Right.

Chairman BAKER. And you in normal conduct of business, you have to get access to capital, if you are going to get access to capital, you have to have a rating. It has to be by a nationally recognized rating organization.

Secondly, it is I think generally known that there are officials of the credit rating corporations, to make it clear, there are businesses making business judgments for their own shareholders who serve in either a board or administrative or executive capacity who also serve on the boards of the companies they rate.

Now that to me is an extraordinary—a difficult matter.

Has the SEC looked at that relationship or an executive in a rating agency serving on a—as a board member of a company which they are not rating?

Ms. NAZARETH. No, we have not. If that is the case, I think that is a good area of pursuit. We have more to suggest but we will get to those later.

That is my two questions.

Mr. Miller?

Mr. MILLER. A quick couple of questions. All of our concerns about conflict of interest, about the lack of detachment by these agencies does seem to date from the agencies from being paid principally by investors being paid principally by issuers.

Is it possible to go back? Can the market work? Can we get that genie back in the bottle?

Ms. NAZARETH. You know, the rating agencies themselves may be able to speak more directly to that. I think the reason it switched originally was because it is very difficult in a world where information is sort of freely disseminated through technology to be able to make their money through subscriptions because these ratings become widely known, and you know, there is sort of a free-rider effect.

So this was really their alternative to that problem. And certainly the rating agencies can address, how they think the potential conflicts are mitigated. Largely it is done, I think, both through their view that their franchise value is based substantially on the integrity of their ratings.

That is certainly one thing they argue. But also they rate so many issuers that their income is not reliant to any significant extent on any one issuer so that they do not feel that they are unduly influenced by an issuer leaving because there is no concentration.

Mr. MILLER. Second question. Mr. Shays pointed out the number of times that changes in ratings did not appear until immediately before bankruptcy. That also may be because the change of rating precipitated bankruptcy.

One of the things that seems to be most troubling about the amount of power that these agencies have and the lack of—and relative lack of regulation either by the marketplace or by government or anybody is those triggers. Do you think that those are a necessary part of the marketplace having accelerated payments on debt because of changes in ratings?

Ms. NAZARETH. I think that is a great question. I think certainly one of the lessons learned from some of these situations is that we need a greater understanding of the ratings triggers. I think from what I understand the credit rating agencies themselves do a more rigorous job now of understanding where all of the ratings triggers are and what impact the change in rating would have.

And I also think that it is something the Commission will consider in terms of adding more disclosure information as well, because it obviously has a material effect. There is in some sense a spiraling effect when things go bad if you have these triggers that as you say, precipitates a bigger crisis.

Chairman BAKER. Thank you, Mr. Miller.

Mr. Shays?

Thank you Mr. Chairman.

Mr. Chairman, I am going to make two observations. One is that when I have an employee, I want an employee who is anticipating problems and looking for solutions.

And so Ms. Nazareth, I understand you are not a Commissioner, but this is your area. And I want to go on record as saying that I believe your lack of energy points out that a fire needs to be lit underneath you.

Tell me why I should take more comfort in the four rating agencies that basically have your “no action” stamp of approval than I should on the ones that do not?

In other words, it strikes me that there are some rating agencies that do not have the status of your stamp of approval that really have done a better job. Why should I be comfortable when I look at what two of these firms have done, they have 80 percent of the business and they do not compete with each other.

Why should I take comfort in what they have done?

Ms. NAZARETH. We are not by virtue of designating these entities saying that any of these other ratings services cannot be used. What we are saying is that we had tried very narrowly for purposes of our regulations to determine that we had agencies that were nationally recognized and as Mr. Miller suggested, who were significant enough and whose ratings presumably would not be influenced by other factors, like other competitive factors, to have credible ratings.

Obviously, you have raised a number of important issues that the Commission will consider. I take issue with your characterization unfortunately of a lack of zeal. I think that you are perhaps misinterpreting a cautiousness on my part because I am in fact representing the views of a number who may not at this moment in time have completly formulated their views on what the Commission is going to do.

But I can assure you that the Commission is examining this issue with a tremendous passion and that there is a huge amount of effort going on at the Commission to come to the right answer on this.

And again, if we feel that more is needed to be done, we may in fact be back here asking Congress for additional authority to do more in this area.

Mr. SHAYS. Well, the fact that you would “if I feel more that needs to be done,” we all know that more needs to be done. It is the question of what needs to be done.

My second question, living with the format of the question, is to ask why should I draw comfort that there are no formal requirements to have your stamp of approval and it is not transparent?

Why should I draw any comfort from that at all?

Ms. NAZARETH. I am not suggesting that you draw comfort from that. It is quite clear that if the Commission continues to use this designation, there will be much greater transparency around that process. I have no doubt about that at all.

Mr. SHAYS. And so the proposed rule of 97, maybe we will finally be acted on?

Ms. NAZARETH. Or some other form of it, yes.

Mr. SHAYS. Interesting that it is a proposed rule in 1997, isn’t it?

Ms. NAZARETH. Yes.

Chairman BAKER. Thank you, Mr. Shays.

Mr. Kanjorski?

Mr. KANJORSKI. Who is going to win the World Series?

[Laughter.]

Thank you very much, Mr. Chairman.

Ms. NAZARETH. Happy birthday.

Mr. KANJORSKI. Thank you.

Chairman BAKER. Thank you, Mr. Kanjorski.

Ms. Capito?

Mr. SHAYS. Can I make an observation?

I like Mr. Kanjorski, when it is not his birthday. He is just too nice today.

[Laughter.]

Totally out of character for the record.

[Laughter.]

Mr. KANJORSKI. One day here——

Chairman BAKER. Officially no comment?

Ms. Capito?

Mr. Ney?

Ms. Hart?

Mr. Scott?

Mr. SCOTT. Yes, I would like to—let me ask you in terms of regulatory oversight, do you think that the Securities and Exchange Commission should monitor credit agency compliance with performance and training standards?

Ms. NAZARETH. That is something that is under very serious consideration by the Commission. I know that was something that was recommended in one of the congressional reports. And it is one of the items that is going to be explored in the concept release.

Mr. SCOTT. What about you? What do you think? Do you think this should be done?

Ms. NAZARETH. I think if we continue to use this designation we cannot be sort of half in. If we are going to do that, then we are going to have to do more rigorous oversight. Exactly what form that will take I do not know and whether or not we need to come for additional authority is also an open question.

Mr. SCOTT. Okay.

Ms. NAZARETH. But it is for the Commission to decide. I do not have a vote.

Mr. SCOTT. Let me ask you this question about conflict of interest.

Chairman BAKER. And that will have to be your last, Mr. Scott so we can wrap up. Thank you Mr. Scott.

Mr. SCOTT. What do you think should be done about potential conflicts of interest that arise when insurers pay for ratings and when rating agencies develop additional fee based services?

Ms. NAZARETH. That definitely raises questions for us. As you may know, at this point, the additional fee-based services that the credit rating agencies, that those businesses are involved in, are rather small. But certainly, intellectually, it raises all the same issues that we saw with the accounting industry. So that is another issue that the Commission is looking at very closely.

Mr. SCOTT. Thank you, Ms. Nazareth.

Chairman BAKER. Thank you Mr. Scott.

Let me express my appreciation on behalf of the committee for your willingness to participate at such length. Your appearance here has been a great help to the committee, and we look forward to working with you on the results of the concept study. And appreciate the efforts of the agency .

Thank you very much.

Ms. NAZARETH. Thank you.

Chairman BAKER. At this time I would like to call up our—members of our second panel, please. I want to welcome each of you here this morning to participate in this informational hearing for the subcommittee.

To the extent possible, I would ask that each witness try to summarize their testimony. All of your formal statements will be made part of the official record. It is my observation, given the interest of members, that the follow-on discussion between the committee members and each of you will probably be of great interest to us. And given the number of folks we have to hear from this morning, please try to constrain your remarks to no longer than five minutes.

To that end, I would like to begin by calling on the managing director of Egan-Jones Ratings Company, Mr. Sean J. Egan.

Welcome, sir.

STATEMENT OF SEAN J. EGAN, MANAGING DIRECTOR, EGAN-JONES RATINGS CO.

Mr. EGAN. Thank you.

My name is Sean Egan. I am managing director of Egan-Jones Ratings, a credit ratings firm. By way of background, I am the co-founder, and we were established for providing timely, accurate ratings to institutional investors.

We are dissimilar to the rating firms that are currently recognized by the SEC, the NRSROs, in that we are not paid by the issuers of ratings. We think there is a fundamental conflict of interest, and we do not think that it is surmountable.

We are paid by approximately 300 institutional investors and broker-dealers. Unlike the current NRSROs, we provided warning to investors on the major debacles, such as Enron, WorldCom, Global Crossing, Genuity.

We are based in the Philadelphia, Pennsylvania, area, but we have employees that are in other offices.

We believe that the rating industry is flawed in a couple of fundamental ways. One is that there is little competition. This is not an oligopoly. People refer to it as an oligopoly; it is not. What it is is a partner monopoly. That is, that you have two firms, S&P and Moody's, having between 80 and 85 percent of the revenues in this business, and neither of them compete against each other because you need two ratings, typically, for a bond underwriting.

So, if S&P is awarded a designation for rating a particular issue, Moody's is soon to follow. It is not as if they are competing against each other, unlike the accounting firms. In fact, they are side by side.

The second problem, of course, is that there is a conflict of interest. The major rating firms, S&P and Moody's, used to be paid by the users of credit ratings, but that changed approximately in the mid-1970s, whereby they received the bulk of their rating, their fees, now from the issuers.

Some people refer to this as a natural oligopoly. We disagree. It is not a natural oligopoly in any other way than, let's say, the financial analysis industry, or the money management industry; you do not have two firms controlling 80 to 85 percent of the industry.

Likewise, in the equity research area you do not have two firms controlling 80 to 85 percent. It is simply not a natural oligopoly. There have been barriers that have been set up for getting this NRSRO designation.

Because of the unhealthy state of the credit rating industry, investors have lost hundreds of billions of dollars, pensioners have lost their pensions, and workers have lost their futures.

Now, the current NRSROs will put up what we call five defenses for why they should be the only NRSROs recognized, and I will run through these very quickly. I have four in my written testimony, but we added a fifth.

One is issuer misdeeds. That is that the issuers did not tell us that they had fraudulent financial statements. Our feeling is that any decent credit rating firm should be able to figure it out. There is always fraud. It always happens. When Bernie Ebbers has a $400 million loan from the company, that should be a fairly good signal that something is wrong.

The second defense that the S&P and Moody's put up for why they missed it is that they have little incentive. We call that the Jack Grubman defense, and you heard a little bit about that this morning from Annette.

Our feeling is that, just like Jack Grubman and Henry Blodget of Merrill Lynch constitute a small part of their respective firms' revenue base, they still misled investors, to their benefit. So we do not believe that the little incentive argument holds much water.

A third comment you will hear for the defense of the current situation is that "our reputation is key." We refer to this as the Arthur Andersen defense, that, "There is no way we would let a rating company be misrated"—this is what they will say—"because our reputation is too important." Well, we think that is trumped by the compensation issue.

This fourth defense that they will use is the committee approach. That is, that, "We rate things via committee and that way no one particular person can affect things." We refer to this as the lemming defense, that it is very clear that there is just one analyst that is looking at the company, it is very clear what the hierarchy is, and it is very difficult to buck that.

The last defense that will be used for not changing this industry is what we call the "great, great grandfather defense," and that is that a firm needs to be established around World War I, which is when S&P and Moody's were established, to have any sort of presence in this industry. We disagree with this.

We have a number of recommendations. I do not want to get into them now. What we would encourage the SEC to do is to broaden their definition of what is appropriate for an NRSRO. They list national recognition in the United States as being the primary criterion for recognition.

We commissioned a survey. We contacted the SEC before that survey, during that survey and afterwards, and that survey basically indicated that we had more than four times the recognition of any other non-NRSRO firm. We provided that to the SEC, we asked for a meeting, they refused to have a meeting with us.

We were somewhat surprised when DBRS was given the designation. We had more than four times the recognition of them. We asked the SEC what exactly we needed to get this designation and they said they simply could not tell us and they are still studying it.

So if you have any additional questions, I will be happy to answer them later.

[The prepared statement of Sean J. Egan can be found on page 75 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Egan.

Our next witness is the Senior Vice President of Federated Investors, Ms. Deborah A. Cunningham.

Welcome, Ms. Cunningham.

STATEMENT OF DEBORAH A. CUNNINGHAM, SENIOR VICE PRESIDENT, FEDERATED INVESTORS

Ms. CUNNINGHAM. Thank you, Chairman Baker.

I am in charge of the taxable money market group at Federated investors, which is a mutual fund company based in Pennsylvania, and it is in that context that I offer my remarks to you here today.

The group that I am in charge of at Federated is required from a regulatory standard to utilize the ratings from the various NRSROs, and this is set forth by Rule 297 from the Investment Company Act of 1940, which requires money market funds to utilize NRSROs as information in the minimal credit risk determination that we make. It is one piece of the puzzle that is used in the determination of creditworthiness that our analysts use, but we are required to do so.

The securities that the funds that I manage purchase are generally corporate notes from either financial-or industrial-type corporations, as well as asset-backed securities. The asset-backed securities that I purchase are required, again from a regulatory standpoint, to have NRSRO ratings, while that requirement is not mandatory for the corporate securities that we purchase. On average, however, though, 99 percent of the securities that I purchase in the funds that I manage are indeed rated by at least one NRSRO.

On the positive side, I think that the content of the NRSRO writeups that have been disseminated has improved drastically over the last several years. The qualitative information, as well the timeliness of those writeups is very good.

On the negative side, there have been instances in recent times when I have reviewed information that shows data that is more than 18 months out of date. So it is obviously not a perfect scenario yet in this context.

The NRSRO reports are helpful from my analysts standpoint because they are concise, they offer peer-group information, show industry averages, industry comparisons. They also show a large array of historical information, so you are able to look at some trend analysis from this information that is disseminated by the rating agencies.

In general, then, they have a summary that has positives and negatives that effectively is the justification for the rating that in fact that rating agency is giving to that particular company.

The NRSROs are also providing clues for future financial health of the particular entities that we are using by way of their outlook and by way of their watch lists. The watch list companies are basically those who are closer to having their ratings change, either upward or downward, in the near future.

Occasionally, however, an issuer will be downgraded without first having a negative outlook or first being listed on a watch list as a potential downgrade, and this causes a lot of havoc in the marketplace. It is a very disruptive procedure.

The reason for those sort of sudden surprise changes can be necessarily a sudden surprise change in the information that is being disseminated by the company or it can be misrepresentation or a misunderstanding of the information that had been previously disseminated.

Whichever the case is, I think an improvement that we would like to see would be for any type of sudden, unexpected changes by the NRSROs to be accompanied by a more detailed, transparent statement as to why those changes occurred and what the future outlook will be for other such changes.

Switching to asset-backed securities for a second, these issuers are special purpose entities, they are not publicly traded, publicly held companies, so the information that is available in the marketplace for them is much, much lower than it is for publicly traded corporates and financials.

The NRSROs do require a great amount of information to be submitted in order for them to rate these special purpose entity, asset-backed securities and they require that information on a regular basis to monitor and upkeep that rating.

Another suggestion that I would have for the NRSROs for improvement would be to better disseminate a lot of this information to the investing community so that we are not always at odds trying to get that information directly from the issuers.

Now let me address for a second the issue of fees. The fees that are paid by fund companies, such as Federated Investors, who manage money market funds and other types of bond funds, are a substantial portion of the advisory fees that we charge our customers for those funds.

Although these fees may indeed pale to what the issuers are actually paying those NRSROs, I guess I believe that it is incremental enough that the rating agencies are in fact looked upon by us as being unbiased third-party experts.

In order to ensure this unbiased quality, I think all of the contract negotiations that take place for fees from the issuers to the rating agencies should be done away from the analysts and the committee members that are actually responsible for designating ratings for that particular company. And I am not sure if that is the case today or not.

With regard to additional fee-based businesses, I guess I take a different tack, and it is one that we are familiar with, in that I have many of the funds that I manage rated by the rating agencies themselves.

And in those instances some of the rating agencies dictate that the securities that are held within those funds are also rated by that same NRSRO. So this seems to be a little bit of a bad business practice that I think could be amended in that, as long as there is any rating on those securities within those rated funds, this should suffice.

Let me recap by looking at the current NRSRO status. The SEC most recently designated Dominion Bond Ratings as the fourth NRSRO. At one point there was a high of seven NRSROs and through consolidation that shrunk down to three.

I think this recognition of DBRS as the fourth agency is one that is welcome. Investors are always looking for additional information and additional opinions, and we are in the process right now of negotiating with DBRS as to how we are going to utilize their information.

I think that the addition, though, of these NRSROs should be deliberate and it should be detailed by the Commission. However, more transparency in that process is probably a good idea.

[The prepared statement of Deborah A. Cunningham can be found on page 71 in the appendix.]

Chairman BAKER. Thank you very much, Ms. Cunningham.

Out next witness is the Executive Vice President of Dominion Bond Rating Service, Mr. Greg Root.

Welcome, sir.

STATEMENT OF GREG ROOT, EXECUTIVE VICE PRESIDENT, DOMINION BOND RATING SERVICE

Mr. ROOT. Thank you very much. I would like to thank you and the subcommittee for giving us the opportunity to address such an important issue today.

As we all know, ratings have become a key, integral part of the financial markets, and therefore I think it is imperative that there be a clear understanding of the role of rating agencies, how they operate and how they compete.

Let me begin with just a brief overview of Dominion Bond Rating. We are based in Toronto, founded in 1976 by Walter Schroeder, who remains the company's president. And DBRS is employee owned. We do not have public shareholders, we are not affiliated with any other organization and we limit our business to providing credit ratings and research.

DBRS is what we call a general rating agency in that we analyze and rate a wide variety of institutions and provide credit research on these as well.

We currently rate about 700 different entities, and we have about another 250 companies, most of which are based here in the U.S., that we are providing credit research on without ratings.

DBRS has 65 employees and we have 45 analysts at this time.

Since our inception, DBRS has been widely recognized as a provider of timely, in-depth, impartial credit analysis. Our opinions are conveyed to the marketplace using a familiar, easy-to-use letter grade rating scale. These ratings are supported by extensive research, which include detailed reports on individual companies, as well as comprehensive industry studies.

This information is disseminated through various means, including a proprietary subscription service, which is used by more than 300 institutional investors, financial institutions and government bodies.

DBRS credit ratings reflect the company's opinion as to the likelihood of timely payment in full of principal and interest. In arriving at these decisions, our team of analysts consider a wide range of quantitative and qualitative factors that could affect the future creditworthiness of the issuer or specific instrument in question.

As part of the process, we maintain an ongoing dialogue with the managements of the companies we rate. All ratings are processed through a committee system and are reviewed constantly. Ratings are changed whenever we are of the opinion the relative creditworthiness has changed positively or negatively.

Next I would like to say a few words about the role of rating agencies in the capital markets. Again, over the past 30 years the SEC, other federal and state regulators and even Congress have increasingly relied on credit ratings as a way to monitor the risk of investments held by regulated entities. In addition to these legislative and regulatory uses, NRSRO credit ratings are widely used extensively in debt covenants and other financial instruments between private parties.

I am pleased to say that the confidence the regulators and the markets have shown in the rating agencies is not misplaced. While ratings are certainly not guarantees of future performance, studies show that there is a strong positive correlation between ratings and default rates.

However, although DBRS is proud of the role rating agencies play in the global securities markets, we are aware that there are certain concerns that have been raised regarding our industry, and I would like to touch on a few of these at this time.

First is transparency. At the SEC's rating agency hearings last fall we heard institutional investors express a desire for a clear understanding of the reasoning behind rating decisions. DBRS makes every effort to satisfy this desire by issuing full detailed reports on the companies we rate. These reports openly convey our views on both current ratings and on the direction of ratings. We believe everyones' interests are best served when the reasons behind ratings are widely known.

The second involves conflict of interest. DBRS has worked diligently to minimize the potential for conflicts of interest in the rating process. My written testimony goes into this topic in my detail, but let me just say here that the success of our business is primarily based on one key factor: our reputation. If at any point investors doubted the independence of our judgment, the demand for our services would decline. We have no intention of letting that happen.

And the third is the competition and barriers to entry. As the rating that has been most recently granted the NRSRO designation, DBRS has somewhat of a unique perspective on this issue. Because credit ratings play such an important role in the capital markets, we believe that barriers to entry in this field should be high.

That said, the real concern, as we see it, is not so much that the barriers make it difficult for new competitors to enter the field, but rather that there is no well-defined process for designating NRSROs.

The no action letter process that the SEC currently use is, in our opinion, ill suited for this task because the criteria for designation are not sufficiently defined, the application process is not standardized and adverse decisions on requests for designation are not subject to appeal.

Based on our recent experience, DBRS believes that there should be a clear definition of what constitutes an NRSRO and a transparent process to enable qualified companies to apply for this designation.

In conclusion, I believe that the credit rating system as it exists today works quite well and has helped foster the growth of the financial markets globally. In light of recent events, it is appropriate that the issues being raised by the subcommittee be thoroughly reviewed, and we very much appreciate having the opportunity to be part of this process.

Thank you.

[The prepared statement of Greg Root can be found on page 137 in the appendix.]

Chairman BAKER. Thank you, Mr. Root.

It would be my intent, we have announcement of two votes on the floor that are now pending, we have about 10, 12 minutes left before the first vote closes, so we could proceed with Dr. White's testimony. The committee would then stay in recess for 15 minutes to go over and come back for the two votes and hopefully not inconvenience you too greatly.

Dr. White is a Professor of Economies at Stern School of Business, New York University.

Welcome, Doctor.

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

Mr. WHITE. Thank you, Mr. Chairman. I am very pleased to be here and to have this opportunity to testify before the subcommittee. My written testimony states my position in greater depth.

The problem of the regulation of the NRSROs is what I have described as "the SEC's other problem." Of course the SEC's efforts with respect to corporate governance and public accounting is at center stage, but the NRSRO issues could well be as important for the efficient operation of the U.S. capital markets.

The SEC's current regulatory barriers to entry into the NRSRO category are highly unsatisfactory, and the two potential paths out of these difficulties are clear. Unfortunately, the SEC's recent report was a great disappointment. It simply raised the same old questions instead of pointing toward the solutions.

The basic problem is as follows: Since 1931, financial regulators have required their regulated institutions to pay attention to the credit ratings of the bonds and obligations that they hold. That regulation has grown greatly, especially in the past three decades.

The issue of whose ratings should be paid attention to was addressed only in 1975, when the SEC created the NRSRO category. It immediately grandfathered into the category the three major incumbents, and it then allowed only four additional entrants over the next 17 years. But mergers and consolidation among those entrants and between those entrants and Fitch then reduced the total number back to the original three by the end of the year 2000.

From 1992 until the end of February of this year, the SEC allowed no new entrants. Only at the end of February, as we have just heard, did DBRS enter this category.

So that is where we are: greatly expanded regulatory demand that financial institutions use ratings, and limited supply of SEC-designated approved rating firms, the NRSROs. It is no wonder that we are here today discussing the problems of this industry.

Now, it is important to remember: So long as regulators delegate their safety judgments to ratings firms, there is going to be a need to designate whose ratings should be heeded by the regulated financial institutions. So long as we have that process set up, this designation is unavoidable. But that process forces the capital markets to pay attention primarily to the designated entities, and there are unfortunate consequences to this whole limitation process. One has to worry whether new ideas, new innovations are going to enter the marketplace in this kind of framework.

There are two basic paths that could be followed to get us out of these difficulties. The first and best is to have the financial regulators withdraw those safety delegations and to make the safety judgments themselves. I say this as a former bank regulator myself. For almost three years I served on the Federal Home Loan Bank Board. I had a number of sessions in just this hearing room, Mr. Chairman, some of them enjoyable, some of them less so, but I know what it is like. And those delegations can be withdrawn, those judgments can be made by the financial regulators themselves.

Once that is done, the SEC could eliminate the NRSRO category, and the capital markets would then be free to make up their own minds: "Whose judgments do we follow? Whose predictions of default do we pay attention to? What new ideas should we be paying attention to?"

Indeed, they might even ask, "Do we even need rating firms in the 2003, 94 years after John Moody's first started issuing ratings?"

This is the best, the clearest, the cleanest and the most market-oriented approach to dealing with these problems.

But if this route is considered infeasible, then there is Plan B: The SEC must cease being a barrier to entry, it must actively certify qualified firms as NRSROs and inevitably it must periodically assess the suitability of incumbents to continue to be NRSROs.

The SEC in this process must focus on performance: How well does the firm, entrant or incumbent, predict defaults?

In this light, the criteria that the SEC proposed in 1997 must be scrapped. Those criteria focused on inputs, not on performance. An innovative firm that could predict defaults well could nevertheless fail the input criteria. Also, the criteria create a Catch-22 that could exclude entrants.

If this expanded regulatory task is considered to be beyond the capabilities of the SEC, then there is always Plan A: Withdraw those regulatory delegations, then eliminate the NRSRO category and let the markets make their own choices and decisions.

The paths are clear, and I disagree with Ms. Nazareth's comment this morning. This is not a complicated issue. The time for action is now.

Thank you very much, Mr. Chairman.

[The prepared statement of Lawrence J. White can be found on page 144 in the appendix.]

Chairman BAKER. Thank you very much.

Time for action has also occurred for me. I have to go vote and I will be right back. We stand in recess.

[Recess.]

Chairman BAKER. If I may ask folks to resume the seats at table, we will reconvene. Members will be on their way back as they conclude the vote.

At this time I would like to call on the President and Chief Executive Officer of Fitch, Inc., Mr. Stephen W. Joynt.

Welcome, sir.

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

Mr. JOYNT. Thank you, Mr. Chairman. Thank you for inviting me to come participate today.

My name is Steve Joynt, and I am President and CEO of Fitch Ratings.

Ratings are used by a broad mix of investors as a common benchmark to grade the credit risk of various securities. In addition to their ease of use, efficiency and widespread availability, credit ratings are most useful to investors because they allow for reliable comparisons across many diverse investment opportunities.

Credit ratings assess credit accurately in the overwhelming majority of cases. Credit ratings have proven to be a reliable indicator for assessing the likelihood of a securities default possibilities.

I think it is important to note that while the current inquiry into the role of rating agencies has been focused on issues surrounding the ratings of corporate issuers, corporate ratings only represent approximately 10 percent of the total rated universe. Fifty percent or more of Fitch's activities and revenues and ratings come from mortgage-backed and asset-backed securities analysis. New criteria development, original analysis, published research and follow-up surveillance information have support transparency in development of these markets.

Fitch is also very active in rating other markets, such as global financial institutions and the 1.8 trillion U.S. municipal market. Any changes for the rating industry need to consider the impact on these markets as well.

We believe the SEC's review of the rating agencies is a constructive process. As a result of this review, the SEC has already recommended some improvements to our policies and procedures and we are voluntarily implementing them.

Today's hearings may probe several areas regarding the business of rating agencies: regulatory barriers to entry, potential conflicts of interest with issuers and information disclosure. And I would like to briefly comment on each of these.

At Fitch we firmly believe in the power of competition. Fitch's emergence as a global, full-service rating agency capable of competing against Moody's and S&P across all products and market segments has created meaningful competition in the ratings market for the first time in a decade.

Fitch's challenge to the Moody's-S&P monopoly has enhanced innovation, forced transparency in the ratings process, improved service to investors and created much needed price competition.

We also believe that there is a demand for insightful, independent credit research. The NRSRO system is designed appropriately, in our view, to assure that recognized organizations possess the competence to develop accurate and reliable ratings. Without a system to recognize rating organizations for their competence, many important capital adequacy and eligibility investment rules used in financial institutions regulations would be ineffective.

To address concerns regarding potential conflicts of interest and issuer fees, Fitch goes to great efforts to assure that our receipt of fees from issuers does not affect or impair the objectivity of our ratings. Fitch culture emphasizes the importance of integrity and independence as critical foundations of our most important asset, our reputation. Fitch has separate sales and marketing teams that work independently of the analysts that cover the issuers.

Our analyst compensation philosophy reflects quality of effort and individual accomplishment in research and ratings. Individual company fees, revenue production and individual department profitability do not factor in analyst compensation.

Analysts may not own securities in companies that they rate. Fitch does not have an advisory relationships with companies it rates.

Another issue that merits discussion is better disclosure of information. We believe for the most part the credit rating agencies have adequate access to the information they need to form an independent and objective opinion about the creditworthiness of an issuer. Non-public information is provided to the rating agencies as part of the rating process. The nature and level of that information varies widely, by company, industry and even country.

Typically, it is not the value of any particular piece of non-public information that is important to the rating process, but that access to such information and senior management can assist us in forming a qualitative judgment about a company's management and its prospects.

At Fitch, we are working to encourage transparency throughout all sectors of the capital markets. As we found in our recently published study on credit derivatives in the global market, financial reporting and disclosure with respect to areas such as credit derivatives. off-balance-sheet financing and other forms of contingencies varies greatly by sector. Comparability is further obscured by differences in international reporting and accounting standards.

If this type of information is difficult for us to obtain, it is almost impossible for the typical investor. Better disclosure not only leads to more accurate ratings, it creates a more informed investor.

Fitch is an independent global rating agency valued by the credit markets, and we are here today open to all suggestions on how to improve our industry's performance and our performance.

Thank you.

[The prepared statement of Stephen W. Joynt can be found on page 87 in the appendix.]

Chairman BAKER. Thank you, sir.

Our next witness is Mr. James A. Kaitz, President and Chief Executive Officer, Association for Financial Professionals.

Welcome, sir.

STATEMENT OF JAMES A. KAITZ, PRESIDENT AND CEO, ASSOCIATION FOR FINANCIAL PROFESSIONALS

Mr. KAITZ. Thank you, Mr. Chairman.

I am Jim Kaitz, President and CEO of the Association for Financial Professionals, and we thank you for the invitation today.

Chairman BAKER. And I took my best guess on the name. I am sorry. Mr. Kaitz.

Mr. KAITZ. You did a great job. Thank you.

AFP represents 14,000 finance and treasury professionals from over 5,000 organizations throughout the United States. Our members are drawn generally from the Fortune 1000 and the largest of the middle market companies in a wide variety of industries.

Our members are responsible for issuing short-term and long-term debt and investing corporate cash and pension funds for their organizations. They rely on the rating agencies when their companies issue debt and when they make investment decisions. As such, their experience with the rating agencies provides them with an opportunity to form opinions on both the strengths and weaknesses of the agencies.

AFP's members recognize the important role that the SEC and the rating agencies play in ensuring the efficient operation of the capital markets.

In September 2002, we surveyed senior-level corporate practitioners, such as chief financial officers, vice presidents of finance and corporate treasurers, regarding the accuracy and timeliness of credit ratings, the role the SEC should take in regulating the rating agencies, and the impact additional competition may have on the marketplace for ratings information.

In summary, survey respondents expressed concerns about the accuracy and timeliness of credit ratings. Twenty-nine percent of corporate treasury and finance professionals who work for companies with rated debt indicate that their companies' ratings are inaccurate. This is true for companies that have recently been upgraded, as well as for those that have been downgraded.

Respondents from companies that have seen their debt upgraded indicate that the change took place more than six months after the improvement in the company's financials.

Additionally, some respondents from companies that were downgraded report that it took more than six months for their ratings to reflect a deterioration in the company's financial condition.

The survey also found that rating agencies are primarily serving the interests of parties other than investors. Less than one-quarter of treasury and finance professionals believe that ratings most favored the interests of investors. Rather, they believe ratings favored debt issuers, investment banks and commercial banks.

Our members believe that the SEC plays an important role in overseeing the rating agencies. The overwhelming majority of respondents indicate that the SEC should take additional steps in the oversight of the rating agencies.

Currently, there is no clearly defined process for credit agencies to achieve nationally recognized statistical rating organization status. Most respondents believed that the SEC should clarify the procedures it follows to determine whether it will recognize a rating agency as an NRSRO. Granting NRSRO status to other credit-rating agencies would provide additional competition that could result in improved accuracy and timeliness of ratings. Respondents believed that additional competition could increase both the accuracy and timeliness of credit ratings and lead to greater certainty in the assessment of corporate credit risk.

Once the SEC recognizes a rating agency as an NRSRO, there is currently no ongoing process to ensure that the agency's methodologies and procedures continued to be appropriate. Our survey respondents believe that periodic review of the rating agencies is necessary.

In conclusion, AFP believes that our survey results clearly show that the time has come to reexamine the role, function and regulation of credit-rating agencies. We are encouraged by the SEC report delivered to Congress in January and the issues it identified for further examination. Many of those issues are consistent with the findings of our survey. We look forward to reviewing and commenting on the SEC's concept release when it is published.

We are also encouraged by the SEC's recognition of Dominion Bond Rating Service as a fourth nationally recognized statistical rating organization. As I mentioned, our members expect additional competition to improve the accuracy and timeliness of the information provided by rating agencies, providing them with a greater certainty in assessing corporate credit risk.

AFP believes that the credit-rating agencies are vital to the efficient operation of capital markets and is pleased that you have taken the lead in examining these issues. We hope that this hearing will bring to light opportunities to increase competition in the market for credit ratings and improve the quality of the information provided by credit-rating agencies for the benefit of issuers and investors in the securities markets.

Thank you, Mr. Chairman, and I would be pleased to answer any questions you might have.

[The prepared statement of James A. Kaitz can be found on page 95 in the appendix.]

Chairman BAKER. Thank you, Mr. Kaitz.

Our final witness is Mr. Raymond W. McDaniel, President, Moody's Investors Service, Inc.

Welcome, sir.

STATEMENT OF RAYMOND W. MCDANIEL, PRESIDENT, MOODY'S INVESTORS SERVICE, INC.

Mr. MCDANIEL. Thank you, Chairman Baker.

My name is Ray McDaniel. I am the President of Moody's Investors Service. On behalf of my colleagues, I appreciate the opportunity to be here today.

As you know, a large number of companies over the past two years have experienced serious financial difficulties, causing suffering for their employees and sometimes significant losses for the investors in their stocks and bonds.

Attempting to understand, and where appropriate redress the underlying reasons associated with these failings, has been both necessary and beneficial.

Yet it is also important to keep in mind that the economy and financial markets of the United States remain the envy of most of the world.

Moody's is proud of our role as a supporting participant in these markets. Credit ratings help level the playing field for information between borrowers and investors. Ratings improve both transparency and efficiency in debt markets by promoting investor confidence, which in turn allows creditworthy borrowers greater access to capital.

With that perspective in mind, I would like to offer a few comments about our industry and Moody's in particular.

Founded at the beginning of the last century, Moody's is the oldest credit-rating agency in the world. From the start, Moody's has focused on rating debt instruments.

Our long-term debt rating system for public bonds is the heart of our business. We have 21 long-term debt rating categories which provide a relative measure of risk. The probability of default increases with each step down our ratings scale.

Our ratings are reliable predictors of relative creditworthiness. Their predictive content has been demonstrated and consistently confirmed through Moody's publication of annual corporate bond default studies and by third-party academic analysis.

What this means is that, as forward-looking opinions, our ratings have effectively distinguished bonds with higher credit risk from bonds with lower credit risk.

At Moody's, we are committed to providing the highest quality credit assessments available in the global markets. We are committed to continuous learning, both from our successes and our mistakes.

In this spirit, we have undertaken substantial internal initiatives to learn from recent difficulties in the credit markets, as well as in response to potential shortcomings in our own analytical approach and in the broader system of market checks and balances.

Our business model is based primarily on receipt of fees from debt issuers. Issuers are the natural source of rating agency fees for several related reasons, but most importantly for one key attribute demanded of our ratings: that they be freely and widely disseminated to the investing public.

Ratings are critical because they condense and transmit a great deal of credit information about issuers and because they do so for the equal benefit of all investors, publicly and promptly.

We recognize that being paid by issuers creates potential conflict of interest. Moody's has taken strict measures to avoid conflicts. As a corporation, for example, Moody's does not offer investment products, nor do we buy, sell or recommend securities. Within our ratings practice, committees, rather than individual analysts, assign Moody's ratings. Analysts are neither compensated based upon the revenues associated with the companies that they analyze, nor are they permitted to hold or trade the securities in their areas of primary analytical responsibility.

Over time, the use of our ratings has been adopted by numerous capital market participants for multiple and sometimes conflicting objectives. For example, issuers use our ratings because many investors demand ratings on debt issues.

Not surprisingly, issuers would like the highest possible plausible ratings and greater control over the rating process. Large institutional investors often use our ratings in their portfolio composition and governance guidelines. Generally, these investors prefer stability in the ratings on securities that they own.

Finally, global governmental authorities have incorporated ratings into banking, insurance, securities and other regulations to limit risk in financial institutions for the dual purposes of promoting investor protection and improving financial market stability.

Because each group has different objectives in using ratings, the performance or quality of ratings has been subjected to multiple assessment processes. In some cases, those assessments are incompatible with Moody's goal of leveling the information playing field.

Let me briefly turn to the degree of competition within the industry. We are confident of our ability to compete in diverse competitive environments, if competing successfully is driven by who offers the most reliably predictive credit opinions.

That form of competition requires diverse, independent opinions. As such, we urge that any new framework not inadvertently encourage competition based on forced harmonization or reduced standards.

Lastly, we believe that in examining ratings quality and rating-agency performance, two essential principles must be kept in mind.

First, ratings at their core must be independently formed opinions. They must capably predict bond issuers' future creditworthiness, which means that the rating agencies must be motivated to act independently of each other, of governments and of issuers and their agents to reach the highest standards, not the most popular or most convenient standards.

And second, rating agencies must disseminate ratings broadly and promptly to all of the investing public. Without this attribute, ratings would cease to be a public good. They would become a tool for the few and would further tilt the playing field for information.

Only by preserving these principles can ratings continue to fulfill the larger public values of transparency and investment protection that the marketplace, regulatory authorities and lawmakers expect of us.

Moody's greatly appreciates the subcommittee's invitation to participate in this important panel discussion, and I look forward to answering any questions that you might have.

Thank you.

[The prepared statement of Raymond W. McDaniel can be found on page 123 in the appendix.]

Chairman BAKER. Thank you, Mr. McDaniel.

To Moody's, especially, Mr. McDaniel, I want to express the view that the committee's work is not about any particular company's performance in light of the past 36 months of market disappointments. But rather an obligation to examine the structure and question on periodic basis, whether there are alterations that are warranted or significant structures that would be justified in light of the past pass performance.

There have been issues raised, for example, not with Moody's, that a rating agency might perform for as much as a $150,000 fee, a corporate governance examination to tell the corporate management how they can better improve their methods of operations in order to presumably enhance their ratings. It would be difficult to see someone pay such a fee, and then not have a subsequent enhancement in the rating result, otherwise the recommendations seem to be without merit. Just that one is an example.

We could go to other issues where a rating agency executive could serve on a broad of a company which they might be rating.

When we went through the Sarbanes-Oxley debate, much was made to do about the relationship of analysts with investment bankers with clients and that there needed to be more separation or at least disclosure where separation was not deemed advisable of those relationships; transparency.

It may be okay to do business with someone for a fee outside your principle public responsibility, as long as the individuals who rely on that information are made aware of the relationship and make their own judgments about the quality of that review. I think that is fine.

And I am not suggesting that we need to have dramatic new regulatory structures, but given where we are today, in light of some of the comments made by those here on the panel and other information brought to the committee's attention, it would seem some modifications.

For example, a clear-cut guideline by the SEC as what constitutes the approval process within a fixed period of time in which you would either get approval or not get approval as a designated rating organization.

A clear-cut set of standards for the SEC in oversight of your activities to ensure that Moody's high standards of conduct are being attained by all others. Finally, a clear-cut process by which, if one fails to perform to that standard, one could be de-designated or undesignated. Would those kinds of principle constructs present any operational concern to an organization, such as Moody's?

Mr. McDANIEL. With respect to the general nature of your question and transparency and disclosure, Moody's could not agree more strongly that disclosure and transparency of information is critical to the sound operation of our financial markets.

We are a consumer of good information, as much as we are a provider of good information. And in that respect, we absolutely would support any efforts to improve transparency not only in the markets, but in our own industry. That is something that is very easy for us as a firm to get behind.

With respect to two of your specific comments, I should just say that Moody's does not offer any corporate governance fee-based service, nor do we have any of our executives sit on the boards of any rated companies.

Chairman BAKER. To that end, let's assume for the moment that members of the committee would find some generalized package not to be necessarily advisable, in light of the rating agency's performance over past years, what about the flip side? What would be the negative to a company with the stature and market share of Moody's in simply not having an SEC impromptu on the front bumper of the corporate automobile.

I do not believe neither S&P nor Moody's needs that designation to maintain its market position and may, then, obviate the need for all these standards relative to entry, oversight and decommissioning because the market would do that between the two. Or is there a third position that you proffer as being more appropriate?

Mr. McDANIEL. Moody's had a very strong position in the market prior to 1975 and prior to the introduction of what was the more rapid acceleration of the use of the NRSRO designation in regulations and legislation. And we would certainly expect that we would be able to compete effectively if that designation were removed. In fact, we have a similar position elsewhere around the world where the NRSRO designation does not play a role in——

Chairman BAKER. In your opinion, would such a determination be to the public's disinterest in any way?

Mr. McDANIEL. For a number of years, Moody's observed that there were risks of incorporating ratings and regulation. More recently, however, I think we have taken a pragmatic view that the concept of or the interaction of regulation with the rating agency industry as a practical matter, has become very broad and deep and it would be difficult to reverse that process. We feel that we can perform a valuable public service and compete effectively regardless of the existence or nonexistence of this designation.

Chairman BAKER. Thank you.

My time has expired.

Mr. Kanjorski?

Mr. KANJORSKI. I just want to correct something. Mr. Alexander is the Chairman of Moody's?

Mr. McDANIEL. Mr. Alexander, Cliff Alexander is the Chairman of the Board of Moody's Corporation currently, that is Moody's Investors Service parent company, yes.

Mr. KANJORSKI. Well, didn't he serve as a director of MCI from 1981 to 1998 and on WorldCom from 1998 until June of 2001?

Mr. McDANIEL. I do not know the dates specifically, but he did serve on the board of MCI, and then of WorldCom.

Mr. KANJORSKI. Well, didn't you rate those two corporations?

Mr. McDANIEL. Yes, we did.

Mr. KANJORSKI. Well, isn't that in conflict to what you just testified that your officials and officers are not allowed to serve on boards?

Mr. McDANIEL. He is nonexecutive Chairman of our Board——

Mr. KANJORSKI. So Board of Directors Chairman——

Mr. McDANIEL. Yes. I am sorry. If I either misspoke or——

Mr. KANJORSKI. Well, he has sort of an interest, so——

Mr. McDANIEL. He is the nonexecutive Chairman of——

Mr. KANJORSKI. Chairman?

Mr. McDANIEL. ——Moody's corporation. Yes. Absolutely.

Mr. KANJORSKI. I would imagine that he is a major stockholder of Moody's.

Mr. McDANIEL. I do not know that.

Mr. KANJORSKI. Okay. So you are giving a very limited qualification. Those in direct line authority are not allowed to serve on boards of corporations that are rated.

Mr. MCDANIEL. The management and executives of Moody's Investor Service and Moody's Corporation did not serve on the boards of any rated companies. We do have members of the board of——

Mr. KANJORSKI. But Directors and Chairman of the Board of Directors are allowed to.

Mr. MCDANIEL. Yes.

Mr. KANJORSKI. And you make a distinction.

Mr. MCDANIEL. Yes.

Mr. KANJORSKI. Okay.

Mr. Egan, did you rate Enron or WorldCom or any of the failed corporations in your organization?

Mr. EGAN. Yes, we did.

Mr. KANJORSKI. Okay. Do you think that some of the questions should have been asked by Moody's and other rating organizations of these corporations? Should they have known the answers that would have indicated that they should not have had the ratings that they had immediately prior to bankruptcy? What did your organization rate Enron and WorldCom, et cetera? At what time did you change your ratings relative to when Moody's changed their ratings?

Mr. EGAN. It is a part of the written testimony that I provided. Let me just refer to it.

We started downgrading Enron in January 27th of 2001. Okay?

Mr. KANJORSKI. About six months before bankruptcy.

Mr. EGAN. That is correct, yes.

And then, you can see in the testimony our other negative actions on Enron.

Mr. KANJORSKI. Okay.

Mr. EGAN. WorldCom is the same sort of thing.

Mr. KANJORSKI. Was that based on the fact that your examiners or raters asked certain questions that indicated there were offshore transactions that you felt were risky toward the viability of the organization?

Mr. EGAN. We rely on information in the public domain. In fact, we encourage companies not to give us any information that is not public.

Mr. KANJORSKI. You mean without asking the questions of the company you came to this conclusion?

Mr. EGAN. That is correct. There is enough information out there to perform the analysis.

Mr. KANJORSKI. Because Mr. Egan did not attack Moody's directly because you are on the same panel, let me throw out the question: Why did you operate only within a week of bankruptcy to find out what they found out six months before?

Mr. MCDANIEL. The actions that Moody's took with respect to Enron were based on all the information that we were able to gather both publicly and privately on Enron.

Mr. KANJORSKI. So you had the information of the offshore transaction?

Mr. MCDANIEL. I am sorry?

Mr. KANJORSKI. You knew about all the offshore transactions, the off-balance sheet transactions?

Mr. MCDANIEL. No, absolutely not. We did not know about all of those. We knew about a very small handful of them.

Mr. KANJORSKI. So Mr. Egan's people, assuming they only knew what you knew, made a six-month perception that there was a problem here, six months ahead of when you were able to do it.

But the question that we are faced with is we are trying to protect investors. How is he did not ask these questions. You were not aware that they were offshore transactions? Some of them were actually disclosed, if I recall, in the statements' footnotes.

Mr. MCDANIEL. Yes, we did have information on a handful of offshore transactions, that is correct.

Mr. KANJORSKI. Well, didn't you follow through what they were, what was the nature of them, how large were they, why were they there? Didn't that send up any signal that they were putting debt off the books?

Mr. MCDANIEL. The scope of fraud with Enron was unprecedented. And we asked many questions over the course of the rating relationship with Enron to try and have the best possible understanding of that company's credit worthiness.

However, there were multi-billion dollars worth of transactions and assets off the balance sheet which were not revealed.

Mr. KANJORSKI. I understand all that. But what we are trying to find is a mechanism here of how to find out, get transparency of those things, so that the information is related to the investor.

It seems to me you are telling us that, under the existing ways of what rating agencies are doing, they are not going to find this fraud, and they are not going to find this misinformation that is being given to the investor and the public and everyone else in the marketplace. So then you seem to be telling me that we have a very serious problem here that we do not have a functioning credit-rating system.

Mr. MCDANIEL. In hindsight, Congressman, we could have done a better job——

Mr. KANJORSKI. I know, but that is what the accountants said. What do we have to fix?

You heard my opening statement. I do not want to clutter up the marketplace with anymore regulations that are absolutely necessary to get to positive ends. I mean, we can have the SEC come in here with books of regulations that by the time—as a matter of fact—that will limit the business because nobody will be able to compete cause they will not be able to spend the money to conform to the regulations, and then we will really have a monopoly.

Forgetting all of that—and we do not want to do that—how do we advise the public and the marketplace of scurrilous activity like this? For example, let's forget Enron for a moment. Did you rate HealthSouth?

Mr. MCDANIEL. Yes, we did.

Mr. KANJORSKI. What was it rated at?

Mr. MCDANIEL. It has been a junk bond rated credit for three years.

Mr. KANJORSKI. Okay. Now why was it rated that way?

Mr. McDANIEL. Because our analysis of the fundamentals of that company indicated that it was a relatively weak company.

Mr. KANJORSKI. Right. And one of the things would have been, maybe, the CEO's income and residence and yachts and airplanes may exceed what he should be getting, and then maybe the board is not really a board.

All of these things are what analysts should be looking at in making the ratings. Obviously, you got the bell to ring over there. You saw something was wrong and you notified the investor. It would be interesting to see how many people listen to your rating and got out in time to save their money.

Chairman BAKER. Will the gentleman yield on that point?

Mr. KANJORSKI. Sure.

Chairman BAKER. I would just help in the cause here.

What troubles me is that we were very upset with the conduct of the analysts who were supposed to be advising the broader market. But in this case, rating agencies have a level of access to data which even the analysts do not have. From my uninformed position, it would appear that the rating agencies should be out ahead of the professional analysts. Did the gentleman know that?

Mr. McDANIEL. Yes.

Mr. KANJORSKI. You are in the same position, as I see it, as the auditor. You can ask any question. They must have the fear of God of you, and the CEO is not going to give you misinformation that is going to kick his bond ratings and other ratings down significantly. So it would seem to me he is going to respond or else the response is going to indicate that there is some fraud going on, something is being misstated here. It should become apparent.

All I would like to correct is to fill that vacuum. I probably would like the industry to make a self-analysis. What happened? Why? Where did the vacuums occur? What responsible actions should the Congress or the SEC also take to make sure it does not happen again in the future so that we have a better market?

I say that because, quite frankly, I am so impressed with the fact that we are making so much out of 10 or 15 major failures. A lot of money was lost. But, there are the thousands and thousands of good companies, good executives, and good people that are out there. I cannot over emphasize that point.

We are just talking about problems in the margins, more than two standard deviations from the norm. We are way out here. But still we cannot allow hundreds of billions of dollars to be lost fraudulently or by misrepresentation that either the accountants, the rating agencies, the analysts, or somebody else has to be out there picking up.

I come to the question Dr. White proposed. He said that we had two alternatives: We can do it in-house or we can enlarge the number of recognized entities that can perform this function and try and agitate some competition out in the field. Are you suggesting a government-sponsored enterprise to perform ratings?

Mr. WHITE. Absolutely not, Congressman. The basic choices I laid out were essentially the position that Moody's held until a few years ago. If you look at their comments to the SEC back at the 1997——

Mr. KANJORSKI. What did they do a few years ago that changed them? In your estimation, what made them lose the right——

Mr. WHITE. I do not know. And I must confess, I was distressed to hear Mr. McDaniel's statement. I fear that this is a bargain with the devil and that you [Mr. McDaniel] are going to regret it when you find SEC regulations coming down on top of you. I think that this is a mistake.

I think the clean market-oriented result is to get the regulators out of delegating, have them do their jobs, make their own judgments about the safety of, for example, corporate bonds in bank portfolios——

Mr. KANJORSKI. But when you were talking about the regulators——

Mr. WHITE. ——and then the capital markets can make their own decisions.

Mr. KANJORSKI. But when you were talking about the regulators, Dr. White, you are talking about the SEC as being one major regulator?

Mr. WHITE. That is right.

Mr. KANJORSKI. And this Congress refused to appropriate sufficient funds for them to hire the personnel to do the job. I say in the last three years since the peak of the bubble, thank God we had the private market to self regulate. I mean, those people at the SEC were inundated. What were they doing, one audit every five years of major corporations?

When we have the political swings and the philosophical swings in this country there is a tendency if you want to avoid regulations you can repeal them. But if it is not politically acceptable or if you do not want to do it, just starve the agency that has the responsibility and you have accomplished the same thing. And we did starve the SEC.

Mr. WHITE. Congressman, I could not agree with you more and I think that was a big mistake. Where regulation is needed, the regulators should have the funds and the resources to do the job.

Here is one area, though, where I think we could pull back and let the financial markets make their own decisions. We would get more innovation, more new ideas, and we would not have to worry about, "Is the SEC doing the right thing or the wrong thing with respect to the NRSRO."

Mr. KANJORSKI. Accomplishing that by taken a designation away as a nationally recognized statistical rating organization.

Mr. WHITE. That is right, get rid of the category. But it does mean you have to get the other regulators, including the SEC to make their own judgments——

Mr. KANJORSKI. But then we would have to back up and change a lot of prior legislation that used that standard.

Mr. WHITE. It is really worth doing. You would not be holding this hearing today in that kind of world.

Mr. KANJORSKI. How about if we have a Texas cowboy—and I hate to use that expression——

[Laughter.]

But what if we have a Texas cowboy rating agency that comes along and says, you know, "You hire us for $1 million, and you just may get the best rating you have ever heard of."

Mr. WHITE. And very quickly the markets—if you do not have that regulatory overlay, the markets will figure out, "This guy's ratings ain't worth the paper they are written on. We will pay no attention to this guy's ratings." And very quickly other companies will realize they do not get anything by paying this guy whatever he is asking.

Mr. KANJORSKI. After several years. But up until that time, what would happen?

Mr. WHITE. Oh, I think it will be quicker than that.

Chairman BAKER. If I can, recognize Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman.

Mr. Joynt, in your prepared testimony you talk about addressing concerns raised about conflicts of interest posed when rating agencies offer ratings advisory services. And according to your testimony, I understand that you have already decided to stop providing this service to some issuers and are contemplating doing away with it altogether. Is that correct?

Mr. JOYNT. It is. But it is sort of an easy concession because we just started doing rating assessments last June, and we had only completed three. So we did not have an extensive practice at all. And so what we have decided to do for now, while it is being looked into, is not accept any new proposals in the U.S., at least for any rating assessment services, and consider whether they should be done by separate analysts, nothing to do with our rating analysts.

Mr. OXLEY. And after three examples, what changed your mind?

Mr. JOYNT. Only the outside spotlight on that practice coming from the SEC's review and thinking about it; not a concern of our own internally.

Mr. OXLEY. I see.

Mr. Root and Mr. McDaniel, what is the status in that particular issue with Dominion and Moody's? Do you offer similar services, and have you determined whether you wish to continue those?

Mr. ROOT. At Dominion, we do not offer those services. Our revenue stream is strictly from the rating of institutions and the research that we provide.

Mr. MCDANIEL. We do offer the service called the rating assessment service. It constitutes less than 1 percent of our annual revenues. I would expect, even if we continue it, that it would continue to represent 1 percent or less of our total revenues. And we do it as an accommodation for companies that are contemplating major transactions, acquisitions or mergers or something of that sort. And are looking for some idea of what the consequences of those activities might be on the credit rating.

We frankly would prefer to provide informal feedback. It is less time consuming. It is a process that does not carry some of the issues that, I think, concern the SEC and other authorities that have looked into the business, and we do encourage that.

Mr. OXLEY. Informal meaning, noncompensated?

Mr. MCDANIEL. Yes, exactly, noncompensated.

Mr. OXLEY. Do other members of the panel have any opinions on the conflict of potential conflict of interest in this particular service.

Mr. WHITE. Congressman, it cannot be a completely black box. Suppose a company needs to know, "Now, if I do X, what are the consequences going to be?" The answer just cannot be, "Well, we cannot tell you, just go ahead and do it, and then we will tell you." That is just not a feasible way to proceed. I am very sympathetic to this process. But you know, I am not sympathetic to the whole, larger structure.

Mr. OXLEY. So you like what Mr. McDaniel's said in terms of the informal aspect to it?

Mr. WHITE. Whether it is formal or informal is not important. It cannot be a black box.

Mr. OXLEY. Now, Mr. Chairman, I could raise a question, and I apologize for this because Ms. Nazareth, our first panelist, in her testimony this morning talked about some issues regarding the potential changes in regulation and how this whole concept is treated at the SEC. And she made the comment—and I made a note at the time, and then we had to go vote and I did not get a chance to ask her.

I am kind of paraphrasing this, but she indicated that there were some First Amendment issues raised by the ratings agencies—and I see the professor shaking his head—could you help me on that? What First Amendment issues are out there and how are they raised.

Mr. WHITE. Sorry, I am not a lawyer. I do not practice law without a license, especially in this August body——

Mr. OXLEY. We give you a dispensation here.

Mr. WHITE. Well, thank you.

I think the representatives of the agencies would be in a better position to be able to explain.

My understanding is that they have described themselves as publishers. They are publishing opinions and are thereby covered by the First Amendment, in terms of commercial speech.

Mr. MCDANIEL. Chairman Oxley, I would be happy to add. I agree with Professor White. The basis for the First Amendment comments that Ms. Nazareth made, I believe relate to the fact that we are publishers of opinions, and our opinions are released to the general public in the form of ratings and press releases explaining the ratings. And it is not just simply an assertion on our part, there is case law history that supports that.

Mr. OXLEY. Yes?

Mr. EGAN. In our view, the First Amendment has provided an ideal cover for the major rating firms to take anti-competitive behavior. They were sued by two municipal issuers in the early 1990s when in Moody's case, they were not retained by the issuer and they issued a punishment rating. The issuers sued Moody's. And Moody's said: "This is our opinion. I am sorry we did not have enough information, we had to issue a very low rating." The fact is, they were protecting the monopoly.

Mr. OXLEY. And that defense was a First Amendment defense?

Mr. EGAN. Exactly.

Mr. OXLEY. And that was the case that you referred to.

Mr. EGAN. That is what I was referring to, yes.

Mr. OXLEY. Was that the case—I am sorry—Mr.—was that the case you referred to?

Mr. MCDANIEL. Well, I am not sure if I am talking about the same case as Mr. Egan. We have never issued a punishment rating. We would never put anything into market other than our best possible opinion. It may be right, it may be wrong, but it is our best possible opinion.

And we have had cases where issuers have not wanted us to publish opinions. And in a particular case, one in Colorado is one I would be referring to, an issuer did sue us for assigning a rating on an unsolicited basis. And we had a successful First Amendment defense to that suit.

Mr. OXLEY. Mr. Egan, is it your understanding that that case is a controlling authority in that area?

Mr. EGAN. I think it was—well, I do not know.

Mr. OXLEY. Mr. Chairman, I would ask unanimous consent, perhaps, that Mr. Egan could supply us with some of that information in writing.

Mr. EGAN. Yes. There are some articles in Wall Street Journal in the mid-90s about the two municipal issuers that did sue Moody's for the punishment ratings——

Mr. OXLEY. And for balance in if I may suggest we ask Mr. McDaniel for the same information to have their—that would be helpful, I think, for staff and the members to better understand that whole First Amendment issue.

Mr. EGAN. Yes.

Mr. OXLEY. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Shays?

Mr. SHAYS. Thank you, Mr. Chairman, again, for holding this hearing.

And thank you to the witnesses.

When bad things happen it is easy to, with hindsight, obviously to cast dispersions, and I do not want to do that, but I am interested, with hindsight, how people reacted. And I found Ms. Nazareth's response is frankly, you know, not alarming, but very disappointing.

And I also want to say, you know, since I have been in college, Moody's and Standards & Poors, you know, I just put them way up there, but I have to say, I also put Enron up pretty high, too. And for me, what happened in Enron, was a wake-up call. I want to know if we are waking up.

So let me ask you, first, Mr. McDaniel, what was your reaction when you learned about what happened at Enron?

Mr. MCDANIEL. The Enron situation was, I would agree, indeed a wake-up call not just for Moody's, but for the market generally. And we took a number of steps in response to the collapse of Enron, as well as some of the other corporate collapses that have followed over the last 18 months or so.

We began publishing liquidity risks assessments which focused on the short-term liquidity position of the firms that we rate. We conducted a comprehensive rating trigger survey, both in the United States and in Europe asking companies specifically whether they had elements in financial contracts that would cause posting of collateral or cash calls in the event that rating fell below a certain level. And we found that there were a large number of those and a large number of those that were not otherwise disclosed.

We created two regional chief credit officer positions for our corporate ratings; one in the United States and one in Europe. Most importantly, though, we began what we call a specialist initiative or an enhanced analysis initiative where we have been hiring accountants, off-balance sheet risk transfer specialists and corporate governance specialists to both broaden and deepen the scope of our rating analysis.

Mr. SHAYS. Let me ask you, though, in terms of your own state of mind, was this a shock to you?

Mr. MCDANIEL. Yes.

Mr. SHAYS. Were you embarrassed that Moody's was so high on this company for, you know, until death do us part?

Mr. MCDANIEL. I want to be careful in answering because we were not high on the company. We had rated it in our lowest investment grade category.

Mr. SHAYS. Yes, but your lowest investment rating is still—I mean, was it that in the standard of one to 20-something, it is still pretty high up there, right?

Mr. MCDANIEL. Yes. Well, it is in the middle.

Mr. SHAYS. But it clearly—you mean it is like a 10 or is it more like a four? I mean, in terms of your rating scale.

Mr. MCDANIEL. It is in the middle. A BAA rating is—there are three rating categories above it and three rating categories below it. So it is a rating indicating that we do believe it is investment grade and, as we publish in our definitions, contains——

Mr. SHAYS. Do you have people that are totally focused on Enron or is your business so big that you just—I mean, do you have people dedicated to just looking at Enron?

Mr. MCDANIEL. We never had a single individual dedicated to Enron.

Mr. SHAYS. When VIVA, a Germany company, wanted to unite with Enron, and another accounting firm was called in, like two years before Enron took a nose dive, I think, the U.S. accounting firm said there is $2 billion of undisclosed liability. Why didn't that impact Moody's determination of this company?

Mr. MCDANIEL. I apologize, Congressman, but I do not have those specific facts at hand. I would be happy to, you know, provide them for you afterward.

Mr. SHAYS. Help me out, Mr. White. I would also say I do not often get someone from the Stern's school, where I graduated in economics, but never had you, sir, only cause I was there 30 years ago.

I am intrigued by the fact that evidently there are no standards, no formal requirements in which to joint this select group of nationally recognized statistical rating organizations—and it is done in private—how someone—to know how they qualify.

Mr. WHITE. Congressman, I think that is an excellent question. I do not have a good answer for you, and I was not happy with Ms. Nazareth's answers either. Basically it is body language. If you look at the 1997 proposed criteria, the SEC said, "We have been sort of using this criteria for our no-action letters. We might as well put them out and see what the reaction is." So——

Mr. SHAYS. But it strikes me, how are you able to determine if you do not have—I mean, it is almost like what you would be taught in ninth grade or earlier that you got to have some kind of standards and people have to meet these standards and then you know. I mean, it is like I have an impression that the business community is pretty smart. And that when people criticize politicians, you know, we sometimes take hits. But I am begging to think the business community almost makes politicians look brilliant.

Because, seriously, I mean—I am almost sounding very self-righteous here—but someone on this panel tell me why you do not need, first, if you disagree and you think there are standards, and then tell me why we do not need standards. One person here tell me why.

Mr. WHITE. Again, Congressman, if we are going to have the NRSRO category, then we need standards. They need to be transparent. And they need to be applied equally to incumbents, as well as to entrants. They should be performance standards, not input standards the way the 1997 criteria were stated.

Mr. SHAYS. Does anyone on this panel disagree with that, with what Mr. White said? Anybody? I am going to infer that all of you agree with that.

Chairman BAKER. Mr. Shays, if I can seize upon that moment? We are going to come back for another round. And Mr. Inslee's arrived, and since he has not had an opportunity to ask, I would like—Mr. Inslee do you have questions at this time?

Well, that makes it easy. Well, we will start a second round here. Just briefly; following on Mr. Shays' point, I may suggest in writing, to each of you, just to respond to us on some points that were raised during the course of the hearing today, one of which will be the Shays' observation about no objection to the generalized points he made.

Mr. Kanjorski had a few points he wanted to get on that record that, I think, we would include in that document.

And I want to find out, basically, two generalized approaches. If we maintain the current system, from each of you, what do you see as the minimal steps necessary to have a functioning system treating all participants equally that is transparent and understood by the market without getting into day-to-day regulation of your business, whether you engage in rating and consulting with the same client or not? I am not prejudging any activity. But if you do it, how do you disclose that?

Whether officers and officials of the rating agency serve in a board capacity of a rate enterprise? Fine. But if you do it, how do you disclose that in a broad context, not as narrowly defined today?

And further, the comment as to whether or not you deem it advisable to maintain the current system, meaning the bumper sticker on the front of the corporate vehicle, as a necessity for the flow of information to the capital markets and to the public? And it will be cleaned up where it makes more sense than that.

But just indicate to you that I hope we have several members of the committee sign on and we may very well send the same letter to the appropriate SEC officials for comments, which will enable us to kind of get to closure on this. I do not want to have this hearing raise a bunch of issues, and then not subsequently take some steps to bring us to resolution. So I think Mr. Shays' question is a good starting point. And Mr. Kanjorski and others who are interested will engage in that activity and get it out forthwith.

Mr. Kanjorski, I believe you had some more questions.

Mr. KANJORSKI. Yes. I am going to take advantage of my position and the quality of our panel. I direct this question to everybody on the panel, but primarily the representatives of the major rating agencies, including Mr. Egan.

A number of months ago, probably less than six, probably more than three—I cannot quite yet place it in, I had an extensive meeting with a very highly appointed official of the present Administration who has a great deal to do with economics, financial markets, et cetera. I will leave it at that.

In the course of that meeting, in analyzing the macroeconomic condition of the United States and the world, he indicated to me that he had great worries that there were perhaps more than 200 corporations that had difficulties yet undisclosed and unknown that he saw coming down the road. Most recently, HealthSouth fell into that category.

Now, those of you who are in the rating agencies, are you giving the investors a macroeconomic picture of that possible future? Are you giving the public any awareness that could help us out? Do we have to go through every company that is on all the exchanges to try and come up with the identification of who those companies may be?

The thing that worries me, since I do not either have the time nor the inclination to examine every publicly traded corporation to try and identify those 200, is would they, the problem companies clearly, in your ratings, show up so that a simpleton, such as myself, could look at those ratings and say, "Here are the 200 of them that are in trouble, and that we can anticipate problems that will have a definite impact on the economy."

Mr. EGAN. Yes. We maintain a list where we compare our ratings against Standard & Poors ratings, and there are a number of companies where we are significantly lower. And by the way, we are in the business of protecting investors, period. So we want to get to the truth quickly.

We measure ourselves on what is called hits and misses. That is, if there is convergence where S&P or Moody's move toward our ratings, that is considered a hit. If they move away, it is a miss. Last year, there were 440 hits and about 19 misses; year before, about the same. So we constantly keep track of it.

And we do see a number of huge problems out there. Probably the biggest one that has not been dealt with is the pension fund and health care liabilities. A lot of corporations are not treating it as real liabilities. They are hoping that the market is going to zip up 100 percent over the next two years. We tell our clients or identify where there are huge problems. Many times we get into difficulty because our ratings are so far apart from the majors. And the Enron, the WorldCom, the Global Crossing has given us the leeway with our clients to maintain that huge discrepancy.

Chairman BAKER. Would the gentleman yield?

How many companies do you rate?

Mr. EGAN. Approximately 800.

Chairman BAKER. And how many does S&P rate?

Mr. EGAN. In the corporate area, significantly more——

Chairman BAKER. Including bond market and everything. The scope of their full authority, what do they do in an annual period of time?

Or if I can, I will jump Mr. McDaniel. What is your rating responsibility? I am trying to get some sense of scale here.

Mr. MCDANIEL. Almost 6,000 corporate and structured finance—corporate entities and structured financed vehicles, about 16,000 public finance issuers.

Chairman BAKER. So a total of 22,000 obligations versus——

Mr. EGAN. Eight hundred, maybe 900. But we focus on the corporate.

Chairman BAKER. I understand.

I thank the gentleman for yielding.

Mr. KANJORSKI. Mr. McDaniel, do you have any macro picture that you could make available? In other words, I am trying to determine whether this remark was off the top of his head or is this really a serious matter where we have 200 major corporations that may be in significant difficulty out there that the public is not aware of?

Mr. MCDANIEL. Well, we rate slightly over 1,000 corporations in the junk category, speculative grade, below investment grade. I think your question is going more to, "Are we providing a macroeconomic framing around that?" And we do do that through our economics department, and that is published both on our Web site and through major media outlets, and that includes economic analysis and default probability analysis and forecasting.

Mr. KANJORSKI. Is this information readily made available? It was rather shocking to me when he told me that statement, but maybe it just means I am under read.

Mr. MCDANIEL. It is available on our Web site. Our economists would speak to the major news outlets. I do not know how broadly it might be consumed. I have not looked at the Web sites hits on that in some time.

Mr. KANJORSKI. Mr. Joynt, do you have a comment on that?

Mr. JOYNT. I have a couple of comments. One, I think, also Fitch does industry surveys describing whole industries and how they would be affected by economic development. So if we expect in the next several years deteriorating economic conditions globally or in the U.S., then you could first look at those industry pieces to try to identify companies that might be problematic; the airlines industry today. So I could not have maybe told you the amount of problems they would have had a year ago, but in light of what has happened in the world today and with the war, then they are having significant problems and they are quickly deteriorating.

Also, by looking at industry studies you can look at groups of companies that are competing against each and how they are leveraged. And so there are a significant number of companies, as Mr. McDaniel has pointed out, that Moody's rates 1,000 that are non-investment grade, many of which would be highly leveraged, and so those would be candidates for a more rapid deterioration.

Is that helpful?

Mr. KANJORSKI. Yes, it is helpful.

I am sitting back here and listening to a lot of analysis coming out of government, coming out of industry, coming out of academia, and it does not seem to me that there are many people out there discussing real potential economic risks.

Some people call it meltdown, others have termed it something else. Everybody can use their own imagination to describe it. But it is something that we must explore. For example, about two or three months ago, the Japanese Government went to the bond market and they wanted to sell Japanese bonds and there were no buyers. Is that correct?

And I do not know how they were rated.

Now, just around two weeks ago, the Deutsche Bank formally notified the German government that under present conditions, if they continue as they might, the German banking system might become insolvent.

So now we have the second-largest economy in the world unable to sell its bonds; we have the third-largest economy in the world talking about bank insolvency; and we are the first economy in the world and I do not know whether we are in the stage of prosperity or recession. We do not know. I would say, however, we are probably in stagnation, and in the midst of a war.

Additionally, I am hearing hue and cry out there indicating that not only the United States but the world may have some very, very, very serious economic situations. We seem to be only talking about the economic situation of the United States vis-a-vis the 2004 presidential and congressional elections at this point. You know, as long as we can do anything to not address this issue between now and then, we do not want to shake the population up.

And yet, let me go further with this analysis, this discussion, because it did disturb me and does continue to disturb me. It is something I want to take up with my chairman in the not too distant future. The unnamed official then indicated that the problematic period would be 12 to 18 months. We subsequently did talk about an economic meltdown.

We did not just talk about an industry meltdown, such as the airlines, but a global meltdown. I said I was always worried about that problem and I had always wanted to look at that problem. I also estimated at best there would be maybe a one-in-ten chance of that meltdown happening, but he shook his head knowingly. He then said that he thought it was more like a one-in-three chance of that meltdown happening.

Is there any reasonable truth to that analysis?

Mr. EGAN. We would not disagree with that. The problem that we face is when we sound the alarm, and we did on some of the auto companies recently, that we have run into a lot of difficulty. We have sounded the alarm on some major government-sponsored entities and some major bond insurers who have Triple A ratings by our competitors; we think they are far from it.

There are a number of things that can happen that can trigger it and we are very concerned. So we are balancing that high level of concern with protecting investors and really trying to steer them to the safe harbors.

Mr. MCDANIEL. The issues that you are identifying that are macroeconomic level, Congressman, particularly in the situation of Japan and Germany, I think might be more fairly characterized as longer term, chronic problems, rather than acute problems that are likely to have significant deterioration over the next 12 to 18 months. We have a Single A rating on Japanese government bonds, those are the Yen denominated bonds——

Mr. KANJORSKI. Those are the ones they could not sell?

Mr. MCDANIEL. The ones that they sold several months ago, yes, we rate them A-2.

Mr. KANJORSKI. But there were some that they had no buyers?

Mr. MCDANIEL. And the Bank of Japan and governmental authorities may step in and buy the paper.

Mr. KANJORSKI. The real market did not buy those bonds, though you had an "A" rating?

Mr. MCDANIEL. I read the papers, in terms of what the market appetite was for those bonds. You know, we did not have conversations with the Japanese government about what the appetite was for those bonds. But we do hold a Single A rating on the government of Japan for the yen-denominated bonds. That is down from a number of years ago, from Triple A. So we have been moving down on the rating scale for the yen-denominated securities. And, in fact, they are substantially below their dollar-denominated securities.

Chairman BAKER. If I can, Mr. Kanjorski, can I jump to Mr. Shays.

Mr. Shays?

Mr. SHAYS. Mr. Chairman, I want to say, this is an excellent panel. We have just kind of scratched at the surface, though. For instance, Ms. Cummingham, I would like to ask you, the rating agencies are important to you because of law, but do they provide a valuable service to you if the law was not requiring that you use them?

Ms. CUNNINGHAM. They are one of many inputs that go into our decision-making process for the securities that we purchase in the institutional marketplace with funds that we manage. I think that by and large the fixed income marketplace is an institutional marketplace; it is really not a retail marketplace.

If you are going to buy bonds as a retail investor, you would probably buy Treasury securities. So it is not necessarily something you would be utilizing rating agencies for.

On the assessment of the other types of fixed-income securities that are in the marketplace, I think by and large the retail investor is looking to independent adviser services, such as Federated, that utilize the rating agencies as one of the inputs, but certainly not entirety.

Mr. SHAYS. Do you have to use the nationally recognized statistical rating organizations or can you use Mr. Egan's organization?

Ms. CUNNINGHAM. We can use any input that we would like. We are required by law to recognize if a rating is designated from one of the NRSROs.

Mr. SHAYS. So it becomes pretty important that it be from one of the four?

Ms. CUNNINGHAM. It is a hurdle level that is mandated on a regulatory basis if it exists. If it does not exists, we do not have to use them.

Mr. SHAYS. Mr. Egan, would you explain to me why you have worked so hard to be one of these four, now five. What difference does it make to you? You have how many employees?

Mr. EGAN. I think we are up to about 13 right now. We have about 300 institutional clients, mostly institutional investors, some broker dealers. A number of institutions simply will not look at our ratings since we are not an NRSRO. The thought is that if you are any good, you would have the designation.

It is interesting, but I just heard yesterday from a client when they heard about this hearing, they said, "Please, please, do not become an NRSRO because their ratings are no good." In other words, they did not want us to be compensated by the issuers, who—they think that is a fundamental conflict, and we said, "We could not agree with you more." And we are not going to change our business practice. We are going to continue to refuse compensation from the issuers, and just get it from the investors.

So to answer your question, it will broaden our voice in the market.

Chairman BAKER. If the gentleman will yield on a point you asked Ms. Cummingham about, just to make sure that I got it correct. In your earlier testimony you did indicate that the Investment Company Act does require you by law to utilize the NRSROs with regard to money market funds and asset-backed securities.

Is that correct?

Ms. CUNNINGHAM. That is correct.

Chairman BAKER. Okay, thanks. I thank the gentleman for——

Mr. SHAYS. So you only have, basically, four companies to turn to?

Ms. CUNNINGHAM. That is correct, if those ratings exist. If those ratings do not exist for those particular issuers that we are purchasing we can buy non-rated securities.

Mr. SHAYS. Mr. Kaitz observes in his testimony that 29 percent of corporate treasury and finance professionals who work for companies with rated debt, indicated that their companies ratings are inaccurate.

He also states that only 65 percent of the corporate respondents that use credit ratings to make investment decisions believe that the ratings of the companies in which they invest are accurate.

Doesn't this lack of confidence in the accuracy of firms ratings raise concerns about their ability to perform their jobs. And, Mr. Kaitz, would you start and then I want to ask each of you to answer.

Mr. KAITZ. The premise of the survey really was a result of, to your point earlier, Mr. Shays, the debacle with Enron. So this was an outgrowth of our membership, which is a professional organization.

And I think that it was expressed in some of our membership that this was a broader issue, which is why we did this survey. Obviously, the results speak for themselves in terms of the accuracy and the timeliness of those ratings. And interestingly enough, as I pointed out, members revealed that not only with upgrades, but also with downgrades that there was a significant time lag.

So I think the survey speaks for itself that our membership does believe that there are some issues, both in accuracy and timeliness of the rating agencies.

Mr. SHAYS. Before I go to the other panelists, to answer who rates the rating agencies?

Mr. KAITZ. From a——

Mr. SHAYS. From a standpoint of how accurate they are in comparing them? Does Fortune Magazine look at the others?

Mr. KAITZ. To my knowledge there is no one that currently does that.

Mr. SHAYS. I would think that would be a great business to go into.

Mr. EGAN. In fact, the——

Mr. SHAYS. No, I am serious, it would seem to me that if you could start to develop a standard on how accurate these folks are, that you would basically provide a tremendous public service.

I would think an entrepreneur like you, Mr. Egan, would jump on that.

Mr. EGAN. In fact, the Federal Reserve Board of Kansas City just came out with a study, it was published yesterday, and it indicated that there is a lot of stickiness in the investment grade ratings of S&P and Moody's——

Mr. SHAYS. There are a lot of what?

Mr. EGAN. What they call stickiness. In other words, like the Enron case, where the rating was kept too high for too long—same with WorldCom.

And that the other rating agencies, S&P and Moody's moved in, down to our ratings afterwards, an average of about three months or something like that.

But, yes, you are absolutely right. And they went through all of our ratings from when we started in December of 1995. I think I sent to your staff, it just became available yesterday, a copy of that survey.

Mr. SHAYS. I guess that I could kind of change the design of the question that I asked Mr. Kaitz and ask, the four rating agencies, three that have the designation, how are you held accountable?

Mr. MCDANIEL. At Moody's we publish annual default studies——

Mr. SHAYS. Annual what?

Mr. MCDANIEL. Annual default studies. It looks at all of the ratings that we have out in the corporate bond market, and it looks at the defaults that have occurred over the previous year.

I think we have just published our 16th annual default study. That shows whether or not our ratings are predictive. It shows whether or not companies that receive higher ratings default less frequently that companies that receive lower ratings.

Mr. SHAYS. Would that be the standard or should there be some levels in between? A default means bankruptcy, basically?

Mr. MCDANIEL. A failure to pay on an obligation.

Mr. SHAYS. But what, would there be anything that would be in between that that you could also—I mean, I think that is good that you do that, obviously.

So, but that is the extreme, correct?

Mr. McDANIEL. Well, it is an aggregate measure of whether as you move down the rating scale defaults become more frequent or whether there is not a relationship between a lower rating, in increasing degrees, with higher default probability.

Mr. SHAYS. How about, I am sorry, thank you.

Mr. JOYNT. I might just add to that, actually, to address your question, there is also transition studies that are published by Moody's, Standard & Poor's and Fitch, of the movement of ratings among categories, A to A minus, so in addition to the ultimate default probability there is the movements that are studied.

Mr. SHAYS. Okay.

Mr. JOYNT. And Fitch also——

Mr. SHAYS. And the study of the movement suggests what? That you are describing the movement or you are saying we could have called it better here or here?

Mr. JOYNT. No, it is actually looked at in the many ways one would want to look. Does it look like the ratings are moving too quickly—overreactions? Are they moving too slowly? Have they jumped categories? Do they move by one notch at a time?

So, and to come back to your more basic question, which is, who rates the rating agencies? Investors do, all the time.

I think the effectiveness of rating agencies comes from investor scrutiny and the improvements in rating agencies come from investor demands for more research and more background information, not just the published rating alone.

And I think that is who is rating the rating agencies. And I think that is a separate matter from just the NRSRO designation, which I would acknowledge has some bearing and merit on people's usage of ratings, as well.

But not the sole——

Mr. SHAYS. Just to put it on the record.

Mr. ROOT. Yes, I am going to add, you know, our core business is in Canada, and there is no such thing as NRSRO; so, you know, kind of following up on what Steve just said that, you know, who is rating us, who is grading us? It is the marketplace.

Because there is no regulatory designation that gives us the similar type of status, if you will, as we have here. So to the extent——

Mr. SHAYS. So you would argue that you do not need that status?

Mr. ROOT. As long as everybody else did not have it, correct.

Mr. SHAYS. Right.

No, but that is interesting. I think that is a summation for me. I mean, if the others do not have it then let the marketplace—I mean, S&P and Moody's would be way up there, it is just, they are both great companies, they are big, they are large, and it is not like the ratings are enabling the new folks with just 13 employees to jump in and be given that status.

Would you agree with Mr. Egan that maybe you just get rid of it all?

Mr. EGAN. I believe so. What has happened to this point is that there has become a whole infrastructure that has supported the two majors. For example, if an issuer decided not to hire S&P and Moody's, and they hired somebody else, the investment bankers could very well make it difficult for that issuer and discourage the issuer from using those other sources.

It is very—the system has already been set up, it does not work and there are a lot of parties supporting the current system. So maybe—it probably would be better than what is currently, but I do not know if that is the ultimate answer.

Mr. SHAYS. Okay, Mr. White, I am going to just let you finish, I am sorry.

Mr. WHITE. Thank you. I want to give you my reaction to what you have just heard.

Mr. SHAYS. Okay.

Mr. WHITE. First, I did not before and I was derelict as a professor at the NYU Stern School of Business in not commending you for having made a good choice of institutions.

Mr. SHAYS. Yes, you made a good choice in the past.

Mr. WHITE. I have been there for 27 years, so I think we just——

Mr. SHAYS. 1974 is when I graduated.

Mr. WHITE. And I arrived in 1976. But I will make sure our alumni office has you——

Mr. SHAYS. Trust me, they do.

Mr. WHITE. Okay.

As I stated earlier, I believe in a markets-oriented approach; I think that this is the best way to ensure that we get new ideas, innovations, in the whole assessment of corporate health and viability. That is the direction we need to go. But if we going to go in that direction, then we have to realize that this does require a number of financial regulators to cease delegating their judgments to the rating companies. They must make those judgments themselves.

For example, since 1931, bank regulators have been telling banks that the banks must pay attention to the ratings on the bonds that the banks hold in their portfolios. Since 1936, banks have not been permitted to hold bonds that were below investment grade in their portfolios.

The immediate question is: Whose judgment——

Mr. SHAYS. Right.

Mr. WHITE. ——as to investment grade? And that was in limbo until 1975 when the SEC stepped up, to its credit, and said, NRSRO, that will be the category whose judgments should be adhered to.

If you are going to get rid of the NRSRO category, then you have to somehow deal with this issue of what is to prevent the XYZ rating company from coming along, giving out AAA ratings to anybody——

Mr. SHAYS. Very good point.

Mr. WHITE. ——willing to line their pockets?

And the bank regulators can do it. They need to deal with bonds the way they deal with loans: Bonds are just another form of loans. When the bank regulators sent their examiners into a bank, on day one the examiner says, "tell me about your loans." And on day two the examiner should say, "tell me about your bonds."

Moody's, back in 1997, offered similar types of suggestions to the SEC as to how the SEC could substitute its own judgments for its use of NRSRO status. That could be done across the board.

Mr. SHAYS. You took about four minutes to give me a one-second answer, but I got it.

Well, I get the point. In other words, you made your point.

Mr. WHITE. Okay. Thank you, Congressman.

Mr. EGAN. I question whether bank regulators would be able to catch Enron or Worldcom or Genuity. I do not think they have the training, the incentive, the tools to do it. I think to reform the system you need rating firms not to be paid by the issuers, get rid of some of these basic conflicts of interest, that is the first step to reforming it.

Encourage young firms, like ourselves, to have a vibrant, healthy credit analysis industry, as opposed to what we have—this basic partner monopoly, with people sitting on boards and all the other unhealthy aspects.

Chairman BAKER. Okay. Thank you, Mr. Shays.

Mr. SHAYS. Thank you.

Chairman BAKER. I want to thank all of you for your participation in a what was not expected—if anybody had told me that a hearing on transparency in credit reporting agencies would last until 1:30 in the afternoon, I would have had them—well, in any event, I am surprised by the events of the day.

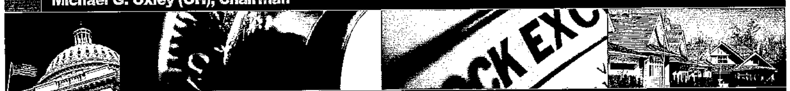
And I do find it very helpful to the committee's work. We will followup with our letter of inquiry. And we look forward to your responses, as timely as possible. We thank you for your participation. And this meeting is adjourned.

[Whereupon, at 1:32 p.m., the subcommittee was adjourned.]

A P P E N D I X

April 2, 2003

House
Committee on Financial Services
Michael G. Oxley (OH), Chairman



News

Opening Statement
Chairman Michael G. Oxley
Committee on Financial Services

Subcommittee on Capital Markets
"Rating the Rating Agencies: the State of Transparency and Competition"
April 2, 2003

Good morning, Mr. Chairman. I want to commend you for holding this important hearing to study the role and function of credit rating agencies in the securities markets. Over the past two years, this Committee has led the way on investor protection, beginning with an examination of Wall Street analysts and continuing with a review of accountants, corporate officers and boards, investment banks, mutual funds, and corporate governance practices generally. Our inquiries resulted in the Sarbanes-Oxley Act and other regulatory reforms. Now, we turn to credit rating agencies.

Sarbanes-Oxley required the SEC to submit to the Committee a report on rating agencies. That report was issued in January. I am pleased that the SEC's top market regulator, Annette Nazareth, is here this morning to discuss its contents. I know that members of this Committee have questions about the Commission's oversight of this industry.

Some commentators have called for greater transparency in the rating process and have raised questions about potential conflicts of interest that arise because agencies collect fees from, and sell other services to, the companies they rate. We have seen so many instances where greater transparency has led to better functioning markets, and more informed investors. The similarities between the potential conflicts of interest presented in this area and those that were addressed in the area of accounting firms in Sarbanes Oxley are impossible to ignore. I look forward to our panelists' views on the need for more disclosure and clarity in the rating process.

Beyond the potential conflicts and the lack of transparency, some have questioned the reliability of the ratings themselves, particularly in light of the rating agencies' failure to warn investors about the impending bankruptcies at Enron, WorldCom, Global Crossing, and other major companies.

There are also concerns regarding the openness of the industry, and whether anticompetitive barriers to entry exist for ratings firms seeking recognition by the SEC. We're all familiar with the accounting scandals which turned the Big Five into the Final Four, and the resulting concerns that have been raised. Somehow, the fact that – until very recently – there were only three SEC-recognized credit rating agencies has not seemed to garner the same level of scrutiny. The Commission has recognized only one new firm in over a decade.

I am concerned that the Commission may have allowed an oligopoly to exist. I hope and expect to hear from the SEC on how they plan to clarify and improve the application process for firms striving to qualify as recognized rating agencies.

Thank you, Chairman Baker, for holding this hearing. Focusing attention on the role of rating agencies, and examining the current levels of disclosure, competition, accuracy, and regulatory oversight in the industry, will surely benefit investors and the market.

STATEMENT OF THE HONORABLE WM. LACY CLAY
Before the
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises

"Rating the Rating Agencies: the State of Transparency and Competition"

Good morning Mr. Chairman and Members of the committee. I am elated that the committee is leaving "no stone unturned" in proposing regulations that will correct various ills throughout the investment and credit spectrum. Today's hearing is yet another example of that.

We have held hearings for the many corporate failings that we witnessed in the last couple of years. In this climate of corporate and individual greed being used as the catalyst for bilking the investing public of their retirements, savings, and other important personal financial goals, there are several other aspects of investments and credit that need scrutiny.

The credit rating agencies have escaped this scrutiny despite their failure to warn investors about the financial straits of companies, including bankruptcies. We have also heard numerous complaints of conflicts of interest and inadequate transparency of its process of recognizing official rating firms.

Rating firms do more than just monitor the credit rating of the individual consumer. Our money market industry depends on the correct and reliable ratings of the credit agencies to monitor the risk of investments held by regulated investment firms.

We must have transparency to understand some of the reasons behind the ratings. Additionally, we must make sure that the rating agencies are completely independent and make their decisions solely on the research gathered in the marketplace. These decisions must not in any way be based on the politics of a parent or controlling business.

We must also examine the abuses of withheld rating, intentional and unsolicited low ratings and lowering the rating of a rival rating service as retaliation for not contracting the business of the rating service.

I look forward to discussing these and other issues during this hearing.

Mr. Chairman, I ask unanimous consent to insert my statement into the record.

April 2, 2003

Statement of the Honorable Rahm Emanuel
U.S. House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Re: Hearing on "Rating the Rating Agencies: The State of Transparency and Competition

I would like to thank Chairman Baker for holding this important hearing on the state of transparency and competition among the credit rating agencies. I also appreciate that our distinguished guests have taken the time to share their views with us on these topics.

As a former investment banker, I am quite familiar with the issues we will cover today. The fundamental goal of our examination of the rating agencies should be to provide investors with the information they need to make informed decisions. The corporate scandals that led to the Sarbanes-Oxley Act taught us that the integrity of the capital markets depends on investors receiving accurate, timely, and transparent information. Many individual investors and pension funds in my home state of Illinois lost millions of dollars due to the Enron and WorldCom collapses. In fact, Illinois' state and municipal pension funds estimate that they lost $107 million alone because of the drop in the value of WorldCom stock. This was on top of the $45 million these pensions lost in the Enron collapse. For example, the Illinois State University Retirement System and Teachers' Retirement System, which invest retirement monies on behalf of hard-working teachers and municipal employees, suffered significant losses as a result of these corporate meltdowns. There was little or no warning to investors from the firms themselves, from Wall Street or from the rating agencies before these firms imploded.

Sarbanes-Oxley and recent SEC actions have addressed the behavior of corporate officers and boards, accountants, investment bankers, research analysts and attorneys. However, credit rating agencies have faced comparably little government scrutiny, despite extensive criticism for failing to warn investors about the impending bankruptcies at major public companies such as those I mentioned earlier. I have also noted the criticism of those stating that the rating agencies have engaged in anticompetitive practices and in activities that raise conflict of interest concerns. Although the SEC has recently shown renewed interest in the rating agencies, the Commission should share some of the blame for its years of inaction in this area. Rating agencies' decisions have a significant impact on the capital markets, and these agencies have a responsibility to provide investors with precise and clear information.

I look forward to seeing the SEC's mid-April report proposing new rules governing the activities of the rating agencies, and I am eager to work with my colleagues and the SEC to ensure that individual investors have accurate and transparent information in order to make informed decisions.

April 2, 2003

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing entitled, "Rating the Rating Agencies: the State of Transparency and Competition"

Thank you, Mr. Chairman, for calling this important hearing to address the current practices of credit ratings agencies. Unfortunately, a Markup of the "Energy Policy Act of 2003" is also taking place in the Energy and Commerce Committee this morning, so I may not be able to attend the majority of today's hearing.

Section 702(b) of the Sarbanes-Oxley Act required the Securities and Exchange Commission (SEC) to study the role and function of credit rating agencies in our securities markets and a report was released in January. At that time, the SEC also announced plans to begin a rule-making process to address the problems uncovered as a result of their inquiry.

I look forward to hearing the opinions of today's witnesses on the SEC investigation and the resulting criticisms of the industry. I think it is fair to say that credit rating agencies have not received the same amount of scrutiny from the SEC or Congress as many other players in the securities industry. Given the system-wide problems uncovered as a result of recent corporate scandals, it is time we take a closer look. Why did they fail to warn investors of the impending bankruptcies at Enron and WorldCom?

Last year, in the Sarbanes-Oxley Act, Congress identified several issues in need of further examination. In particular, I am interested to learn more today regarding the credit reporting agencies' responsibility to investors and recognition of the significant role their decisions play in the securities market. Perhaps more information should be disclosed on how rating decisions are made to ensure that conflicts of interest do not arise when issuers pay for ratings or rating agencies develop additional fee-based services.

Again, I would like to thank Chairman Baker for allowing us this opportunity to learn more about this industry and thank today's witnesses for joining us. I look forward to an informative session.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON RATING THE RATING AGENCIES: THE STATE OF TRANSPARENCY AND COMPETITION

WEDNESDAY, APRIL 2, 2003

Mr. Chairman, for nearly a century rating agencies like Moody's, Standard and Poor's, and Fitch have published their views on the creditworthiness of the issuers of debt securities. The importance of these opinions has grown significantly in recent decades as a result of increases in the number of issues and issuers, the globalization of our financial markets, and the introduction of complex financial products, like asset-backed securities and credit derivatives.

As you know, Mr. Chairman, I have made investor protection one of my top priorities. I believe that strong regulation helps to protect the interests of America's investors. Accordingly, I am pleased that we have worked diligently during the last year to augment the resources available to the Securities and Exchange Commission, enact sweeping reforms of auditing and accounting practices, restore accountability to investment banking and analyst research, and improve the conduct of business executives and corporate boards.

Although rating agencies received some scrutiny after the recent spate of corporate scandals, we have not yet mandated any substantive change in their practices. At hearings before our Committee last year, however, one witness noted that the rating agencies "played a significant role" in Enron's failure. Additionally, a recent Senate investigative report found that the monitoring and review of Enron's finances "fell far below the careful efforts one would have expected from organizations whose ratings hold so much importance." I wholeheartedly agree. Outside of Arthur Andersen, the rating agencies probably had the greatest access to non-public information about Enron's complicated financial arrangements, and they exhibited a disappointing lack of diligence in their coverage of the company.

Furthermore, rating agencies have missed a number of other large-scale financial debacles over the last several decades. They failed to sound appropriate alarms before New York City's debt crisis in 1975 and the Washington Public Power Supply System's default in 1983. They also foundered before First Executive Life's collapse in the early 1990s and Orange County's bankruptcy in 1994. The failure of rating agencies to lower their ratings in these cases ultimately resulted in the loss of billions of dollars for American investors who little understood the true credit risks.

As a result of concerns about the role that rating agencies played in the recent downfalls of Enron, WorldCom and other companies, we called upon the Securities and Exchange Commission to study these issues and report back to us. In reviewing this report, it has become clear to me that while our capital markets and the rating industry have evolved considerably in recent decades the Commission's oversight and regulations in this area have changed little.

Moreover, it disturbs me that the Commission has studied this issue for more than a decade without reaching any firm conclusion. In 1992, for example, then-SEC Commissioner

Richard Roberts first noted that rating agencies -- despite their importance and influence -- remained the only participants in the securities markets without any real regulation. In 1994, the Commission also solicited public comment on the appropriate role of ratings in our federal securities laws and the need to establish formal procedures for recognizing and monitoring the activities of Nationally Recognized Statistical Rating Organizations. This release led to a rule proposal in 1997 that the Commission never finalized.

In releasing its latest rating agency report to the Congress in January, the Commission stated that it would issue within sixty days a concept paper asking questions about rating agency regulation. Sixty days have now passed. It is therefore my expectation that the SEC will publish its concept release as quickly as possible and that it will move with due diligence to finally resolve this issue and publish regulations regarding rating agencies.

Many others in the financial industry share my concerns. A recent survey by the Association for Financial Professionals found that ninety percent of treasury and finance professional believe that the Commission should take additional action to improve its oversight of the rating agencies. We are at a critical moment in the evolution of our capital markets and the SEC has a legitimate interest in ensuring the continued integrity of the rating agencies and the credit rating process.

As we proceed today, it is my hope that we will carefully examine the many issues raised in the recent SEC report on rating agencies. We must discern how the Commission should oversee rating agencies in a systematic way. We should also explore the conflicts of interest that rating agencies encounter, like their reliance on payments by issuers and their provision of consulting services to issuers. Last year, accountants came under fire for similar problems. We should additionally discuss the competitiveness of the credit rating industry. In particular, many critics have raised concerns about the ability of participants to enter the market.

Furthermore, I think that we should evaluate the ability of investors to understand credit ratings. In studying the recommendations of investment analysts two years ago, we heard stories about "buy" meaning "hold" and "hold" meaning "sell". With respect to credit ratings, investors may well understand that "AAA" is an excellent credit risk with little probability of default and that "BBB+" means an acceptable credit risk with some chance of default, but they may not know that "B-", a passing grade that their child might earn at school, signifies junk bond status. Average American investors need help in deciphering this convoluted code.

In closing, Mr. Chairman, I expect the Commission to take prompt and prudent action on rating agency regulatory issues. I also look forward to working with you on these matters as we move forward deliberately.

The Role of Credit Rating Agencies in the Portfolio Management of Money Market Funds

Introduction

This memorandum is being written to accompany the oral testimony of Deborah A. Cunningham to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises at a hearing entitled "Rating the Rating Agencies: the State of Transparency and Competition," on Wednesday, April 2, 2003. Deborah A. Cunningham is a Senior Vice-President with Federated Investors, Inc. in charge of the firm's taxable money market area.

This memorandum addresses the role of Nationally Recognized Statistical Rating Organizations (NRSROs) in the context of portfolio management for money market funds. Rule 2a-7, which the Securities and Exchange Commission (SEC) promulgated under the Investment Company Act of 1940, dictates how money market funds must utilize NRSRO ratings to try and mitigate credit risk in such portfolios. All money market portfolio securities must be deemed to present minimal credit risks. This determination of minimal credit risks must be based on internal credit analysis but also be inclusive of any rating assigned to such securities by an NRSRO.

A money market fund may only hold Eligible Securities. An Eligible Security is a First Tier Security or Second Tier Security with a maturity of 397 days or less. To determine if a security is First Tier or Second Tier, we must first determine if it is a Rated Security. A Rated Security either (a) has received short-term ratings from NRSROs or (b) is comparable in priority and security to other obligations of the issuer that have received short-term ratings from NRSROs. A security that does not meet either criteria is an Unrated Security.

Currently, there are four NRSROs: Dominion Bond Rating Services ("DBRS"), Fitch Investors, Inc. ("Fitch"), Moody's Investors Service, Inc. ("Moody's") and Standard & Poor's ("S&P"). The following table identifies the two highest short-term rating categories for each NRSRO.

NRSRO	DBRS	Fitch	Moody's	S&P
Highest Category	**R-1**	**F1+ or F1**	**Prime-1 or MIG-1**	**A-1+, A-1, SP-1+ or SP-1**
2nd Highest Category	**R-2**	**F2**	**Prime-2 or MIG-2**	**A-2 or SP-2**

If a Rated Security (or the obligations to which it is comparable) received a short-term rating from only one NRSRO, then this rating determines its tier. If the rating is in the highest category, it is a First Tier Security. If the rating is in the second highest category, it is a Second Tier Security. If the rating is below the second highest category, it is not an Eligible Security.

If a Rated Security (or the obligations to which it is comparable) received short-term ratings from more than one NRSRO, then the ratings of the Requisite NRSROs determine its tier. Rule 2a-7 defines the Requisite NRSROs as the two NRSROs giving the highest short-term ratings. The lowest of these two NRSRO ratings then determines the security's tier, as shown in the following table.

Number of Ratings	Ratings Received	Tier Under Rule 2a-7
Two NRSROs:	**P-1/A-1**	**First Tier**
	P-2/A-1	**Second Tier**
	P-3/A-1	**Not an Eligible Security**
Three NRSROs:	**A-1/F-1/P-3**	**First Tier**
	A-2/F-1/P-3	**Second Tier**
	A-3/F-1/P-3	**Not an Eligible Security**
Four NRSROs:	**F-1/R-1/A-3/P-3**	**First Tier**
	F-2/R-1/A-3/P-3	**Second Tier**
	F-3/R-1/A-3/P-3	**Not an Eligible Security**

In the case of an Unrated Security, the fund's Board of Directors must determine whether it is comparable to Rated Securities that are First Tier or Second Tier Securities. However, the Board may only make such a determination if the Unrated Security satisfies one of the following three conditions:

- At the time of issuance, the Unrated Security's maturity did not exceed 397 days.
- The Unrated Security has not received a long-term rating from any NRSRO.
- The Unrated Security has received long-term ratings within the three highest categories from the requisite NRSROs.

Demand Features and Guarantees. A money market fund may also treat a security as an Eligible Security based upon a Demand Feature or Guarantee. Guarantees include, along with ordinary guarantees, letters of credit, bond insurance and Unconditional Demand Features. A Demand Feature is Unconditional if it can be exercised notwithstanding a default on the underlying security.

If the Demand Feature or Guarantee qualifies as a First Tier Security (or Second Tier Security), then the fund may treat the underlying security as a First Tier Security (or Second Tier Security) also. However, the terms of the security must provide notice to the fund of any substitution of the Demand Feature or Guarantee. In addition, a Guarantee from a non-affiliated person of the issuer must quality as a Rated Security.

If a fund relies upon a Conditional Demand Feature for this purpose, then it must satisfy three additional requirements. First, the fund's Board of Directors must find a minimal risk that the Demand Feature will terminate before the fund can exercise it. Second, the events that would terminate the Demand Feature must meet one of the following criteria:

- The event must be an occurrence that a fund can readily monitor;
- The event must trigger a notice that gives a fund an opportunity to exercise the Demand Feature before it terminates; or
- The event must relate to the taxability of the security.

Finally, the underlying security must have received ratings from NRSROs in one of their two highest long-term or short-term categories, be comparable in priority and security to other obligations of the issuer that have received such ratings, or the Board must determine that they are comparable to securities receiving such ratings.

If a Guarantee or Demand Feature is not an Eligible Security, the fund may still treat the underlying security as an Eligible Security. However, the underlying security must qualify independently as a First or Second Tier Security. Moreover, if the security has a Demand Feature, the fund may not rely on the Demand Feature to determine the security's maturity or to provide liquidity for the security.

Asset Backed Securities. Rule 2a-7 defines an Asset Backed Security as a security issued by a Special Purpose Entity payable from cash flows from Qualifying Assets. A Special Purpose Entity is an entity that exists primarily to hold Qualifying Assets and service its securities. Qualifying Assets include any type of self liquidating financial asset. If the security is an Asset Backed Security, it must have received a rating from at least one NRSRO. The rating must apply to the Asset Backed Security itself, not to comparable obligations of the Special Purpose Entity. However, the rating may be long or short-term and does not have to be above a specific category. This requirement does not apply to an Asset Backed Security supported exclusively by municipal obligations.

Having established the role of the NRSROs as necessitated by the regulatory requirement, the following comments pertain to the quality of information received from the NRSROs. In general, the content of NRSRO write-ups has improved over time. Specifically, they have more qualitative content and are generally more timely. On the other hand, some most recent full reports on companies contain information over eighteen months out of date. There is normally a quantitative section that compares the specific company to industry peers which is relatively helpful. There are also usually charts showing financial trends over time for the specific company. The verbiage accompanying the charts and graphs generally explains any trends that should be noted. The summary is typically a list of positives and negatives that should be noted for the company. This summary provides the justification for the rating given to the company by the NRSRO.

In most cases, the NRSROs place a company on a watchlist, with either a positive or negative outlook, before changing that company's ratings. The watchlisted companies typically are accompanied by a list of items to consider in the further ratings developments for each company. Occasionally, however, a company's ratings are changed without any prior warning or without ever being placed on any type of watchlist. This is disruptive to the market and perhaps hints at either a sudden change in the company's creditworthiness that had not been foreseen, or a misinterpretation of previous company data by the NRSRO. It's these times of unexpected, sudden rating changes that should be accompanied by further clarification from the NRSRO.

Some clarification should be given to address the difference between corporate credit comments and asset-backed securities (ABS) credit comments. Because corporate issuers are generally operating companies with periodic financial statement filings, the NRSROs are usually quite up-to-date disseminating their interpretation of the most recent financial information and analysis. In contrast, ABS issuers are Special Purpose Entities (SPEs) that provide monthly financial data to the NRSROs. Because the corporate entities are publicly held, in large part, investors are able to obtain most information and substantiate minimal credit risk decisions. ABS issuers, however, are not publicly held and therefore are not required to submit the same detail to investors as is required by NRSROs. Increased and more timely disclosure in the ABS market by the NRSROs would benefit the investor in this marketplace.

Fees paid by fund companies managing money market funds are a substantial portion of the advisory fees for those funds. Although these fees may pale in comparison to issuer fees paid by a company to obtain that rating, it is incremental enough to cause the NRSROs to be considered unbiased third party experts.

In order to insure this unbiased quality, NRSRO analyst discussions with issuers they rate should be restricted to just those items that affect the financial health of the issuers. All contract negotiations between NRSROs and issuers should be separate and handled by an operations and administrative group, not the analysts.

With regard to additional fee-based businesses, the example used will be that of money market fund ratings. Some of the NRSROs that rate money market funds require that all securities owned within that money market fund contain that specific NRSROs ratings. Other NRSROs only require that the fund contain rated securities by any one of the NRSROs. The latter seems to be in line with good business practices if all securities held within the fund are indeed analyzable.

The SEC most recently recognized DBRS as a fourth NRSRO. Consolidation had caused what was a high of seven NRSROs to dwindle to three before this recent addition. The status afforded this NRSRO designation should be, and has appropriately been, treated with much debate and detail. The SEC's recognition of the current four NRSROs seems reasonable, although investors generally welcome all additional information. Allegations of anti-competitive or unfair practices against these NRSROs seems with little merit. Greater NRSRO oversight although, could come in the form of insuring that a "Chinese Wall" exists between the analysts and committees assigning the ratings and the executives negotiating the payment of fees.

Egan-Jones Ratings Company
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Providing timely, accurate credit ratings to Institutional Investors

Prepared Testimony of Sean J. Egan, Managing Director, Egan-Jones Ratings Company
Before the House Financial Services Committee, Capital Markets Subcommittee

April 2, 2003

Chairman Baker, members of the Subcommittee, good morning. I am Sean Egan, Managing Director of Egan-Jones Ratings Company, a credit ratings firm. I am pleased to appear before you to present the views of my firm on the important issues regarding the state of transparency and competition of credit rating agencies being discussed today.

By way of background, I am a co-founder of Egan-Jones Ratings Co., which was established in 1992. We provide credit ratings on a number of issuers of U.S. and international debt and some structured finance transactions. As discussed further below, our business model differs significantly from that of the major nationally-recognized statistical ratings agencies ("NRSROs") in that we are not engaged by the issuer of a security. Instead, our clients consist of approximately 300 national firms consisting mainly of institutional investors and broker/dealers. We are based in the Philadelphia Pennsylvania area, although we do have employees that operate from other offices.

In our view, the current NRSROs recognized by the SEC have failed in their responsibility to provide timely alerts to investors about credit failures over the past couple of years. Market capitalization losses from WorldCom, Enron, Global Crossing and Genuity have been in excess of $200 billion, not to mention the loss of livelihoods and pensions of thousands of employees of these companies. The performance of NRSROs in connection with these corporate failures has fallen far short of an adequate level in protecting investors as witnessed by the following specific failures:

- **Enron** was rated investment grade by the NRSRO's four days before bankruptcy;
- The **California utilities** were rated "A-" two weeks before defaulting;
- **WorldCom** was rated investment grade three months before filing for bankruptcy;
- **Global Crossing** was rated investment grade in March 2002 and defaulted on loans in July 2002;
- **AT&T Canada** was rated investment grade in early February 2002 and defaulted in September 2002; and
- **ABB** was rated "A2" by Moody's as of March 14th 2002 and was rated "Ba2", negative watch as of October 31, 2002. Similarly, S&P rated ABB at "A+" as of March 14th, 2002 and "BBB-", negative watch as of November 5th 2002.

In addition, investors are becoming increasingly skeptical of credit ratings, and NRSRO ratings in particular. For example, a survey by H. Kent Baker and Sattar A. Mansi published in Table 9 of their June 18, 2001 article Assessing Credit Rating Agencies by Bond Issuers and Institutional Investors indicated that only 29% of bond fund managers believe the NRSRO's update their ratings in a timely manner.

Since other ratings firms succeeded in providing investors with timely warning of the financial problems looming for the issuers noted above, we believe the failures of NRSROs can be attributed to (i) monopolistic conditions, and (ii) the conflicts of interest. Until the flawed structure of the industry is addressed, investors, workers and pensioners can expect additional massive failures to occur without adequate warning from the major ratings agencies. In particular, we believe that the industry is flawed in the following respects:

■ **Monopolistic Conditions/ Ready Opinion Defense -** Moody's and Standard & Poors (S&P) now rate the vast majority of issues and can accurately be described as a "partner monopoly", a term used by the Department of Justice personnel. Unlike the accounting industry where four firms compete for revenues, S&P and Moody's share revenues with respect to the overwhelming majority of ratings since two ratings are normally needed for a debt issuance. In other words, any gain to Moody's does not come at the expense of S&P and vice versa.

The opportunities for maintaining and extending their monopoly are vast since most issuers rely on investment bankers who are reluctant to incur the wrath of the two major NRSROs by recommending another rating firm. In a symbiotic manner, there is a tendency for the rating firms to listen to investment banking firms representing issuers of securities on important issues related to the issuer and, relatedly, to the rating ultimately assigned to a debt issue. For example, prior to finally taking action on Enron, Moody's had a series of conversations with investment banks which stood to gain $50 to $100 million in fees if the Enron/Dynergy transaction was consummated. In the event that any party questions the rating assigned by S&P and Moody's the firms have used the defense that the ratings are merely their opinions.

Conflict of Interest – Over the past 15 years, S&P and Moody's have shifted the manner in which they are compensated for their ratings from investor-based compensation to issuer-based payments (according to Moody's 10K, it obtains 87% of its compensation from issuers). In our view, this compensation structure presents conflicts of interest similar to those involving Wall Street equity analysts who were paid via the investment banking fees generated by their firms. With respect to debt ratings, the conflict appears to be particularly acute for large important issues such as the California utilities, Enron, and WorldCom. In these cases investors desperately need unbiased guidance from credit rating firms, but often do not get it because of pressure from issuers, investment banks, commercial banks and in some cases, security exchange officials (see the October 8, 2002 Report of the Staff to the Senate Committee on Governmental Affairs, Financial Oversight of Enron: the SEC and Private-Sector Watchdogs, page 113). In sum, the old adage that "one cannot serve two masters" applies to the ratings field; a firm can either support issuers or investors but not both.

The arguments used by the NRSRO's to defend their actions are the following:

"Issuer Misdeeds" (they didn't tell us) – S&P, Moody's, and Fitch did not assign the correct rating to WorldCom, Enron, et al. because these firms did not provide the ratings agencies accurate information concerning their operations. We believe it is a pathetic state when major rating firms are unable to recognize when an issuer and its executives are desperate to keep their firms solvent; for example, it was public knowledge that Bernie Ebbers owed WorldCom more than $400 million. Fraud is present in most failures, and the rating firms (at least those recognized by the SEC) should be able to detect the majority of egregious cases.

"Little Incentive" (the Jack Grubman defense) – another argument used by the current NRSRO's to defend their compensation structures is that any one issuer represents only a small portion of their overall revenue base and, therefore, potential conflicts are minimized. However, revenues produced by Jack Grubman and Henry Blodget were likewise only a small portion of CitiGroup's and Merrill's revenues. Furthermore, when large investment banks are pressing the rating firms to hold off on any rating action, it becomes difficult not to listen.

"Our Reputation is Key" (the Arthur Andersen defense) – Arthur Anderson argued that it would not do anything untoward because it would hurt the firm's reputation. Likewise, the current NRSRO's argue that they would not risk their reputation for any one issuer. However, since most issuers believe their ratings are too low and press for higher ratings, the lack of competition among rating agencies provides little downside for inaccurate ratings and, therefore, few checks in the industry.

"Committee Approach" (the Lemming Defense) – a final defense normally proffered for the flawed industry is that unlike the investment banks, the NRSRO's use a committee approach for assigning ratings, which is harder to manipulate. Unfortunately, normally one analyst typically covers a firm and during rating committee meetings it is probably clear what superiors want in terms of ratings for a company's issuer clients.

Recommendations

Employees, pensioners, and investors were badly hurt by the unwarned failure of Enron, Global Crossing, the California utilities and other companies. ; More unnecessary pain can be expected unless and until changes are made in the seriously flawed system in which ratings agencies operate. We recommend the following changes:

1. Recognize some non-conflicted firms, which have warned investors – The hearings are an attempt to prevent future Enron and WorldCom failures. The best way is to recognize as NRSRO's rating firms that do not have a conflict of interest with investors and which have succeeded in providing warnings to investors. The current NRSRO's argue that no additional firms should be admitted because it will force them to compete by issuing liberal ratings in an effort to maintain their revenue base. Our view is that rating firms that are compensated by investors are forced to issue timely accurate ratings and that some real competition among ratings firms would improve the industry.

2. Prohibit issuer compensation – just as equity research practices were not corrupted until such research was linked to the investment banking practices of broker-dealers and their associated large issuer-based compensation in the form of investment banking fees, existing NRSRO's prior to 1970 obtained most of their compensation from investors rather than issuers. NRSRO's argue that the copy machine made the old business model less attractive because of the ease of distributing ratings. Our response is that there are a number of firms that have thrived without issuer compensation; Sanford Bernstein and Prudential are prime examples on the equity side, and Egan-Jones and Mikuni are examples on the credit rating side.

3. Prohibit involvement with rated firms and dealers – Moody's Chairman, Clifford Alexander, served as a director of MCI from 1982 until 1998 and of WorldCom from 1998 until June 2001; WorldCom filed for bankruptcy in July 2002 making it the largest bankruptcy in US history. Officials of credit rating agencies should be prohibited from serving on the boards of those companies that they rate. In addition, such officials should be prohibited from serving on the board such as the National Association of Security Dealers, which represents security dealers (Moody's president, John Rutherfurd, Jr. is listed on the NASD Board of Governors). Dealers' interests are not parallel to investors' interests.

4. Remove the exclusion from Regulation FD – rating firms are essentially private research firms and therefore should not be provided with any special treatment when it comes to the dissemination of information to the public by issuers. Information gathered by the monopolistic rating firms for the rating triggers was subsequently distributed only to clients paying for the research portion of the NRSRO's service.

5. Separate ratings from consulting – just as accountants were compromised by their consulting assignments, ratings firms have similar issues. Investors and issuers are likely to feel compelled to use the services of S&P and Moody's because of their market dominance.

6. Prohibit the use of rating triggers – affording another example of putting issuers' interests ahead of investors', the current NRSRO's were reluctant to downgrade firms because of the fear of setting off rating triggers (see the Enron history).

7. Prohibit the use of "independent" moniker – all the current NRSRO's obtain the majority of their compensation from issuers and therefore should not mislead investors by describing themselves as independent.

8. Police monopolistic practices – a fair amount of controversy has been generated by Moody's notching (cutting) Fitch's ratings by up to five or six notches in the structured finance area in an attempt to extend its reach. Similarly, it appears as though the large NRSRO's have discouraged major news organizations from carrying ratings or news generated from competing rating firms.

9. Prohibit providing "color" to investors – some investors, particularly large investors are given information on analysts' opinions in advance of others.

A Sampling of Abuses
The problems associated with the lack of competition and conflicts of interest go beyond the Enron, Global Crossing and California utility failures.

Withholding Ratings – We received a letter (available upon request) from a senior executive at a brokerage firm whose clients were defrauded by Allied Signal which requested that the rating firms withdraw their rating of an issue of Grimes, an Allied subsidiary, so that investors holding the bonds would be forced to sell (because of the lack of a credit rating), thereby enabling Allied Signal to repurchase the bonds at a lower price. The response given by the rating firms for not rating the bonds was "an official of Allied ... told them they [Allied] would be very unhappy if that agency rated Grimes. That rating agency said candidly that Allied was a source of rating income and that they would not jeopardize the relationship".

Punishment Ratings – In another variation of the abuses of the NRSRO designation and anti-competitive practices, Moody's in the 1993 assigned an unsolicited and intentionally low rating to some municipal issues which refused to retain Moody's for its ratings services. In these and most other cases, Moody's successfully used the First Amendment protection, arguing that its ratings were merely its opinions and that it was exercising its freedom of speech. Individuals have the right to free speech, but when a monopoly firm employs anti-competitive practices to extend its monopoly, the SEC needs to revoke its NRSRO designation. Because of the dominance of S&P and Moody's it is rare to find parties willing to file a public complaint against them.

Notching - Lastly, Moody's in their review of collateralized debt issues has cut the ratings assigned by Fitch by five or more notches while providing little evidence that Fitch's ratings were overly generous. The effect of the action is to discourage the use of ratings from firms other than S&P and Moody's.

The SEC Review Process

Notwithstanding the problems expressed above with respect to ratings agencies and NRSROs in particular, attaining designation as an NRSRO from the SEC is a critical step, in our view, in remaining competitive as a ratings agency. To this end, our firm currently is pursuing such designation from the SEC staff. We initially applied for NRSRO status in August 1998 and are continuing to provide information to the SEC staff as requested.

As you know, the process of attaining designation as an NRSRO is not objective and involves consideration of many factors. For example, the SEC staff has indicated that the single most important criterion for receiving NRSRO recognition is the acceptance of an applicant in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings. In response, we commissioned a survey to evaluate the extent to which our firm is recognized throughout the market. The SEC was provided with a design of the survey before it was conducted and with the results of the survey in June2002. The results indicated that *we had more than four times the recognition of any other non-NRSRO firm including Dominion Bank,* the rating agency most recently afforded NRSRO status (our market presence is greater now than its was last year).

While we continue to work with the SEC staff on attaining NRSRO status, there are certain fundamental considerations that must be understood to maintain the fairness of the process and ensure that investors receive timely and accurate ratings. First, not all rating agencies use the same business model. As alluded to above, and unlike the current NRSRO's, we are not compensated by issuers for our ratings but instead are compensated by the users of our ratings. From our perspective, this distinction is a good one as we see fewer conflicts associated with our compensation model. Moreover, as noted in the attached pages to my testimony, we successfully flagged most of the major credit failures.

Second, while a ratings agency must have adequate resources to issue reliable, credible and timely ratings, there is no single appropriate level of staffing or capitalization for all rating agencies. Different agencies use varying methods of preparing their ratings. Focusing on the scale utilized by the largest firms not only would ignore this fact, it also would result in a defacto barrier to entry to smaller ratings agencies thereby precluding the competition necessary to spur improvements in this industry.

Thank you very much for the opportunity to appear before you. I'd be pleased to answer any questions you may have.

Selected Quotes – Egan-Jones Ratings Co.

New York Times
Gretchen Morgenson (Pulitzer Prize Winner) July 7, 2002

"Egan-Jones makes a practice of alerting investors to corporate credit problems well before they are acknowledged by management... As early as November 2000, for example, Egan-Jones cut its ratings on WorldCom to the lowest investment-grade level, citing its deteriorating profit margins and credit quality."

Fortune's "Against the Grain"
Herb Greenberg January 21, 2002

"The best balance-sheet snoops are often way ahead of the pack in finding signs of trouble. Sometimes, however, the big credit-rating firms, Standard & Poor's and Moody's, which get paid by the companies they rate, are slow off the mark--slower, as a rule, than independent bond-rating services like Egan-Jones of Wynnewood, Pa...."We don't have the constraint of trying to keep a company happy," says Egan-Jones President Sean Egan, whose downgrade of Enron to junk beat the big guys by about a month."

Investment Dealers Digest (cover)
Dave Lindorff August 13, 2001

"It didn't take long for Sean Egan, managing director of Egan-Jones Ratings Co., a small ratings agency outside Philadelphia, to figure out last fall's California power crisis would eventually put the state's utilities in a bind. "We saw a train wreck ahead for these companies," recalls Egan, who says his analysts quickly fired off two reports to clients warning them of the troubles facing the state's two utilities-Pacific Gas & Electric Corp. and Edison International, the parent company of Southern California Edison. On Sept. 27, the firm lowered EIX's rating from A- to BBB-, and PG&E's rating from A to BBB+."

Grant's Interest Rate Observer
Jim Grant Annual Conference, October 2002

"The big two-and-a-half rating agencies have not exactly covered themselves in glory during the current credit debacles. Sean Egan, co-founder of Egan-Jones Ratings Co. (which saw many disasters coming before they landed in the newspapers), will discuss debacles and opportunities yet over the horizon."

Egan-Jones Ratings Co.
3/31/2003
Page 8

Enron's Senior Unsecured Ratings

Date	Egan-Jones*	S&P	Moody's
4/19/2001	BBB+	BBB+	Baa1
→ **6/27/2001**	**BBB**	BBB+	Baa1
→ **8/15/2001**	**BBB/ BBB-**	BBB+	Baa1
10/16/2001	**BBB/ BBB-**	BBB+	Baa1 (neg.)
10/23/2001	**BBB-**	BBB+	Baa1 (neg.)
10/24/2001	**BBB-/ BB+**	BBB+	Baa1 (neg.)
10/26/2001	**BB+**	BBB+	Baa1 (neg.)
10/29/2001	**BB+/ BB**	BBB+	Baa2 (neg.)
10/31/2001	**BB+/ BB**	BBB+	Baa2 (neg.)
11/1/2001	**BB**	BBB (neg.)	Baa2 (neg.)
11/6/2001	**BB**	BBB (neg.)	Baa2 (neg.)
11/7/2001	**BB-/ B-**	BBB (neg.)	Baa2 (neg.)
11/9/2001	**BB**	BBB- (neg.)	Baa3 (neg.)
11/21/2001	**BB/ BB-**	BBB- (neg.)	Baa3 (neg.)
11/26/2001	**BB-/ B+**	BBB- (neg.)	Baa3 (neg.)
11/28/2001	**B+/ B-**	**BBB- (neg.)**	**Baa3 (neg.)**
11/28/2001	**C/ D**	**B-**	**B2 (neg.)**
11/29/2001	**D**	**B-**	**B2 (neg.)**
11/30/2001	**D**	**CC (neg.)**	**B2 (neg.)**
12/3/2001	**D**	**D**	**Ca**

* Current and projected ratings

Egan-Jones Ratings Co.
3/31/2003
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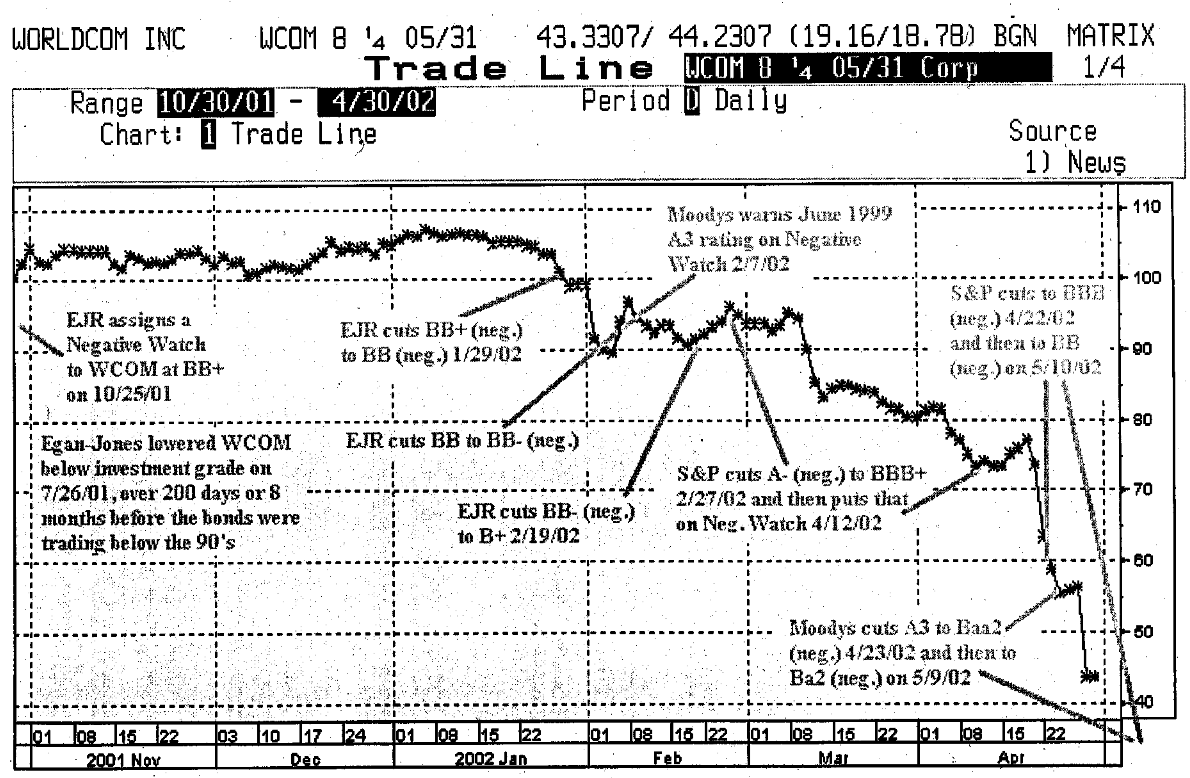
WorldCom's Senior Unsecured Ratings

The bold indicates non-investment grade

Date	Egan-Jones*	S&P	Moody's	Action
11/1/2000	A- (neg. watch)	A-	A3	EJR issued neg. watch (A-)
11/ 3/00	A- (neg. watch)	A- (neg. watch)	A3	S&P issued a neg. watch (A-)
11/17/2000	BBB+ (neg. watch)	A- (neg. watch)	A3	EJR cut A- to BBB+ (neg. watch)
2/8/2001	BBB	A- (neg. watch)	A3	EJR cut BBB+ to BBB
2/27/01	BBB	BBB+	A3	S&P cut A- to BBB+
6/25/2001	BBB-	BBB+	A3	EJR cut BBB to BBB-
7/26/2001	**BB+ (neg. watch)**	BBB+	A3	EJR cut BBB- to BB+ (neg watch)
1/29/2002	**BB (neg. watch)**	BBB+	A3	EJR cut BB+ to BB (neg watch)
2/ 7/02	**BB- (neg. watch)**	BBB+	A3	EJR cut BB to BB- (neg watch)
2/ 7/02	**BB- (neg. watch)**	BBB+	A3 (neg. watch)	Moody's issued a neg. watch (A3)
2/19/2002	**B+**	BBB+	A3 (neg. watch)	EJR cut BB- to B+
4/12/02	**B+**	BBB+ (neg. watch)	A3 (neg. watch)	S&P issued a neg. watch (BBB+)
4/22/02	**B+**	BBB	A3 (neg. watch)	S&P cut BBB+ to BBB
4/23/02	**B**	BBB	A3 (neg. watch)	EJR cut B+ to B
4/23/02	**B**	BBB	Baa2	Moody's cut A3 to Baa2
4/25/2002	**B-**	BBB	Baa2	EJR cut B to B-
5/ 9/02	**B-**	BBB	**Ba2**	Moody's cut Baa2 to Ba2
5/10/02	**B-**	**BB**	**Ba2**	S&P cut BBB to BB
6/14/2002	**B- (neg. watch)**	**BB**	**Ba2**	EJR issues neg. watch
6/17/02	**B- (neg. watch)**	**B+**	**Ba2**	S&P cut BB to B+
6/20/02	**CCC (neg. watch)**	**B+**	**Ba2**	EJR cut B- to CCC (neg. watch)
6/20/02	**CCC (neg. watch)**	**B+**	**B1**	Moody's cut Ba2 to B1
6/26/02	**D**	**B+**	**B1**	EJR cut CCC to D
6/26/02	**D**	**CCC-**	**B1**	S&P cut B+ to CCC-
6/26/02	**D**	**CCC-**	**Ca**	Moody's cut B1 to Ca
7/ 1/02	**D**	**CC**	**Ca**	S&P cut CCC- to CC
7/17/02	**D**	**D**	**Ca**	S&P cut CC to D



WORLDCOM INC WCOM 8 ¼ 05/31 43.3307/ 44.2307 (19.16/18.78) BGN MATRIX
Trade Line WCOM 8 ¼ 05/31 Corp 1/4
Range 10/30/01 - 4/30/02 Period D Daily
Chart: 1 Trade Line
Source
1) News
EJR assigns a Negative Watch to WCOM at BB+ on 10/25/01
Egan-Jones lowered WCOM below investment grade on 7/26/01, over 200 days or 8 months before the bonds were trading below the 90's
EJR cuts BB+ (neg.) to BB (neg.) 1/29/02
EJR cuts BB to BB- (neg.)
EJR cuts BB- (neg.) to B+ 2/19/02
Moodys warns June 1999 A3 rating on Negative Watch 2/7/02
S&P cuts A- (neg.) to BBB+ 2/27/02 and then puts that on Neg. Watch 4/12/02
S&P cuts to BBB (neg.) 4/22/02 and then to BB (neg.) on 5/10/02
Moodys cuts A3 to Baa2 (neg.) 4/23/02 and then to Ba2 (neg.) on 5/9/02
110
100
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80
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01 08 15 22 03 10 17 24 01 08 15 22 01 08 15 22 01 08 15 22 01 08 15 22
2001 Nov
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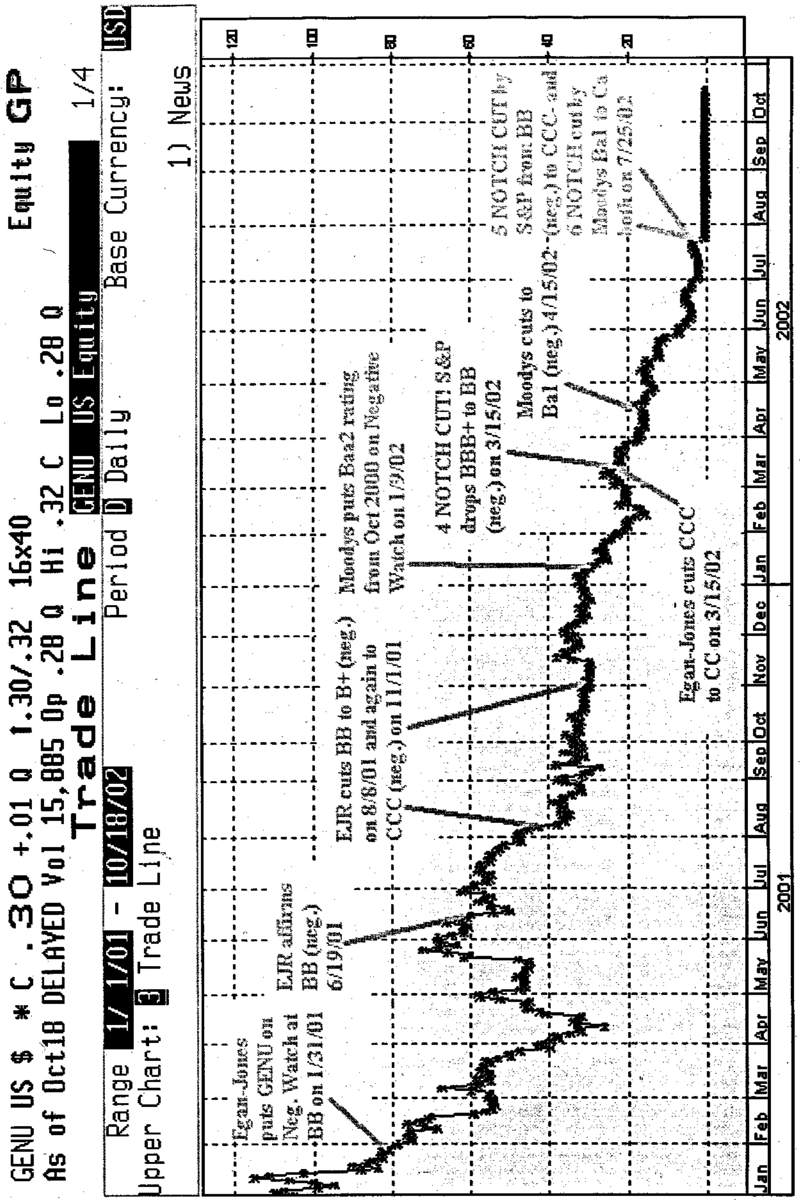
GENU US $ * C .30 +.01 Q t.30/.32 16x40
Equity GP
As of Oct18 DELAYED Vol 15,885 Op .28 Q Hi .32 C Lo .28 Q
GENU US Equity
1/4
Trade Line
Range 1/ 1/01 - 10/18/02
Period D Daily
Base Currency: USD
Upper Chart: 3 Trade Line
1) News
Egan-Jones puts GENU on Neg. Watch at BB on 1/31/01
EJR affirms BB (neg.) 6/19/01
EJR cuts BB to B+ (neg.) on 8/8/01 and again to CCC (neg.) on 11/1/01
Moodys puts Baa2 rating from Oct 2000 on Negative Watch on 1/9/02
4 NOTCH CUT! S&P drops BBB+ to BB (neg.) on 3/15/02
Moodys cuts to Ba1 (neg.) 4/15/02
5 NOTCH CUT by S&P from BB (neg.) to CCC- and 6 NOTCH cut by Moodys Ba1 to Ca both on 7/25/02
Egan-Jones cuts CCC to CC on 3/15/02
120
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20
Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Jul Aug Sep Oct
2001
2002

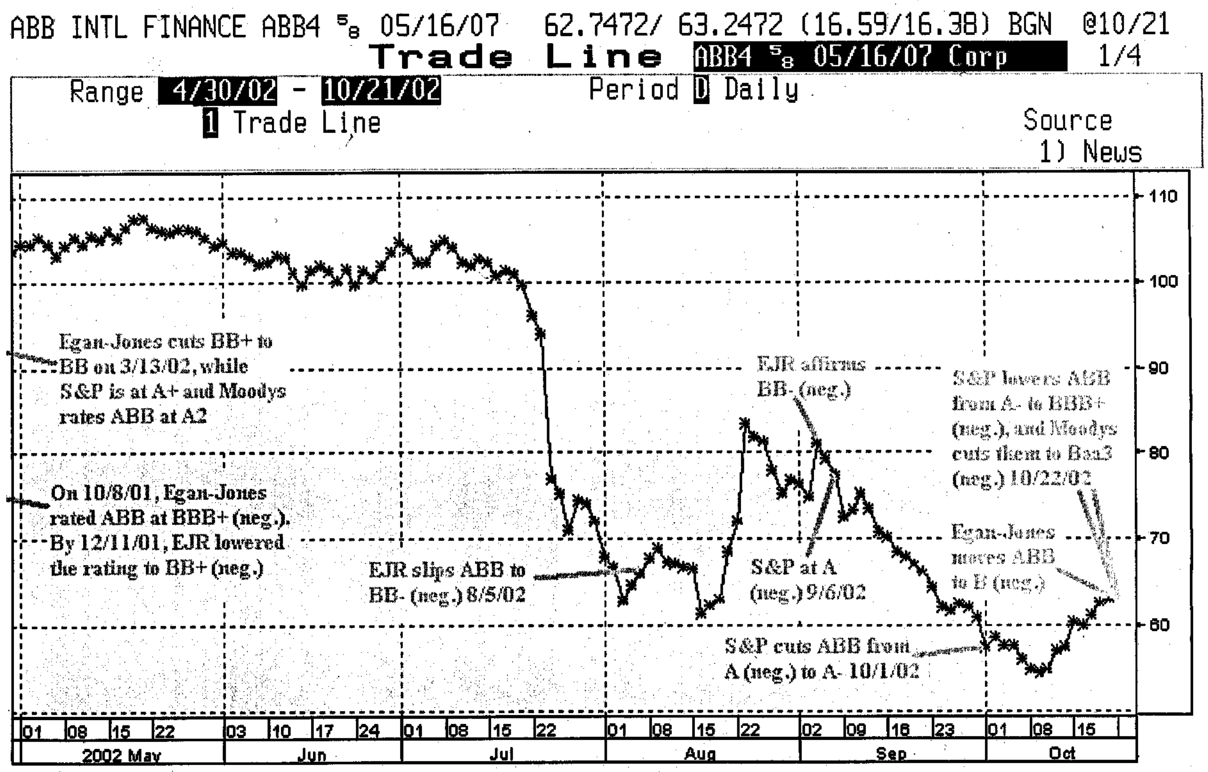
ABB INTL FINANCE ABB4 5/8 05/16/07 62.7472/ 63.2472 (16.59/16.38) BGN @10/21
Trade Line ABB4 5/8 05/16/07 Corp 1/4
Range 4/30/02 - 10/21/02 Period D Daily
1 Trade Line
Source
1) News
Egan-Jones cuts BB+ to BB on 3/13/02, while S&P is at A+ and Moodys rates ABB at A2
On 10/8/01, Egan-Jones rated ABB at BBB+ (neg.). By 12/11/01, EJR lowered the rating to BB+ (neg.)
EJR slips ABB to BB- (neg.) 8/5/02
EJR affirms BB- (neg.)
S&P at A (neg.) 9/6/02
S&P cuts ABB from A (neg.) to A- 10/1/02
S&P lowers ABB from A- to BBB+ (neg.), and Moodys cuts them to Baa3 (neg.) 10/22/02
Egan-Jones moves ABB to B (neg.)
110
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60
01 08 15 22 03 10 17 24 01 08 15 22 01 08 15 22 02 09 16 23 01 08 15
2002 May
Jun
Jul
Aug
Sep
Oct

FitchRatings

Statement of

Stephen W. Joynt
President and Chief Executive Officer
Fitch, Inc.

to

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

April 2, 2003

Introduction

Fitch Ratings traces it roots to the Fitch Publishing Company established in 1913. In the 1920s, Fitch introduced the now familiar "AAA" to "D" rating scale. Fitch was one of the three rating agencies (together with Standard & Poor's ("S&P") and Moody's Investors Service ("Moody's")) first recognized as a nationally recognized statistical rating organization (a so-called "NRSRO") by the Securities and Exchanges Commission ("SEC") in 1975.

Since 1989 when Fitch was recapitalized by a new management team, Fitch has experienced dramatic growth. Throughout the 1990's, Fitch especially grew in the new area of structured finance, by providing investors original research, clear explanations of complex credits, and more rigorous surveillance than the other rating agencies.

In 1997, Fitch merged with IBCA Limited, another NRSRO headquartered in London, significantly increasing Fitch's worldwide presence and coverage in banking, financial institutions and sovereigns. Through the merger with IBCA, Fitch became owned by Fimalac S.A., a holding company which acquired IBCA in 1992. The merger of Fitch and IBCA represented the first step in our plan to respond to investors' need for an alternative global, full service rating agency capable of successfully competing with Moody's and S&P across all products and market segments.

Our next step in building Fitch into a global competitor was our acquisition of Duff & Phelps Credit Rating Co., an NRSRO headquartered in Chicago, in April, 2000 followed by the acquisition later that year of the rating business of Thomson BankWatch. These acquisitions strengthened our coverage in the corporate, financial institution, insurance and structured finance sectors, as well as adding a significant number of international offices and affiliates.

FitchRatings

United States House of Representatives
April 2, 2003

As a result of Fitch's growth and acquisitions, it today has approximately 1,250 employees, including over 700 analysts, in over 40 offices and affiliates worldwide. Fitch currently covers 2,300 banks and financial institutions, 1,000 corporations, 70 sovereigns and 26,000 municipal offerings in the United States. In addition, we cover over 7,000 issues in structured finance, which remains our traditional strength.

Fitch is in the business of publishing research and independent ratings and credit analysis of securities issued around the world. A rating is our published opinion as to the creditworthiness of a security distilled in a simple, easy to use grading system ("AAA" to "DDD"). Explanatory information is typically provided with each rating.

Rating agencies gather and analyze a variety of financial, industry, market and economic information, synthesize that information and publish independent, credible assessments of the creditworthiness of securities and issuers thereby providing a convenient way for investors to judge the credit quality of various alternative investment options. Rating agencies also publish considerable independent research on credit markets, industry trends and economic issues of general interest to the investing public.

By focusing on credit analysis and research, rating agencies provide independent, credible and professional analysis for investors more efficiently than the investors could perform that analysis themselves.

Currently, we have over 3,200 institutional investors, financial institutions and government agencies subscribing to our research and ratings and thousands of investors and other interested parties that access our research and ratings through our free website and other published sources and wire services such as Bloomberg, Business Wire, Dow Jones, Reuters and *The Wall Street Journal.*

Ratings are used by a diverse mix of both short-term and long-term investors as a common benchmark to grade the credit risk of various securities.

In addition to their ease of use, efficiency and wide spread availability, we believe that credit ratings are most useful to investors because they allow for reliable comparisons of credit risk across diverse investment opportunities.

Credit ratings accurately assess credit risk in the overwhelming majority of cases. Credit ratings have proven to be a reliable indicator for assessing the likelihood that a security will default. Fitch's most recent corporate bond and structured finance default studies are summarized below.

Fitch Average Annual Default Rates

	Corporate Finance* 1990 - 2001	Structured Finance** 1991 - 2001
AAA	0.00%	0.00%
AA	0.00%	0.01%
A	0.04%	0.01%
BBB	0.27%	0.11%
BB	1.55%	0.31%
B	1.68%	1.24%
CCC - C	21.97%	20.88%
Investment Grade	0.09%	0.02%
Non Investment Grade	3.01%	1.27%

* Based on Fitch-rated global corporate debt issuers.
** Based on Fitch-rated U.S. structured finance bonds.

The performance of ratings by the three major rating agencies is quite similar. We believe this similarity results from the common reliance on fundamental credit analysis and the similar methodology and criteria supporting ratings.

Through the years, NRSRO ratings also have been increasingly used in safety and soundness and eligible investment regulations for banks, insurance companies and other financial institutions. While the use of ratings in regulations has not been without controversy, we believe that regulators rely on ratings for the same reason that investors do: ease of use, wide spread availability and proven performance over time.

Although other methods can be used to assess the creditworthiness of a security, such as the use of yield spreads and price volatility, we believe that such methods, while valuable, lack the simplicity, stability and track record of performance to supplant ratings as the preferred method used by investors to assess creditworthiness.

However, we also believe that the market is the best judge of the value of ratings. We believe that if ratings begin to disappoint investors they will stop using them as a tool to assess credit risk and the ensuing market demand for a better way to access credit risk will rapidly facilitate the development of new tools to replace ratings and rating agencies.

The SEC Report

Beginning last spring, the SEC began a thorough study of rating agencies that included informal discussions with Fitch and the other rating agencies, a formal examination of our practices and procedures and two full days of public hearings held in November in which we participated. In July, Congress passed the Sarbanes-Oxley Act of 2002 requiring that the SEC produce a report on the role and function of credit rating agencies in the operation of the securities markets. All of the work of the SEC culminated in the issuance of its Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Market (the "Report") as required by the Sarbanes-Oxley Act in January of this year.

The Report stated that the SEC plans to publish a concept release eliciting public comments on the following issues: information flow, potential conflicts of interest, competition and barriers to entry and ongoing oversight. We expect the concept release to be published in the very near future.

We believe the SEC review of the rating agencies has been a constructive and thorough process. As a result of its review, the SEC recommended that we consider certain changes to our policies and procedures including enhancements to our document retention and securities trading and compliance policies that we voluntarily agreed to institute in this coming year.

Set forth below is a summary of our views on the issues we understand the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises intends to explore at its hearing entitled *Rating the Rating Agencies: the State of Transparency and Competition* to be held on April 2, 2003.

Conflicts of Interest

Fees. We do not believe that the fact that the issuer pays a fee to Fitch creates an actual conflict of interest, i.e., a conflict that impairs the objectivity of Fitch's judgment about creditworthiness reflected in Fitch ratings. Rather, for the reasons stated below and based on our experience, it is more appropriately classified as a potential conflict of interest, i.e., something that should be disclosed and managed to assure that it does not become an actual conflict.

Charging a fee to the issuer for the analysis done in connection with a rating dates back to the late 1960s. It is widely known by investors.

By way of context, our revenue comes from two principal sources: the sale of subscriptions for our research and fees paid by issuers for the analysis we conduct with respect to ratings. In this we are similar to other members of the media which derive revenue from subscribers and advertisers that include companies that they cover. Like other journalists, we emphasize independence and objectivity because our independent, unbiased coverage of the companies and securities we rate is important to our research subscribers and the marketplace in general.

Fitch goes to great efforts to assure that our receipt of fees from issuers does not affect our editorial independence. We have a separate sales and marketing team that works independently of the analysts that cover the issuers. In corporate finance ratings, analysts generally are not involved in fee discussions. Although structured finance analysts may be involved in fee discussions, they are typically senior analysts who understand the need to manage the potential conflict of interest.

We also manage the potential conflict through our compensation philosophy. The revenue Fitch receives from issuers covered by an analyst is not a factor in that analyst's compensation. Instead, an analyst's performance, such as the quality and timeliness of research, and Fitch's overall financial performance determine an analyst's compensation. Similarly, an analyst's performance relative to his or her peers and the overall profitability of Fitch determine an analyst's bonus. The financial performance of analysts' sectors or groups do not factor into their bonuses.

Fitch does not have an advisory relationship with the companies it rates. It always maintains full independence. Unlike an investment bank, our fees are not based on the success of a bond issue or tied to the level of the rating issued. The fee charged an issuer does not go up or down depending on the ratings assigned or the successful completion of a bond offering.

Our fee is determined in advance of the determination of the rating and we do not charge a fee for a rating unless the issuer agrees in advance to pay the fee. While we do assign ratings on an unsolicited basis, we do not send bills for them. Any issuer may terminate its fee arrangement with Fitch without fear that its rating will be lowered, although we do reserve the right to withdraw a rating for which we are not paid if there is insufficient investor interest in the rating to justify continuing effort to maintain it.

Ancillary Businesses. Concern has also been raised about the potential conflicts of interest that may arise when rating agencies develop ancillary fee-based businesses. Over the years, revenue derived by Fitch from non-rating sources, including consulting and advisory services, has been minimal. Historically, the bulk of such services related to providing customized ratings, performance, or scoring measures and were usually provided to subscribers of our subscription products, which were not necessarily entities that we rate.

In the fourth quarter of 2001, Fitch's parent company established Fitch Risk Management, Inc. ("FRM"), a newly formed company offering risk management services, databases and credit models to help financial institutions and other companies manage both credit and operational risk. Fitch Ratings and FRM are subject to a "fire wall" policy and FRM has its own employees, offices and marketing staff.

Concerns also have been expressed that additional conflicts of interest issues are posed by rating agencies providing so-called ratings advisory services. In the course of the SEC's review of Fitch, the SEC also expressed their concern to us about conflicts arising from rating advisory services. Although Fitch only recently introduced our ratings assessment service in May 2002 and performed only three assessments, in order to address the concerns raised about this service, we have decided to stop accepting new assessment assignments from United States issuers currently rated by Fitch where members of the rating committee will be involved in conducting the assessment. We are currently evaluating whether we will continue the service using analysts that are not part of the rating committee or discontinue the separate fee service.

Competition and Barriers to Entry

Fitch believes that our emergence as a global, full service rating agency capable of competing against Moody's and S&P across all products and market segments has created meaningful competition in the ratings market for the first time in years. Fitch's challenge to the Moody's/S&P monopoly has enhanced innovation, forced transparency in the rating process, improved service to investors and created much needed price competition.

Academic research confirms our belief that innovations in the ratings industry have often "been initiated by the smaller rating firms [Fitch and its legacy firms], with the larger two [Moody's and S&P] then following."[1] At Fitch, we are particularly proud of the work that we have done in the development of innovative methodologies to analyze new structured finance securities. These innovations in the securities markets have had substantial economic benefits. For instance, academic research has found that securitization has had a positive impact on both the availability and cost of credit to households and businesses.[2]

Fitch firmly believes in the power of competition. We also believe that there is always a demand for insightful, independent credit research. The NRSRO system is designed, appropriately in our view, to assure that recognized organizations possess the competence to develop accurate and reliable ratings and protect against the establishment of rating organizations that would ignore their rating process to issue investment grade ratings to low quality securities as convenient. Without a system to recognize rating organizations for their integrity, many important capital adequacy and eligible investment rules used in financial institution regulation would be ineffective.

We believe that the SEC should formalize the process by which a rating organization is recognized. The criteria for recognition should include an evaluation of the organization's resources and policies to avoid conflicts of interest, use of the organization's ratings by market participants and studies of the performance of the ratings over time. We believe these are the reasons that market participants widely use NRSRO ratings, whether or not they are subject to regulations that refer to ratings. We also believe that the SEC should consider continuing the practice of limited recognition that acknowledges the special expertise of smaller organizations in selected areas of specialty such as the prior recognition of IBCA and BankWatch for their expertise in rating banking and financial institutions.

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[1] Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis,* June 2001 (paper presented at the conference on "Rating Agencies in the Global Financial System", presented at the Stern School of Business, New York University, June 1, 2001.

[2] Mark M. Zandi, *The Securitization of America,* Regional Financial Review, February 1998; Ali Anari, Donald R. Fraser and James W. Kolari, *The Effects of Securitization on Mortgage Market Yields: A Cointegration Analysis,* Real Estate Economics, 1998.

Transparency

We believe quite strongly that the process and procedure that rating agencies use should be transparent. Accordingly, at Fitch, there are hundreds of criteria reports published highlighting the methodology we use to rate various types of entities and securities, together with detailed sector analysis on a broad array of sectors, companies, and issues, all available free on our web site (www.fitchratings.com). Fitch has also been a leader in publishing so-called presale reports in the areas of structured finance, global power, project finance and public finance where our published analysis of various transactions of interest to the market is made available free of charge on our web site prior to the pricing of the transaction. In addition, Fitch makes available free of charge on our web site all of our outstanding ratings. Announcements of ratings actions are also distributed through a variety of wire services as mentioned above.

However, certain of our publications and data are only available to our paid subscribers. We commit extensive time and resources to produce our publications and data and we believe they are valuable to anyone interested in objective credit analysis. In this practice we are no different than other members of the financial media, such as Bloomberg, Dow Jones, Thomson Financial and others, that charge subscribers for access to their publications and data services.

While we believe that for the most part credit rating agencies have adequate access to the information they need to form an independent and objective opinion about the creditworthiness of an issuer, improved disclosure by issuers would be welcomed by Fitch. As we found in our recently published study of the use of credit derivatives in the global market[3], financial reporting and disclosure with respect to areas such as credit derivatives, off-balance sheet financing and other forms of contingencies vary greatly by sector and comparability is further obscured by differences in international reporting and accounting standards.

As the SEC noted in their Report, nonpublic information is provided to rating agencies as part of the rating process. The nature and level of nonpublic information provided to Fitch varies widely by company, industry and country. Nonpublic information frequently includes budgets and forecasts, as well as advance notification of major corporate events such as a merger. Nonpublic information may also include more detailed financial reporting.

While access to nonpublic information and senior levels of management at an issuer is beneficial, an objective opinion about the creditworthiness of an issuer can be formed based solely on public information in many jurisdictions. Typically, it is not the value of any particular piece of nonpublic information that is important to the rating process, but that access to such information and senior management can assist us in forming a qualitative judgment about a company's management and prospects.

It is also important that rating agencies not be inhibited in requesting information and thereafter subjecting that information to vigorous internal analysis and discussion. In that connection it is critical that the courts afford shield law and journalist privilege protection to

[3] Fitch Ratings Special Report, *Global Credit Derivatives: Risk Management or Risk?*, March 10, 2003 available at www.fitchratings.com.

rating agencies so that rating agencies are not unduly burdened by third-party discovery and the confidentiality of their deliberative processes are respected.

Another factor critical to the adequate flow of information to and from the rating agencies is the understanding that information can be provided to a rating agency without necessitating an intrusive and expensive verification process that would largely if not entirely duplicate the work of other professionals in the issuance of securities. Thus, as noted by the SEC Report, rating agencies do not perform due diligence or conduct audits and assume the accuracy of the information that is provided to them by issuers and their advisors. Since rating agencies are part of the financial media, we believe that our ability to operate on this assumption, and to exercise discretion in deciding how to perform our analysis and what to publish, is protected by the First Amendment.

Statement of James A. Kaitz

President and CEO

The Association for Financial Professionals

Before the House Financial Services Committee

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Rating the Rating Agencies: The State of Transparency and Competition

Wednesday, April 2, 2003

Statement of James A. Kaitz
President and CEO
The Association for Financial Professionals

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

Wednesday, April 2, 2003

Thank you Mr. Chairman. Chairman Baker, Ranking Member Kanjorski, and members of the Subcommittee, I am Jim Kaitz, President and CEO of the Association for Financial Professionals (AFP). Thank you for the invitation to testify before the Subcommittee today. In September 2002, we conducted a survey of our members to learn their views on the quality of the information provided by rating agencies and their regulation by the Securities and Exchange Commission (SEC), the results of which I am pleased to present to you today. (I have attached the entire survey results as Appendix A.)

INTRODUCTION

AFP represents 14,000 finance and treasury professionals from over 5,000 organizations. Organizations represented by our members are drawn generally from the Fortune 1000 and the largest of the middle-market companies in a wide variety of industries.

Our members are responsible for issuing short-term and long-term debt and investing corporate cash and pension funds for their organizations. They rely on the rating agencies when their company issues debt and when they make investment decisions. As such, their relationship with the rating agencies provides them with an opportunity to form opinions on both the strengths and weaknesses of the agencies.

In September 2002, we surveyed senior-level corporate practitioners such as CFOs, vice presidents of finance, and corporate treasurers regarding the accuracy and timeliness of credit ratings, the role the SEC should take in regulating the credit rating agencies, and the impact additional competition may have on the marketplace for ratings information. We released the results of the survey in November 2002. Following the release, we presented the results to the SEC during a hearing that was held to gather information for its study on the role and function of credit rating agencies in the operation of the securities markets. In summary, the survey found that many of our members believe that:

- the information provided by credit rating agencies is neither timely nor accurate;
- the rating agencies are primarily serving the interest of parties other than investors; and
- the SEC should increase its oversight of rating agencies and takes steps to foster greater competition in the market for credit rating information.

BACKGROUND

For nearly 100 years, rating agencies have been providing opinions on the creditworthiness of issuers of debt to assist investors. In 1975, the SEC recognized Moody's, Standard & Poor's, and Fitch, the three major rating agencies in existence at that time, as the first nationally recognized statistical rating organizations (NRSRO). The SEC and other regulators use the ratings from the NRSROs to determine whether certain regulated investment portfolios, including those of mutual funds, insurance companies and banks, meet established credit quality standards. As a result, companies that hope to have their debt purchased by these portfolios must have a rating from an NRSRO. Prior to this year, the SEC had recognized four other rating agencies, but each of these new entrants merged with Fitch.

SURVEY RESULTS

A) Performance of Rating Agencies

i) Accuracy of Ratings

A significant minority of survey respondents indicate that they have reservations about the accuracy of the information provided by rating agencies. Twenty-nine percent of corporate treasury and finance professionals who work for companies with rated debt indicated that their company's ratings are inaccurate. This is true for companies that had recently been downgraded, as well as for those that were recently upgraded.

Corporate investors also shared the concerns of debt issuers regarding the accuracy of credit ratings. Only 65 percent of corporate respondents that use credit ratings to make investment decisions believe that the ratings of the companies in which they invest are accurate.

While credit ratings are supposed to reflect a creditor's ability to service and repay debt, one third of treasury and finance professionals from companies with rated debt believe that their company's rating is more reflective of the industry in which it operates than the company's finances. Fewer than one of five respondents believes their company's ratings are more reflective of the company's finances, while more than two of five respondents believe that their company's ratings are reflective of a balance of the company's finances and the industry.

ii) Timeliness of Ratings

A majority of both debt issuers and investors also indicate that they believe ratings do not reflect changes in a company's finances in a timely manner. Only forty percent of companies with rated debt believe that their ratings have been changed in a timely manner. Nearly three of five respondents from companies that have seen their debt upgraded indicate that the change took place more than six months after the improvement in the company's financials. While more timely than upgrades, downgrades still took more than six months to reflect a deterioration in a company's financial condition according to twenty-seven percent of respondents. Many investors also question the timeliness of the information provided by credit ratings; less than 40 percent of respondents that use credit ratings for investment decisions agree that credit ratings are timely.

iii) Assisting Investors

Rating agencies exist to provide tools for the investing public. However, only twenty-two percent of respondents believe the ratings most favor the interests of investors in debt. Treasury and finance professionals instead believe the ratings favor other interests. Fifteen percent of respondents believe the ratings most favor issuers of debt, while another 15 percent of corporate practitioners believe rating agency ratings most favor either commercial or investment banks. Financial professionals from companies that do not issue rated debt are even more skeptical about who the rating agencies favor.

B) Role of the SEC

i) Recognition of NRSROs

AFP members believe that the SEC plays an important role in overseeing the rating agencies. The overwhelming majority of respondents indicate that the SEC should take additional steps in its oversight of the rating agencies. Through its recognition of the NRSROs, the SEC determines which rating agencies are acceptable for purposes of assessing credit risk in certain regulated portfolios. Fifty-seven percent of corporate practitioners believe that it is appropriate for the SEC to continue its role in determining which rating agencies are acceptable. Only 18 percent of respondents disagree with the SEC's role. More telling is that 91 percent of respondents believe that the SEC should take additional steps in its oversight of the rating agencies.

Currently, there is no clearly defined process for credit agencies to achieve Nationally Recognized Statistical Rating Organization (NRSRO) status. Without a clear process and the possibility that other agencies may be recognized, there is little motivation for recognized rating agencies to improve their performance. Sixty-five percent of corporate practitioners believe the SEC should clarify its procedures for rating agencies to be recognized as NRSROs.

Granting NRSRO status to other credit rating agencies would provide additional competition that could result in improved accuracy and timeliness of ratings. In our survey, twenty-three percent of treasury and finance professionals supported the immediate recognition of at least one rating agency that was conducting business without NRSRO status. They believe that the additional competition stimulated by the recognition of additional rating agencies would increase both the accuracy and timeliness of credit ratings and ultimately lead to greater certainty in the assessment of corporate credit risk. Nearly three of five respondents believe the recognition of additional rating agencies would improve the quality of ratings and reduce the time it typically takes the rating agencies to account for material financial changes in their ratings.

ii) Oversight of NRSROs

Once the SEC recognizes a rating agency as an NRSRO, there is currently no ongoing process to ensure the agency's methodologies and procedures continue to be appropriate. Survey respondents believe a periodic review of the rating agencies is necessary. Seventy-three percent of corporate practitioners, believe that the SEC should periodically review the rating agencies it currently recognizes, for example, every five years.

CONCLUSION

AFP believes that our survey results clearly show that the time has come to re-examine the role, function and regulation of credit rating agencies. We are encouraged by the SEC's report that was delivered to Congress in January and the issues it identified for further examination. Many of those issues are consistent with the findings of our survey. We look forward to reviewing and commenting on the SEC's concept release when it is published.

We are also encouraged by the SEC's recognition of Dominion Bond Rating Service as a fourth Nationally Recognized Statistical Rating Organization (NRSRO). As I mentioned, our members expect additional competition to improve the accuracy and timeliness of the ratings. These improvements will provide greater certainty in assessing corporate credit risk.

Recent SEC actions are important first steps in addressing concerns about the accuracy and timeliness of the information provided by credit rating agencies. AFP believes that the credit rating agencies are vital to the efficient operation of capital markets and is pleased that you have taken the lead in examining these issues. We hope that this hearing will bring to light opportunities to increase competition in the market for credit ratings and improve the quality of the information provided by credit rating agencies for the benefit of issuers and investors in the securities markets.

Appendix A

RATING AGENCIES SURVEY:
Accuracy, Timeliness, and Regulation

RATING AGENCIES SURVEY:
Accuracy, Timeliness, and Regulation

Report of Survey Results

November 2002

Association for Financial Professionals

Introduction

For nearly 100 years, rating agencies have been providing opinions on the creditworthiness of issuers of debt to assist investors. The Securities and Exchange Commission (SEC) and banking regulators also rely on ratings from rating agencies. In 1975, the SEC recognized Moody's, Standard & Poor's, and Fitch, the three major rating agencies in existence at that time, as the first nationally recognized statistical rating organizations (NRSRO). The SEC and other regulators use the ratings from the NRSROs to determine whether certain regulated investment portfolios, including those of mutual funds, insurance companies and banks, meet established credit quality standards. As a result, companies that hope to have their debt purchased by these portfolios must have a rating from an NRSRO. Since 1975, the SEC has recognized four other rating agencies, but each of these entrants has merged with Fitch leaving only the original three agencies. No new agencies have been recognized since 1992.

Some market participants have argued that the NRSROs did not adequately warn investors of the impending failure of Enron, Worldcom, and other recently bankrupt companies. For example, in 2001, the rating agencies continued to rate the debt of Enron at "investment grade" levels days before the company filed for bankruptcy. An October 2002 Senate Governmental Affairs Committee report on financial oversight specifically criticizes the failure of the NRSROs to take action in the case of Enron. {**See Appendix B for background information.**}

Treasury and finance professionals rely on the NRSROs when their company issues debt and when they make investment decisions. Their relationship with the NRSROs provides them with an opportunity to form opinions on both the strengths and weaknesses of the agencies' practices. In September 2002, the Association for Financial Professionals surveyed senior level corporate practitioners and financial industry service providers on their views regarding the quality of the NRSROs' ratings, the role the SEC should take in regulating the agencies, and the impact additional competition may have on the marketplace for ratings information.

Executive Summary

Treasury and finance professionals, concerned with the quality and timeliness of credit ratings, believe the SEC should take additional action to improve its oversight of ratings agencies and foster greater competition. Nearly a third of corporate practitioners believe their company's ratings are inaccurate. Further, most respondents identify several other major problems that adversely affect their trust in the ratings. For example, most respondents do not believe changes in their company's finances are promptly reflected in the ratings. Many respondents also believe that their company's ratings are more reflective of the industry in which their company operates rather than the company's financial condition. Finally, most treasury and finance professionals do not believe the ratings favor the interests of investors in debt.

A significant minority of treasury and finance professionals believe that their company's credit ratings are inaccurate.

- Twenty-nine percent of practitioners who work for companies with rated debt believe that their company's ratings are inaccurate. Sixty-five percent of respondents believe that their company's ratings are accurate.

Most respondents do not believe changes in their company's finances are promptly reflected in the ratings.

- Only 40 percent of practitioners who work for companies with rated debt believe that changes in their company's ratings are timely. Further, most respondents believe ratings upgrades take longer to occur compared to ratings downgrades.
- Thirty-seven percent of corporate practitioners who use credit ratings for investment decisions feel that changes in the ratings are timely, with 43 percent of financial industry service providers holding similar views.

Treasury and finance corporate practitioners are more likely to believe that their company's ratings are reflective of the industry in which their company operates rather than their company's financial performance.

- Twice as many respondents believe that their company's credit ratings are more reflective of the industry in which it operates rather than of their company's finances (33 percent versus 17 percent).
- Forty-three percent of respondents believe their company's ratings reflect a balance between their company's finances and the industry.

Despite the fact that rating agencies are supposed to support the information needs of investors in debt, relatively few treasury and finance professionals believe the ratings favor the interests of investors.

- Only 22 percent of treasury and finance corporate practitioners believe the ratings favor the interests of investors in debt while 13 percent believe that the rating agencies balance the interests of all stakeholders, including debt issuers and commercial and investment banks. Rather, most respondents believe the ratings agencies serve other stakeholders—including 15 percent who believe ratings favor the interests of debt issuers—or are not sure whose interests the ratings represent.
- Only 11 percent of financial industry service providers believe ratings favor the interests of investors in debt, while 13 percent believe the ratings favor the interests of issuers of debt. Ten percent believe rating agencies balance the interests of all stakeholders. Nearly half of financial industry service providers are not sure whose interests the ratings favor.

A majority of treasury and finance professionals believe that it is appropriate for the Securities and Exchange Commission to identify "acceptable" rating agencies.

- Fifty-seven percent of treasury and finance corporate practitioners believe that it is appropriate for the SEC to identify acceptable rating agencies. Fifty-nine percent of financial industry service providers agree with the role the SEC plays in identifying acceptable rating agencies.

Ninety percent of treasury and finance professionals believe the SEC should take additional action to improve its oversight of the rating agencies and foster greater competition.

- More than seventy percent of treasury and finance professionals believe that the SEC should periodically review the rating agencies it currently recognizes.
- Treasury and finance professionals also support additional competition in the market for credit ratings.
- Three out of five treasury and finance professionals believe that the SEC should clarify the procedures for rating agencies to be recognized by the Commission to facilitate the entry of other rating agencies.
- More than 20 percent of treasury and finance professionals believe that the SEC should immediately recognize other rating agencies already in the business (e.g., Egan-Jones, Dominion).

More treasury and finance professionals expect benefits from the recognition of additional rating agencies than expect additional costs.

- Fifty-six percent of treasury and finance corporate practitioners believe that the recognition of additional rating agencies would improve the quality of the ratings. Sixty-three percent of financial industry service providers share similar beliefs.
- Fifty-eight percent of corporate practitioners, along with 59 percent of finance industry service providers, expect improved timeliness of rating changes as a result of additional competition among rating agencies.

- Forty-eight percent of corporate practitioners believe the recognition of additional rating agencies would increase certainty in the assessment of corporate credit risk. Sixty percent of financial industry service providers share similar beliefs.
- Less than half of corporate practitioners believe that additional competition would lead to increased expense for debt issuers while only a third of respondents believe expenses will increase for investors in debt.

Survey Findings

Importance of the NRSROs

Credit ratings affect nearly all businesses—regardless of whether a company issues debt. Just under half of the respondents to the survey work for a company that has rated debt, while the vast majority work for a company that uses ratings from an NRSRO to make investment decisions.

Issuers of Debt

While many companies are able to issue debt without a rating from an NRSRO, non-rated debt is typically subject to higher interest rates and fees. As a result, many companies are reluctant or unable to issue debt without an NRSRO rating. Only 21 percent of survey respondents indicate that their company would be able to issue public debt without a rating from one of the "Big Three" agencies.

Despite being able to access analysis from all three NRSROs, most companies with rated debt tend to seek out ratings from only two of the three NRSROs. **Among the three NRSROs, most businesses that issue short-term debt receive a rating from both Moody's and Standard & Poor's (at least 90 percent each), while Fitch is less prevalent (40 percent). At least 90 percent of companies issuing long-term debt are rated by Moody's and Standard & Poor's, while only 36 percent receive ratings from Fitch.**

Market Penetration of Rating Agencies Among Companies with Rated Debt
(Percentage of Respondents)

Debt	Short-term Debt	Long-term
Standard & Poor's	92%	92%
Moody's	90	90
Fitch	40	36

Rating Triggers

Credit and debt agreements held by companies may contain clauses called "rating triggers." These triggers may require an issuer to repay debt at an accelerated pace or reduce or eliminate the amount of credit available to a borrower if their ratings drop below a level specified in their agreement. **Over a quarter of respondents from companies with rated debt indicate that their company is subject to ratings triggers.**

Investors in Debt

Companies may rely on a number of resources to assess credit risk, including the analyses provided by NRSROs, when making investment decisions. Two of the three NRSROs dominate the market for information used for investment decisions. **More than 80 percent of survey respondents report that their company considers ratings from Moody's and Standard & Poor's to be acceptable sources of credit risk information per their company's investment policy. More than a third of respondents list analysis from Fitch as an acceptable source for credit risk information.**

Use of NRSROs for Investment Decisions
(Percentage of Respondents)

	Corporate Practitioners	Financial Industry Service Providers
Standard & Poor's	88%	86%
Moody's	87	85
Fitch	34	35
None	4	2

Accuracy & Timeliness

Accuracy

Debt Issuers

Twenty-nine percent of corporate practitioners believe the ratings on their company's short-term and long-term debt are inaccurate. Sixty-five percent of respondents believe the ratings of their company's short-term and long-term debt are accurate.

Not all of the respondents who believe their company's ratings are inaccurate are from companies that recently received a ratings downgrade. Among those working for companies that recently experienced a downgrade, 37 percent of respondents believe their company's ratings inaccurately reflect their company's financial situation. Twenty-six percent of practitioners from companies that recently experienced a ratings upgrade also believe their company's ratings are inaccurate.

Agreement on Whether Company's Ratings Are Accurate
(Percentage Distribution)

	All Corporate Practitioners	Corporate Practitioners-Recent Downgrade	Corporate Practitioners-Recent Upgrade
Strongly agree	21%	10%	20%
Somewhat agree	44	45	50
Neither	6	8	4
Somewhat disagree	21	29	18
Strongly disagree	8	8	8

While most treasury and financial professionals working for companies with rated debt have confidence in the rating agencies' knowledge of their company and their industry, one out of five respondents disagree with each of these statements. **Only 62 percent of respondents agree with the statement "the rating agencies understand my company." Further, 66 percent of respondents believe the rating agencies understand the industry in which their company operates. Finally, two-thirds of respondents are pleased with the frequency with which the rating agencies' staff meet with their company's staff.**

Evaluation of Rating Agencies' Understanding of Companies and Industries
(Percentage Distribution)

	Agencies Understand Company	Agencies Understand Industry	Agencies Meet with Company Staff Frequently
Strongly agree	19%	25%	27%
Somewhat agree	43	41	39
Neither	14	12	15
Somewhat disagree	19	17	11
Strongly disagree	5	5	8

Accuracy

Investors

Treasury and finance professionals who use rating agency analysis for investment decisions share the opinions of those who work for companies with rated debt. While a majority of respondents believe the ratings are accurate, many others either believe the credit ratings of the companies in which they invest are inaccurate or are unsure of their accuracy.

Among corporate practitioners from companies that use ratings for investment decisions, only 65 percent believe the ratings of companies in which their company invests are accurate. AFP members who work for financial industry service providers—such as banks—hold a similar, if somewhat more positive, viewpoint. Three-quarters of respondents from financial industry service providers believe the ratings of the companies in which their company invest are accurate.

Agreement by Investors that Credit Ratings are Accurate
(Percentage Distribution)

	Corporate Practitioners	Financial Industry Service Providers
Strongly agree	7%	9%
Somewhat agree	58	66
Neither	21	21
Somewhat disagree	12	4
Strongly disagree	2	*

*Less than one percent

Timeliness

Debt Issuers and Investors

Most respondents—whether they work for a company with rated debt or use ratings for investment decisions—do not believe that ratings reflect changes in a company's finances in a timely fashion. **Only 40 percent of corporate practitioners from companies with rated debt believe that changes in their company's ratings have been timely. Further, only 37 percent of corporate practitioners who use ratings for investment decisions believe changes in the ratings are timely.**

Agreement on Whether Company's Ratings Are Timely
(Percentage Distribution)

	Corporate Practitioners from Companies w/ Rated Debt	Corporate Practitioners from Companies that Use Ratings for Investment Decisions	Financial Industry Service Providers
Strongly agree	11%	4%	8%
Somewhat agree	29	33	35
Neither	22	25	29
Somewhat disagree	28	28	25
Strongly disagree	10	10	3

Corporate practitioners indicate that it can take months or even a year or more for a change in their company's financial condition to be reflected in the ratings. Slightly more than half of practitioners from companies that have experienced a ratings downgrade report that it took the ratings agencies between one and six months for a deterioration in their company's financials to be reflected in their ratings. **Twenty-seven percent of respondents said the downgrade took place more than six months after the deterioration in the company's financials.**

Rating upgrades can take even longer. **Fifty-seven percent of respondents who represent companies that have experienced a ratings upgrade report that the upgrade took place more than six months after the improvement in the company's financials.**

Length of Time for Ratings Changes—Companies that Have Experienced a Change
(Percentage Distribution)

	Downgrades	Upgrades
Less than a month	22%	14%
One to six months	51	29
Six months to a year	19	22
More than a year	8	35

Determinants of Ratings

Credit ratings are supposed to reflect a creditor's ability to service and ultimately repay debt. **Yet, 33 percent of corporate practitioners believe their company's ratings are more reflective of the industry in which it operates than the company's finances.** Only 17 percent of respondents believe their company's ratings are more reflective of the company's finances. Forty-three of respondents believe their company's ratings reflect a balance between their company's finances and the industry.

Opinions on Whether Ratings Are More Reflective of Company's Finances or the Industry in Which it Operates
(Percentage Distribution)

Company finances	17%
Industry in which company operates	33
Balanced between both	43
Don't know	7

Assisting Investors

Rating agencies have been providing opinions on the creditworthiness of issuers of debt to assist investors for over 100 years. However, relatively few treasury and finance professionals believe the ratings favor the interests of investors. **Only 22 percent of corporate practitioners believe the ratings most favor the interests of investors in debt.**

Treasury and finance professionals instead believe the ratings favor other interests. Fifteen percent of respondents believe the ratings most favor issuers of debt, while another 15 percent of corporate practitioners believe rating agency ratings most favor either commercial or investment banks. Commercial and investment banks may play different roles in relation to a company that issues debt or borrows. First, both commercial and investment banks may invest in debt and therefore may have the same interests as investors. Banks can also profit by lending to a company and by providing services to the debt issuer.

The Interests Credit Ratings Favor
(Percentage Distribution)

	Corporate Practitioners	Financial Industry Service Providers
Investors in debt	22%	11%
Issuers of debt	15	13
Investment banks	10	11
Commercial banks	5	5
Interests are balanced	13	10
Don't know	35	50

Treasury and finance professionals from companies that do not issue rated debt, including those from banks, are even more skeptical about who the rating agencies most favor. Only nine percent of corporate practitioners who work for a company that does not issue rated debt, along with 11 percent of financial industry service providers, believe the ratings favor the interests of investors in debt. This compares with 38 percent of corporate practitioners from companies with rated debt. A possible reason for the difference in opinion is that staff from companies with rated debt must interact with personnel from the rating agencies and, therefore, may have a better appreciation of how the agencies develop ratings.

Alternative Sources of Information

When making investment decisions, many companies tap other resources for credit risk information to supplement the analysis provided by the three NRSROs. **Eighty-three percent of corporate practitioner respondents indicate that their company turns to information sources beyond the NRSROs when making investment decisions.** These resources, however, are not adequate by themselves for most companies' investment policies.

The three alternative external resources most cited by corporate practitioners are Dun & Bradstreet (48 percent), investment banker research (36 percent), and A.M. Best Company (26 percent). In addition, 42 percent of practitioners report that their company has developed proprietary research.

Respondents from financial industry service providers use alternative information resources in a similar fashion. Seventy-eight percent of respondents report using Dun & Bradstreet while 22 percent indicate that their company uses A.M. Best Company. Sixty-eight percent of respondents use information developed from internal proprietary research while 17 percent turn to research prepared by investment bankers.

Other Resources Used to Make Investment Decisions
(Percentage of Respondents)

	Corporate Practitioners	Financial Industry Service Providers
A.M. Best Company	26%	22%
Dominion Bond Rating Service	4	4
Dun & Bradstreet	48	78
Egan-Jones Rating Company	1	3
KMV	1	13
Lace Financial	3	4
Other rating agencies	1	3
Internal research	42	68
Research from investment bankers	36	17
Other	7	6
Company does not consult other resources	17	3

The Role of the SEC

Since 1975, the SEC has been responsible for recognizing rating agencies as NRSROs. Treasury and finance professionals believe that the SEC should continue its oversight of the NRSROs. In addition, survey respondents believe the SEC should take additional action to improve its oversight of the rating agencies and foster greater competition.

Fifty-seven percent of corporate practitioners believe that it is appropriate for the SEC to determine which rating agencies are acceptable for purposes of assessing credit risk in regulated portfolios. Only 18 percent of respondents disagree with the SEC's role. Fifty-nine percent of financial industry service providers also support the SEC's role, with only 11 percent dissenting.

Appropriateness of SEC's Role in Recognizing Rating Agencies
(Percentage Distribution)

	Corporate Practitioners	Financial Industry Service Providers
SEC's role is appropriate	57%	59%
SEC's role is not appropriate	18	11
Do not know	25	30

Expanded Role for the SEC

Most treasury and finance professionals support proposals for the SEC to expand its oversight of the rating agencies beyond simple recognition of NRSROs. **More than ninety percent of survey respondents believe the SEC should take additional steps in its oversight of the rating agencies.** A majority of respondents agree that these additional steps should include periodic review of NRSROs and clarifying the procedures for the recognition of additional agencies. Even respondents who believe the SEC should not be recognizing rating agencies support an expanded role for the SEC should the Commission's role continue.

Currently, the SEC does not periodically review the methodologies and performance of NRSROs. Once the SEC recognizes a rating agency as an NRSRO, there is no ongoing process to ensure the agency's methodologies and procedures remain valid.

Most survey respondents believe a periodic review of the rating agencies is necessary. **Seventy-three percent of corporate practitioners, along with 71 percent of respondents from financial industry service providers, believe that the SEC should periodically review the rating agencies it currently recognizes, for example, every five years.**

Some observers, including some rating agencies that have attempted to be recognized as an NRSRO, argue that there is no defined process for credit agencies to achieve NRSRO status. Without additional rating agencies—or at least the threat of entry by other agencies—some observers believe the three major agencies have little motivation to improve their performance. Most treasury and finance professionals agree the SEC should take steps to clarify the process for agencies to achieve NRSRO status. **Sixty-five percent of corporate practitioners and 60 percent of respondents from financial service providers believe the SEC should clarify its procedures for rating agencies to be recognized as NRSROs.**

Recently, several rating agencies, including Egan-Jones and Dominion, sought NRSRO status and were rejected. Some observers believe that granting NRSRO status to at least one of these companies would provide additional competition that could result in improved accuracy and timeliness of ratings. **Twenty-three percent of corporate practitioners, along with 22 percent of respondents from financial industry service providers, support the immediate recognition of at least one rating agency currently conducting business without NRSRO status.**

Additional Actions that the SEC Should Take in its Oversight of Rating Agencies

	Corporate Practitioners	Financial Industry Service Providers
Periodically review rating agencies	73%	71%
Clarify procedures for rating agency recognition	65	60
Immediately recognize other rating agencies	23	22
Other	5	4

(Percentage of Respondents)

The Impact of Entry

Treasury and finance professionals support the entry of competitors to Moody's, Standard & Poor's, and Fitch in the marketplace for ratings information. They believe additional competition would increase both the accuracy and timeliness of credit ratings and ultimately lead to greater certainty in the assessment of corporate credit risk. Further, they are more likely to believe that there will be benefits from additional competition than they are to believe there will be increased costs.

Most respondents indicate that the following beneficial outcomes would result from the recognition of additional rating agencies:

- **Fifty-six percent of treasury and finance corporate practitioners, along with 63 percent of finance industry service providers, believe the recognition of additional rating agencies would improve the quality of ratings.**
- **Fifty-eight percent of corporate practitioners, plus 76 percent of financial industry service providers, believe entry of other rating agencies would reduce the time it typically takes the rating agencies to account for material financial changes in their ratings.**
- **Forty-eight percent of corporate practitioners, along with 60 percent of financial industry service providers, believe that additional choices for rating agencies would increase certainty when assessing corporate credit risk.**

More treasury and finance professionals expect benefits from the recognition of additional rating agencies than expect additional costs. Forty-six percent of corporate practitioners, along with 43 percent of financial industry service providers, believe expenses would rise for issuers of debt. A third of corporate practitioners, along with 36 percent of financial industry service providers, believe expenses would rise for investors in debt.

Impact of Recognizing Additional Rating Agencies
(Percentage of Respondents Choosing "Strongly Agree" or "Somewhat Agree")

	Corporate Practitioners	Financial Industry Service Providers
Improved ratings quality	56%	63%
Improved timeliness	58	76
Greater certainty when assessing credit risk	48	60
Increased expense for debt issuers	46	43
Increased expense for investors	33	36

Appendices

Appendix A: Methodology
Appendix B: Background

Appendix A: Methodology

In September 2002, the Association for Financial Professionals e-mailed a 17-question survey to more than 2,700 practitioner members of AFP holding senior level job titles[1]. 327 surveys were returned. AFP also sent the same survey to prospective practitioner members of AFP, producing an additional 207 completed surveys. At the same time, AFP sent a nine-question survey to financial industry service providers who indicated their employer is a bank, generating a response of 181 surveys. At a 95 percent confidence level, the responses from practitioners are accurate within a four-percentage point interval. For responses from finance industry service providers, the 95 percent confidence interval is seven percentage points.

The respondents to this survey are similar to the demographic profile of AFP's membership. Among corporate practitioners, the typical respondent works for a company with annual revenues slightly less than $1 billion. As a comparison, the typical AFP corporate practitioner member works for a company with revenues slightly greater than $1 billion. More than half of the respondents from financial industry service providers work for banks with assets greater than $20 billion.

The survey questionnaires are available on the Research page of AFP's Web site at www.AFPonline.org.

[1] Senior job titles include CEO, CFO, president, vice president, assistant vice president, director, treasurer, and assistant treasurer.

Appendix B: Background

For nearly 100 years, rating agencies have been providing opinions on the creditworthiness of issuers of debt to assist investors. In 1909, Moody's published the first bond ratings in the U.S. for railroad bonds. Poor's began issuing ratings in 1916, with Standard Statistics and Fitch Publishing following in 1922 and 1924, respectively. In 1941, Standard Statistics and Poor's merged into Standard & Poor's. These ratings were intended as tools for the investing public, which provided revenue to the rating agencies by purchasing their published reports.

Since their beginning, the importance of credit ratings to investors, issuers, and other participants in the securities markets has increased significantly. This is in part due to the dramatic increase in the number of debt issuers and issues. Perhaps more importantly, the complexity of many financial products, such as asset-backed and derivative securities, has made it more difficult for investors to assess credit risk on their own. The role of credit ratings has also expanded to other countries as a result of the globalization of financial markets.

Regulatory requirements have also contributed to the increased importance of credit rating agencies. Many regulators, responsible for ensuring the safety and soundness of banks, brokers, insurers, mutual funds and pension funds, found the process of assessing risk in these portfolios to be costly and inaccurate. Rather than continue to conduct this analysis on their own, regulators recognized that the private market was already rating bonds at no cost to the government. Regulators began to rely on the information provided by these ratings to fulfill their regulatory obligations and required regulated entities to report the ratings of the bonds in which they invested. Starting around 1970, Moody's and Standard & Poor's began to charge issuers for bond ratings rather than relying on publication revenue from investors and other market participants as their primary source of income.

Because of its increased reliance on credit ratings, the SEC in 1975 recognized Moody's, Standard & Poor's, and Fitch, the three major rating agencies in existence at that time, as the first nationally recognized statistical rating organizations (NRSRO). The SEC originally recognized these three firms for the purpose of determining capital charges on debt securities for broker-dealers. Over time, the NRSRO concept was also incorporated into new regulations related to the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. Other regulators have followed suit and adopted the NRSRO designation in their regulations. Only ratings from an NRSRO are recognized in many of these regulations. As a result, companies that hope to have their debt purchased by large institutional investors, including banks, mutual funds, and insurers, must have a rating from an NRSRO.

The SEC considers many criteria for NRSRO recognition. According to testimony by SEC Commissioner Isaac C. Hunt, Jr. before the Senate Committee on Governmental Affairs in March 2002, the single most important criterion that the SEC considers when determining whether a rating agency may be considered a nationally recognized statistical rating organization "is that the rating agency is nationally recognized." Hunt also said that this "means the rating organization is widely accepted in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings." The SEC also reviews the operational capability and reliability of each rating organization, including their rating procedures, organizational structure, financial resources, staffing, independence from the companies it rates, and internal controls.

Since 1975, the SEC has recognized only four new rating agencies: Duff and Phelps, McCarthy Crisanti and Maffei, IBCA, and Thomson BankWatch. Each of these entrants has subsequently merged with Fitch, leaving only the original three agencies. No new agencies have been recognized since 1992. Several rating agencies, including LACE Financial, Dominion Bond Rating Service, and Egan-Jones Ratings, have sought the NRSRO designation in recent years with little success. In 1998, the U.S. Department of Justice's Antitrust Division submitted comments to the SEC stating its belief that the requirements to become an NRSRO create an anti-competitive barrier to entry for new credit rating agencies.

Credit ratings are important to companies for many reasons. Whether a company has a credit rating from one or more of the NRSROs and the level of its ratings have a significant impact on the company's ability to issue debt and the terms, including pricing, under which the company may do so. Changes in credit ratings can also impact existing credit and debt agreements. Over one quarter of respondents to this survey indicate that there are ratings triggers in their company's credit or debt agreements that would reduce the amount of credit available to them or would require them to repay debt at an accelerated pace as a result of a ratings downgrade. Many companies also rely heavily on ratings from NRSROs when making investment decisions.

Some market participants have criticized the rating agencies, who are given enhanced access to corporate executives and financial information, for failing to warn investors of problems at Enron, WorldCom and other companies that later declared bankruptcy. Congress joined the debate and mandated action by regulators.

The Sarbanes-Oxley Act of 2002 will have significant effects on corporate governance, financial accounting, and SEC reporting. Because of the importance of rating agencies to regulatory agencies and the securities markets, the Act also requires that the SEC conduct a study of the role and function of credit rating agencies in the operation of the securities market. That study must be completed by January 26, 2003.

On October 7, 2002, the Senate Governmental Affairs Committee issued a report, "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs." That report criticized the three major credit rating agencies for failing to warn the public with respect to Enron and recommended additional regulation and training for rating agencies.

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Moody's Investors Service

Statement to the United States House of Representatives
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises

Raymond McDaniel, President, Moody's Investors Service

Good morning Chairman Baker, Congressman Kanjorski, and members of the Subcommittee. My name is Ray McDaniel, and I am the President of Moody's Investors Service, which is one of the leading global credit rating agencies. On behalf of my colleagues, let me begin by thanking the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises for the opportunity to participate in today's panel on the state of transparency and competition in the rating agency industry. Before I comment on several of the more specific themes and issues that I expect you will want this panel to consider today, I wanted briefly to offer a more generalized perspective.

Over the past two years there have unfortunately been a large number of companies that have experienced financial difficulties, causing suffering for their employees and sometimes significant losses for the investors in their stocks and bonds. I believe everyone agrees that attempting to understand and, where appropriate, redress the underlying reasons associated with these failings has been both necessary and beneficial. Yet, it is also important to keep in mind that the economy and financial markets of the United States remain the envy of most of the world. Moody's is proud of our role as a supporting player in these markets. Credit ratings help level the playing field for information between borrowers and investors. This function improves both transparency and efficiency in debt markets by promoting investor confidence, which in turn allows creditworthy borrowers greater access to capital.

As you know, throughout the past year the Securities and Exchange Commission and both branches of the U.S. Congress have carried out a series of investigations and fact-finding studies on the various participants in the U.S. market. Among these participants have been the rating agencies. In hearings conducted last November by the Commission, it repeatedly heard that, overall, the rating agencies have adequately fulfilled their role;[1] that, although there is always room for improvement, the system in general is not broken.

With that perspective in mind, I'd like now to offer a few more in-depth comments about our industry in general, and Moody's policies and practices in particular. Moody's is the oldest credit rating agency in the world, having been founded at the beginning of the last century. From the start, Moody's has focused on rating debt instruments. Our long-term debt rating system for public bonds is the heart of our business. We have 21 long-term debt rating categories, which provide a relative measure of risk, with the probability of default increasing with each step down our rating scale. Our ratings are reliable predictors of relative creditworthiness. Their predictive content has been demonstrated and consistently confirmed through Moody's publication of annual corporate bond default studies,[2] and by third party academic analysis. As forward-looking opinions, our ratings have effectively distinguished bonds with higher credit risk from bonds with lower credit risk. Moody's long history of success in the credit ratings business demonstrates both the effective disclosure regime in the U.S. securities market and the methodology employed by our analysts.

At Moody's, we are committed to providing the highest quality credit assessments available in the global markets. For 100 years our culture has been based on a commitment to continuous learning, both from our successes and our mistakes. In this spirit, and in line with our statement before the U.S. Senate Committee on Governmental Affairs,[3] we have undertaken

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1 See, e.g., Report on the Role and Function of Credit Rating Agencies in the operation of the Securities Markets, U.S. Securities and Exchange Commission, January 2003, at 21 ("In selecting which rating agencies to use, issuers seek those capable of a competent, rigorous analysis that is recognized by the market place. As a practical matter, these have tended to be one or more of the NRSROs.")

This sentiment has also been expressed by the Staff of the Senate Governmental Affairs Committee in a recent report: "If history is a guide, credit rating agencies generally get it right." *Financial Oversight of Enron: The SEC and the Private Sector Watchdogs*, Report of the Staff to the Senate Committee on Governmental Affairs, at 99 (Oct. 8, 2002).

2 We are including, as Exhibit A, a copy of our latest default study, published in February 2003, which provides a look at default rates from 1920 through 2002.

3 *See* Rating the Raters: Enron and the Credit Rating Agencies, Hearing Before the Senate Governmental Affairs Committee, 107th Cong., S. Hrg. 107-471 (March 20, 2002). These initiatives include: an enhanced training program for our analysts; the hiring of specialist that provide more in-depth expertise in the areas of accounting, corporate governance, off balance-sheet risk transference. We have already begun to see the impact on our analysis

substantial internal initiatives to learn from recent difficulties in the credit markets, as well as in response to potential shortcomings in our own analytical approach and in the broader system of market checks and balances.

Our business model is based primarily on receipt of fees from debt issuers. Issuers are the natural source of rating agency fees for several related reasons, but most importantly for one key attribute demanded of our ratings: that they be freely and widely disseminated to the investing public. Ratings from the major rating agencies play an integral role in the securities markets not only because they condense and transmit a great deal of credit information about issuers, but because they do so for the equal benefit of *all* investors, and not just a select group of subscribers. Ratings offered in this manner are a public good. Today, the market and regulatory authorities *expect* that ratings on issuers and instruments of publicly offered debt be disseminated ***publicly*** and ***promptly***.

As a rating agency, however, it is also our obligation to manage and protect against the latent conflicts of interest that our business model creates. Moody's has taken strict measures on both an institutional level and on a ratings-practice level. As a corporation, for example, Moody's does not offer investment products, nor do we buy, sell, or recommend securities. Moody's also does not invest in securities for its own account.[4] Within our ratings practice, committees rather than individual analysts assign Moody's ratings. Analysts are neither compensated based upon the revenues associated with the companies that they analyze, nor are they permitted to hold or trade the securities in their areas of primary analytical responsibility.

Over time, use of our ratings has been adopted by numerous capital market participants for multiple and sometimes conflicting objectives. For example, issuers use our ratings because many investors demand ratings on debt issues. Not surprisingly, issuers would like the highest possible, plausible ratings and greater control over the rating process. Large institutional investors often use our ratings in their portfolio composition and governance guidelines.

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because of these various initiatives, and hope to continue improving the quality of our analysis and the reliability of our credit ratings.

4 Moody's ultimate parent company, Moody's Corporation, has a publicly disclosed stock repurchase program for Moody's Corporation's New York Stock Exchange listed equity (NYSE: MCO). Moody's Corporation may also, from time to time, invest in short-term securities for Treasury management purposes.

Generally, these investors prefer stability in the ratings on securities that they own.[5] Finally, global governmental authorities have incorporated ratings into banking, insurance, securities and other regulations to limit risk in financial institutions for the dual purposes of promoting investor protection and improving financial market stability. Because each group has different objectives in using ratings, the performance or "quality" of ratings has also been subjected to multiple assessment processes, which in some cases are incompatible with Moody's stated purpose of our ratings: that is, to help level the playing field for information between issuers and investors.

Another issue that has been raised frequently in examining rating agencies is the degree of competition within the industry. Moody's observes that we have been successful over time and around the world in serving markets with different and changing competitive structures. We are confident of our ability to continue to do so, *if* competing successfully is driven by who offers the most reliably predictive credit opinions. That form of competition requires diverse, independent opinions – as opposed to a diversity of firms offering the same opinion, or a diversity of firms whose opinions are all accorded equal authority for reasons unrelated to predictive content. As a key industry participant, therefore, Moody's does not oppose alternative industry structures; we do, however, urge that any framework not inadvertently encourage competition based on reduced standards.

The role of a rating agency is inherently controversial. It is a rating agency's task to publish opinions regarding the most powerful and influential entities in the financial markets, including governments. We would, therefore, suggest that in examining ratings "quality" and rating agency performance, two essential principles be kept in mind:

- *First*, ratings at their core must be independently formed opinions. To have continuing public value, they must capably predict bond issuers' future creditworthiness, which means that the agencies must be motivated to act independently of each other, of governments, and of issuers and their agents to reach the highest standards, not the most popular or most convenient standards; and,

[5] Portfolio guidelines as adopted by many institutions can cause investors to sell securities, sometimes into unfavorable market conditions. As a result, portfolio managers desire stability in ratings to avoid potential trading losses from rule-based trading actions.

- *Second,* rating agencies must disseminate ratings broadly and promptly to all of the investing public. Without this attribute, ratings would cease to be a public good. They would become a tool for users with the greatest financial capacity, and would further tilt, rather than level, the playing field for information.

Only with these principles preserved can ratings continue to fulfill the larger public values of transparency and investor protection that the marketplace, regulatory authorities, and lawmakers expect of us.

Moody's greatly appreciates the Subcommittee's invitation to participate in this important panel discussion. The obligation to assure that the U.S. financial markets remain the fairest and most transparent in the world is one that all market participants share, especially those of us who have been entrusted with that direct responsibility. I look forward to answering any questions the Subcommittee has in pursuit of this important goal.

Thank you.

TESTIMONY
OF
ANNETTE L. NAZARETH
DIRECTOR, DIVISION OF MARKET REGULATION
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
RATING THE RATING AGENCIES: THE STATE OF TRANSPARENCY AND COMPETITION

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

APRIL 2, 2003

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Rating the Rating Agencies: the State of Transparency and Competition

Testimony
of
Annette L. Nazareth
Director, Division of Market Regulation
U.S. Securities and Exchange Commission

Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services
April 2, 2003

Chairman Baker, Ranking Member Kanjorski and Members of the Subcommittee:

On behalf of the Securities and Exchange Commission ("Commission" or "SEC"), I appreciate the opportunity to testify before you today regarding credit rating agencies and their role and function in the operation of the securities markets.

As you know, this past January the Commission submitted to Congress a detailed report on credit rating agencies ("Report")[1] in response to the Congressional directive contained in the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act").[2] The Report was designed to address each of the topics identified for Commission study in the Sarbanes-Oxley Act, including the role of credit rating agencies and their importance to the securities markets, impediments faced by credit rating agencies in performing that role, measures to improve information flow to the market from rating agencies, barriers to entry into the credit rating business, and conflicts of interest faced by rating agencies. As the report called for by the Sarbanes-Oxley Act coincided with a review of credit rating agencies already underway at the Commission, the Report addressed certain issues regarding rating agencies, such as allegations of anticompetitive or unfair practices, the level of diligence of credit rating agencies, and the extent and manner of Commission oversight, that went beyond those specifically identified in the Sarbanes-Oxley Act.

In my testimony this morning, I would like to highlight for you some of the key points in the Commission's Report, and give you a sense of some of the areas we intend to explore in more depth.

Background

For almost a century, credit rating agencies have been providing opinions on the creditworthiness of issuers of securities and their financial obligations. During this time, the importance of these opinions to investors and other market participants, and the

1 *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets*, U.S. Securities and Exchange Commission (January 2003) (available at http://www.sec.gov/news/studies/credratingreport0103.pdf).

2 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 702(b), 116 Stat. 745 (2002).

influence of these opinions on the securities markets, have increased significantly. This is due in part to the increase in the number of issuers and the advent of new and complex financial products, such as asset-backed securities and credit derivatives. The globalization of the financial markets also has served to expand the role of credit ratings to countries other than the United States, where the reliance on credit ratings largely was confined for the first half of the twentieth century. Today, credit ratings affect securities markets in many ways, including an issuer's access to capital, the structure of transactions, and the ability of fiduciaries and others to make particular investments.

During the past 30 years, regulators, including the Commission, have increasingly used credit ratings to help monitor the risk of investments held by regulated entities, and to provide an appropriate disclosure framework for securities of differing risks. Since 1975, the Commission has relied on ratings by market-recognized credible rating agencies for distinguishing among grades of creditworthiness in various regulations under the federal securities laws. These "nationally recognized statistical rating organizations," or "NRSROs," are recognized as such by Commission staff through the no-action letter process. There currently are four NRSROs – Moody's Investors Service, Inc., Fitch, Inc., Standard and Poor's, a division of The McGraw-Hill Companies Inc., and Dominion Bond Rating Service Limited. In the past, the Commission staff has recognized other rating agencies as well, although these firms have since been acquired by existing NRSROs.

Although the Commission originated the use of the term "NRSRO" in regulation, ratings by NRSROs today are widely used as benchmarks in federal and state legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts. In this connection, Commission staff recognizes the importance of consulting with other relevant regulatory agencies regarding the role of NRSROs.

To assess whether a rating agency may be considered an NRSRO for purposes of the Commission's rules, the Commission staff consider a number of criteria. The single most important criterion is that the rating agency is nationally recognized, which means the rating organization is widely accepted in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. Thus, the designation is intended largely to reflect the view of the marketplace as to the credibility of the ratings, rather than represent a "seal of approval" of a federal regulatory agency.

The staff also reviews the operational capability and reliability of each rating organization. Included within this assessment are: (1) the organizational structure of the rating organization; (2) the rating organization's financial resources (to determine, among other things, whether it is able to operate independently of economic pressures or control from the companies it rates); (3) the size and experience and training of the rating organization's staff (to determine if the entity is capable of thoroughly and competently evaluating an issuer's credit); (4) the rating organization's independence from the companies it rates; (5) the rating organization's rating procedures (to determine whether it has systematic procedures designed to produce credible and accurate ratings); and (6) whether the rating organization has internal procedures to prevent the misuse of non-public information and whether those procedures are followed. The staff also recommends that the rating agency become registered as an investment adviser under the Investment Advisers Act of 1940.

Recent Commission Initiatives

Over the last several years, the Commission has reviewed a number of issues regarding credit rating agencies and, in particular, the need for a system of regulatory oversight of entities whose credit ratings are to be relied upon for purposes of federal securities regulation. In 1994, the Commission issued a Concept Release soliciting public comment on the appropriate role of ratings in the federal securities laws, and the need to establish formal procedures for recognizing and monitoring the activities of NRSROs.[3] That Concept Release led to a rule proposal in 1997 which, among other things, would have defined the term "NRSRO" in Rule 15c3-1 under the Securities Exchange Act of 1934,[4] the Commission's net capital rule. However, the Commission has not acted upon that rule proposal. We note that the rating agencies take the position that these issues currently are addressed by their existing policies, procedures and competition. In addition, the rating agencies have asserted that their ratings activities are, at least to some extent, protected by the First Amendment.

More recently, the Commission has pursued several approaches, both formal and informal, to conduct a thorough and meaningful study of the use of credit ratings in the federal securities laws, the process of determining which credit ratings should be used for regulatory purposes, and the level of oversight to apply to recognized rating agencies. Commission efforts included informal discussions with credit rating agencies and market participants, formal examinations of each of the NRSROs, and public hearings that offered a broad cross-section of market participants the opportunity to communicate their views on credit rating agencies and their role in the capital markets. Those hearings – held this past November – addressed a wide range of topics, including: (1) the current role and functioning of credit rating agencies; (2) information flow in the credit rating process; (3) concerns regarding credit rating agencies (*e.g.*, potential conflicts-of-interest or abusive practices); and (4) the regulatory treatment of credit rating agencies (including concerns regarding potential barriers to entry).

Commission Report

These Commission initiatives coincided with the requirement of the Sarbanes-Oxley Act that the Commission conduct a study of credit rating agencies and submit a Report on that study to Congress. The Commission submitted that Report to Congress this past January. The Report identified a number of important substantive issues relating

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3 *See* Nationally Recognized Statistical Rating Organizations, Release No. 34-34616 (August 31, 1994), 59 FR 46314 (September 7, 1994).

4 *See* Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Release No. 34-39457 (December 17, 1997), 62 FR 68018 (December 30, 1997).

to credit rating agencies that the Commission would be exploring in more depth, including the following: (1) improved information flow in the credit rating process; (2) potential conflicts of interest; (3) alleged anticompetitive or unfair practices by NRSROs; (4) potential regulatory barriers to entry into the credit rating business; and (5) ongoing regulatory oversight of credit rating agencies. As noted in the Report, the Commission plans to issue a Concept Release that would seek public comment on these matters. Among other things, the Concept Release would ask a wide range of questions regarding possible approaches the Commission could develop to address various concerns regarding credit rating agencies.

I will devote the remainder of my testimony to a synopsis of some of these complex issues.

1. *Information Flow*

One important group of issues the Commission staff has been reviewing relates to the information flow surrounding the credit rating process.

First, we are exploring the current amount of disclosure that rating agencies provide regarding their ratings decisions. As you may know, the nature and extent of information made available to the public and/or subscribers varies from one credit rating agency to another. Credit rating agencies may provide comprehensive, lengthy research reports detailing the criteria and support for their ratings, or they may provide less intensive summary information that can be quickly and easily reviewed, or both. At the Commission's credit rating agency hearings, representatives of users of securities ratings – particularly buy-side firms – stressed the importance of transparency in the ratings process. In their view, the marketplace needs to more fully understand the reasoning behind a ratings decision, and the types of information relied upon by the rating agencies in their analysis. Better information about rating decisions, they assert, would reduce the uncertainty, and accompanying market volatility, that frequently surrounds a ratings change.

Second, the Commission staff is reviewing the implications of direct contacts between rating analysts and subscribers. Some have expressed concern regarding the special access subscribers have to rating agency information and personnel. The largest rating agencies generally make their ratings available to the public and subscribers at the same time. As the rating agencies' paying customers, subscribers receive more extensive information and, as a practical matter, many subscribers have direct access to rating agency analysts for elaborative conversations. Questions have been raised as to whether this direct access creates the potential for inappropriate selective disclosure of information (*e.g.*, through the disclosure, intentional or inadvertent, of information concerning a rating prior to its issuance, or regarding the timing or nature of a forthcoming rating change).

Finally, the Commission staff is assessing the extent and quality of disclosure by issuers (including disclosures relating to "ratings triggers"[5]). The accurate appraisal of issuers by credit rating agencies necessarily depends on the ability of rating agencies to access a continuous flow of accurate and reliable information from issuers. Some have questioned whether the level of public disclosure by issuers is adequate. At the Commission's credit rating agency hearings, several specific areas for improved issuer disclosure were mentioned, including the need for additional detail regarding an issuer's short-term credit facilities and, particularly in light of the Enron experience, better disclosure of the existence and nature of "ratings triggers" in contracts material to an issuer.

2. *Potential Conflicts of Interest*

Another set of issues the Commission staff has been examining is the potential conflicts of interest faced by credit rating agencies.

First, the Commission staff is reviewing potential conflicts of interest that could arise when issuers pay for ratings. Concerns have been expressed for a number of years about the potential conflict of interest that arises from the fact that the largest credit rating agencies rely on issuer fees for the vast majority of their revenues. The practice of issuers paying for their own ratings creates at least the potential for a conflict of interest. Arguably, the dependence of rating agencies on revenues from the companies they rate could induce them to rate issuers more liberally, and temper their diligence in probing for negative information. Rating agencies assert that their processes, procedures and market competition sufficiently address these concerns.

Second, the Commission staff is assessing the potential for conflicts of interest to arise when rating agencies develop ancillary fee-based businesses. The large credit rating agencies recently have begun developing ancillary businesses to complement their core ratings business. These businesses include ratings assessment services where, for an additional fee, issuers present hypothetical scenarios to the rating agencies to determine how their ratings would be affected by a proposed corporate action (*e.g.*, a merger, asset sale, or stock repurchase). They also include risk management and consulting services. The development of these ancillary businesses creates another potential conflict of interest for rating agencies. For example, concerns have been expressed that credit rating decisions might be impacted by whether or not an issuer purchases additional services offered by the credit rating agency. In addition, some believe that, whether or not the purchase of ancillary services actually impacts the credit rating decision, issuers may be pressured into using them out of fear that their failure to do so could adversely impact their credit rating (or, conversely, with the expectation that purchasing these services could help their credit rating). Furthermore, in the case of ratings assessment services, there are concerns that, to the extent a rating agency has already "promised" a certain rating to an issuer's hypothetical scenario, pressure to match the actual rating to the

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5 In essence, "ratings triggers" are contractual provisions that terminate credit availability or accelerate credit obligations in the event of specified rating actions, with the result that a rating downgrade could lead to an escalating liquidity crisis for issuers subject to ratings triggers.

promised rating is likely to be forceful, even if the ultimate analysis otherwise might not have supported the rating.

3. *Alleged Anticompetitive or Unfair Practices*

The Commission staff also has been exploring the extent to which allegations of anticompetitive or unfair practices by large credit rating agencies have merit. In the course of the Commission's study, there were a few allegations that the largest rating agencies have abused their dominant position by engaging in certain aggressive competitive practices. For example, Fitch complained that S&P and Moody's were attempting to squeeze them out of certain structured finance markets by engaging in the practice of "notching" – lowering their ratings on, or refusing to rate, securities issued by certain asset pools (*e.g.*, collateralized debt obligations), unless a substantial portion of the assets within those pools were also rated by them. With respect to unsolicited ratings, some also alleged that rating agencies may have used what critics termed "strong-arm" tactics to induce payment for a rating an issuer did not request (*e.g.*, sending a bill for an unsolicited rating, or sending a fee schedule and "encouraging" payment).

4. *Reducing Potential Regulatory Barriers to Entry*

A fourth set of issues under review by the Commission staff is whether the Commission's historical approach to NRSRO designation has created potential regulatory barriers to entry into the credit rating business. For many years, market participants have voiced concerns about the concentration of credit rating agencies in the U.S. securities markets, and whether inordinate barriers to entry exist. Most agree that significant natural barriers exist, particularly given the longstanding dominance of the credit rating business by a few firms – essentially the NRSROs – as well as the fact that the marketplace may not demand ratings from more than two or three rating agencies. There also has been substantial debate regarding the extent to which any natural barriers to entry are augmented by the regulatory use of the NRSRO concept, and the process of Commission recognition of NRSROs. In essence, the argument is that important users of securities ratings have a regulatory incentive to obtain ratings issued by NRSROs, and that without NRSRO status new entrants encounter great difficulties achieving the "national recognition" necessary to acquire the NRSRO designation. In other words, new entrants are faced with something akin to a "chicken and egg" problem in achieving NRSRO status, which they view as necessary or, at a minimum, very important for becoming a substantial presence in the credit rating industry. Users of credit ratings and others point out, however, that there must be substantive threshold standards for achieving NRSRO status for that term to have meaning.

One obvious way to avoid potential regulatory barriers to entry is to eliminate the regulatory use of the NRSRO concept, and the Commission staff is exploring this possibility. A key issue, of course, is whether better viable alternatives can be found to the current approach of relying on ratings by agencies recognized by the Commission. Further, it must be recognized that, given the widespread use of the NRSRO concept in other federal and state laws and regulations, substitutes would need to be developed by authorities other than the Commission to effectively eliminate any regulatory barriers to entry. We expect to be exploring these issues in depth in the Commission's forthcoming Concept Release.

The Commission staff also is reviewing steps short of eliminating the NRSRO concept that could reduce potential regulatory barriers, including (1) possible clarifications of the current process and criteria for regulatory recognition of rating agencies; (2) instituting timing goals for the evaluation of applications for regulatory recognition; and (3) considering whether rating agencies that cover a limited sector of the debt market, or confine their activity to a limited geographic area, should be recognized for regulatory purposes. In addition, the staff is monitoring the actions of non-U.S. regulators and international bodies, such as IOSCO, in addressing alternative approaches.

5. *Ongoing Oversight*

Finally, the Commission staff is assessing whether more direct, ongoing oversight of rating agencies is warranted and possible and, if so, the appropriate means for doing so. Given the importance of credit ratings to investors, and the influence ratings can have on the securities markets, the staff is considering the implications of a more active Commission role in reviewing the operation of credit rating agencies on an ongoing basis, including jurisdiction, feasibility, resources and other considerations. This oversight could include, among other things, recordkeeping requirements designed for the credit rating business, and a program of regular Commission inspections and examinations. As part of this analysis, we are examining the scope of the Commission's present oversight authority, as well as the potential impact on the credit-rating market of any action the Commission may take.

Another aspect of possible ongoing Commission oversight is whether rating agencies should – and can be required to – incorporate general standards of diligence in performing their ratings analysis, and develop standards for the training and qualifications of credit rating analysts. In the aftermath of the Enron situation and other recent corporate failures, some have criticized the performance of the credit rating agencies, and questioned whether they are conducting sufficiently thorough analyses of issuers, particularly given their special position in the marketplace. Concerns also have been raised regarding the training and qualifications of credit rating agency analysts. Whether and how such standards might be incorporated into the Commission's oversight of credit rating agencies likely will be explored more deeply in our forthcoming Concept Release.

Conclusion

As you can see, credit rating agencies raise a wide range of complex regulatory and policy issues for the Commission. I expect you will get a sense of some of the diverse perspectives on these matters from the witnesses who will be testifying later this morning. The Commission has made substantial progress in its review of credit rating agencies, as I hope is evident from our recent Report to Congress, and I expect our analysis to be focused further based on comments received in response to the planned Concept Release.

Thank you for the opportunity to testify before you today. I would be happy to answer any questions you may have.

TESTIMONY OF GREGORY ROOT
EXECUTIVE VICE PRESIDENT
DOMINION BOND RATING SERVICE

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES OF THE COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

APRIL 2, 2003

Good morning, Mr. Chairman and members of the Committee. My name is Greg Root, and I am Executive Vice President of Dominion Bond Rating Service. I am pleased to have the opportunity to present DBRS' views on the role and function of credit rating agencies in the capital markets. Without question, credit ratings have become an integral part of the financial markets globally; therefore, it is imperative that there be a clear understanding of the role of rating agencies, how they operate, and how they compete.

I would like to begin with an overview of our company.

Overview of DBRS and Its Credit Ratings

Based in Toronto, DBRS was founded in 1976 by Walter Schroeder, who remains the company's President. DBRS is employee-owned, is not affiliated with any other organization, and limits its business to providing credit ratings and research. DBRS is a "generalist" rating agency, in that we analyze and rate a wide variety of institutions and corporate structures, including government bodies, and various structured transactions. At this time, we rate some 700 different entities and provide credit research on another 250 companies, with most of the latter based in the United States. DBRS has 65 employees, 45 of whom are analysts.

Since its inception, DBRS has been widely recognized as a provider of timely, in-depth and impartial credit analysis. Our opinions are conveyed to the marketplace using a familiar, easy-to-use letter grade rating scale. These ratings are supported by an extensive research product, which includes detailed reports on individual companies, as well comprehensive industry studies. This information is disseminated through various means, including a proprietary subscription service which is used by more than 3,000 institutional investors, financial institutions and government bodies.

DBRS' credit ratings reflect the company's opinion as to the likelihood of timely payment in full of principal and interest (or the equivalent, with respect to claims-paying or preferred stock ratings). In arriving at these credit decisions, our team of analysts considers a wide range of factors, both quantitative and qualitative. All ratings are processed through a committee system and are reviewed regularly. DBRS strives to consider all factors that could have an impact on the future creditworthiness of the issuer or specific instrument in question. Among the various factors we consider are:

1. A company's financial risk profile, with particular focus on leverage and liquidity;

2. Complexion of the industry in which the company operates and its position in that sector;

3. Quality of management;

4. Core profitability and cash flow; and

5. Other miscellaneous issues which may affect the creditworthiness of the issuer or instrument in question.

As part of the process, we maintain an ongoing dialogue with the managements of the companies we rate. Oftentimes, they provide us with information that may not be publicly available. This information is used strictly for the purposes of arriving at an accurate rating decision. Prior to finalizing our decisions, we discuss our preliminary views with the company, and we allow them to review any releases prior to public dissemination to assure that our ratings are accurate and that we have thoroughly considered all relevant facts. Ratings are reviewed constantly and changes are made whenever we are of the opinion that the relative creditworthiness has changed, positively or negatively.

I would next like to briefly discuss the role of rating agencies in the capital markets.

Role of Credit Rating Agencies in Capital Markets

As the SEC noted in its recent report to Congress on credit rating agencies, over the past 30 years, the SEC and other federal and state regulators have increasingly relied on credit ratings as a way to monitor the risk of investments held by regulated entities. In 1975, the Commission introduced the concept of "nationally recognized statistical rating organization" or "NRSRO" as a means of identifying ratings of market-recognized credible agencies for purposes of applying the broker-dealer net capital rule. From that modest beginning, the NRSRO concept has spread to several other areas of federal securities regulation, as well as federal banking regulation, state laws and rules, and even foreign law. Congress itself has incorporated the term NRSRO into legislation on at least two occasions. In addition to these legislative and regulatory uses, NRSRO credit ratings are also used extensively in debt covenants and other financial instruments between private parties.

NRSROs play a critical role in the complex and volatile debt marketplace, and I am pleased to say that the confidence the regulators and the markets have shown in the rating agencies is not misplaced. While ratings are certainly not guarantees of future performance, studies show that there is a strong positive correlation between ratings and default rates.

However, although DBRS is proud of the role rating agencies play in the global securities markets, we are aware that certain concerns have been raised recently regarding the rating industry. I would now like to turn my attention to three of those concerns: (1) transparency of the ratings process, (2) conflicts of interest and (3) competition and regulatory barriers to entry.

Transparency

We at DBRS are aware of the importance of transparency in the ratings process. At the SEC's rating agency hearings last fall, we heard institutional investors express their desire for a clear understanding of the reasoning behind ratings decisions. DBRS makes every effort to ensure that our ratings are transparent. Among other things, we issue full, detailed reports on individual companies and industries. These reports openly convey our views on both current ratings and on the direction of ratings.

In short, we believe everyone's interests are better served when the reasons behind are ratings are widely known.

Conflicts of Interest

DBRS is very sensitive to the potential for conflicts of interest when it comes to making our ratings decisions, and we have been very diligent in working to minimize that potential. As mentioned earlier, the company is independently owned and operated and is not affiliated with any other organization. Providing credit ratings with supporting research is our only business. Employees are prohibited from purchasing any security issued by companies rated by DBRS and we have policies n place to deal with and monitor a wide range of compliance issues. Our revenues are generated from two sources: fees paid by issuers to rate their securities and the sale of subscriptions for our research.

Rating agencies' practice of receiving fees from issuers has come under some scrutiny for the industry as a whole, and merits a few words here. First, this has been the industry practice for many years. The industry would not play the vital role in the securities markets that it plays today if market participants believed this fee structure were being abused. Second, because no one issuer accounts for a meaningful percentage of DBRS' overall revenues, no one issuer can exert untoward pressure on our rating activities.

Third, analyst compensation is in no way tied to the amount of revenues generated from issuers within the analysts' respective areas. Finally and perhaps most importantly, the success of our business is based on one key factor -- our reputation. If at any point, investors become concerned about the independence of our judgment and therefore the accuracy of our ratings, the demand for our services would greatly diminish. Since we often follow most companies in an industry, an over-rated or under-rated company would show up quickly, and would hurt our reputation if we could not support the relative ratings we have assigned. We have no intention of letting that happen.

Competition and Barriers to Entry

As the rating agency that has most recently been through the NRSRO designation process, DBRS has a somewhat unique perspective on this issue.

Because credit ratings play such an important role in the capital markets from a regulatory perspective, we believe the barriers to entry should be high. That said, the real concern as we see it is not so much that the barriers make it difficult for new competitors to enter the field, but rather that there is no well-defined process by which companies can be designated as NRSROs. The no-action letter process that the SEC currently uses to issue this designation is, in our opinion, ill-suited to this task, because the criteria for designation are not sufficiently defined, the application process is not standardized, and adverse decisions on requests for designation are not subject to appeal.

Based on our recent experience, DBRS believes that there should be a clear definition of what constitutes an NRSRO and a transparent process in place to enable qualified companies to apply for this designation.

Conclusion

In conclusion, I would like to say that overall, I believe that the credit rating system as it exists today works quite well and has helped foster the growth of the financial markets globally. In light of recent events, it is only appropriate that the issues being raised by the Subcommittee be thoroughly reviewed, and we very much appreciate having the opportunity to be part of this process.

The SEC's Other Problem

Lawrence J. White[*]

Testimony prepared for delivery before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, at the hearing entitled "Rating the Rating Agencies: the State of Transparency and Competition," Wednesday, April 2, 2003, 10:00am, Room 2128 of the Rayburn House Office Building.

I am pleased to have this opportunity to testify about the state of the bond rating industry and its regulation in the United States.

The U.S. Securities and Exchange Commission (SEC) currently has its hands filled dealing with the corporate governance mess. There is, however, another problem that the SEC faces, which may well have as much importance for the efficient operation of the United States' financial markets: the Commission's obscure but nearly impervious regulatory barriers to entry into the bond rating industry.

In January 2003, in response to the requirements of Section 702 of the Sarbanes-Oxley Act of 2002, the SEC released its "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets." Unfortunately, the report was an excuse for more delay in addressing the problem. Instead, the SEC should be pursuing solutions that would tear down these regulatory barriers.

The SEC's regulation of the bond rating industry began in 1975 with perfectly good intentions. As bank and insurance regulators earlier had done for their regulated institutions, the SEC wanted to use corporate bond ratings to set minimum capital requirements for broker-dealers.

The SEC realized -- apparently, for the first time among regulators -- that specifying the use of ratings also required specifying *whose* ratings. What would prevent a bogus rating company

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from awarding (for a suitable fee) "AAA" ratings to *any* corporation's bonds? Could the broker-dealers then use those "ratings" for regulatory purposes?

So, the SEC duly created a new regulatory category -- "nationally recognized statistical rating organization" (NRSRO) -- and immediately "grandfathered" the three major incumbent bond raters -- Moody's, Standard & Poor's, and Fitch -- into the category.

In the following 17 years, through 1992, the SEC bestowed the NRSRO designation on only four new entrants — but mergers among them and with Fitch had reduced the field to just the original three by the end of 2000. There were no new NRSRO designees by the SEC between 1992 and February 2003.

After a protracted process, and a month after the SEC's January 2003 agreement to study the state of competition in the ratings business, the SEC extended the NRSRO designation to Dominion Bond Rating Service, a Canadian firm. As of today, then, there are only four NRSROs.

Why does the NRSRO designation matter? Almost all regulated financial institutions -- banks, insurance companies, pension funds, etc. -- must heed the NRSROs' ratings in deciding which bonds they can hold in their portfolios. For example, banks cannot hold bonds that are below "investment grade".

Accordingly, any would-be bond rater, who would not initially have the NRSRO designation, would have great difficulties in getting the time and attention of bond issuers, since the start-up entity's rating would carry no weight in the portfolio decisions of banks and other regulated financial institutions.

The NRSRO designation thus erects high barricades to entry into bond rating, providing a sinecure for the incumbents and putting a damper on the introduction of fresh ideas, methodologies, and technologies that entrants might otherwise bring.

In essence, the SEC has given the incumbents a captive audience: the entire US bond market. In turn, the weight of US capital markets on the global financial scene extends the influence of these few raters far beyond our borders. Further, the Basel Committee on Banking Supervision, under the auspices of the Bank for International Settlements and representing banking regulators around the world, has proposed expanding the regulatory influence of ratings to other countries as well. One of the Committee's three proposed methods of determining banks' minimum capital requirements would use the banks' borrowers' bond ratings (when available) in that determination.

There is an irony here: Financial regulators have long been using private-sector information (the ratings) to supplement their safety-and-soundness judgments. Regulatory critics have recently urged regulators generally to incorporate private-sector information into their judgments. Yet it is one thing to use impersonal market information (from, say, the Treasury bill market); it is quite another to require the use of private-sector rating information. The latter effort cannot avoid the "whose ratings" problem -- and the potential abuses that can follow.

And the potential for bad economic outcomes under the SEC's restrictive and protective regulatory regime is clear. Not only are the standard consequences of inadequate competition -- excessively high prices and profits, and stodgy behavior -- to be expected. The current regulatory arrangement also runs the risk of the squelching of new ideas and innovations in bond ratings and solvency assessments if the handful of incumbents somehow concludes that the innovations are not worthy of their notice.

This innovation question raises a larger issue: How could one tell if the incumbent bond rating firms currently meet a market test? With regulatory requirements that the incumbents' ratings must be heeded, the capital markets have no choice but to heed them. The capital markets have no way of knowing or discovering whether there are better, more efficient and effective ways in which the capital markets might assess the creditworthiness of bond issuers -- or whether there are better, more efficient organizations that could conduct those assessments. The efficiency of those markets themselves is potentially affected.

Clearly, the public policy goal that should be sought is to improve competition and to increase the potential for innovation in the ratings business. How can public policy get there? There are two sensible routes. By far the best is for the SEC, and other financial regulators, to cease delegating their safety judgments to a handful of protected bond raters. In essence, the regulators should make the same safety-and-soundness judgments about bonds that they currently make about loans and other financial assets.

The SEC could then withdraw the NRSRO designation. The financial markets would then be free to make their own decisions as to which rating companies, incumbents or entrants, offered the best judgments about the relative safety of a company's bonds -- or even whether rating companies (which began in the early twentieth century) are still needed in the twenty-first century. Also, if rating firms are still valued, the markets could make new judgments as to what business model is most appropriate. Should the raters earn their revenues from fees charged to the rated companies, as is currently the case for the three incumbents? Or should they charge investors, as was true prior to the 1970s and as a few small non-NRSRO raters still do?

If the removal of the NRSRO designation is too radical, then there's Plan B: The SEC must cease barricading entry and must permit qualified firms to attain the NRSRO designation. This means that the SEC must assess the entrant's track record of bond failure predictions (and should also assess incumbents' performances as well -- which the SEC has never done).

However, the SEC's tentative criteria for assessing a NRSRO, which the Commission proposed in 1997 but never finalized, should be scrapped. Those criteria focused on measuring inputs to the rating process rather on evaluating a firm's rating performance (i.e., a bond rater's track record of accuracy with respect to bond defaults), which could be fatal to a rating firm that might employ innovative methodologies and that might not use traditional inputs. Those criteria also would create a "Catch 22" requirement: To receive the NRSRO designation, a rating organization would already have to be "recognized as an issuer of credible and reliable ratings by the predominant users of ratings in the United States." Instead, sensible criteria should focus on the accuracy/efficacy/competency of rating firms -- incumbents, as well as prospective entrants -- with respect to bond defaults.

Of course, if such assessments are beyond the SEC's capabilities, there's always Plan A: Cease the safety delegations to the bond raters, and eliminate the NRSRO category.

The possible paths are clear. Further study will mean only delays in needed reform. The time for action is now.

I have appended to this statement the text (which was subsequently lightly edited) of an article that appeared in the Winter 2002-2003 issue of Regulation magazine, which provides a more complete elaboration of my position with respect to the SEC's regulation of the bond rating industry. I have also appended a brief bio; my longer curriculum vitae is available on my website at http://pages.stern.nyu.edu/~lwhite/Ljwvita.htm. And I have previously faxed to the Subcommittee a signed copy of the Committee's "Truth in Testimony" disclosure form.

I welcome the opportunity to respond to questions from the Subcommittee.

The SEC's Other Problem: The Bond Rating Industry
(from Regulation magazine, Winter 2002-2003, pp. 38-42)

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The U.S. Securities and Exchange Commission (SEC) currently has its hands full with its efforts to deal with corporate governance issues and oversight of the accounting industry. Lurking in the background, however, is a different and less well known problem of SEC regulation -- but one that seriously undercuts the SEC's frequent claim that it promotes open and efficient capital markets.

This problem concerns the SEC's regulation of the bond rating industry. Until recently few people, even among knowledgeable Washington insiders, were aware that the SEC regulates the bond rating industry. But it has done so since 1975: by limiting entry, in an indirect but powerful way. And that's the problem. Incumbent bond rating firms are protected; potential entrants are excluded; and new ideas and technologies for assessing the riskiness of debt, and thereby the allocation of capital, may well be stifled.

This entry regulation is a perfect example of good intentions going awry, via the "law" of unintended consequences. The good intentions were to improve the safety-and-soundness regulation of financial institutions, and even to use "market" information to do so. But the unfortunate result has been a distortionary entry restriction regime with respect to bond rating firms.

Fortunately, there are better ways to achieve the desired goals.

Some background.

Bond rating firms primarily provide judgments about the credit quality of debt instruments: bonds and similar debt obligations, issued by companies and by governments. The information provided by the bond raters can be seen as part of the process by which lenders (bond buyers) try to gather information so as to pierce the "fog" of asymmetric information and determine to whom to lend (whose bonds to buy) and on what terms, and also part of the efforts by borrowers (bond issuers) to "tell their story" as to why they are worthy recipients of lent funds.

In the U.S. today there are only three debt rating firms of any significant size: Moody's; Standard & Poor's (S&P); and Fitch. Moody's is the largest. It is currently a free-standing corporation, having been spun off by Dunn & Bradstreet in 2000 (which acquired Moody's in 1962). Moody's had revenues of $797 million in 2001, of which 87% was derived from its bond rating activities; 70% of its revenues arise from its U.S. activities.

S&P's bond rating activities are embedded in S&P's wider financial information activities (e.g., the compilation of stock market indexes), and S&P itself is part of McGraw-Hill. Consequently, far less is known about the specifics of S&P's bond rating activities. Fitch is distinctly the third-place bond rater. It is part of a French conglomerate and has a larger relative presence in Europe than in the U.S.

There are a few smaller bond rating firms, and at least one specialized firm (A.M. Best) that focuses on the obligations of the insurance industry. But the major players number only three, and historically their numbers have fluctuated only within a narrow range of three to five since the 1920s.

Why so few? Partly, there are fundamental economic forces at work. Economies of scale and scope are surely important in allowing a rating firm to gain a reputation as a reliable rater across a variety of industries, time periods, and economic situations. Reputation is important for market participants who are trying to deal with asymmetric information. Also, investors may prefer to keep track of just a few rating scales in assessing bonds, just as college admissions offices surely prefer dealing with only one or two standardized entrance examinations in assessing potential admitees.

But something more has been at work, at least since 1975. That something is the SEC's restrictive regulation.

The history.

John Moody published the first public bond ratings, for railroad bonds, in 1909. Poor's Publishing Co. followed in 1916; the Standard Statistics Co. began issuing ratings in 1922 (S&P was formed through the merger of the two in 1941; McGraw-Hill absorbed S&P in 1966); and the Fitch Publishing Co. began its ratings in 1924. The standard business model was that the companies sold their ratings to investors.

The financial markets' ready embrace of the information provided by the ratings firms in that era is understandable, since financial disclosure was quite limited, at least by modern standards. Recall that the SEC and its requirements for corporate financial disclosure (which would provide further information for lenders) came into existence only after 1933. Through the 1920s, then, it is clear that the bond rating companies were meeting a market test as to the value of their services.

A major change occurred in the 1930s. In 1930 the Federal Reserve began using ratings in its informal judgments about the suitability of the bond portfolios of its member banks. In 1931 the Office of the Comptroller of the Currency (OCC), the federal regulator of nationally chartered banks, formally required banks to use current market prices ("mark to market") for any bonds in their portfolios that were below "investment grade"; e.g., below a "BBB" rating, which was (and still is) S&P's designation of investment grade; but they could continue to value bonds that were rated at BBB (or its equivalent) or higher at original purchase cost.

The OCC followed in 1936 with a far more draconian measure, which persists to the present day: Banks could not hold bonds in their portfolios that were below investment grade.

Notice the impact of these regulatory measures: For the first time, government regulators were *requiring* major transactors in the bond markets to pay attention to the ratings of the bond rating firms.

These bank regulatory requirements were followed in the 1930s and 1940s by state insurance regulators, who began to link insurance companies' capital requirements to the ratings of the bonds in their portfolios. Again, regulators were requiring major bond transactors to heed the ratings of the bond rating firms.

There was, however, a curious blind spot in the bank and insurance regulators' requirements: The issue of *whose ratings* -- which rating firms' ratings should be heeded -- was not addressed specifically. Instead, there were vague references to "recognized rating manuals", which were probably understood to mean Moody's, S&P, and Fitch.

One other historical fact is worth noting: In the early 1970s the rating firms' business model changed from one in which rating manuals were published and sold to investors to one in which the bond issuers paid for the privilege of providing information to the raters, who would subsequently openly publish and distribute the ratings. It seems likely that the technological phenomenon of low-cost photocopying was the major source of the change, although financial historians also point to the trauma of the Penn-Central bankruptcy in 1970 and its effect in heightening the bond market's sensitivity to credit quality issues and especially in making issuers willing to pay to have the quality of their bond obligations certified by the rating firms.

The SEC's actions.

In 1975 the SEC proposed (in Rule 15c3-1) the establishment of minimum net worth (capital) requirements for securities broker-dealers. It wanted to link those requirements to the quality of the bonds of the broker-dealers' portfolios; and, following the lead of the other financial regulators, it wanted to employ the bond rating firms' ratings. But the SEC apparently noticed the "whose ratings" problem: What was to prevent the bogus XYZ rating firm from issuing AAA ratings to any company that paid a suitable sum to XYZ? And what was to prevent a broker-dealer from claiming that XYZ's ratings were "reputable" and therefore should be used in judging that broker-dealer's bond portfolio and its capital requirements?

Consequently, as part of the broker-dealer capital regulation, the SEC also established an entirely new regulatory category for bond rating firms -- nationally recognized statistical rating organizations" (NRSROs) -- and designated the NRSROs' rating as the only ratings that could be used for determining the broker-dealers' capital requirements. The SEC also immediately "grandfathered" the three incumbents (Moody's, S&P, and Fitch) into the NRSRO category.

Over the next few years other financial regulators adopted the SEC's NRSRO category designation, so that the regulators' requirements as to the use of bond ratings would mean the required use of only the NRSROs' ratings. Further, the use of bond ratings for financial regulatory purposes greatly expanded during the 1980s and 1990s. The SEC, for example, again invoked the NRSRO category in 1991 when it declared (in Rule 2a-7) that no more than 5% of the assets of money market mutual funds could be invested in low rated commercial paper. And, most recently, in 2001 the regulator of Fannie Mae and Freddie Mac (the Office of Federal Housing Enterprise Oversight) linked its minimum capital requirements for Fannie and Freddie to the NRSROs' bond ratings of the insurers that often provide mortgage insurance on the mortgages that the two enterprises buy and hold or securitize.

The SEC was not wholly dormant with respect to the new category that it had created. In 1982 and 1983 it designated Duff & Phelps and McCarthy, Crisanti, & Maffei, respectively, as NRSROs. And in 1991 and 1992 it designated IBCA (a British rating firm) and Thomson BankWatch, respectively, as specialized NRSROs for the obligations of banks and financial institutions only. However, mergers among these entrants and with Fitch subsequently removed all of the entrants from the field by the end of 2000, leaving only the original three grandfathered incumbents as the current NRSROs.

A point of further interest: The SEC did not state any explicit criteria for admission into the NRSRO category at the time of the original grandfathering, nor at the time of its subsequent approval of the four entrants.

Good intentions... and the consequences.

Consider the sequence of regulatory events. Initially, bank regulators, entrusted with the safety and soundness of banks, decided to make use of outside parties -- the bond rating firms -- to help in evaluations of the appropriateness of bonds in banks' portfolios. Regulators today are often urged to make more use of market information. The bank regulators of the 1930s would appear to have been ahead of their time.

However, it is one thing to rely on market information, where the "market" is a well-defined but impersonal mechanism. The bank regulators of the 1930s appear to have hoped for such reliance, with their reference to "recognized rating manuals". But bond ratings were never going to have the impersonality of, say, market prices of Treasury bills. Thus, the reliance could be considered more as a regulatory *delegation* of safety judgments to specific parties. And so there was no way to avoid the "whose ratings" issue, which the SEC addressed in 1975.

Having addressed it, the SEC opted for a restricted "who": the three grandfathered incumbents, and only four entrants permitted during the subsequent 27 years! Potential entrants -- smaller domestic firms, and foreign rating firms -- have been ignored. Indeed, a major reason for IBCA's purchase of Fitch in 1997 (with the Fitch name persisting) was IBCA's impatience in being restricted to a narrow NRSRO category and not being granted broad NRSRO powers.

Notice the power that the NRSRO bestows on incumbents. Since almost all bond issuers hope that their bonds can be bought by regulated financial institutions, they *must* seek a rating by at least one, and often two NRSROs. Thus, the NRSROs have a guaranteed market for their ratings. Even if the participants in the bond markets were capable of devising better methods, technologies, and/or institutions for helping determine credit risks, those new and improved ways could well falter if the incumbent NRSROs failed to embrace them, *because of the incumbent NRSROs'* *sinecure.*

The additional difficulties that the NRSRO designation creates for non-NRSRO entrants is worth emphasizing. Entrants, of course, always face difficulties in overcoming the advantages of incumbents. But for a bond rating entrant, the absence of a NRSRO designation could well be fatal. Why should the senior management of any bond issuer spend time "telling its story" to a non-NRSRO, if the latter's ratings cannot help the issuer get its bonds into the portfolios of regulated financial institutions?

Do the incumbent bond rating firms meet a market test?

The fabric of financial regulation is now so tightly woven around the incumbent bond rating firms -- with regulation-driven demand for ratings, combined with regulation-driven restrictions on supply -- that it is impossible to know if the incumbent bond raters currently meet a market test as to the value of their services to the debt markets.

The previous sentence may seem quite strong, especially in light of well-documented evidence that the changing of a bond rating by Moody's or S&P can cause the price of that bond to change. Doesn't this market reaction indicate that the bond rating firms are providing useful information about the likelihoods of bond defaults to the markets?

Not necessarily. The regulatory "cliff" for banks' holdings of bonds -- "investment grade" (BBB or better, in the S&P rating system) -- provides a good illustration of why the responsiveness of bond prices to rating changes may not reflect changes in market beliefs about default probabilities. Suppose that S&P downgrades a bond from AA to A. The market's likely (negative) reaction would be a decrease in the equilibrium price for the bond (and thus an increase in its interest yield). This reaction could be an indication that the market has learned something new about the increased default probability of the bond. *Or the market's reaction could simply be a recognition that the bond has gotten closer to falling off the BBB cliff, with the consequent decrease* *in price that would surely follow when banks could no longer hold the bond.* Even if market participants believed that S&P's change was erroneous and that there had been no change in the underlying probability of default on the bond, the decrease in the bond's price would still be a sensible reaction to the bond's closer proximity to the BBB cliff.

Thus, unlike the 1920s, it is not possible to say whether the incumbents' ratings today (and since 1975, and arguably since 1930) meet a market test.

<u>The SEC proposes criteria</u>.

In 1997, the SEC proposed regulations that would specify criteria for admitting any new firms into the NRSRO category (if the SEC were to permit any new entry). The proposed criteria for admission (in the SEC's own regulatory language) were as follows:

1) national recognition, which means that the rating organization is recognized as an issuer of credible and reliable ratings by the predominant users of securities ratings in the United States;

2) adequate staffing, financial resources, and organizational structure to ensure that it can issue credible and reliable ratings of the debt of issuers, including the ability to operate independently of economic pressures or control by companies it rates and a sufficient number of staff members qualified in terms of education and expertise to thoroughly and competently evaluate an issuer's credit;

3) use of systematic rating procedures that are designed to ensure credible and accurate ratings;

4) extent of contacts with the management of issuers, including access to senior level management of the issuers; and

5) internal procedures to prevent misuse of non-public information and compliance with these procedures.

The shortcomings of the SEC's proposed criteria are readily apparent. First, criterion (1) would constitute an obvious "Catch 22" barrier to entry; criterion (4) also has this quality, since non-NRSROs would have difficulties in establishing managerial contacts. Further, criteria (2) through (5) essentially focus on *inputs* into the rating process, rather than on *outputs* (say, accuracy in predicting bond defaults); firms with innovative technologies that didn't meet the input criteria would flunk the SEC's admissions test.

Mercifully, the SEC has not acted on its regulatory proposal over these past five years.

Global consequences.

The consequences of the safety-and-soundness good intentions gone awry are not confined just to the U.S. They extend beyond our borders in at least two ways. First, Moody's, S&P, and Fitch are important participants in providing ratings in debt markets around the world. Their protected position in the U.S. surely gives them extra leverage in their activities elsewhere.

Second, the Basel Committee on Banking Supervision, under the auspices of the Bank of International Settlements, has proposed a revision (often described as "Basel II") to its 1988 capital standards for banks. The revision, which is far more complicated than its 1988 rules, has three alternative schemes for determining appropriate capital levels for banks, one of which would bring bond ratings directly into the determination of the minimum capital requirements that would be required for a bank's loans to any borrower that had rated debt.

Thus, the Basel II proposals would explicitly expand the role of bond rating firms in the safety-and-soundness regulation of banks in the U.S. and simultaneously expand that infiltration to bank regulation around the world. Perforce, the Basel II proposals would also expand globally the role of governments in limiting entry into bond rating. As the Basel Committee explicitly recognizes, other countries' financial regulators would have to establish criteria to answer the "whose ratings" question for their bank regulation as well. The Basel Committee's suggested criteria for answering that question are slightly better than the SEC's 1997 proposals, but they are nevertheless heavily oriented toward input measures rather than output measures.

What is to be done?

There are two ways that public policy could proceed so as to avoid the distortionary entry limitations of the SEC's NRSRO approach.

First, and by far the best route, would be for financial regulators to cease delegating their safety-and-soundness judgments to the bond rating firms. This may seem to be a step backwards in the efforts to bring more market-oriented information to bear on regulatory decisions. But when the safety delegation is to specific parties, and entry into that category is then restricted and a sinecure is created, the effort to bring more market-oriented information into the regulatory process has been perverted.

How would the cessation of safety delegations work? It is easiest seen for bank regulation. Bonds should be treated by bank regulators on a par with how banks' loans are treated. When a bank examiner is examining a bank's bond portfolio, she ought to ask the same types of questions about the bonds that she asks about the bank's loan portfolio. Are these bonds suitable for holding by the bank? Why? What research has the bank done on the companies that issued the bonds? If the bank has relied on the ratings of a rating firm, what research has the bank done about the reliability of that rating firm's ratings?

These questions would place the responsibility for determining the safety and soundness of a bank's bond portfolio initially on the bank and then on the regulator for review, where it ought to be. Similar methods could be developed to replace the other financial regulators' safety delegations to the bond rating firms, including the safety delegations of the SEC itself.

With the safety delegations withdrawn, there would no longer be a need for the NRSRO category, and the SEC could eliminate it. The participants in the financial markets would then be free to make their own determinations as to whose ratings and which methods provided the most useful information in predicting defaults. The current incumbents might continue to thrive if the markets judge their information to be worthwhile; or upstarts might unseat them. The important thing, of course, would be that these would be the judgments of the capital markets and not of bureaucrats in Washington.

The SEC might lead the way by simply withdrawing its own safety delegations and eliminating the NRSRO category, thereby exposing the other regulators' safety delegations as the specific sinecures that they are.

If this wholesale withdrawal of safety delegations is considered too radical or utopian, then any "plan B" would have to keep the NRSRO designation, so as to deal with the bogus rating firm problem. But then the SEC must cease being an artificial barrier to entry for firms that want and are qualified to become a NRSRO. It must actively consider applicants and have a transparent process for reviewing incumbents as well as potential entrants. Its criteria must be centered on *outputs* -- the efficacy of firms in predicting bond defaults -- rather than on the inputs that were the focus of its 1997 proposals.

If such judgments are considered beyond the capabilities of the SEC, then there's always "plan A": end the safety delegations to the bond rating firms, and eliminate the NRSRO category.

Finally, the Basel II proposals should be similarly revised, so as to eliminate the global delegation of bank regulators' safety judgments to bond rating firms and the concomitant necessity for restrictive entry regulation.

Is change possible?

The bond raters and their special position received a brief flurry of attention in February and March of this year. After Enron declared bankruptcy in early December 2001, it was noticed that Moody's and S&P had persisted giving "investment grade" ratings to Enron's debt until a few days before the company's bankruptcy filing. Newspaper stories were written, and Congressional hearings were held. The SEC promised to look into the matter. To make sure that the agency did so, the Sarbanes-Oxley legislation that was passed in July contained a specific provision (Sec. 702) that instructed the SEC to compile a report for the President and the Congress, within 180 days, that studied "the role and function of credit rating agencies [firms] in the operation of the securities market" including "any barriers to entry into the business of acting as a credit rating agency, and any measures needed to remove such barriers..."

This report could provide the SEC, the Bush administration, and the Congress with the opportunity to re-think the entire issue of safety judgment delegations and the consequent distortionary NRSRO approach. It may well be a once-in-a-lifetime opportunity.

Readings

"An Analysis and Critique of the BIS Proposal on Capital Adequacy and Ratings," by Edward I. Altman and Anthony Saunders. Journal of Banking and Finance, 25 (January 2001), pp. 25-46.

"The Credit Rating Industry," by Richard Cantor and Frank Packer. Journal of Fixed Income, 5 (December 1995), pp. 10-34.

"The Credit Rating Industry: An Industrial Organization Analysis," by Lawrence J. White. In Ratings, Rating Agencies and the Global Financial System, edited by Richard M. Levich, Giovanni Majnoni, and Carmen Reinhart. Boston: Kluwer, 2002, pp. 41-63.

"An Historical Primer on the Business of Credit Ratings," by Richard Sylla. In Ratings, Rating Agencies and the Global Financial System, edited by Richard M. Levich, Giovanni Majnoni, and Carmen Reinhart. Boston: Kluwer, 2002, pp. 19-40.

Ratings, Rating Agencies and the Global Financial System, edited by Richard M. Levich, Giovanni Majnoni, and Carmen Reinhart. Boston: Kluwer, 2002.

"The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit Rating Agencies," by Frank Partnoy. Washington University Law Quarterly, 77 No. 3 (1999), pp. 619-712.

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April 11, 2003

Chairman Richard H. Baker
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
341 Cannon House Office Building
Washington, DC 20515-1806

Re.: Hearing on Credit Rating Agencies

Dear Chairman Baker:

This letter is to respond to Chairman Oxley's request for additional information on the Freedom of Speech Defense used by the major rating firms and to provide suggestions on how the industry might be reformed. Regarding the Freedom of Speech Defense, Moody's has been sued by a municipal issuer, which chose not to retain Moody's to rate their bonds and were given "punishment ratings" by Moody's.

> "There have been other complaints about the clout the agencies have--Moody's in particular. In the early 1990s allegations began to swirl that Moody's bullied municipalities into hiring it by issuing unsolicited (and negative) ratings to those that declined the offer. One Colorado school district [Jefferson County] sued the rater after it made negative comments about a pending bond sale, claiming that investors used the pan to demand a higher interest rate, resulting in a net loss of $769,000. The court ruled that Moody's ratings were opinions, not facts--and therefore the company was protected under the First Amendment."
>
> Source: Forbes, December 11, 2001

We view this abuse as another manifestation of the partner monopoly conditions in the industry. If there were a robust level of competition, Moody's would not be able to take abusive actions. Although we support the notion that ratings are opinions, some checks have to be made on abusive practices since there is little competition. **We doubt that mere disclosures will be sufficient to curb these and other market abuses; alerting neighbors of a thug does not address the problem.**

Although the elimination of the NRSRO designation is interesting, we do not believe it will result in improved investor protection. Government-employed examiners do not have the incentive and the proper training for warning investors of failures such as WorldCom and Enron. Furthermore with the elimination of the NRSRO system, major brokers and issuers are likely to continue pointing investors to the ratings produced by conflicted rating firms (i.e., firms that are paid by issuers) since the long-standing, major NRSRO's have been legitimatised by the designation. **However, if the recommendations on page 2 are not implemented, we suggest eliminating the NRSRO system since it currently provides a false sense of security to investors.**

The usage of ratings is not limited to sophisticated major investors, but is a part of the fabric of the investment community. Employees, pensioners, and investors were badly hurt by the failure of Enron, WorldCom, the California utilities and other companies after receiving some comfort from the firms' investment grade rating. Furthermore, some major issuers such as CIT, GM and Ford have undertaken offerings totaling several billion dollars geared toward individual investors. As mentioned in our March 31, 2003 letter, we have succeeded in providing warning to investors for Enron, WorldCom, Genuity, Global Crossing and the other major failures. Regarding a comparison of all our ratings, the Kansas City Federal Reserve Bank recently conducted a review of our ratings since inception in December 1995 to S&P and concluded:

> "Overall, it is robustly the case that S&P regrades from BBB- moved in the direction of EJR's earlier ratings. It appears more likely that this result reflects systematic differences between the two firms' rating policies than a small number of lucky guesses by EJR."
> Source: Research Division, Federal Reserve Bank of Kansas City, Feb. 2003

Regarding the steps needed for reforming the credit rating industry, we believe the following are relatively simple and will succeed in enhancing investor protection:

1. Recognize some non-conflicted firms, which have warned investors – The best start is to recognize rating firms that do not have a conflict of interest and which have succeeded in providing warnings to investors. The current NRSRO's argue that no additional firms should be admitted because it will force them to compete by issuing liberal ratings in an effort to maintain their revenue base. Our view is that rating firms that are compensated by investors are forced to issue timely accurate ratings and that some real competition among ratings firms would improve the industry.

2. Prohibit issuer compensation – just as equity research practices were not corrupted until such research was linked to the investment banking practices of broker-dealers and their associated large issuer-based compensation in the form of investment banking fees, existing NRSRO's prior to 1970 obtained most of their compensation from investors rather than issuers. NRSRO's argue that the copy machine made the old business model less attractive because of the ease of distributing ratings. Our response is that there are a number of firms that have thrived without issuer compensation; Sanford Bernstein and Prudential are prime examples on the equity side, and Egan-Jones and Mikuni are examples on the credit rating side.

A prohibition of issuer compensation might be phased in over several years and should include issuer compensation provided via broker/dealers.

3. Prohibit involvement with rated firms and dealers – Moody's Chairman, Clifford Alexander, served as a director of MCI from 1982 until 1998 and of WorldCom from 1998 until June 2001; WorldCom filed for bankruptcy in July 2002 making it the largest bankruptcy in US history. Officials of credit rating agencies should be prohibited from serving on the boards of those companies that they rate. In addition, such officials should be prohibited from serving on the boards of organizations such as the National Association of Security Dealers, which represents security dealers (Moody's president, John Rutherfurd, Jr. is listed on the NASD Board of Governors). Dealers' interests are not parallel to investors' interests.

4. Remove the exclusion from Regulation FD – rating firms are essentially private research firms and therefore should not be provided with any special treatment when it comes to the dissemination of information to the public by issuers. Information gathered by the monopolistic rating firms for the rating triggers was subsequently distributed only to clients paying for the research portion of the NRSRO's service. Note, currently, the major NRSRO's are given preferential treatment on Regulation FD disclosures (the issuer does not provide the same information to all rating firms at the same time) and the major rating firms can include the non-public information in their subscription research services. Since this area is nearly impossible to police, we recommend removing the exclusion from Regulation FD.

5. Separate ratings from consulting – just as accountants were compromised by their consulting assignments, ratings firms that obtain a majority of their compensation from issuers have similar conflicts. Investors and issuers are likely to feel compelled to use the services of S&P and Moody's because of their market dominance.

6. Prohibit the use of rating triggers – affording another example of putting issuers' interests ahead of investors', the current NRSRO's were reluctant to downgrade firms because of the fear of setting off rating triggers (see the Enron history).

7. Prohibit the use of "independent" moniker – all the current NRSRO's obtain the majority of their compensation from issuers and therefore should not mislead investors by describing themselves as independent.

8. Police monopolistic practices – a fair amount of controversy has been generated by Moody's notching (cutting) Fitch's ratings by up to five or six notches in the structured finance area in an attempt to extend its reach. Similarly, it appears as though the large NRSRO's have discouraged major news organizations from carrying ratings or news generated from competing rating firms.

9. Prohibit providing "color" to investors – some investors, particularly large investors are given information on analysts' opinions in advance of others.

10. More regulation and more conflicted firms will not help – increasing the level of scrutiny of rating firms by the SEC or other regulatory bodies is unlikely to improve their responsiveness to investors, but rather will delay most rating firms actions until they can develop documentation for their actions. The introduction of firms that are paid mainly by issuers and have not succeeded in warning investors will not protect investors.

I would be happy to explain any of the above recommendations and evaluate the impact of these and other changes on the ratings industry.

Sincerely,

Sean J. Egan

Special Comment

February 2003

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Default & Recovery Rates of Corporate Bond Issuers

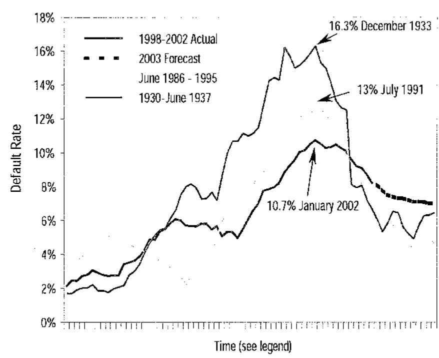
A Statistical Review of Moody's Ratings Performance, 1920-2002

Summary

This report is Moody's 16th annual study of global corporate defaults and ratings performance. Moody's reviews the default, recovery and credit loss experience of 2002 and for the historical period since 1920. Briefly, we find:

- Worldwide, 141 Moody's-rated corporate bond issuers defaulted on a total of $163 billion in 2002. Thirty-six issuers defaulted on over $1 billion each, quadrupling the 1983-2001 average real size of default to $1.7 billion.
- Default rates measured as a percentage of issuers generally fell in 2002, while default rates measured as a percentage of dollar volume surged. Moody's global issuer-weighted default rate fell to 3.0% in 2002 from 3.8% in 2001. On a dollar volume-weighted basis, the default rate increased from 4.2% in 2001 to 5.3% in 2002.
- Moody's speculative-grade default rate forecasting model indicates that over the next year the global issuer-weighted speculative-grade default rate will fall by just over one percent, from 2002's 8.3% to 6.9% at the end of 2003.
- The percentage of issuers downgraded reached record highs in 2001 and 2002. 25% of US issuers rated speculative-grade 2002 were downgraded, while 22% of US investment-grade rated issuers were downgraded. The percentage of investment-grade rated issuers that became fallen angels reached a peak of 5.2% in 2002, up from just over 2% in 2001.
- Sovereign bond issuers experienced an overall improvement in credit quality in 2002. No sovereign bond issuers defaulted in 2002, and 15 sovereign bond issuers were upgraded compared with only three downgrades.
- Though no commercial paper (CP) issuers defaulted in 2002, CP issuers were downgraded from the P-1 and P-2 rating categories at a particularly high rate in 2002.
- The average recovery rate for defaulted bonds was 34.4% of par measured on issue-weighted basis and 25.6% on a dollar-weighted basis in 2002. Excluding telecommunications bonds, the average recovery rates were 39.3% and 33.6%, respectively.
- Recovery rates show a strong negative correlation with default rates measured as a percentage of the dollar volume outstanding, indicating that credit loss rates rise when defaults increase.

Historical Speculative-Grade Default Rate Extrema



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Introduction

This report is Moody's sixteenth annual study of global corporate defaults and ratings performance. The year 2002 marks the low-point of a credit cycle that has witnessed an historic increase in the total number and dollar volume of corporate defaults. The duration and depth of the trough of the current credit cycle has eclipsed that of the 1990-1991 period and, in fact, has not been matched since the early 1930s.

This report is primarily concerned with the statistical documentation of the performance of Moody's ratings of corporate bond issuers, for the year 2002 as well as the historical period since 1920. Although most of this study reports statistics for corporate bond issuers, in two sections that appear in Moody's annual default study for the first time we include separate, brief statistical summaries of default and rating transition rates for sovereign issuers and issuers of commercial paper.

As this study and previous default studies have shown, Moody's ratings are highly correlated with ex-post default rates. Several important aspects of Moody's rating process are not given a full treatment or are not addressed in this report, but will be analyzed in a companion report later this year. These include default and rating transition rates that condition on rating outlooks and Watchlist, and the path dependence of ratings.

The first section of this study reviews some of the major trends characterizing defaults in 2002. Notable among these trends is a peak in Moody's issuer-weighted default rate, but a continued rise in the average size of default in 2002. Also important among these trends is the high number and magnitude of defaults by issuers rated investment grade within a year of default. We conclude the first section by presenting Moody's default rate forecast for 2003.

The second section of this study analyzes changes in credit ratings that do not necessarily result in default. We examine the incidence of credit rating upgrades and downgrades, the surge in investment-grade issuers whose ratings have been lowered to speculative-grade ("fallen angels"), and the connection between these trends and macroeconomic conditions.

In the third section, we put the current credit cycle in perspective by taking a long view of defaults in the 83-year period between 1920 and 2002. We present new statistics that measure default rates both as a percentage of defaulting issuers and as a percentage of dollar volume of debt. Ultimately, we seek to quantitatively gauge the performance of Moody's ratings as predictors of default and expected credit losses. To that end, section three presents some direct tests of the predictive accuracy of Moody's credit ratings. Although Moody's ratings have become more accurate over time, the relatively high number of investment-grade defaults in 2002 has resulted in lower annual accuracy statistics relative to previous years.

The concluding sections deal with recovery rates for bonds in default and credit loss rates. We document historical recovery rates and their determinants, and examine the cyclicality and correlation of recovery rates with default rates. We find that defaulted bonds have suffered record low recovery rates as the default rate has surged. However, the peak in default rates in 2002 also seems to signal a nadir for recovery rates.

DATA SOURCES

Moody's bases the results of this study on its proprietary database of ratings and defaults. In total, the data covers the credit experiences of over 16,000 corporate issuers that sold long-term public debt at some time between 1919 and 2002. As of January 1, 2002 over 4,800 of those issuers held Moody's ratings. These issuers account for the bulk of the outstanding dollar amount of U.S. public long-term corporate debt and a substantial part of public issuance abroad. Moody's database of default covers over 3,500 long-term bond defaults by issuers both rated and non-rated by Moody's. Lehman Brothers index data supplemented Moody's proprietary data in the construction of the aggregate dollar volume-weighted default rates.

Defaulted bond pricing data was derived from Interactive Data Corp. (IDC), Bloomberg, and Reuters. The majority of these market quotes represent an actual bid on the specific instrument, although no trade may have occurred at that price.

2002 Corporate Bond Defaults

In 2002, 141 Moody's-rated issuers of corporate bonds defaulted on a total of $163.4 billion globally. Although the total number of defaulting issuers failed to surpass the annual record set in 2001 (186 obligors), the total dollar volume of defaulted debt far surpassed that of any previous year. Indeed, the total dollar volume of corporate bond defaults in 2002 is higher than the GDPs of advanced economies such as Greece, Finland, and Denmark.

Exhibit 1 presents annual total issuer default counts and dollar volumes from 1982 to 2002. The chart shows that even as the count of defaulting issuers fell by 24% from 2001 levels, the total dollar volume of defaulted debt jumped by 53%. The number of defaulting corporate bond issuers has in fact been rising at an increasing rate since 1996. Significantly, 2002 marks the first time in five years that the annual count of defaulting corporate bond issuers has fallen. Default volumes, initially lagging behind the growth in the number of defaulting obligors between 1996 and 2000, have exploded since 2000. The total dollar volume of defaulted debt increased by an incredible 34% annualized rate between 1996 and 2002, with most of the increase attributable to the past two years.

Exhibit 1 - Moody's Rated Corporate Bond Defaulter Counts & Dollar Volumes, 1982-2002

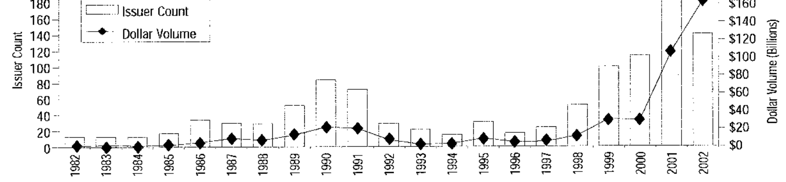


Exhibit 2 shows the initial event of default for issuers that defaulted in 2002. Missed interest and/or principal payments made up the majority of defaults, with 83 issuers (59%) missing interest and/or principal payments on bonds totaling $102.8 billion. Thirty-six corporate issuers defaulted by filing for bankruptcy. The bankruptcy category includes issuers that filed for protection from creditors under Chapter 11 of the U.S. Bankruptcy Code (including prepackaged Chapter 11) or, for issuers domiciled outside the U.S., that filed for bankruptcy under their legal bankruptcy regime. The latter category includes administration, receivership, or seizure by regulators.

Thirty issuers whose initial default event was not bankruptcy subsequently filed for bankruptcy, resulting in a total of 66 bankruptcies by issuers of corporate bonds totaling $100.7 billion in 2002. WorldCom, which initially missed a bond interest payment on July 15, filed for Chapter 11 less than a week later. The dollar volume of WorldCom's public bonds (not including its affiliates) totals over $23 billion – approximately 14% of the value of all defaulted bonds in 2002 and 24% of the value of bonds of obligors that filed for bankruptcy.

Distressed exchanges and grace period defaults constituted a relatively small share of corporate defaults in 2002, roughly in line with their historical proportions since 1988.

Exhibit 2 – 2002 Default Counts & Dollar Volumes by Initial Default Event

Initial Default Event	Issuer Count	Volume (Billions)
Bankruptcy	36	$33.8
US Chapter 11	25	$23.5
Prepackaged US Chapter 11	3	$0.7
Foreign Bankruptcy	8	$9.6
Missed interest and/or principal payment	83	$102.8
Distressed exchange	16	$24.6
Grace period default	6	$2.2
Total	**141**	**$163.4**

The divergent trends in the count of defaulting issuers and total dollar volume of defaulted debt resulted in a dramatic four-fold increase in the average total dollar size of default in 2002. Exhibit 3 tabulates the annual average total dollar size of default from 1982 to 2002. The series are expressed in 1996 dollars using the GDP deflator, so the values in the table are in real terms. Between 1982 and 2002, the average corporate bond default totaled $422 million ($285 million in nominal terms). As of 2002, the average real size of a corporate bond default totaled $1.7 billion. Astute readers might suggest that the presence of WorldCom's $23 billion default skews the 2002 average. There is no doubt that WorldCom's massive corporate bond default total - the largest in history - exerts an influence on the average size of default. Readers should note, however, that in 2002 thirty-six out of 141 issuers (14%) defaulted on over one billion dollars *each*. That is, there were a significant number of obligors for whom the total value of defaulted corporate bonds fell in the upper tail of the distribution.

The average size of default statistics highlight another distinguishing feature of the 2002 default experience – the relatively high severity of investment-grade defaults. Over $55 billion of 2002's $163.4 billion total dollar volume (34%) was due to the default of firms that carried investment-grade ratings within a year of default. Columns three and four of Exhibit 3 show the real average size of default for investment-grade and speculative-grade rated issuers. Both series have experienced a sharp increase over the last four years, but the increase in the real average size of default for investment-grade issuers is most pronounced.

Surprisingly, it is not 2002 but 2001 that witnessed the largest average size of default among investment-grade issuers. Despite the record overall default volume and the inclusion of WorldCom in the 2002 total, the relatively high number of issuers that defaulted with an investment-grade rating within a year of default in 2002 lowered the average. Exhibit 4 lists the nineteen issuers that defaulted in 2002 with an investment-grade rating within a year of default. Sixteen of those issuers are included in the 2002 cohort as investment-grade bond defaults.[1]

Exhibit 3 – Average Real Size (Millions) of Default*, Corporate Bond Issuers, 1982-2002

Year	All Rated	Investment-Grade	Speculative-Grade
1982	$103.2	$180.3	$89.1
1983	$245.8	N/A	$245.8
1984	$156.4	$271.8	$146.9
1985	$170.1	N/A	$170.1
1986	$216.3	$66.0	$236.3
1987	$476.6	N/A	$476.6
1988	$383.7	N/A	$383.7
1989	$378.8	$610.1	$359.5
1990	$394.2	N/A	$394.2
1991	$426.1	$1,998.5	$404.0
1992	$392.4	N/A	$392.4
1993	$180.1	N/A	$180.1
1994	$335.5	N/A	$335.5
1995	$442.0	N/A	$442.0
1996	$436.2	N/A	$436.2
1997	$335.1	N/A	$335.1
1998	$350.8	$591.5	$346.2
1999	$452.5	$683.3	$450.1
2000	$385.8	$1,525.4	$344.4
2001	$868.6	$8,201.8	$704.8
2002	$1,732.5	$5,159.4	$1,294.0

** Average size of default is expressed in real terms using the GDP deflator (1996 = 100).*

1. *Investment-grade corporations, such as Genuity and Banco de Montevideo, that defaulted on rated obligations other than bonds (e.g., bank loans or bank deposits) that are listed as defaulters are not included in Moody's cohort bond default rate statistics.*

Exhibit 4 - 2002 Corporate Defaulters with Investment-Grade Ratings within One Year of Default*

Company Name	Rating 1 Year Prior to Default*	Rating 1/1/02	Bond Volume (Millions)
AT&T Canada, Inc.	Baa3	Baa3	$2,959.9
Banco Commercial S.A.	Baa3	Baa3	$220.0
Banco de Montevideo S.A.	Baa3	Baa3	$300.0
Covanta Energy Corporation	Baa2	Ba1	$248.7
Duty Free International, Inc.	Baa2	Baa2	$115.0
Energy Group Overseas B.V.	Baa1	Baa1	$500.0
Genuity, Inc.	Baa2	Baa2	$2,000.0
Intermedia Communications Corporation	Baa2	Baa2	$3,122.3
Kmart Corporation	Baa3	Ba2	$2,480.6
Marconi Corporation, Plc	Baa2	Ba3	$3,271.9
MCI Communications Corporation	A3	A3	$2,640.0
NRG Energy, Inc.	Baa3	Baa3	$2,455.0
NRG Northeast Generating LLC	Baa3	Baa3	$750.0
NRG South Central Generating LLC	Baa3	Baa3	$800.0
Petroleum Geo-Services ASA	Baa3	Baa3	$1,460.0
PG&E National Energy Group, Inc.	Baa2	Baa2	$1,000.0
Qwest Capital Funding, Inc.	Baa1	Baa1	$12,902.7
Teleglobe Inc.	Baa1	Baa1	$1,224.0
TXU Eastern Funding Company	Baa1	Baa1	$2,136.4
TXU Europe, Ltd.	Baa1	Baa1	$150.0
WorldCom, Inc.	A3	A3	$23,244.9

** Investment-grade corporations, such as Genuity and Banco de Montevideo, that defaulted on rated obligations other than bonds (e.g., bank loans or bank deposits) are listed here as defaulters, but are not included in Moody's cohort-based bond default rate statistics.*

Not surprisingly, issuers based in the United States dominated defaults in 2002. Notably, however, the share of US issuers in the annual default total was at its lowest level since World War II. Exhibit 5 shows the distribution of 2002 default counts and dollar volumes by geographical region and country of domicile. US issuers made up 64% of defaults by dollar volume and 62% as percentage of issuers. In 2001, 77% of all defaults in number and 85% in volume were in the US.

Between 1920 and 2002, US-based corporate bond issuers have represented 91% of defaults as a percentage of issuers and 90% of defaults as a percentage of dollar volume, on average.

Europe experienced a considerable rise in corporate bond defaults in 2002. The increase in defaults in the European market is not surprising, however, considering the robust return of corporate bond issuance in Europe – a market effectively closed to speculative-grade rated issuers for the forty years following World War II. European defaulters constituted 4.2% of defaults by volume and 7% in number in 2001. Those proportions rose to 23% and 19%, respectively, in 2002. As Exhibit 5 shows, the UK was the source of the majority of defaults in Europe. Defaults by European issuers were some of the largest in 2002, and include NTL Communications Corp. ($8.5 billion), Telewest Communications PLC ($5.2 billion), and United Pan-Europe Communications N.V. ($5.1 billion).

The economic turmoil in Latin America led to an increase in the percentage of defaulters originating in that part of the world in 2002: 5.4% of defaults as a percentage of Moody's-rated issuers and 10.5% by dollar volume. In 2001, 1.5% of volume and 1.6% of Latin America issuers defaulted. Argentinean issuers account for the largest share of defaults in Latin America.

Exhibit 5 – Geographical Distribution of 2002 Corporate Bond Defaulters by Issuer Count & Dollar Volume

Region	Country	Percent of Total Volume	Percent of Total Issuers
North America & Caribbean		70.51%	68.09%
	United States	64.43%	62.41%
	Canada	5.53%	4.26%
	Mexico	0.55%	1.42%
Europe		23.37%	19.15%
	United Kingdom	15.48%	9.93%
	Netherlands	5.82%	5.67%
	Germany	1.22%	0.71%
	Sweden	0.34%	0.71%
	Norway	0.22%	0.71%
	Switzerland	0.14%	0.71%
	France	0.14%	0.71%
Latin America		5.44%	10.64%
	Argentina	4.95%	8.51%
	Chile	0.21%	0.71%
	Brazil	0.15%	0.71%
	Uruguay	0.13%	0.71%
Australia		0.43%	1.42%
Asia		0.25%	0.71%
Total	**16 Countries**	**$ 163 B = 100%**	**141 = 100%**

Telecommunications issuers dominated defaults by industry sector, far exceeding concentrations in the sector in 2001. Last year, telecommunications issuers constituted 25.8% of issuers by dollar volume and 16.1% as a percentage of issuers. In 2002, an extraordinary 56.4% of defaults by dollar volume and 31.2% of issuers defaulted in the telecommunications sector. Not since 1970 when 83% of defaulting issuers were in the transportation sector has a single industry represented such a large percentage of the annual default total. The 1970 default surge was due, however, entirely to the bankruptcy of the Penn Central railroad and its affiliates. While industry downturns have historically resulted in correlated and concentrated defaults, the telecommunications sector default surge is notable because of the number of firms and the total dollar volume of debt affected in a single industry in a relatively short time period. In combination with defaults by media and technology issuers, "New Economy" firms made up 75% of defaults in 2002 by dollar volume and 47% of issuers.

Ripples from Enron's bankruptcy continued to be felt in the energy sector in 2002. As a percentage of issuers, 11.4% of the total number of issuers in 2002 were in the energy sector (including public utilities). As a percentage of total dollar volume, firms in the energy sector constituted 7.6% of defaults. The transportation sector also saw heightened default rates in 2002 as several airlines, including UAL, parent of United Airlines, defaulted or filed for bankruptcy as a result of industry overcapacity and the aftershocks of the September 11[th] attacks. The distribution of defaults by industry sector is shown in Exhibit 6 below.

Exhibit 6 – Distribution of Defaults by Industry Sector

	Percent of Total	
Industry	**Volume**	**Issuers**
Telecommunications	56.4%	31.2%
Media, Publishing, & Broadcasting	15.6%	10.6%
Energy	7.6%	11.4%
Finance, Insurance, Real Estate	4.8%	7.0%
Transportation	3.8%	4.9%
Electronics	2.6%	4.3%
Banking	2.0%	2.1%
Metals & Mining	1.8%	6.4%
Retail	1.6%	1.4%
Automobile	0.7%	3.5%
Containers, Packaging, & Glass	0.7%	2.8%
Chemicals, Plastics, & Rubber	0.5%	2.1%
Forest Products & Paper	0.4%	0.7%
Beverage, Food, & Tobacco	0.3%	2.1%
Nondurable Consumer Products	0.3%	2.8%
Miscellaneous	0.2%	1.4%
Textiles, Leather, & Apparel	0.2%	1.4%
Hotels, Casinos, & Gaming	0.1%	1.4%
Healthcare, Education, & Childcare	0.1%	0.7%
Leisure, Amusement, & Entertainment	0.1%	0.7%
Miscellaneous Manufacturing	0.1%	0.7%
Total	**$163.4 B = 100%**	**141 = 100%**

Consistent with the trends presented in Exhibit 1 on page 4, aggregate default rates measured as a percentage of issuers fell in 2002, while aggregate default rates measured as a percentage of the total dollar volume outstanding increased. Exhibits 7 and 8 present summary default statistics for Moody's-rated issuers for the year 2002. Moody's global issuer-weighted default rate for all rated corporate bond issuers fell to 2.97% in 2002 from 3.80% in 2001. On a dollar volume-weighted basis, the default rate for all rated corporate bond issuers worldwide increased from 4.16% in 2001 to 5.29% in 2002. For speculative-grade rated issuers, Moody's issuer-weighted default rate fell to 8.33% in 2002 from 10.60% in 2001. The dollar volume-weighted default rate for speculative-grade rated issuers increased from 17.97% in 2001 to 21.03% in 2002.

Aggregate default rates for the US were mixed in 2002. The issuer-weighted default rate for all Moody's-rated obligors fell from 4.17% in 2001 to 3.17% in 2002, while the comparable dollar volume weighted statistic increased from 4.96% to 5.39%. Most of the improvement came from a reduction in the number of speculative-grade issuer defaults. Both the issuer- and dollar volume-weighted speculative-grade default rate fell in 2002: from 10.67% to 7.22% as percentage of issuers and from 16.88% to 16.07% as a proportion of dollar volume.

By rating category, default rates increased for ratings in the middle and at the lowest end of the ratings scale. The default rates for 2002 reported in Exhibits 7 and 8 can be compared with the annual default rates in Exhibits 37, 38 and 39 in the appendix, which show the time series of default rates by whole letter and alphanumeric ratings. Only in the B1-B3 range did default rates fall in 2002. Consistent with the findings for aggregate default rates, increases in default rates by rating category were much larger when measured as a percentage of dollar volume.

Exhibit 7 – 2002 Corporate Bond Default Summary Statistics - Whole Letter Ratings

	Global				United States			
Rating as of 1/1/02	Issuer Count	Volume (Billions)	Default Rate % Issuers	Default Rate % Volume*	Issuer Count	Volume (Billions)	Default Rate (% Issuers)	Default Rate (% Volume)
A	2	$25.9	0.16	2.92	2	$25.9	0.87	3.62
Baa	14	$29.8	1.22	3.47	8	$22.8	1.14	3.72
Ba	8	$9.2	1.53	4.08	4	$3.5	1.23	2.16
B	36	$35.1	5.11	17.39	27	$24.3	4.86	13.91
Caa-C	81	$63.3	29.45	82.82	47	$29.0	23.44	66.03
Investment-Grade	16	$55.7	0.49	2.35	10	$48.7	1.07	2.95
Speculative-Grade	125	$107.7	8.33	21.03	78	$56.8	7.22	16.07
All Rated	141	$163.4	2.97	5.29	88	$105.5	3.18	5.39

** Global dollar volume default rates consist of U.S. and European Issuers only.*

Exhibit 8 – 2002 Corporate Bond Default Summary Statistics - Alphanumeric Ratings

	Global			United States		
Rating as of 1/1/02	Issuer Count	Volume (Billions)	Default Rate (% Issuers)	Issuer Count	Volume (Billions)	Default Rate (% Issuers)
A3	2	$25.9	0.43	2	$25.9	0.87
Baa1	5	$16.9	1.26	1	$12.9	0.42
Baa2	3	$4.2	0.73	3	$4.2	1.17
Baa3	6	$8.6	1.78	4	$5.7	1.93
Ba1	3	$2.2	1.58	2	$0.8	1.76
Ba2	2	$3.1	1.41	1	$2.5	1.27
Ba3	3	$3.9	1.58	1	$0.2	0.76
B1	5	$6.7	2.00	4	$5.9	2.12
B2	19	$22.4	6.81	14	$14.9	6.06
B3	12	$6.0	6.86	9	$3.6	6.59
Caa1	15	$14.0	13.95	7	$4.7	8.05
Caa2	19	$13.4	33.93	16	$3.9	32.00
Caa3	13	$7.1	30.59	8	$4.0	25.40
Ca	32	$28.3	50.00	15	$16.2	51.72
C	2	$0.4	40.00	1	$0.2	33.33
Investment-Grade	16	$55.7	0.49	10	$48.7	1.07
Speculative-Grade	125	$107.7	8.33	78	$56.8	7.22
All Rated	141	$163.4	2.97	88	$105.5	3.18

2003 DEFAULT RATE FORECAST

Although issuer default counts and dollar volumes appear to have peaked in this credit cycle, Moody's believes that sufficient credit pressures remain to prevent the default rate from falling significantly in 2003. Exhibit 9 graphs Moody's 2003 speculative-grade default rate forecast with 90% confidence bounds.[2] The forecast indicates that over the next year the speculative-grade default rate will fall by just one percentage point, ending 2003 at 6.9%. A significant renewed rise in the default rate is not out of the question, as the upper 90% confidence bound shows. In the absence of an exogenous and unpredictable negative credit shock, the default rate will not rise much above 9% in an extreme scenario, which is safely below the 10.7% peak default rate of January 2002.

The change in the distribution of Moody's ratings is the single best predictor of default rates.[3] The average first-time speculative-grade rating deteriorated from B1 to B2 over 2002. A one-notch change in the average first-time rating might appear inconsequential, but as Exhibit 46 in the appendix shows, the expected one-year default rate more than doubles from B1 to B2. Driving the decline in the average speculative-grade rating is the growing proportion of issuers holding the lowest speculative-grade ratings. The percentage of obligors rated below Ba1-Ba3 grew from 62% of the speculative-grade rated pool in 2001 to 65% in 2002. More troublesome is the growth in the percentage of issuers in the Caa1-C rating range. 14% of speculative-grade rated issuers were rated in the Caa1-C rating range in 2001. In 2002, that proportion has grown to 18%.

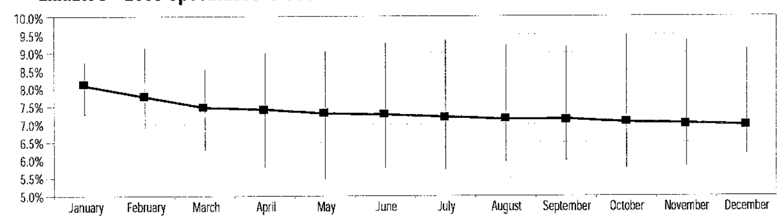
2. *The 90% confidence bounds are derived from a regression of the actual default rates on Moody's ex-post n=1...12-month-ahead default rate forecast. See Keenan, Sobehart, and Hamilton (1998).*
3. *Ibid.*

Another factor arguing against a sharp drop in the default rate in 2003 is the $45 billion of speculative-grade rated bonds and bank loans that will need to be refinanced in 2003. Roughly $28 billion of these bonds and bank loans (62% of the total) matures in the second half of 2003. The risk profile of speculative-grade rated bonds and bank loans will also increase going forward, with the percentage of maturing bonds and bank loans rated below Ba1-Ba3 expected to grow over the next three years.[4]

In addition to credit conditions, the state of the economy (in the US and globally) is likely to play a significant role in deciding the direction of default rates in 2003. Macroeconomic conditions are proxied in Moody's default rate forecasting model by the trend growth of US industrial production (IP). Although IP grew in 2002, recent IP data suggests IP growth may be anemic in 2003. Corporate bond issuers may not find much relief from credit stress in the form of a robust economic recovery in 2003. Should a macroeconomic downturn impact the key economies in Europe and the US for any prolonged amount of time, already tenuous macroeconomic conditions might tip enough to drive default rates considerably higher than forecast.

While Moody's does not forecast the dollar-volume weighted speculative-grade default rate, it does expect the gap between dollar-volume and issuer-weighted series to close in 2003. As the average size of default begins to regress toward its long-run trend, the dollar-volume weighted default rate should begin to converge with the issuer-weighted series. The gap between the two series peaked in November 2002 at 8%. In December, the gap shrank to 6%. This expected convergence does not necessarily depend on a continued decline in the issuer-weighted rate. Even if the issuer-weighted rate ends 2003 at a level different than forecast, Moody's still expects the gap between the dollar-volume and issuer-weighted speculative-grade default rate to narrow.

Exhibit 9 - 2003 Speculative-Grade Default Rate Point Forecasts & 90% Confidence Bounds



Corporate Credit Quality & Rating Transition Rates

Even in the absence of default, many companies experienced sharp changes in their credit profiles in 2002. Changes in an obligor's credit risk are captured in changes in its Moody's rating. A rating may be upgraded or lowered, depending on whether the obligor's credit risk has increased or decreased. A rating may also be withdrawn when an obligor exits the capital markets.

Rating transition matrices show the complete set of possible states a rating can take over a given time horizon. Each of the cells of a transition matrix shows the percentage of issuers who held the the rating shown in the row at the beginning of the measurement period (for example, one year) that ended the period with the column rating, including default and withrawal.[5] The prime diagonal of a transition matrix shows the percentage of issuers whose ratings did not change over the given time horizon.

Exhibit 32 in the appendix presents two transition matrices by alphanumeric rating. The first shows the average one-year transition rates for annual cohorts from 1983 to 2002, where each annual cohort is weighted by the size of the cohort (number of issuers); the second for just the 2002 cohort. Exhibit 33 in the appendix shows average one-year rating transition rates by whole letter rating from 1920 to 2002 and from 1970 to 2002.

4. *See Marshella and Aran (2003).*
5. *The default rates reported in rating transition matrices do not adjust the denominator for withdrawn ratings (withdrawn ratings appear in the last column of the matrix). Hence, the default rates reported in the transition matrix for 2002 in Exhibits 32 and 33 will not match default rates reported in Exhibits 43, 44, and 46, which do adjust the denominator for withdrawn ratings.*

Exhibits 32 and 33 illustrate some important features of the behavior of Moody's ratings. Over a one-year time horizon, a corporate bond issuer is most likely to end the period with the same rating with which it began. That probability is positively correlated with an obligor's credit quality: the inertial probability declines as one moves down the rating scale. The matrices also show that multi-notch rating changes are relatively infrequent. But comparing the transition matrix for year 2002 to the average transition matrix for the 1983-2002 period shows that these transition frequencies vary greatly with the credit cycle.

The transition matrix for 2002 in Exhibits 32 and 33 in the appendix show that credit risk increased considerably in 2002. In addition to high default rates, rating downgrade rates for virtually all rating categories were as high or higher than 2001. Rating downgrade rates for some rating categories were considerably higher than their historical averages. For example, 20.6% of issuers that began 2002 in the A2 category were downgraded by the end of the year, nearly double the average downgrade rate between 1983 and 2001. Downgrade rates for issuers in the Baa1–Ba3 rating categories experienced downgrade rates twice as high as the downgrade rate between 1983 and 2001.

Exhibit 10 illustrates the trend deterioration in credit quality over the past four years by plotting the annual percentage of investment-grade and speculative-grade issuers downgraded. The percentage of issuers downgraded reached record highs in 2001 and 2002. In 2001, 27% of US speculative-grade issuers were downgraded, surpassing the previous 24% peak in 1990. The percentage of US speculative-grade rated issuers downgraded fell to 25% in 2002.

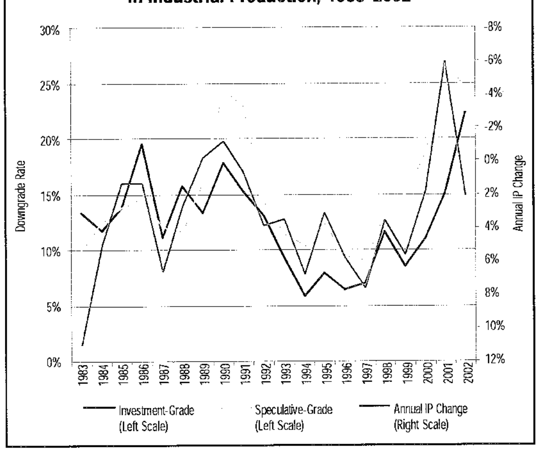
Notably, investment-grade issuers have experienced a similarly intense deterioration in credit quality. Exhibit 10 shows that the rise in the percentage of investment-grade issuers downgraded is not a unique phenomenon, but that the deterioration of investment-grade credit quality has been particularly intense in the current credit cycle. As early as 1998, the credit quality of investment-grade rated issuers began to come under pressure. The downgrade rate of investment-grade rated issuers increased from 15% in 2001 to a record high of 22% in 2002.

The deterioration in credit quality is highly correlated with changes in the level of economic activity. The annual percentage change in total US industrial production (IP) is plotted against the downgrade rates in Exhibit 10. Annual changes in US IP exhibit a -0.51 contemporaneous correlation with investment-grade downgrades and a -0.79 correlation with speculative-grade downgrades.[6] Exhibit 10 also suggests that downgrade rates are positively serially correlated. For example, annual investment-grade downgrade rates are 0.53 correlated with its previous year. For speculative-grade rated issuers, the one-period correlation is stronger: 0.71.

The above analysis reinforces Moody's forecast that credit conditions are expected to continue to be challenging in 2003. Even if the state of the economy improves – an uncertain prospect – downgrades are likely to remain relatively high in 2003. A renewed downturn in IP in 2003 would place additional strain on an already stressed credit environment, and imply increasing rating downgrades and defaults.

A type of rating transition of particular interest to investors is issuers that cross over from investment-grade to speculative-grade, so-called "fallen angels." Exhibit 11 presents the total number of issuers that became fallen angels between 1983 and 2002. It also shows the percentage of investment-grade issuers that became fallen angels and the percentage of fallen angels in the speculative-grade rated cohort. Were we to measure fallen angels on a dollar volume weighted basis, the figures would appear quite different. Issuers with a large total dollar volume of bonds outstanding – such as WorldCom and Kmart – would be heavily weighted in the calculations.

Exhibit 10 – Annual US Downgrade Rate & Annual Change in Industrial Production, 1983-2002

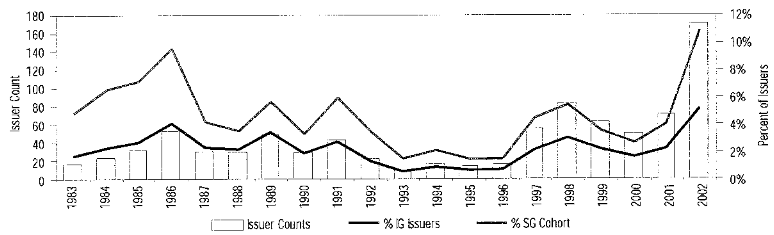


6. *Annual investment-grade and speculative-grade downgrade rates show a 0.66 contemporaneous correlation with each other.*

The chart reveals some important trends. The most obvious is the high number of fallen angels. In 2002, 171 corporate bond issuers lost their investment-grade ratings. However, in percentage terms, the rise in fallen angels appears less dramatic. The percentage of investment-grade rated issuers that became fallen angels reached a peak of 5.2% in 2002, up from just over 2% in 2001. In contrast, 3.2% of speculative-grade rated issuers were upgraded to investment-grade ("rising stars"). Fallen angels generally represent a small proportion of the speculative-grade pool in any given year, and even in years of heightened credit stress, such as 1986 and 2002, do not exceed 11% of issuers.

In 2002 the highest proportion of fallen angels (87%) originated in the Baa1-Baa3 rating category. Baa3-rated issuers – right at the investment-grade/speculative-grade boundary – accounted for 42% of the total number of fallen angels.

Exhibit 11 - Annual Fallen Angel Totals, 1983–2002



SOVEREIGN DEFAULT & RATING TRANSITION RATES

Although global credit conditions generally worsened in 2002 for corporate bond issuers, sovereign issuers experienced an overall improvement in credit quality. Fifteen sovereign bond issuers experienced credit rating upgrades, while only three sovereign bond ratings were downgraded (see Exhibit 12).[7] Notably, no Moody's-rated sovereign issuer defaulted on its bond obligations in 2002.

Moody's definition of default for sovereign issuers is identical to that for corporate issuers, with the exception, of course, of bankruptcy. As there is no international sovereign bankruptcy framework, most sovereign defaults are initiated as missed interest payments, which often result in distressed debt exchanges.[8]

Until the mid-90s, there were no Moody's-rated sovereign bond defaults. However, since 1998, several countries that were rated non-investment grade have defaulted on either their foreign or local currency bonds or both. Two countries - Russia and Ecuador - defaulted on both foreign and local currency bonds. Argentina's $82 billion bond default in 2001 is the largest sovereign default on record. Exhibit 31 in the appendix provides a list of Moody's rated foreign and/or domestic currency bond defaults.

On average, the sovereign bond rating transition experience has been fairly similar to that of Moody's corporate bond ratings. Exhibit 34 in the appendix compares sovereign whole letter rating transition frequencies to corporate bond issuer rating transition frequencies for the 1985-2002 period. Over that time period, 87% of sovereign ratings did not cross broad rating categories over a one-year horizon. For corporate issuers, the corresponding number is 82%. The exhibit also shows that large rating changes (more than one letter grade) within one year are extremely infrequent for both sovereign and corporate issuers. Moreover, the frequencies of upgrades and downgrades are similar across the two sectors.

The 10-year issuer-weighted average cumulative default rate for sovereign issuers is 9.3%. During the same time period, the comparable default rate for corporate issuers was 11.8%. For speculative-grade sovereign issuers, the 10-year default rate is higher: 45.4% compared to 37.8% for speculative-grade corporate issuers. No sovereign issuer that was ever rated investment grade during this time period has defaulted.

7. *The statistics in this section are derived from Varma (2002), which offers an in-depth analysis of sovereign bond rating transitions, defaults, and defaulted bond recoveries.*
8. *There are some efforts underway by multilateral lending institutions to develop an international framework for "bankruptcy filing" by a sovereign entity. During the Annual Meetings (2002) of the World Bank and IMF in Washington DC, the IMF's International Monetary and Finance Committee (IMFC) agreed to continue work on an international bankruptcy plan or a so-called "sovereign debt restructuring mechanism." For a detailed discussion on this issue see Zarin and Banerjee-Rothe (2002).*

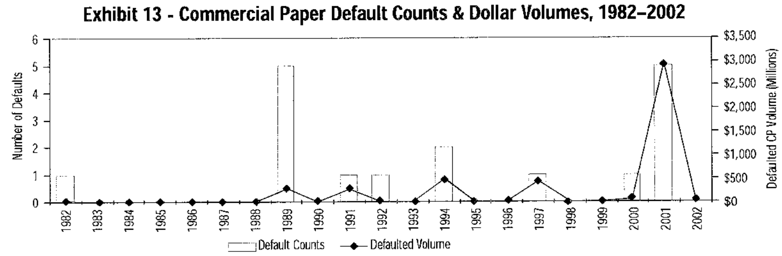
Exhibit 12 – 2002 Sovereign Rating Actions

Upgrades			Downgrades		
Country	**From**	**To**	**Country**	**From**	**To**
Australia	Aa2	Aaa	Japan	Aa3	A2
Canada	Aa1	Aaa	Venezuela	B3	Caa1
Czech Republic	Baa1	A	Uruguay	Ba2	B3
Iceland	Aa3	Aaa			
Kazakhstan	Ba2	Baa3			
Korea	Baa2	A3			
Latvia	Baa2	A2			
Lithuania	Ba1	Baa1			
New Zealand	Aa2	Aaa			
Pakistan	Caa1	B3			
Poland	Baa1	A2			
Qatar	Baa2	A3			
Slovenia	A2	Aa3			
Sweden	Aa1	Aaa			
Ukraine	Caa1	B2			

COMMERCIAL PAPER DEFAULT & RATING TRANSITION RATES

Periods of deteriorating credit quality measured by high bond default activity are often associated with higher downgrade probabilities and defaults in the commercial paper (CP) market.[9] The recent period of credit stress has been no exception. Although no Moody's-rated issuers defaulted on commercial paper in 2002, 2001 witnessed the highest number of defaulting CP issuers since 1989 and the highest total dollar volume of defaulted CP on record. Five CP issuers defaulted on $3 billion in 2001. Defaults in 2001 included Southern California Edison, Pacific Gas & Electric Company, PG&E Corporation, Comdisco, and Enron. Over the 1982-2002 time period, 17 Moody's-rated issuers have defaulted on a total of $4.5 billion of CP since 1982. Exhibit 13 details the number and dollar volume of Moody's-rated commercial paper defaults in each of the past 21 years.

Exhibit 13 - Commercial Paper Default Counts & Dollar Volumes, 1982–2002



Moody's defines a commercial paper default as any delayed, foregone, or incomplete disbursement of principal or interest (in those rare cases in which CP takes the form of an interest-bearing note). This definition includes forced rollovers and delayed payments that are allowed for under the terms of the notes. While conservative, we believe this definition to be the one most closely aligned with commercial paper investors' expectations.

Exhibit 14 lists Moody's-rated issuers of commercial paper that have defaulted since 1982. Most CP defaults have originated from US-domiciled issuers, which is not surprising since commercial paper is a much more important source of short-term funds for large, investment-grade US issuers. It is not a coincidence, then, that in many cases CP defaults are related to defaults of issuers that held investment-grade ratings within a year of default. Of the 17 CP defaulters listed in Exhibit 14, ten had bond defaults within a year of being rated investment grade.

9. *A full treatment of historical credit trends in the CP market can be found in Berthault and Hamilton (2000).*

The CP market's orderly exit mechanism and CP investor risk aversion help to prevent outright defaults in the commercial paper market. The orderly exit mechanism refers to the fact that a weakening of an issuer's credit quality is typically accompanied by a refusal by investors to roll over maturing CP, thus forcing the issuer from the market. CP rating changes are, therefore, crucial determinants of an issuers continued access to the CP market — especially rating downgrades to the NP (Not Prime) category.

Exhibit 14 – Moody's-Rated CP Defaults 1982-2002

Issuer	Default Date	Market Issued	Default Volume (Millions)	Ratings in days prior to default 1	30	60	90	120	180	270	365	Rating of Earliest Outstanding Defaulting Notes
Manville Corp.	08/26/82	USCP	$15.2	P-2	P-2	P-2	P-2	P-1	P-1	P-1	-	P-2
Wang Credit Corporation	08/16/89	ECP	$100.0	NP	NP	NP	NP	NP	P-3	P-3	P-3	NP
Wang Laboratories Inc.	08/16/89	ECP	$96.0	NP	NP	NP	NP	NP	P-3	P-3	P-3	NP
Colorado-Ute Financial Service Corp.	08/17/89	USCP	$19.0	NP	NP	NP	NP	P-1	P-1	P-1	P-1	P-1
Lomas Financial Corp.	09/01/89	ECP	$17.0	NP	NP	NP	P-3	P-3	P-3	P-3	P-3	NP
Equitable Lomas Leasing Corp.	09/12/89	USCP	$53.0	NP	P-3	P-3	P-3	P-2	P-2	P-2	P-2	P-3
Columbia Gas System Inc.	06/20/91	USCP	$268.0	NP	P-2	P-2	P-2	P-2	P-2	P-2	P-2	P-2
UNI Storebrand	08/25/92	ECP	$5.0	NP	P-3	P-2	P-2	P-2	P-2	P-2	P-2	P-2
Metallgesellschaft Aktiengesellschaft	01/07/94	DMCP	$292.8	NP	P-2	-	-	-	-	-	-	P-2
Metallgesellschaft Finance B.V.	01/07/94	ECP	$200.0	NP	P-2	-	-	-	-	-	-	P-2
Mercury Finance Company	01/31/97	USCP	$437.0	NP	P-2	P-2	P-2	P-2	P-2	P-2	-	P-2
Armstrong World Industries, Inc.	11/22/00	USCP	$50.0	NP	P-2	P-2	P-2	P-2	P-2	P-2	P-2	P-1
Southern California Edison Company	01/16/01	USCP	$722.0	P-3	P-1	P-1	P-1	P-1	P-1	P-1	P-1	P-1
Pacific Gas & Electric Company	01/17/01	USCP	$684.0	P-3	P-1	P-1	P-1	P-1	P-1	P-1	P-1	P-1
PG&E Corporation	01/17/01	USCP	$120.0	P-3	P-1	P-1	P-1	P-1	P-1	P-1	P-1	P-2
Comdisco, Inc.	07/16/01	USCP	$454.3	NP	NP	NP	NP	P-2	P-2	P-2	P-2	P-2
Enron Corporation	12/02/01	USCP	$986.0	NP	P-2	P-2	P-2	P-2	P-2	P-2	P-2	P-2

Exhibit 35 in the appendix shows weighted-average CP rating transition rates for investment horizons ranging from 30 days to 365 days. It also shows CP transition rates for the years 2001 and 2002. CP rating transition rates share many of the same general characteristics as corporate rating transition rates: inertia; declining stability moving down the rating scale; and a high correlation with lower ratings and default.

For each time horizon from 30 days to one year, the probability of a transition to the NP rating from a Prime rating is greater for lower credit ratings. That probability increased at the 365-day horizon in 2001 and 2002. Between 1982 and 2002 an average of 0.02% of P-1 rated issuers and 0.1% of P-2 rated issuers were downgraded over a 365-day period. In 2001 those proportion rose to 0.21% and 3.74%, respectively. The year 2002 saw downgrade rates to the NP rating category accelerate to 0.91% for P-1 rated issuers and 7.14% for P-2 rated issuers.

Historical Corporate Bond Default Rates & Ratings Performance

Moody's ratings are credit judgments that are intended to support investment decisions. Default rates are important statistics for evaluating the accuracy of those judgements. Moody's uses two different methodologies for calculating default rates. The first – Moody's traditional approach – uses the obligor as the unit of study. Because the number of credit judgments that Moody's must make does not vary with either the par amount or number of bonds of the issuer, we use the bond issuer itself as the unit of study.

The second approach uses the total dollar volume of debt outstanding as the basis for calculating default rates. Obviously, calculating statistics by total par amount biases the results toward the default characteristics of issuers with multiple or large debt issues. Nevertheless, this calculation provides a natural benchmark of concern to many investors, whose performance may be measured against the performance of the market portfolio. Several tables in the appendix report default rates on a dollar volume-weighted basis.

The first section of this study reported default rates for 2002 calculated using both methods. In this section we take a longer view of default rates with a twofold purpose. First, we seek to put the current credit cycle in historical perspective. But more importantly, we seek to gauge quantitatively the performance of Moody's ratings as statements about default risk.

Moody's definition of default for corporate bond issuers includes three types of default events: (1) there is a missed or delayed disbursement of interest and/or principal, including delayed payments made within a grace period; (2) an issuer files for bankruptcy (including receivership, administration, or seizure by regulators; (3) a distressed exchange occurs where: the issuer offers bondholders a new security or package of securities that amount to a diminished financial obligation (such as preferred or common stock, or debt with a lower coupon or par amount), or the exchange had the apparent purpose of helping the borrower avoid default.[10]

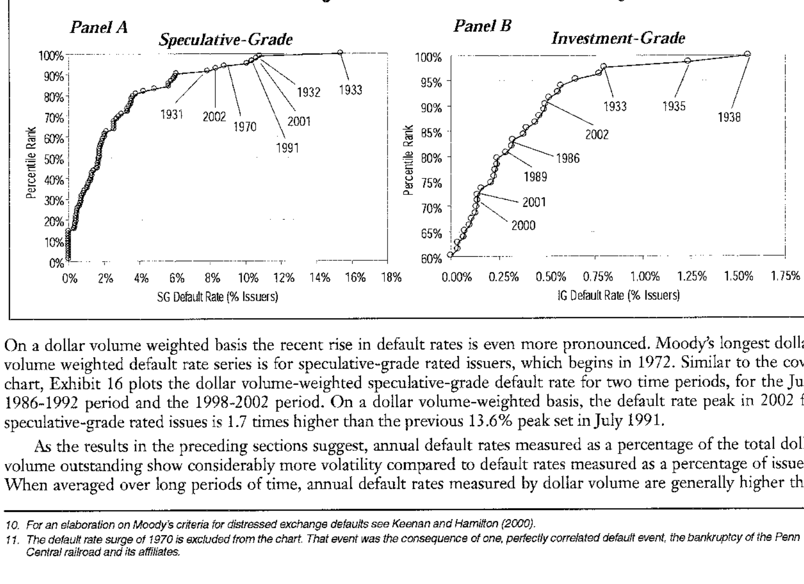
ANNUAL CORPORATE BOND DEFAULT RATES

The rise in default rates in the 1997-2002 period has truly been historic. The chart on the cover of this report shows that in the past 83 years there have been only three historical episodes when the (issuer-weighted) speculative-grade default rate reached extreme levels.[11] The graph shows trailing 12-month default rates for the 1930 to June 1937 period, the June 1986 to 1995 period, and the 1986 to 2003 period, where the 2003 default rate is the forecast reported in Exhibit 9.

The current credit cycle appears less severe relative to the credit cycles in the chart, falling short of the two historical peaks. However, the current credit cycle is distinguishable by its duration. From trough to peak, the current credit cycle is already the longest on record. In the two previous extreme cycles the default rate fell by 50% in the twelve months following their peaks. Following its peak in January of 2002, the global speculative-grade issuer-weighted default rate has fallen by just 2.5%.

Default rates in 2002 and 2001 have only been exceeded in a handful of years, primarily during the Depression years of the 1930s. Exhibit 15 shows the percentile rankings of annual speculative-grade and investment-grade default rates. The median default rate for speculative-grade issuers between 1920 and 2002 is 3%. For investment-grade rated issuers, the median default rate is zero. The percentile plot shows that the 2002 default rate for speculative-grade issuers is in the 93rd percentile, while the investment-grade default rate is in the 92rd percentile. Default rates for speculative-grade rated issuers in 1991 and 2001 exceeded 2002's year-end rate. However, in 2002 the investment-grade default rate registered its highest reading since 1940.

Exhibit 15 - Annual Issuer-Weighted Default Rate Percentile Rankings, 1920-2002



On a dollar volume weighted basis the recent rise in default rates is even more pronounced. Moody's longest dollar-volume weighted default rate series is for speculative-grade rated issuers, which begins in 1972. Similar to the cover chart, Exhibit 16 plots the dollar volume-weighted speculative-grade default rate for two time periods, for the June 1986-1992 period and the 1998-2002 period. On a dollar volume-weighted basis, the default rate peak in 2002 for speculative-grade rated issues is 1.7 times higher than the previous 13.6% peak set in July 1991.

As the results in the preceding sections suggest, annual default rates measured as a percentage of the total dollar volume outstanding show considerably more volatility compared to default rates measured as a percentage of issuers. When averaged over long periods of time, annual default rates measured by dollar volume are generally higher than

10. *For an elaboration on Moody's criteria for distressed exchange defaults see Keenan and Hamilton (2000).*
11. *The default rate surge of 1970 is excluded from the chart. That event was the consequence of one, perfectly correlated default event, the bankruptcy of the Penn Central railroad and its affiliates.*

those measured as a percentage of issuers, although in many cases the difference is not statistically significant. Exhibit 17 below shows issuer- and dollar volume-weighted default rates for US issuers between 1994 and 2002.[12]

The difference between dollar volume- and issuer-weighted average annual default rates for all Moody's-rated and speculative-grade rated issuers between 1994 and 2002 is not statistically significant.[13] The difference for investment-grade rated issuers over the same time period is statistically significant, however. Given the relatively short time period available for comparison, and the extraordinarily high dollar volume of investment grade defaults over that period, this result is not unexpected. WorldCom and Qwest Capital Funding – 2002's largest defaulters – are heavily weighted in the annual dollar volume default rate. If we remove just these two defaulters from the default rate calculation, the one-year weighted average default rate drops to 0.5%

Exhibit 16 - Global Dollar Volume-Weighted Speculative-Grade Default Rates, June 1986-1992 & 1998-2002

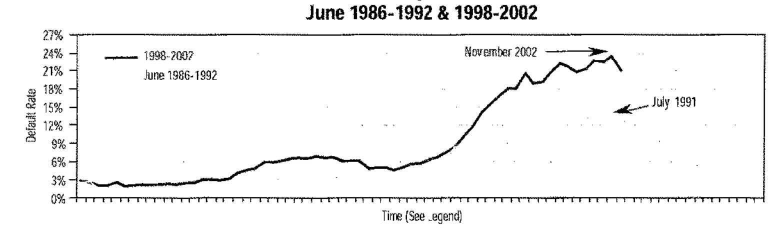
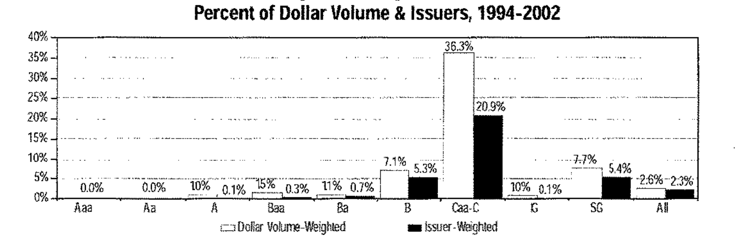


Exhibit 17 - US Weighted Average One-Year Default Rates, Percent of Dollar Volume & Issuers, 1994-2002



MULTI-YEAR DEFAULT RATES

Although one-year default rates are the most commonly reported default statistics, bond investors usually have investment horizons longer than one year. Investors may desire default rate estimates with a horizon roughly equivalent to the average maturity of their portfolios. Cumulative default rates that calculate the frequency of default beyond one year are, therefore, of direct utility.

As with the one-year default rates reported above, one can calculate cumulative default rates as a percentage of issuers outstanding or as a percentage of the dollar volume of debt outstanding. Each calculation assumes that the credit quality of the portfolio remains constant over the given investment horizon. A five-year default rate, for example, estimates the share of a portfolio of bonds of a given credit quality that can be expected to default over a five-year period. Cumulative default rates measured as a percentage of the dollar volume of debt outstanding therefore assumes that maturing debt is reinvested in bonds of the same credit quality.

12. Moody's dollar volume-weighted default rate statistics by whole letter rating category for US issuers begin in 1994. Moody's calculates a dollar volume-weighted speculative-grade default rate series that starts in 1972.

13. The absolute values of the t-statistics are 0.65 for speculative-grade, 0.26 for all rated issuers, and 4 for investment-grade issuers.

Measured both as a percentage of issuers and as a percentage of defaulted bond volumes, Moody's ratings exhibit a strong correlation with subsequent defaults over investment horizons as long as twenty years. Exhibits 43, 44, 45, 46 and 47 in the appendix present average cumulative average default rates by whole and alphanumeric ratings, both as a percentage of issuers and as a percentage of the dollar volume outstanding. The tables illustrate a clear, monotonically increasing relationship between Moody's ratings and the risk of default over multiple investment horizons. This finding has been well documented in Moody's previous annual default studies.

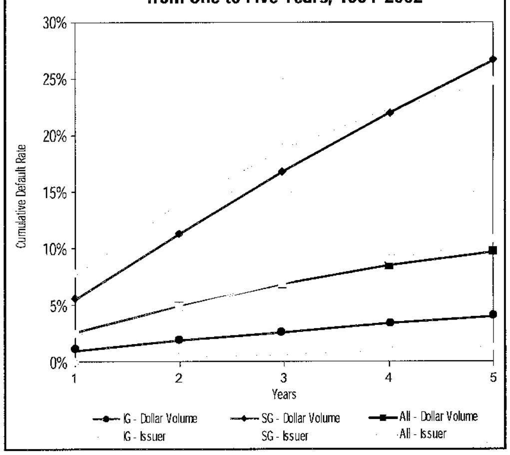
As we observed above, annual default rates measured as a percentage of the dollar volume outstanding are generally higher and exhibit higher variation relative to default rates calculated as a percentage of issuers. However, over periods longer than one year, aggregate cumulative default rates are much less dissimilar. Exhibit 18 combines some of the elements of Exhibits 43, 44, and 45 into one graph. The graph shows average cumulative default rates from one to five years for all rated, investment-grade, and speculative-grade rated issuers, calculated as a percentage of issuers and as a percentage of dollar volume.

Exhibit 18 shows that the cumulative default rates for all Moody's-rated issuers and for speculative-grade rated issuers measured as a percentage of dollar volume and as a percentage of issuers are statistically indistinguishable at the five-year horizon. Although the dollar volume cumulative default rate curve starts higher than the issuer-weighted curve, the two converge by the fourth year. The cumulative default rate curves for all Moody's rated issuers measured as a percentage of dollar volume and as a percentage of issuers lie virtually on top of one another over the entire five-year time horizon.

The shape of the dollar volume-weighted cumulative default rate curve for speculative-grade rated issuers also suggests that the risk of default is relatively more "front loaded" compared to the issuer-weighted default rates. In other words, the shape of the cumulative dollar volume-weighted default rate curve suggests that the risk of default in a portfolio of speculative-grade rated issuers is high during the first four years and flattens out thereafter.

The opposite seems to hold for investment-grade rated issuers. Although the likelihood of default shows a relatively flat profile from one to five years, the portfolio default rate shows no sign of flattening by the fifth year: the cumulative dollar volume-weighted default rate curve starts higher and continues to increase at a higher rate relative to the issuer-weighted cumulative default rate curve. As we noted above, the presence of heavily-weighted statistical outliers inflated the weighted-average dollar-volume default rate. Exhibit 19 shows that these large issuers influence the cumulative default rate up to the fifth year.

Exhibit 18 – US Average Cumulative Default Rates from One to Five Years, 1994-2002



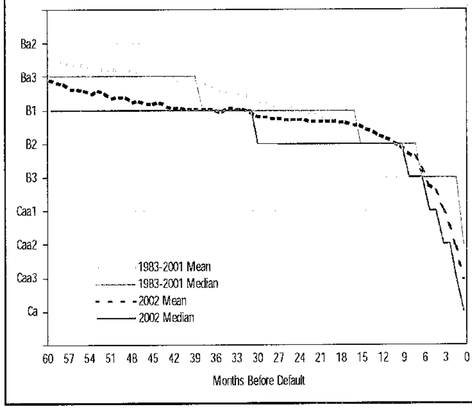
RATINGS AS PREDICTORS OF DEFAULT

With rare exceptions, ratings are downgraded well in advance of default. In Exhibit 19 we plot the median and average rating for the 1983-2001 period and for the 2002 cohort of defaulters. Both the graphs show that five years prior to default the median rating of defaulting companies is speculative-grade. For the 1983-2001 period, the median rating five years prior to default was upper speculative grade, Ba3. For 2001 defaulters, however, the rating five years before default was a significantly lower B1.

The downward slope of the average and median ratings show that these future defaulters were already experiencing downward rating pressure five years in advance of default. At 38 months before default, the median rating has fallen to B1 and falls further to B2 fifteen months prior to default. At the time of default, the rating is Caa2. We also see that as the default date approaches, the pace of rating downgrade accelerates. Exhibit 19 also shows that precipitous rating drops shortly before default have been rare on average. Even for 2002 defaulters we see that there was an orderly progression of rating downgrades leading up to the default date.

Moody's ratings have also demonstrated their ability to capture a very high proportion of defaulting issuers in the lowest rating categories over varying investment horizons. Exhibit 20 shows Cumulative Accuracy Plots (CAP) for one- and five-year horizons. CAP curves are useful for making visual, qualitative assessments of rating performance. A CAP curve is constructed in two ways. The first type sorts the Moody's-rated universe of corporate bond issuers from lowest (i.e. riskiest, Caa-C) rating to highest (default remote, Aaa) rating and calculates the percentage of defaulters whose credit rating is equal to or lower than that rating. An effective rating system would catch relatively more defaults from the rated population in its lowest (high default risk) categories.

Exhibit 19 – Median & Average Rating 60 to Zero Months Before Default

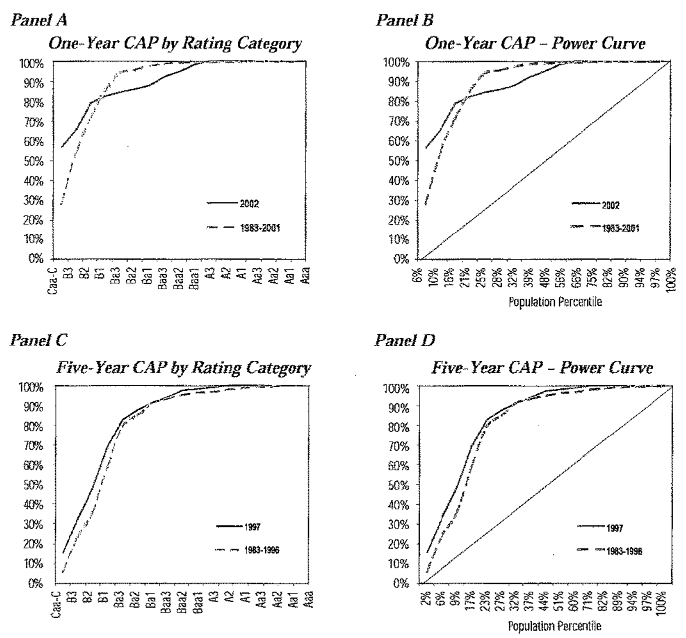


The second type of CAP curve sorts the Moody's-rated pool of issuers into risk percentile, where the measure of risk is the Moody's rating. The percentage of defaulters captured in each percentile is then calculated. This second type of CAP curve can be described as a "power curve," since it shows how effective a risk scoring system (rating system) is at detecting defaults from the population. For both types of CAP curves, the further the curve bows toward the northwest corner, the greater the fraction of all defaults that carry low ratings and the more efficient ratings are at sorting defaults from non-defaults.

Exhibit 20 shows CAP curves for one-year and five-year horizons for the 1983-2001 time period, and for the 1997 and 2002 cohorts. Between 1983 and 2001, over 90% of all defaulters carry ratings that are B1 or below one year before default (Panel A), and 70% are rated B1 or lower five years before default (Panel C). At the one-year time horizon, over 90% of defaulters are captured in the riskiest 25% of the rated population (Panel B). The high number of corporate bond issuers that defaulted with an investment-grade grade rating within a year of January 1, 2002 resulted in lower accuracy in the Ba3-Baa1 rating range for the year relative to the 1983-2001 period, which is illustrated by the relatively flat portion of the CAP curves between those rating categories.

At the five-year horizon, the ratings assigned to the 1997 cohort proved to be particularly effective at identifying subsequent defaults. The CAP curves for the 1997 cohort – both sorted by rating categories and by percentile ranking (power curve), shown in Panels C and D of Exhibit 18 – lie everywhere above the CAP curves for 1983-1996, indicating that more defaults from the 1997 cohort were captured by Moody's lowest ratings.

Exhibit 20 – One- & Five-Year Cumulative Accuracy Plots (CAP)



Corporate Bond Default Severity & Recovery Rates

Moody's ratings are statements about both the likelihood of default and the severity of loss given default (1 - Recovery Rate). While the likelihood of default is roughly the same for various debt obligations of the same obligor, these obligations are readily differentiated by the severity of the loss that may be expected in the event of default.

In this study, recovery rates are measured by the trading prices of debt thirty days after default. For many investors who liquidate their positions after default, post-default trading prices are, in fact, realized recovery rates. For investors that hold defaulted securities through ultimate resolution of the reorganization process, initial post-default prices are also likely to provide reasonable indications of their expected future recoveries.[14] Direct estimates of ultimate recovery, on the other hand, are subject to considerable measurement error. Bankruptcy resolution plans often provide non-cash payments to holders of defaulted debt in the form of new debt, equity, derivative securities (such as warrants on new common stock), or even physical assets. As these payments frequently do not trade in an open market, there is no precise way to estimate their value. Moreover, the appropriate discount rate for valuing these risky future payments is unclear.

14. *The theoretical rationale for the use of secondary market trading prices is the notion that market prices are generally considered to be "efficient" estimates of the appropriately discounted future value of the default securities. Eberhart and Sweeny (1992) test whether the market price of bonds post-bankruptcy is an unbiased forecast of ultimate recovery. The authors find weak but positive confirmation of the efficient markets hypothesis for defaulted bonds. Moody's internal research (unpublished) on realized recovery and defaulted bond pricing corroborates their findings.*

DETERMINANTS OF RECOVERY IN DEFAULT

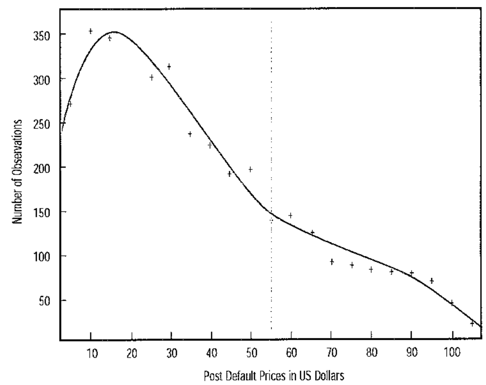
In the event of default, bondholders usually receive some fraction of the value of their original claims. The position of a debt instrument in the firm's capital structure and the degree to which that instrument is backed by liquid assets are important predictors of expected recovery rates. Recovery rates are also impacted by cyclical trends, such as macroeconomic factors and the credit cycle, the relative strength of the firm in its industry, and the nature and severity of the default event.

While it is not unusual to observe high recovery rates in some instances (close to 100% as percentage of face value of the debt), they typically fall in the 30–40% range on average. Exhibit 21 plots the frequency distribution of defaulted bond recovery prices from 1982 to 2002. While there are several hundred observations that are greater than the average issuer-weighted recovery rate of $38, several thousand are less than $38. Most of the observations are concentrated between $25–$50. In fact, for the period 1982–2002, over 70% of post-default prices were below 38% of the original face value.

Defaulted bond recovery rates for 1982–2002 exhibit a beta distribution with the minimum value bounded at 0% and a trailing right side tail, as Exhibit 21 shows. Given the high degree of skewness of the distribution of recovery rates, median values may, for some investors, be a more informative measure of expected recovery rates, since simple averages will heavily weight the handful of very high recovery rates.

Exhibit 22 presents average recovery rates for various classes of debt instruments between 1982 through 2002, and also presents averages for selected sub-periods. (Other descriptive statistics for recovery rates for various security classes are presented in Exhibit 36 in the appendix.) Average recovery rates tend to fall with priority in the capital structure: secured bank loans recover an average of $61.6 per $100 par, with the percentage falling to $23.6 per $100 par for junior subordinated bonds.

Exhibit 21 – Distribution of Recovery Rates (1982-2002)



Recovery rates across all types of debt instruments have generally fallen below their historical averages over the last two years. 2001 and 2002 were probably the years with the lowest average recovery rates for straight bond issues. The average recovery rate for 2001 was only $34. Similarly, the overall recovery rate for 2002 was $34.

Exhibit 22 – Average Defaulted Bond Recovery Rates By Security and Priority

	Average Recovery			
Priority in Capital Structure	**1982-2002**	**1982-2000**	**2001**	**2002**
Secured Bank Loans	$ 61.6	$ 67.3	$ 64.0	$ 51.0
Equipment Trust	$ 40.2	$ 65.9	NA	$ 38.2
Senior Secured	$ 53.1	$ 52.1	$ 57.5	$ 48.7
Senior Unsecured	$ 37.4	$ 43.8	$ 35.5	$ 34.0
Sr. Subordinated	$ 32.0	$ 34.6	$ 20.5	$ 26.6
Subordinated	$ 30.4	$ 31.9	$ 15.8	$ 24.4
Jr. Subordinated	$ 23.6	$ 22.5	NA	NA
All Bonds	$ 37.2	$ 39.1	$ 34.7	$ 34.3

However, the decline in recovery rates has not been uniformly distributed across the capital structure. In 2001, seniority and security helped preserve the value of claims nearest to the assets of defaulting firms. Contrary to the overall trend, the average recovery rate for senior secured bonds actually increased in 2001. Recovery rates for unsecured and subordinated bonds fell sharply, with recovery rates for senior subordinated and subordinated bonds falling to nearly half their historical averages.

In 2002, the trend reversed. Senior and secured defaulted bonds and bank loans saw their average recovery rates fall, while subordinated bonds recovery rates rose significantly. The average recovery rate for bank loans fell by roughly 20%; the average senior secured bond recovery rate fell by 15%. On the other hand, senior subordinated bond recovery rates increased by 30%, while the average subordinated bond recovery rate jumped by 80%.

Highly correlated events of default sometimes occur within industries, as preceding sections have discussed. Given a relatively high concentration of default in an industry, recovery rates might also be expected to be a function of variables related to industry category, such as the extent to which bonds are secured by physical and/or liquid assets. Exhibit 23 shows that average recovery rates do indeed vary by industry category, and that security provisions have been a strong determinant of recovery in default in industries like public utilities. Average recovery rates vary from a low of $20 for the telecommunications sector to a high of $62 for public utilities.

Exhibit 23 – Average Defaulted Bond Recovery Rates by Broad Industry Classification, 1982-2002

	Average	Minimum	Maximum	StdDev	Count
Banking	$25.4	$1.25	$96.40	$20.30	56
Finance Institutions	$57.2	$1.00	$98.00	$29.90	301
Industrial	$36.9	$0.28	$125.00	$24.90	2,456
Insurance	$32.7	$8.00	$94.50	$26.40	53
Public Utilities	$62.3	$2.65	$101.30	$25.59	181
Telecom	$20.0	$0.25	$91.25	$16.24	435
Thrifts	$28.8	$1.50	$84.30	$26.78	26
Transportation	$36.6	$5.00	$103.00	$25.10	277
Miscellaneous	$32.3	$5.00	$66.00	$30.90	5

The high proportion of defaulted issuers in the telecommunications sector over the past two years has strongly influenced average recovery rates. When weighted by the dollar-volume of defaulted bonds, recovery rates show the strong effect of low recoveries in the telecommunications sector. Large defaulted issuers with far below-average recovery rates — such as WorldCom whose average recovery rate is approximately $10 — bring the overall average recovery rate down considerably. Exhibit 24 presents recovery rates calculated as dollar volume-weighted average and as issuer-weighted (equally -weighted) average. Weighting recovery rate by the dollar volume of defaults lowers the 2002 average recovery rate from $34 to roughly $26. The table also shows that large telecom defaults like WorldCom, and the pervasive nature and high volume of telecommunications defaults in 2002 have significantly impacted average recovery rate, both on a dollar-weighted basis and issuer-weighted basis.

Exhibit 24 – 2002 Recovery Rates, Dollar- vs. Issue-Weighted

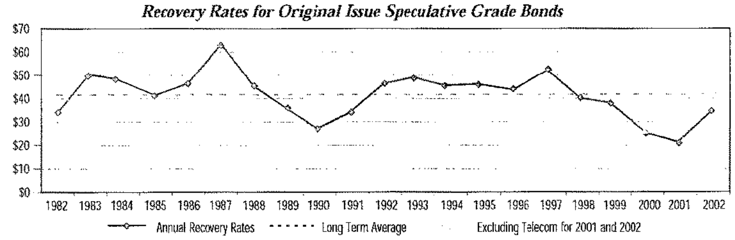
	Dollar-Weighted	Issue-Weighted
All Bonds	$25.6	$34.4
All Ex-Worldcom	$28.1	$35.1
All Ex-Telecom	$33.9	$39.3

TIME VARIATION & DEFAULT CORRELATION

As the findings above indicated, defaulted bond recovery rates in 2001 and 2002 have been below their historical averages. In addition to bond- and obligor-specific determinants of recovery, recovery rates exhibit serial and cyclical correlation that also explain recent trends. Exhibit 25 shows average annual recovery rates for defaulted speculative-grade bonds from 1982–2002. The long-term average for this sample is $41.6, which is slightly higher than the $37.2 dollar average recovery rate experienced by the full issue-weighted sample. (Individual annual averages yield a higher average recovery statistic than the full-sample, issue-weighted average because the last few years have provided many issues and low average recovery rates.)

Exhibit 25 - Average Annual Speculative-Grade Defaulted Bond Recovery Rates, 1982-2002

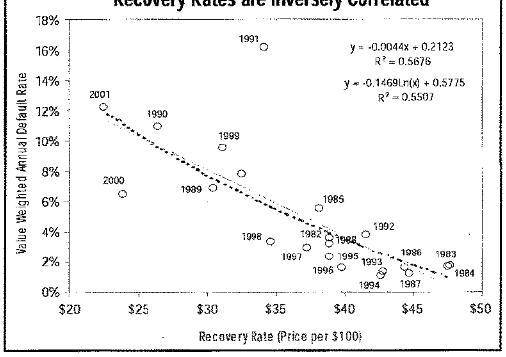
Recovery Rates for Original Issue Speculative Grade Bonds



In 2002, speculative-grade recovery rates averaged $34.1. However, if one excludes bonds issued by the telecommunications industry, the average recovery rate rises to $41.8, roughly equal to the long-term average recovery rate of $41.6.

As discussed in our previous annual default studies, recovery rates and default rates tend to be inversely correlated.[15] To examine this relationship empirically, we use annual speculative-grade dollar volume-weighted default rates for this test. Exhibit 26 is a scatter plot of annual dollar volume-weighted speculative-grade default rates and average annual recovery rates. While there is significant variation in recovery rates year-to-year, a statistically significant relationship exists between recovery rates and default rates.

Exhibit 26 – Speculative-Grade Default Rates and Recovery Rates are Inversely Correlated



The percentage of the variance in recovery rates explained by annual default rates (R-squared) is 0.56. With the exception of two outliers, the exhibit shows virtually a linear relationship between dollar weighted default rates and recovery rates. If the two outliers are removed, the R-squared statistic increases to 0.88. The relationship is consistent with the hypothesis that higher supply of distressed bonds (as indicated by higher default rates) leads to lower prices (as indicated by lower recovery prices) and vice versa.

Credit Loss Rates

The previous sections dealt with the two underlying determinants of credit loss, the likelihood of default and the severity (or recovery) in the event of default. We have seen that Moody's ratings have properly rank ordered default risk and default severity over time. Not only does the probability of default rise with lower ratings, but the severity of loss also rises. In this section we bring together the results of the preceding sections to arrive at estimates of credit loss rates, and demonstrate that Moody's ratings effectively differentiate credit loss rates.

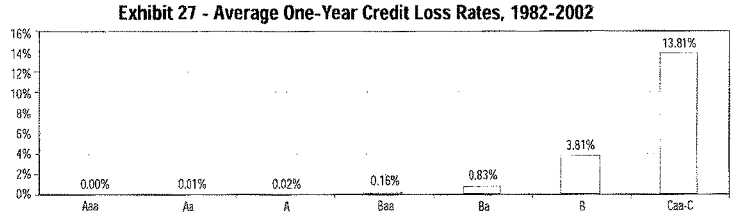
15. The negative correlation between default rates and recovery rates is well documented. See Altman, Brady, Resti and Sironi (2002), Frye (2000), and Hu and Perraudin (2002).

Moody's rating process is designed to produce a consistent measure of relative credit risk, the primary consideration of which is Moody's evaluation of expected credit loss. Moody's evaluation of expected credit loss includes both the probability of default and the severity of loss in the event of default, and can be mathematically expressed as:

Credit Loss Rate = (Default Frequency) (1-Recovery Rate)

Credit losses are the loss in total return of a fixed income portfolio due to defaults. For a portfolio with large exposure to default-risky debt (such as for high yield portfolios), credit losses can materially affect total returns. A portfolio with higher defaults will have higher credit losses than otherwise. A natural progression of this argument is that high-risk (low rated) bond portfolios will most likely have higher credit losses, which may affect total return. Conversely, a relatively low risk portfolio will have lower credit losses. In Exhibit 27 we present the average annual credit losses for portfolios constructed primarily on the basis of Moody's ratings for the 1982-2002 period.

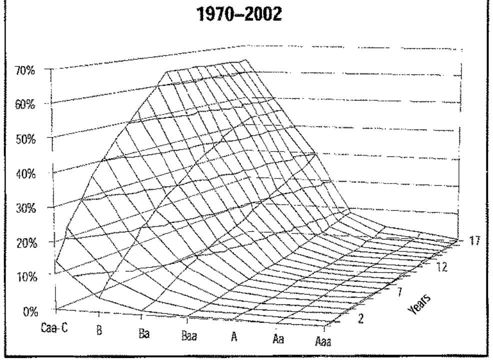
Exhibit 27 - Average One-Year Credit Loss Rates, 1982-2002



The highest credit risk portfolios (with an average rating of Caa-C) have the highest credit losses and the lowest credit risk portfolio (rated Aaa) have the lowest credit losses. In fact, a Aaa-rated portfolio has a zero historical annual credit loss rate. However, one of the most important aspects of this exhibit is that the relationship between the ratings and annual credit losses is non-linear. Annual credit losses increase exponentially as the rating goes from Baa to Caa-C.

Cumulative credit loss rates from one to twenty years calculated for Moody's whole letter ratings is presented in Exhibit 28. The surface chart shows that credit loss rates are readily differentiated by rating notch at every time horizon. Historical credit losses increase monotonically, both cross-sectionally and holding rating constant. Additionally, we find that credit losses saturate at some time horizon. For the Caa-C bucket, saturation arrives at year 10; for the Baa bucket saturation occurs in year 14. Credit losses plateau at various time horizons because after a certain point all issuers in that rating category default and leave the pool (the default rate saturates at 100%).

Exhibit 28 - Cumulative Historical Credit Loss Rates, 1970–2002

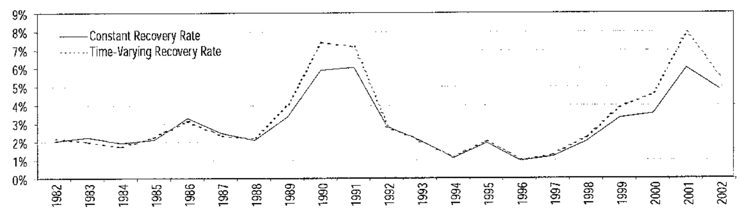


A common assumption made by several credit risk models is that recovery rates and default rates are independent of one another. The sections above showed that recovery rates and default rates are, in fact, cyclical (Exhibit 27). Hence, credit loss rate estimates will vary depending upon the assumptions of constant or time-varying recovery rate. Assuming a constant recovery rate across time will underestimate the losses when the recovery rates are less than the long-run average (when default rates are high), while at the same time overestimate losses when recovery rates are higher than the long run average (when default rates are low).

To illustrate this point we calculate annual credit loss rates for the 1982-2002 time period using both time-varying recovery rates and the constant long-term recovery rates for speculative-grade rated issuers. For the long-term, constant recovery rate we use $42, and for time-varying recovery rates we use the average annual recovery rate for the given year. Exhibit 29 presents the results.

As is evident from the graph, the assumption of a constant recovery rate results in drastically lower estimates of credit losses in high default periods. For example, in the year 1990 the recovery rate was $27, which was about 35% lower than the long run average of $42. Consequently, the credit loss rate assuming a constant recovery rate underestimates the actual credit loss rate by 1.5%. In the current credit cycle,credit loss rates have accelerated as the default rate increased and as recovery rates reached historical lows. The assumption of a constant, $42 recovery rate would have resulted in gross understimates of credit losses since 1998.

Exhibit 29 - Annual Historical Credit Loss Rates for Speculative-Grade Issuers, 1982-2002



Summary

The year 2002 marked the trough in a credit cycle of duration and depth not seen since the 1930s, culminating with the largest corporate bankruptcy in history. An historic increase in the total number and dollar volume of corporate defaults has also been accompanied by a high number of credit rating downgrades relative to credit rating upgrades. The peak in the default rate traces it origins back to the cohort of low-rated, high-risk bond issuers that came to market in 1997 and 1998. Weak economic growth over the past two years has helped push up the default rate, particularly for investment-grade rated issuers.

Despite the volatile credit environment - where risk has been heightened by numerous accounting scandals and geopolitical uncertainty - Moody's ratings have been efficient predictors of default and credit loss. The relatively high number of investment-grade defaulters resulted in somewhat below-average one-year accuracy statistics for ratings in the low investment-grade rating range in 2002. Examined over a five-year horizon, however, the ability of Moody's to identify defaults has improved since 1982: over 90% of defaulters between 1982 and 2002 were rated speculative-grade five years before default.

The high but slowing pace of rating downgrades suggests that credit stress will remain elevated in 2003, but some improvement is expected. The percentage of issuers downgraded is expected to fall in 2003 - particularly if economic growth resumes in earnest - but the high degree of serial correlation of downgrades suggests that downgrade rates will be above the historical average. Moody's default rate forecasting model indicates that the speculative-grade default rate will fall from 2002's 8.3% to 6.9% by the end of 2003.

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Appendix: Statistical Tables of Default, Rating Migration & Recovery

Exhibit 30 – Moody's-Rated 2002 Corporate Bond Defaults

Company	Volume (Millions)	Initial Default Event	Country	Industry
January				
AAi.FosterGrant, Inc.	$75.0	Missed interest payment	United States	Nondurable Consumer Products
Archibald Candy Corporation	$170.0	Missed interest payment	United States	Beverage, Food, & Tobacco
BTI Telecom Corporation	$250.0	Distressed exchange	United States	Telecommunications
Duty Free International	$115.0	Grace period default	United States	Retail
Frontier Corporation	$600.0	Chapter 11	United States	Telecommunications
Glasstech, Inc.	$70.0	Chapter 11	United States	Containers, Packaging, & Glass
Global Crossing Holdings Limited	$3,800.0	Chapter 11	United States	Telecommunications
Hartmarx Corporation	$100.0	Distressed exchange	United States	Textiles, Leather, & Apparel
IT Group, Inc.	$265.3	Chapter 11	United States	Miscellaneous
Kaiser Aluminum & Chemical Corporation	$850.0	Missed interest payment	United States	Metals & Mining
Kmart Corporation	$2,480.6	Chapter 11	United States	Retail
McleodUSA, Inc.	$2,935.0	Missed interest payment	United States	Telecommunications
Millenium Seacarriers, Inc.	$100.0	Chapter 11	United States	Cargo Transportation & Shipping
Natg Holdings, LLC	$150.0	Missed interest payment	United States	Telecommunications
Netia Holdings B.V.	$488.2	Cross default	Netherlands	Telecommunications
Renco Steel Holdings, Inc.	$120.0	Missed interest payment	United States	Metals & Mining
Scotiabank Quilmes S.A.	$250.0	Missed principal payment	Argentina	Banking
Simonds Industries, Inc.	$100.0	Missed interest payment	United States	Construction, Building, & Real Estate
UnitedGlobalCom, Inc.	$1,375.0	Distressed exchange	United States	Printing, Publishing, & Broadcasting
Volume (US$ Millions)	$14,294.1			
Count	19			
February				
Cablevision SA	$727.7	Missed principal payment	Argentina	Printing, Publishing, & Broadcasting
Carrier1 International S.A.	$234.5	Bankruptcy	Switzerland	Telecommunications
Cellstar Corporation	$150.0	Distressed exchange	United States	Telecommunications
Compania de Alimentos Fargo S.A.	$120.0	Missed interest payment	Argentina	Beverage, Food, & Tobacco
Evenflo Company, Inc.	$110.0	Missed interest payment	United States	Leisure, Amusement, & Entertainment
Galey & Lord, Inc.	$300.0	Chapter 11	United States	Textiles, Leather, & Apparel
Insilco Technologies, Inc.	$120.0	Missed interest payment	United States	Automobile
Metrogas S.A.	$195.6	Grace period default	Argentina	Oil & Gas
Nextel International, Inc.	$2,331.5	Missed interest payment	United States	Telecommunications
United Pan-Europe Communications N.V.	$5,133.1	Missed interest payment	Netherlands	Printing, Publishing, & Broadcasting
Volume (US$ Millions)	$9,422.4			
Count	10			

Exhibit 30 – Moody's-Rated 2002 Corporate Bond Defaults

Company	Volume (Millions)	Initial Default Event	Country	Industry
March				
Adelphia Business Solutions	$879.0	Missed interest payment	United States	Telecommunications
Anchor Glass Container Corporation	$200.0	Missed interest payment	United States	Containers, Packaging, & Glass
Banco Hipotecario S.A.	$1,109.3	Missed principal payment	Argentina	Banking
Covanta Energy Corporation	$248.7	Missed interest payment	United States	Electric Utilities
CTI Holdings S.A.	$262.9	Suspension of payments	Argentina	Telecommunications
Doe Run Resources Corporation	$305.0	Missed interest payment	United States	Metals & Mining
Doman Industries Limited	$673.0	Missed interest payment	Canada	Forest Products & Paper
Energis plc	$912.6	Grace period default	United Kingdom	Telecommunications
Flag Telecom Holdings Ltd.	$561.7	Missed interest payment	United Kingdom	Telecommunications
Formica Corporation	$215.0	Chapter 11	United States	Chemicals, Plastics, & Rubber
Gaylord Container Corporation	$675.0	Distressed exchange	United States	Containers, Packaging, & Glass
Heafner Tire Group, Inc.	$150.0	Distressed exchange	United States	Automobile
Hylsa, S.A. de C.V.	$324.1	Missed interest payment	Mexico	Metals & Mining
IFCO Systems NV	$176.7	Missed interest payment	Netherlands	Containers, Packaging, & Glass
Mastellone Hermanos S.A.	$225.0	Missed interest payment	Argentina	Beverage, Food, & Tobacco
Metromedia Fiber Network, Inc.	$2,596.2	Missed interest payment	United States	Telecommunications
National Steel Cororation	$422.7	Chapter 11	United States	Metals & Mining
Pinnacle Holdings, Inc.	$525.0	Missed interest payment	United States	Financial (Non-Bank)
Volume (US$ Millions)	$10,461.8			
Count	18			
April				
Asia Global Crossing Limited	$408.0	Missed interest payment	Multinational	Telecommunications
Budget Group, Inc.	$445.0	Missed interest payment	United States	Construction, Building, & Real Estate
Call-Net Enterprises, Inc.	$2,160.9	Distressed exchange	Canada	Telecommunications
Exide Technologies, Inc.	$637.0	Chapter 11	United States	Automobile
Flag Limited	$430.0	Chapter 11	United Kingdom	Telecommunications
Grapes Communications NV	$176.6	Prepackaged Chapter 11	Netherlands	Telecommunications
Husdon Resipatroy Care, Inc.	$115.0	Missed interest payment	United States	Healthcare, Education, & Childcare
IMASAC S.A.	$80.0	Missed interest payment	Argentina	Printing, Publishing, & Broadcasting
Knowles Electronics, Inc.	$153.2	Grace period default	United States	Electronics
Mpower Holding Corporation	$250.0	Prepackaged Chapter 11	United States	Telecommunications
NTL Communications Corp.	$8,482.5	Missed interest payment	United Kingdom	Telecommunications
Telecom Argentina Stet-France Telecom SA	$1,431.2	Suspension of payments	Argentina	Telecommunications
Williams Communications Group, Inc.	$3,000.0	Missed interest payment	United States	Telecommunications
Volume (US$ Millions)	$17,769.4			
Count	13			

Exhibit 30 – Moody's-Rated 2002 Corporate Bond Defaults

Company	Volume (Millions)	Initial Default Event	Country	Industry
May				
Adelphia Communications Corporation	$6,941.5	Missed interest payment	United States	Printing, Publishing, & Broadcasting
Century Communications Corp.	$1,974.0	Missed interest payment	United States	Printing, Publishing, & Broadcasting
Completel Europe NV	$233.0	Bankruptcy	France	Telecommunications
Diamond Cable Communications Limited	$1,236.6	Chapter 11	United Kingdom	Telecommunications
Diamond Holdings Limited	$307.2	Chapter 11	United Kingdom	Telecommunications
ITC Deltacom, Inc	$585.0	Missed interest payment	United States	Telecommunications
KPNQwest N. V.	$1,418.0	Bankruptcy	Netherlands	Telecommunications
Northern Offshore ASA	$352.0	Grace period default	Norway	Oil & Gas
NTL, Inc.	$1,200.0	Chapter 11	United Kingdom	Telecommunications
Olympus Communications L.P.	$200.0	Missed interest payment	United States	Printing, Publishing, & Broadcasting
Quality Distribution Inc.	$140.0	Distressed exchange	United States	Cargo Transportation & Shipping
Telefonica de Argentina	$885.0	Distressed exchange	Argentina	Telecommunications
Teleglobe, Inc	$1,224.0	Bankruptcy	Canada	Telecommunications
US Timberlands Klamath Falls LLC	$225.0	Missed interest payment	United States	Construction, Building, & Real Estate
WKI Holding Company, Inc	$200.0	Missed interest payment	United States	Nondurable Consumer Products
Volume (US$ Millions)	$17,121.3			
Count	15			
June				
Acterna Corporation	$275.0	Distressed exchange	United States	Telecommunications
Azurix Corp.	$587.8	Distressed exchange	United States	Other Utilities
Banco de Galicia y Buneos Aries	$1,899.5	Missed interest payment	Argentina	Banking
FrontierVision Holdings L.P.	$329.0	Chapter 11	United States	Printing, Publishing, & Broadcasting
FrontierVision Operating Partners L.P.	$200.0	Chapter 11	United States	Printing, Publishing, & Broadcasting
Golden Northwest Aluminum Inc.	$150.0	Missed interest payment	United States	Metals & Mining
GT Group Telecom Inc.	$855.0	Bankruptcy	Canada	Telecommunications
Raintree Resorts International Inc.	$94.5	Missed interest payment	United States	Hotels, Casinos, & Gaming
SWT Finance B.V.	$93.8	Missed interest payment	Netherlands	Financial (Non-Bank)
Venture Holdings Company LLC	$455.0	Grace period default	United States	Chemicals, Plastics, & Rubber
VersaTel Telecom International N.V.	$1,515.3	Bankruptcy	Netherlands	Telecommunications
Viasystems Inc.	$500.0	Missed interest payment	United States	Electronics
Volume (US$ Millions)	$6,954.8			
Count	12			

Exhibit 30 – Moody's-Rated 2002 Corporate Bond Defaults

Company	Volume (Millions)	Initial Default Event	Country	Industry
July				
Advanced Glassfiber Yarns LLC	$148.0	Missed interest payment	United States	Electronics
BGF Industries, Inc.	$100.0	Missed interest payment	United States	Electronics
Callahan Nordrhein-Westfalen GmbH	$1,998.2	Bankruptcy	Germany	Printing, Publishing, & Broadcasting
Evercom, Inc	$115.0	Missed interest payment	United States	Telecommunications
GenTek, Inc.	$200.0	Missed interest payment	United States	Chemicals, Plastics, & Rubber
Intermedia Communications Corporation	$3,122.3	Chapter 11	United States	Telecommunications
Mattress Discounters, Corp.	$140.0	Missed interest payment	United States	Miscellaneous
MCI Communications Corporation	$2,640.0	Chapter 11	United States	Telecommunications
Murrin Murrin Holdings Pty Ltd.	$404.0	Missed interest payment	Australia	Metals & Mining
Panaco, Inc.	$100.0	Chapter 11	United States	Oil & Gas
Romacorp, Inc.	$75.0	Missed interest payment	United States	Hotels, Casinos, & Gaming
US Airways, Inc.	$1,349.7	Missed interest payment	United States	Consumer Transportation
WorldCom, Inc.	$23,244.9	Missed interest payment	United States	Telecommunications
Ziff-Divis Media Inc.	$250.0	Missed interest payment	United States	Printing, Publishing, & Broadcasting
Volume (US$ Millions)	$33,887.0			
Count	14			
August				
Atlantic Express Transportation Corp	$150.0	Missed interest payment	United States	Consumer Transportation
Conseco, Inc.	$5,092.6	Missed interest payment	United States	Insurance
Marconi Corporation , Plc	$3,271.9	Distressed exchange	United Kingdom	Electronics
Pecom Energia, SA	$900.0	Distressed exchange	Argentina	Oil & Gas
Piedmont Avation, Inc.	$268.9	Chapter 11	United States	Consumer Transportation
Song Networks	$561.8	Missed interest payment	Sweden	Telecommunications
Texon International plc	$123.0	Missed interest payment	United Kingdom	Nondurable Consumer Products
Volume (US$ Millions)	$10,368.3			
Count	7			
September				
Advanced Lighting Technologies, Inc.	$100.0	Missed interest payment	United States	Miscellaneous Manufacturing
AT&T Canada, Inc.	$2,959.9	Missed interest payment	Canada	Telecommunications
Edelnor SA	$340.0	Chapter 11	Chile	Electric Utilities
Holley Performance Products, Inc.	$150.0	Missed interest payment	United States	Automobile
NRG Energy, Inc.	$2,455.0	Missed interest payment	United States	Electric Utilities
NRG South Central Generating LLC	$800.0	Missed interest payment	United States	Electric Utilities
Sirius Satellite Radio, Inc.	$583.2	Missed interest payment	United States	Printing, Publishing, & Broadcasting
SpectraSite Holdings, Inc.	$1,971.8	Missed interest payment	United States	Telecommunications
Telewest Communications plc	$5,202.4	Missed interest payment	United Kingdom	Printing, Publishing, & Broadcasting
Volume (US$ Millions)	$14,562.3			
Count	9			

Exhibit 30 – Moody's-Rated 2002 Corporate Bond Defaults

Company	Volume (Millions)	Initial Default Event	Country	Industry
October				
AMERCO, Inc.	$569.5	Missed interest payment	United States	Cargo Transportation & Shipping
Energy Group Overseas B.V.	$500.0	Missed interest payment	Netherlands	Financial (Non-Bank)
EOTT Energy Partners LP	$235.0	Prepackaged Chapter 11	United States	Oil & Gas
Jazztel plc	$660.5	Distressed exchange	United Kingdom	Telecommunications
TXU Europe, Ltd.	$150.0	Missed interest payment	United Kingdom	Electric Utilities
Volume (US$ Millions)	$2,115.0			
Count	5			
November				
Alestra, S. de R.L. de CV	$570.0	Missed interest payment	Mexico	Telecommunications
Banco Comercial SA	$220.0	Missed interest payment	Uruguay	Financial (Non-Bank)
Bayou Steel Corporation	$120.0	Missed interest payment	United States	Metals & Mining
Cherokee International LLC	$100.0	Distressed exchange	United States	Electronics
Encompass Services Corp.	$335.0	Chapter 11	United States	Construction, Building, & Real Estate
Oakwood Homes Corporation	$317.0	Chapter 11	United States	Construction, Building, & Real Estate
Outsourcing Solutions, Inc.	$100.0	Missed interest payment	United States	Nondurable Consumer Products
PG&E National Energy Group, Inc.	$1,000.0	Missed interest payment	United States	Electric Utilities
TXU Eastern Funding Company	$2,136.4	Bankruptcy	United Kingdom	Electric Utilities
Volume (US$ Millions)	$4,898.4			
Count	9			
December				
AES Drax Holdings Limited	$621.7	Suspension of payments	United Kingdom	Electric Utilities
Glencore Nickel Pty. Limited	$300.0	Missed interest payment	Australia	Metals & Mining
Insilco Holdings Co	$138.0	Chapter 11	United States	Automobile
Key3Media Group	$300.0	Missed interest payment	United States	Printing, Publishing, & Broadcasting
Microcell Telecommunications Inc.	$1,160.2	Missed interest payment	Canada	Telecommunications
Net Servicos de Comunicacao S.A.	$248.5	Missed interest payment	Brazil	Printing, Publishing, & Broadcasting
NRG Northeast Generating LLC	$750.0	Missed principal and interest payments	United States	Electric Utilities
Petroleum Geo-Services ASA	$1,460.0	Missed interest payment	United States	Oil & Gas
Qwest Capital Funding, Inc.	$12,902.7	Distressed exchange	United States	Telecommunications
United Air Lines Inc.	$3,630.4	Chapter 11	United States	Consumer Transportation
Volume (US$ Millions)	$21,511.4			
Count	10			

Exhibit 31 – Moody's-Rated Sovereign Defaults, 1985-2002

Year	Country	Total Defaulted Debt ($ millions)*	Comments
Nov 1998	Pakistan	$750	Pakistan had grace period default but cured the default subsequently within the grace period (within 4 days). Later, it defaulted again, and went through a distressed exchange in 1999.
Aug 1998	Russia	$73,336	Missed payments first on local currency Treasury obligations. Later the country also failed to service its foreign currency obligations that were issued locally but mostly held by foreign investors. Subsequently, it also failed to pay principal on MINFIN III foreign currency bonds. Debts were restructured in Aug 1999 and Feb 2000
Sep 1998	Ukraine	$1,422	Moratorium on debt service for bearer bonds owned by anonymous entities. Only those entities willing to identify themselves and convert to local currency accounts were eligible for debt repayments, which amounted to a distressed exchange.
Jul 1998	Venezuela	$270	Defaulted on domestic currency bonds in 1998, although the default was cured within a short period of time.
Aug 1999	Ecuador	$6,603	Missed payment was followed by a distressed exchange with over 90% of the bonds restructured.
Sep 2000	Peru	$4,870	A payment default that was cured within the 30-day grace period. Peru missed payment on its Brady Bonds but subsequently paid approximately $80 million in interest payments to cure the default.
Jan 2000	Ukraine	$1,063	Defaulted on USD-denominated bonds in Jan 2000 and later defaulted on DM-denominated Eurobonds in Feb 2000. Offered to exchange bonds with longer term and lower coupon. The conversion was accepted by a majority of bondholders.
Nov 2001	Argentina	$82,268	Declared it would miss payment on foreign debt in Nov. 2001. Actual payment missed on Jan 3, 2002. The largest rated sovereign default in history. Negotiations are at a very preliminary stage for a distressed exchange with the lenders.
Jun 2001	Moldova	$145	Missed payment on the bond in June 2001 but cured default shortly thereafter. Afterwards, it began gradually buying back its bonds, but in June 2002, after having bought back about 50% of its bonds, it defaulted again on the remaining $70 million of the outstanding issue.

** Total defaulted debt is the sum of defaulted local and foreign currency debt in millions of dollars using the prevailing exchange rate at or around the time of default.*

Exhibit 32 – Alphanumeric Rating Transition Rates (Percent of Issuers), 2002 & One-Year Average

1983-2002 Average

Rating from:	Aaa	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa-C	D	WR
Aaa	85.98	6.11	2.73	0.40	0.56	0.20	0.08	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	3.94
Aa1	2.29	77.39	8.28	6.64	1.59	0.29	0.06	0.12	0.00	0.00	0.06	0.00	0.00	0.00	0.00	0.00	0.00	0.00	3.29
Aa2	0.64	3.18	78.35	8.62	3.21	1.31	0.53	0.11	0.07	0.00	0.00	0.00	0.04	0.07	0.00	0.00	0.00	0.00	3.88
Aa3	0.11	0.64	3.72	77.73	9.35	3.09	0.75	0.23	0.11	0.09	0.02	0.02	0.05	0.00	0.00	0.00	0.00	0.05	4.04
A1	0.02	0.11	0.47	5.52	77.73	7.64	3.04	0.69	0.23	0.08	0.28	0.17	0.04	0.08	0.04	0.00	0.00	0.00	3.87
A2	0.05	0.05	0.34	0.79	4.94	77.66	7.40	2.78	0.89	0.44	0.32	0.08	0.15	0.10	0.08	0.00	0.03	0.03	3.87
A3	0.08	0.12	0.06	0.22	1.14	7.55	73.19	7.07	3.70	1.30	0.54	0.14	0.18	0.20	0.04	0.06	0.04	0.04	4.34
Baa1	0.05	0.05	0.15	0.20	0.25	1.99	6.79	72.10	7.70	3.33	1.06	0.53	0.23	0.61	0.05	0.10	0.13	0.20	4.47
Baa2	0.07	0.12	0.05	0.19	0.22	0.75	3.61	5.98	72.63	7.16	1.73	0.58	0.65	0.51	0.36	0.14	0.31	0.14	4.80
Baa3	0.06	0.00	0.03	0.06	0.18	0.46	0.82	2.49	8.51	69.54	6.20	2.64	1.88	0.76	0.33	0.24	0.43	0.49	4.86
Ba1	0.03	0.00	0.00	0.03	0.24	0.17	0.61	0.74	2.94	8.21	65.19	4.87	4.16	1.52	1.18	0.88	0.51	0.68	8.04
Ba2	0.00	0.00	0.04	0.04	0.04	0.21	0.12	0.37	0.78	2.09	8.53	62.36	7.50	2.50	3.24	1.03	0.74	0.62	9.80
Ba3	0.00	0.03	0.03	0.00	0.05	0.16	0.13	0.21	0.24	0.61	2.55	5.17	64.71	6.55	5.28	2.39	1.09	2.28	8.52
B1	0.02	0.00	0.02	0.00	0.07	0.12	0.10	0.07	0.26	0.19	0.48	2.46	5.64	63.66	8.57	4.35	2.79	3.20	8.00
B2	0.00	0.00	0.04	0.08	0.04	0.00	0.15	0.27	0.12	0.27	0.31	0.85	1.89	6.63	60.17	7.63	6.28	6.78	8.51
B3	0.00	0.00	0.09	0.00	0.05	0.09	0.09	0.09	0.14	0.18	0.14	0.41	0.72	3.30	4.56	59.20	10.48	11.43	9.04
Caa-C	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.06	0.06	0.26	0.00	0.58	0.71	0.97	4.40	60.39	22.52	10.03

2002 Cohort

Rating from:	Aaa	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1	Ba2	Ba3	B1	B2	B3	Caa-C	Default	WR
Aaa	86.82	3.88	3.10	0.78	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	5.43
Aa1	6.34	84.51	2.11	3.52	0.70	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	2.82
Aa2	0.00	2.63	80.00	11.05	1.05	2.11	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	3.16
Aa3	0.25	0.25	6.06	67.17	15.15	5.81	0.00	0.25	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	5.05
A1	0.00	0.00	0.00	7.69	68.34	12.72	5.33	1.18	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	4.73
A2	0.00	0.00	0.00	0.21	0.64	74.95	11.46	3.40	1.70	0.85	0.85	0.21	0.85	1.06	0.21	0.00	0.00	0.00	3.61
A3	0.00	0.00	0.00	0.21	0.00	3.97	72.23	11.90	4.59	0.63	0.63	0.00	0.21	0.00	0.00	0.00	0.21	0.42	5.01
Baa1	0.00	0.00	0.00	0.00	0.49	0.74	2.70	64.46	12.50	6.62	1.72	1.23	0.25	1.72	0.00	0.98	0.49	1.23	4.90
Baa2	0.24	0.47	0.00	0.00	0.24	0.00	2.59	2.12	66.12	11.76	3.29	1.41	1.65	0.71	0.71	0.00	2.59	0.71	5.41
Baa3	0.29	0.00	0.00	0.00	0.00	0.00	0.29	0.87	2.89	70.23	8.38	2.60	3.18	0.87	0.87	0.29	2.60	1.73	4.91
Ba1	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	2.02	3.03	61.62	6.06	7.07	5.56	0.51	2.53	1.52	1.52	8.59
Ba2	0.00	0.00	0.67	0.00	0.00	0.00	0.00	0.00	0.67	1.33	3.33	53.33	18.67	6.67	1.33	0.67	1.33	1.33	10.67
Ba3	0.00	0.00	0.00	0.00	0.00	0.51	0.00	0.00	0.00	0.00	1.54	7.69	58.46	11.79	7.18	2.56	3.08	1.54	5.64
B1	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.39	1.16	5.02	60.23	14.67	5.79	3.86	1.93	6.95
B2	0.00	0.00	0.00	0.00	0.00	0.00	0.34	0.68	0.00	0.00	0.00	0.34	0.34	6.51	57.53	8.90	9.93	6.51	8.90
B3	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.53	0.00	0.00	0.53	0.00	0.53	6.95	54.55	17.65	6.42	12.83
Caa-C	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.34	0.00	0.68	2.74	56.85	27.74	11.64

Exhibit 33 – Global Whole Letter Rating Transition Rates (Percent of Issuers), 2002 & One-Year Averages

2002

	Rating to:	Aaa	Aa	A	Baa	Ba	B	Caa-C	Default	WR
	Aaa	86.82	7.75	0.00	0.00	0.00	0.00	0.00	0.00	5.43
	Aa	1.38	82.23	12.12	0.14	0.00	0.00	0.00	0.00	4.13
Rating	A	0.00	2.18	82.83	8.86	1.01	0.47	0.08	0.16	4.43
from:	Baa	0.17	0.17	2.46	79.47	7.55	2.04	1.87	1.19	5.09
	Ba	0.00	0.18	0.18	2.39	72.38	13.26	2.03	1.47	8.10
	B	0.00	0.00	0.14	0.41	2.71	72.90	9.76	4.88	9.21
	Caa-C	0.00	0.00	0.00	0.00	0.34	3.42	56.85	27.74	11.64

1920-2002 1-Year Average

	Rating to:	Aaa	Aa	A	Baa	Ba	B	Caa-C	Default	WR
	Aaa	88.37	6.31	0.96	0.20	0.01	0.00	0.00	0.00	4.15
	Aa	1.17	86.99	5.75	0.63	0.15	0.02	0.00	0.07	5.21
Rating	A	0.07	2.36	86.09	4.78	0.62	0.10	0.02	0.12	5.82
from:	Baa	0.04	0.25	3.92	82.66	4.72	0.65	0.09	0.29	7.38
	Ba	0.01	0.08	0.42	4.76	78.41	5.38	0.50	1.11	9.33
	B	0.00	0.04	0.14	0.56	5.86	75.99	3.22	3.67	10.52
	Caa-C	0.00	0.02	0.03	0.32	1.21	4.59	71.72	13.27	8.84

1970-2002 1-Year Average

	Rating to:	Aaa	Aa	A	Baa	Ba	B	Caa-C	Default	WR
	Aaa	89.60	7.01	0.72	0.00	0.00	0.00	0.00	0.00	2.67
	Aa	1.16	88.41	7.39	0.26	0.08	0.01	0.00	0.02	2.68
Rating	A	0.05	2.33	89.03	4.83	0.49	0.13	0.01	0.02	3.11
from:	Baa	0.05	0.24	5.09	84.42	4.65	0.74	0.15	0.17	4.48
	Ba	0.01	0.05	0.46	5.13	79.11	6.46	0.47	1.19	7.12
	B	0.01	0.03	0.13	0.41	6.16	77.60	2.69	6.30	6.68
	Caa-C	0.00	0.00	0.00	0.55	1.65	3.82	62.87	23.58	7.53

Exhibit 34 – Weighted Average Rating Transition Rates, 1985-2002, Sovereign vs. Corporate Issuers

Sovereign Bond Issuers

		Rating to:								
		Aaa	Aa	A	Baa	Ba	B	Caa-C	Default	WR
Rating	Aaa	93.90	6.10	0.00	0.00	0.00	0.00	0.00	0.00	0.00
From:	Aa	5.10	92.50	1.10	0.00	0.00	0.00	0.00	0.00	1.40
	A	0.00	2.70	90.30	6.20	0.90	0.00	0.00	0.00	0.00
	Baa	0.00	0.00	4.80	79.60	8.30	0.30	0.00	0.00	7.00
	Ba	0.00	0.00	0.00	3.70	85.20	10.00	0.00	0.70	0.40
	B	0.00	0.00	0.00	0.00	2.20	87.70	2.20	4.00	3.90
	Caa-C	0.00	0.00	0.00	0.00	0.00	100.00	0.00	0.00	0.00

Corporate Bond Issuers

		Rating to:								
		Aaa	Aa	A	Baa	Ba	B	Caa-C	Default	WR
Rating	Aaa	87.80	7.90	0.30	0.00	0.00	0.00	0.00	0.00	4.10
from:	Aa	0.80	86.10	8.60	0.30	0.10	0.00	0.00	0.00	4.10
	A	0.00	2.30	87.00	5.60	0.70	0.20	0.00	0.00	4.30
	Baa	0.10	0.30	5.20	82.90	4.80	1.10	0.10	0.20	5.30
	Ba	0.00	0.00	0.50	5.10	75.10	8.30	0.60	1.40	8.80
	B	0.00	0.10	0.20	0.60	5.10	74.10	4.20	6.80	8.80
	Caa-C	0.00	0.00	0.00	1.00	1.60	6.00	59.70	21.50	10.20

Exhibit 35 –Commercial Paper Rating Transition Rates, 1982-2002

2002

Rating 1/1/02:	Rating 1/1/03: P-1	P-2	P-3	NP	Default	WR
P-1	92.80	6.06	0.11	0.91	0.00	0.11
P-2	2.30	84.95	5.36	7.14	0.00	0.26
P-3	0.00	28.57	52.38	19.05	0.00	0.00
NP	0.00	0.00	8.51	91.49	0.00	0.00

60-Day Average: 1982-2002

Rating from:	Rating to: P-1	P-2	P-3	NP	Default	WR
P-1	99.17	0.79	0.01	0.02	0.00	0.01
P-2	1.06	97.56	1.09	0.28	0.01	0.01
P-3	0.06	3.09	92.38	4.41	0.06	0.00
NP	0.07	0.67	1.54	97.56	0.15	0.02

2001

Rating 1/1/01:	Rating 1/1/02: P-1	P-2	P-3	NP	Default	WR
P-1	90.45	8.93	0.00	0.21	0.21	0.21
P-2	2.41	87.43	5.61	3.74	0.53	0.27
P-3	0.00	7.69	65.38	26.92	0.00	0.00
NP	0.00	0.00	6.00	94.00	0.00	0.00

90-Day Average: 1982-2002

Rating from:	Rating to: P-1	P-2	P-3	NP	Default	WR
P-1	98.75	1.17	0.02	0.03	0.00	0.02
P-2	1.59	96.38	1.56	0.44	0.02	0.02
P-3	0.09	4.70	89.00	6.1[illegible]	0.08	0.00
NP	0.11	1.23	2.36	96.05	0.23	0.02

30-Day Average: 1982-2002

Rating from:	Rating to: P-1	P-2	P-3	NP	Default	WR
P-1	99.58	0.40	0.00	0.01	0.00	0.00
P-2	0.53	98.77	0.57	0.13	0.00	0.00
P-3	0.03	1.53	96.03	2.36	0.05	0.00
NP	0.03	0.31	0.75	98.81	0.08	0.01

180-Day Average: 1982-2002

Rating from:	Rating to: P-1	P-2	P-3	NP	Default	WR
P-1	97.51	2.28	0.07	0.08	0.01	0.05
P-2	3.18	93.06	2.71	0.96	0.05	0.04
P-3	0.16	9.90	80.04	9.77	0.12	0.00
NP	0.23	3.07	5.71	90.09	0.47	0.42

365-Day Average: 1982-2002

Rating from:	Rating to: P-1	P-2	P-3	NP	Default	WR
P-1	95.12	4.32	0.20	0.20	0.02	0.15
P-2	6.30	87.25	4.22	2.00	0.10	0.12
P-3	0.43	20.30	66.06	12.47	0.40	0.35
NP	0.68	7.21	11.43	79.35	0.49	0.84

Exhibit 36 - Descriptive Statistics for Defaulted Bonds Prices, 1982 – 2002

Priority in Capital Structure	Number	Average	Median	Standard Deviation	Inter-Quartile Range	Minimum	10th Percentile	90th Percentile	Maximum
Equipment Trust	86	$40.2	$31.0	$29.9	$53.0	$1.5	$10.6	$90.0	$103.0
Senior Secured	238	$53.1	$34.0	$26.9	$41.0	$2.5	$10.0	$82.0	$125.0
Senior Unsecured	1,095	$37.4	$30.0	$27.2	$43.4	$0.3	$7.0	$82.2	$122.6
Senior Subordinated	450	$32.0	$27.0	$24.0	$31.5	$0.5	$5.0	$66.5	$123.0
Subordinated	477	$30.4	$27.1	$21.3	$29.5	$0.5	$5.0	$60.0	$102.5
Junior Subordinated	22	$23.6	$16.4	$19.0	$25.3	$1.5	$3.8	$48.5	$74.0
All Bonds	2,368	$36.8	$30.0	$26.3	$39.0	$0.3	$7.5	$80.0	$125.0
All Bank Loans	310	$61.6	$67.00	$23.4	$38.00	$5.0	$25.0	$90.00	$98.0

Exhibit 37 – Annual Global Issuer-Weighted Default Rates by Whole Letter Rating, 1970-2002

(Percent)	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
A	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.26	0.00	0.00	0.00	0.00
Baa	0.27	0.00	0.00	0.46	0.00	0.00	0.00	0.28	0.00	0.00	0.00	0.00	0.31	0.00	0.36	0.00	1.33
Ba	4.14	0.42	0.00	0.00	0.00	1.03	1.02	0.52	1.09	0.49	0.00	0.00	2.73	0.92	0.84	1.41	2.03
B	20.78	3.85	7.14	3.77	10.00	5.97	0.00	3.28	5.41	0.00	4.94	4.49	2.41	6.31	6.72	8.22	11.73
Caa-C	53.33	13.33	40.00	44.44	0.00	0.00	0.00	50.00	0.00	0.00	33.33	0.00	25.00	40.00	100.00	0.00	23.53
Investment-Grade	0.14	0.00	0.00	0.23	0.00	0.00	0.00	0.11	0.00	0.00	0.00	0.00	0.21	0.00	0.10	0.00	0.32
Speculative-Grade	8.81	1.11	1.88	1.24	1.31	1.74	0.88	1.35	1.79	0.42	1.61	0.70	3.55	3.83	3.33	3.67	5.64
All Corporates	2.64	0.29	0.46	0.45	0.28	0.36	0.18	0.35	0.35	0.09	0.34	0.16	1.04	0.96	0.92	1.00	1.89

(Percent)	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.61	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
A	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.16	0.16
Baa	0.00	0.00	0.59	0.00	0.27	0.00	0.00	0.00	0.00	0.00	0.00	0.12	0.10	0.38	0.19	1.22
Ba	2.71	1.24	2.98	3.35	5.35	0.30	0.55	0.24	0.69	0.00	0.19	0.63	1.01	0.89	1.56	1.53
B	6.23	6.36	8.95	16.18	14.56	9.03	5.71	3.81	4.80	1.44	2.11	4.22	5.92	5.44	9.48	5.11
Caa-C	20.00	28.57	25.00	58.82	36.84	26.67	28.57	5.13	11.57	13.99	14.67	15.09	20.44	19.65	34.45	29.45
Investment-Grade	0.00	0.00	0.29	0.00	0.06	0.00	0.00	0.00	0.00	0.00	0.00	0.04	0.03	0.13	0.13	0.49
Speculative-Grade	4.23	3.59	5.79	10.08	10.40	4.84	3.51	1.94	3.32	1.67	2.05	3.43	5.68	6.06	10.60	8.33
All Corporates	1.50	1.36	2.34	3.58	3.23	1.31	0.94	0.56	1.03	0.51	0.65	1.23	2.16	2.36	3.80	2.97

Exhibit 38 – Annual Global Dollar Volume-Weighted Default Rates by Whole Letter Rating, 1994-2002*

(Percent)	1994	1995	1996	1997	1998	1999	2000	2001	2002
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
A	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.25	2.92
Baa	0.00	0.00	0.00	0.00	0.00	0.14	0.67	2.83	3.47
Ba	0.14	0.57	0.00	0.05	0.65	2.30	1.04	1.10	4.08
B	2.04	6.54	1.62	3.16	3.02	5.92	5.53	15.49	17.39
Caa-C	2.80	13.06	22.53	7.73	14.70	20.92	20.46	66.15	82.82
Investment-Grade	0.00	0.00	0.00	0.00	0.00	0.03	0.15	1.26	2.35
Speculative-Grade	1.26	4.49	2.31	2.03	2.98	6.46	5.52	17.97	21.03
All Corporate	0.26	1.04	0.66	0.53	0.89	1.29	1.36	4.16	5.29

* *Global dollar-volume weighted default rates consist only of US and European corporate bonds.*

Exhibit 39 – Annual Global Default Rates by Alpha-Numeric Rating, 1983-2002

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa1	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa2	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa3	0.00	0.00	0.00	0.00	0.00	0.00	1.40	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
A1	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
A2	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.42	0.00
A3	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.43
Baa1	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.75	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.28	0.27	1.26
Baa2	0.00	0.00	0.00	0.00	0.00	0.00	0.79	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.31	0.00	0.00	0.27	0.72
Baa3	0.00	1.06	0.00	4.82	0.00	0.00	1.06	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.34	0.97	0.00	1.78
Ba1	0.00	1.16	0.00	0.87	3.70	0.00	0.79	2.67	1.08	0.00	0.83	0.00	0.00	0.00	0.00	0.00	0.47	0.94	0.51	1.58
Ba2	0.00	1.61	1.63	1.20	0.95	0.00	1.82	2.82	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.62	0.00	0.63	1.38	1.41
Ba3	2.65	0.00	2.84	3.44	2.96	2.58	4.71	3.93	10.08	0.73	0.76	0.59	1.76	0.00	0.47	1.12	2.00	1.04	2.93	1.58
B1	0.00	5.84	4.38	7.61	4.93	4.31	5.76	8.50	5.86	1.00	3.24	1.88	4.35	1.17	0.00	2.11	3.28	3.24	3.19	2.00
B2	10.00	18.75	7.69	16.67	4.30	7.14	9.79	22.64	12.90	1.59	5.04	3.75	6.42	0.00	1.54	7.55	6.91	4.10	11.07	6.81
B3	17.91	2.90	13.59	15.79	10.22	10.96	18.05	29.11	28.42	24.84	11.29	7.95	4.06	3.28	7.22	5.52	9.63	10.88	16.38	6.86
Caa-C	40.00	100.00	0.00	23.53	20.00	28.57	25.00	58.82	36.84	26.67	28.57	5.13	11.57	13.99	14.67	15.09	20.44	19.65	34.45	29.45
Investment-Grade	0.00	0.10	0.00	0.32	0.00	0.00	0.29	0.00	0.06	0.00	0.00	0.00	0.00	0.00	0.00	0.04	0.03	0.13	0.13	0.49
Speculative-Grade	3.83	3.33	3.67	5.64	4.23	3.59	5.79	10.08	10.40	4.84	3.51	1.94	3.32	1.67	2.05	3.43	5.68	6.06	10.60	8.33
All Corporates	0.96	0.92	1.00	1.90	1.50	1.36	2.34	3.58	3.23	1.31	0.94	0.56	1.03	0.51	0.65	1.23	2.16	2.36	3.80	2.97

Exhibit 40 – Annual Issuer-Weighted Default Rate Descriptive Statistics, 1970-2002

(Percent)	Min	1st Quartile	Median	Mean	StDev	3rd Quartile	Maximum
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.02	0.11	0.00	0.61
A	0.00	0.00	0.00	0.02	0.06	0.00	0.26
Baa	0.00	0.00	0.00	0.18	0.33	0.27	1.33
Ba	0.00	0.30	0.89	1.21	1.30	1.53	5.35
B	0.00	3.85	5.71	6.50	4.42	8.22	20.78
Caa-C	0.00	11.57	23.53	24.60	21.55	34.45	100.00
Investment-Grade	0.00	0.00	0.00	0.07	0.12	0.11	0.49
Speculative-Grade	0.42	1.67	3.43	3.89	2.94	5.64	10.60
All Corporates	0.09	0.36	0.96	1.25	1.07	1.89	3.80

Exhibit 41 – Annual Issuer-Weighted Default Rate Descriptive Statistics, 1920-2002

(Percent)	Min	1st Quartile	Median	Mean	StDev	3rd Quartile	Maximum
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.06	0.18	0.00	0.83
A	0.00	0.00	0.00	0.09	0.27	0.00	1.70
Baa	0.00	0.00	0.00	0.28	0.48	0.37	1.97
Ba	0.00	0.00	0.63	1.09	1.68	1.31	11.11
B	0.00	0.26	2.32	3.72	4.33	5.42	20.78
Caa-C	0.00	0.00	7.87	13.63	17.26	20.33	100.00
Investment-Grade	0.00	0.00	0.00	0.15	0.28	0.22	1.55
Speculative-Grade	0.00	0.56	1.74	2.67	3.05	3.47	15.39
All Corporates	0.00	0.18	0.65	1.09	1.39	1.27	8.40

Exhibit 42 – Annual Dollar Volume-Weighted Default Rate Descriptive Statistics, 1994-2002

(Percent)	Min	1st Quartile	Median	Mean	StDev	3rd Quartile	Maximum
Aaa	-	-	-	-	-	-	-
Aa	-	-	-	-	-	-	-
A	-	-	-	0.46	1.01	-	2.92
Baa	-	-	-	0.79	1.37	0.67	3.47
Ba	-	0.14	0.65	1.10	1.33	1.10	4.08
B	1.62	3.02	5.53	6.75	5.78	6.54	17.39
Caa-C	2.80	13.06	20.46	27.91	27.49	22.53	82.82
Investment-Grade	-	-	-	0.42	0.83	0.15	2.35
Speculative-Grade	1.26	2.31	4.49	7.12	7.26	6.46	21.03
All Corporates	0.26	0.66	1.04	1.72	1.76	1.36	5.29

Exhibit 43 – Average Cumulative Issuer-Weighted Default Rates from 1-20 Years by Whole Letter Rating, 1920-2002

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.02	0.09	0.19	0.29	0.41	0.59	0.78	1.02	1.24	1.40	1.61	1.70	1.75	1.85	1.96	2.02	2.14	2.20
Aa	0.07	0.22	0.36	0.54	0.85	1.21	1.60	2.01	2.37	2.78	3.24	3.77	4.29	4.82	5.23	5.51	5.75	5.98	6.30	6.54
A	0.08	0.27	0.57	0.92	1.28	1.67	2.09	2.48	2.93	3.42	3.95	4.47	4.94	5.40	5.88	6.35	6.63	6.94	7.23	7.54
Baa	0.34	0.99	1.79	2.69	3.59	4.51	5.39	6.25	7.16	7.99	8.81	9.62	10.41	11.12	11.74	12.33	12.95	13.49	13.93	14.39
Ba	1.42	3.43	5.60	7.89	10.16	12.28	14.14	15.99	17.63	19.42	21.06	22.65	24.23	25.61	26.83	27.96	29.13	30.24	31.14	32.05
B	4.79	10.31	15.59	20.14	23.99	27.12	30.00	32.36	34.37	36.10	37.79	39.37	40.85	42.33	43.62	44.94	45.91	46.68	47.32	47.60
Caa-C	14.74	23.95	30.57	35.32	38.83	41.94	44.23	46.44	48.42	50.19	52.30	54.40	56.24	58.22	60.08	61.78	63.27	64.81	66.25	67.59
Investment-Grade	0.17	0.50	0.93	1.41	1.93	2.48	3.03	3.57	4.14	4.71	5.30	5.90	6.46	7.00	7.48	7.92	8.30	8.65	8.99	9.32
Speculative-Grade	3.83	7.75	11.41	14.69	17.58	20.09	22.28	24.30	26.05	27.80	29.47	31.08	32.64	34.07	35.36	36.58	37.72	38.78	39.67	40.46
All Corporates	1.50	3.09	4.62	6.02	7.28	8.41	9.43	10.38	11.27	12.14	13.01	13.85	14.66	15.40	16.07	16.69	17.24	17.75	18.21	18.64

Exhibit 44– Average Global Cumulative Issuer-Weighted Default Rates from 1-20 Years by Whole Letter Rating, 1970-2002

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.04	0.12	0.21	0.30	0.40	0.52	0.64	0.77	0.92	1.08	1.17	1.27	1.39	1.51	1.65	1.65	1.65
Aa	0.02	0.03	0.07	0.16	0.26	0.36	0.46	0.57	0.65	0.73	0.83	1.01	1.21	1.49	1.64	1.82	2.08	2.31	2.65	2.96
A	0.02	0.09	0.22	0.36	0.51	0.68	0.86	1.07	1.31	1.56	1.82	2.07	2.33	2.57	2.90	3.29	3.70	4.16	4.67	5.17
Baa	0.22	0.61	1.08	1.69	2.25	2.81	3.38	3.94	4.58	5.26	6.00	6.80	7.60	8.41	9.24	10.03	10.87	11.63	12.25	12.73
Ba	1.28	3.51	6.09	8.76	11.36	13.74	15.66	17.60	19.46	21.29	23.35	25.56	27.67	29.63	31.36	33.31	35.03	36.62	37.92	39.15
B	6.51	14.16	21.03	27.04	32.31	36.73	40.97	44.33	47.17	50.01	52.31	54.28	56.25	58.17	59.72	60.97	61.35	61.35	61.35	61.35
Caa-C	23.83	37.12	47.43	55.05	60.09	65.22	69.26	73.88	76.50	78.54	80.92	80.92	80.92	80.92	80.92	80.92	80.92	80.92	80.92	80.92
Investment-Grade	0.08	0.24	0.45	0.72	0.98	1.25	1.52	1.81	2.13	2.47	2.83	3.22	3.63	4.04	4.47	4.93	5.42	5.90	6.37	6.79
Speculative-Grade	4.99	10.05	14.66	18.67	22.18	25.18	27.73	30.00	31.99	33.92	35.89	37.84	39.72	41.47	42.99	44.60	45.93	47.11	48.08	49.02
All Corporates	1.59	3.19	4.64	5.90	6.96	7.85	8.62	9.32	9.96	10.60	11.25	11.92	12.58	13.21	13.81	14.45	15.07	15.65	16.19	16.67

Exhibit 45 – Average U.S. Cumulative Dollar Volume-Weighted Default Rates from 1-5 Years by Whole Letter Rating, 1994-2002

	1	2	3	4	5
Aaa	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.00	0.00
A	0.96	1.63	2.30	2.83	3.45
Baa	1.49	3.12	4.41	6.10	6.99
Ba	1.09	3.56	6.71	9.17	11.30
B	7.12	15.00	20.66	24.68	27.65
Caa-C	36.28	45.38	50.85	54.86	55.89
Investment-Grade	0.96	1.80	2.56	3.38	3.98
Speculative-Grade	7.70	13.98	18.82	22.34	24.79
All Corporates	2.60	4.92	6.89	8.53	9.70

Exhibit 46 - Average Cumulative Issuer-Weighted Default Rates by Alpha-Numeric Rating, 1983-2002

	1	2	3	4	5	6	7	8	9	10
Aaa	0.00	0.00	0.00	0.05	0.17	0.24	0.31	0.40	0.40	0.40
Aa1	0.00	0.00	0.00	0.17	0.17	0.28	0.28	0.28	0.28	0.28
Aa2	0.00	0.00	0.05	0.15	0.33	0.40	0.48	0.57	0.68	0.81
Aa3	0.05	0.07	0.13	0.21	0.29	0.38	0.38	0.38	0.38	0.48
A1	0.00	0.02	0.24	0.37	0.47	0.57	0.62	0.72	0.78	0.93
A2	0.03	0.09	0.24	0.48	0.68	0.89	1.04	1.41	1.73	1.86
A3	0.04	0.21	0.34	0.47	0.62	0.84	1.15	1.34	1.57	1.75
Baa1	0.21	0.60	1.02	1.40	1.80	2.10	2.39	2.56	2.77	2.90
Baa2	0.15	0.46	0.84	1.56	2.24	2.89	3.47	3.99	4.61	5.50
Baa3	0.50	1.27	2.05	3.15	4.23	5.40	6.52	7.55	8.25	8.97
Ba1	0.70	2.11	3.76	5.82	7.61	9.64	10.93	12.23	13.01	13.96
Ba2	0.65	2.34	4.72	7.30	9.42	11.01	13.00	14.44	15.61	15.92
Ba3	2.38	6.60	11.49	16.22	20.70	24.98	28.59	32.32	36.05	39.29
B1	3.33	9.73	16.14	22.05	27.56	32.77	38.42	42.50	46.26	49.97
B2	7.14	15.99	23.43	29.57	34.49	37.94	40.40	42.57	44.96	47.37
B3	11.97	21.97	30.41	37.92	44.40	49.26	53.64	58.21	61.39	62.60
Caa-C	23.65	36.95	47.47	55.61	60.99	66.16	69.72	74.94	78.07	81.73
Investment-Grade	0.09	0.26	0.48	0.77	1.05	1.31	1.55	1.79	2.00	2.21
Speculative-Grade	5.48	11.25	16.59	21.34	25.38	28.90	32.03	34.77	37.08	38.99
All Corporates	1.86	3.80	5.57	7.12	8.37	9.42	10.30	11.06	11.68	12.20

Exhibit 47 –Cumulative Default Rates from 1 to 20 Years by Annual Cohort, 1970-2002

1970	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	2.70	2.70	2.70
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.46	1.46	1.46	2.96	2.96	2.96	2.96
A	0.00	0.00	0.00	0.00	0.00	0.43	0.43	0.43	0.43	0.43	0.91	0.91	0.91	0.91	0.91	0.91	1.42	1.42	2.54	2.54
Baa	0.27	0.27	0.27	1.14	1.44	1.44	1.75	2.40	3.07	3.07	3.44	3.44	4.62	5.03	5.45	6.33	7.73	8.75	9.85	10.45
Ba	4.14	4.57	5.01	5.47	6.42	7.40	7.92	8.48	9.65	9.65	9.65	11.12	13.49	14.34	14.34	16.26	20.35	22.64	22.64	24.03
B	20.78	23.42	26.06	26.06	26.06	26.06	26.06	26.06	26.06	26.06	26.06	26.06	33.64	33.64	33.64	33.64	33.64	33.64	33.64	33.64
Caa-C	53.33	60.00	80.00	88.00	88.00	88.00	88.00	100.00	-	-	-	-	-	-	-	-	-	-	-	-
Investment-Grade	0.14	0.14	0.14	0.57	0.72	0.86	1.02	1.33	1.64	1.64	1.98	1.98	2.51	2.87	3.06	3.43	4.41	5.02	5.89	6.12
Speculative-Grade	8.81	9.86	11.66	12.41	13.18	13.98	14.41	15.31	16.26	16.26	16.26	17.43	20.56	21.23	21.23	22.73	25.97	27.79	27.79	28.91
All Corporates	2.64	2.94	3.45	3.97	4.29	4.61	4.83	5.29	5.77	5.77	6.02	6.29	7.38	7.80	7.95	8.54	9.93	10.76	11.46	11.83

1971	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	2.78	2.78	2.78	2.78
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.82
A	0.00	0.00	0.00	0.00	0.38	0.38	0.38	0.38	0.38	0.79	0.79	1.22	1.65	1.65	1.65	2.10	2.10	3.06	3.06	3.06
Baa	0.00	0.00	0.80	1.07	1.07	1.36	1.97	2.60	2.60	2.94	2.94	4.05	4.44	4.84	5.67	6.99	7.94	8.97	9.52	10.68
Ba	0.42	0.86	1.32	2.25	3.72	4.23	4.78	5.94	5.94	5.94	7.38	9.69	10.52	10.52	12.38	17.36	19.63	19.63	21.00	21.00
B	3.85	7.69	7.69	7.69	7.69	7.69	7.69	7.69	7.69	7.69	7.69	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00
Caa-C	13.33	56.67	74.00	74.00	74.00	74.00	100.00	-	-	-	-	-	-	-	-	-	-	-	-	-
Investment-Grade	0.00	0.00	0.40	0.53	0.67	0.81	1.10	1.39	1.39	1.70	1.70	2.36	2.70	2.87	3.23	3.95	4.52	5.33	5.54	6.20
Speculative-Grade	1.11	3.02	3.82	4.64	5.93	6.38	7.34	8.36	8.36	8.36	9.61	12.96	13.68	13.68	15.28	19.58	21.52	21.52	22.72	22.72
All Corporates	0.29	0.77	1.27	1.57	1.99	2.20	2.65	3.10	3.10	3.35	3.60	4.79	5.20	5.34	5.91	7.25	8.04	8.72	9.07	9.63

1972	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	2.70	2.70	2.70	2.70	2.70
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.72	1.72
A	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.39	0.78	0.78	0.78	1.19	1.19	2.08	2.08	2.57	3.07
Baa	0.00	0.73	0.98	1.24	1.51	2.06	2.64	2.64	3.27	3.27	3.97	4.33	4.70	5.47	6.68	7.55	8.51	9.53	11.16	13.42
Ba	0.00	0.45	1.37	2.82	3.32	3.86	4.99	4.99	4.99	6.37	9.33	10.12	10.96	13.61	18.30	20.41	20.41	21.66	22.98	29.86
B	7.14	7.14	7.14	7.14	7.14	7.14	7.14	7.14	7.14	7.14	18.07	18.07	18.07	18.07	18.07	18.07	18.07	18.07	18.07	18.07
Caa-C	40.00	57.14	57.14	57.14	57.14	78.57	78.57	78.57	78.57	78.57	78.57	78.57	-	-	-	-	-	-	-	-
Investment-Grade	0.00	0.37	0.49	0.62	0.75	1.02	1.29	1.29	1.58	1.58	2.04	2.35	2.51	2.84	3.51	4.04	4.79	5.19	6.21	7.26
Speculative-Grade	1.88	2.66	3.47	4.73	5.17	6.11	7.09	7.09	7.09	8.28	12.09	12.76	13.49	15.77	19.84	21.65	21.65	22.75	23.92	30.05
All Corporates	0.46	0.92	1.21	1.60	1.80	2.21	2.64	2.64	2.87	3.11	4.22	4.60	4.86	5.53	6.78	7.51	8.14	8.63	9.67	11.45

Exhibit 47 –Cumulative Default Rates from 1 to 20 Years by Annual Cohort, 1970-2002

1973	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	2.70	2.70	2.70	2.70	2.70	2.70
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.61	1.61	1.61
A	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.38	0.76	0.76	0.76	1.17	1.17	2.04	2.04	2.51	3.00	3.52
Baa	0.46	0.69	1.17	1.41	1.93	2.46	2.46	3.05	3.05	3.70	4.36	5.05	6.13	7.25	8.06	8.94	9.88	11.90	14.02	14.02
Ba	0.00	0.98	2.00	2.54	3.11	4.30	4.30	4.30	5.74	9.55	10.36	10.36	12.13	16.88	20.10	20.10	21.36	22.68	30.89	32.36
B	3.77	3.77	3.77	3.77	3.77	3.77	3.77	3.77	3.77	15.09	15.09	15.09	15.09	15.09	15.09	15.09	15.09	15.09	15.09	15.09
Caa-C	44.44	44.44	44.44	44.44	72.22	72.22	72.22	72.22	72.22	72.22	72.22	-	-	-	-	-	-	-	-	-
Investment-Grade	0.23	0.35	0.59	0.72	0.97	1.23	1.23	1.50	1.50	1.94	2.39	2.69	3.16	3.80	4.31	5.03	5.40	6.57	7.58	7.80
Speculative-Grade	1.24	2.10	3.00	3.47	4.46	5.50	5.50	5.50	6.75	11.36	12.06	12.06	13.62	17.82	20.63	20.63	21.76	22.96	30.48	31.82
All Corporates	0.45	0.73	1.11	1.31	1.71	2.12	2.12	2.35	2.58	3.77	4.26	4.52	5.16	6.37	7.23	7.83	8.31	9.48	11.38	11.75

1974	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	2.44	2.44	2.44	2.44	2.44	2.44	2.44
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.27	1.27	1.27	1.27	1.27	1.27	1.27	1.27	2.82	2.82	2.82	2.82
A	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.38	0.76	0.76	0.76	1.16	1.16	2.03	2.03	2.49	2.97	3.48	3.48
Baa	0.00	0.47	0.72	1.23	1.76	1.76	2.34	2.34	2.98	3.64	4.32	5.38	5.76	6.56	7.44	8.38	9.88	11.99	11.99	11.99
Ba	0.00	1.07	1.63	2.23	3.49	3.49	3.49	4.24	8.23	9.08	9.08	10.91	17.77	21.08	21.08	22.38	25.11	33.50	35.02	36.73
B	10.00	10.00	10.00	10.00	10.00	10.00	10.00	14.39	23.65	23.65	23.65	23.65	23.65	23.65	23.65	23.65	23.65	23.65	23.65	23.65
Caa-C	0.00	0.00	0.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	-	-	-	-	-	-	-	-	-	-
Investment-Grade	0.00	0.24	0.36	0.61	0.86	0.86	1.13	1.13	1.70	2.14	2.44	2.90	3.22	3.71	4.42	4.78	5.74	6.73	6.94	6.94
Speculative-Grade	1.31	2.23	2.72	3.74	4.81	4.81	4.81	6.08	10.80	11.51	11.51	13.12	19.11	21.98	21.98	23.14	25.61	33.38	34.76	36.32
All Corporates	0.28	0.65	0.85	1.24	1.65	1.65	1.88	2.10	3.40	3.89	4.14	4.78	5.98	6.82	7.42	7.89	9.04	10.91	11.27	11.47

1975	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	2.04	2.04	2.04	2.04	2.04	2.04	2.04	2.04
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.05	1.05	1.05	1.05	1.05	1.05	2.25	2.25	3.51	3.51	3.51	3.51	3.51
A	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.37	0.37	0.37	0.75	0.75	1.59	1.59	2.04	2.97	3.47	4.01	4.01
Baa	0.00	0.00	0.26	0.79	0.79	1.38	1.38	2.34	3.00	3.68	4.74	5.12	5.92	6.35	7.29	9.26	11.32	11.32	11.32	11.32
Ba	1.03	2.11	3.25	3.85	3.85	3.85	4.57	8.40	9.21	9.21	10.96	17.52	20.69	21.86	23.11	24.41	31.10	32.54	34.13	34.13
B	5.97	5.97	5.97	9.27	9.27	9.27	13.13	21.21	21.21	21.21	21.21	21.21	21.21	21.21	21.21	31.06	42.55	42.55	42.55	42.55
Caa-C	0.00	0.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	-	-	-	-	-	-	-	-	-	-	-
Investment-Grade	0.00	0.00	0.12	0.36	0.36	0.62	0.62	1.17	1.59	1.87	2.31	2.61	3.08	3.74	4.09	5.17	6.28	6.48	6.69	6.69
Speculative-Grade	1.74	2.65	4.09	5.09	5.09	5.09	6.30	10.76	11.43	11.43	12.95	18.62	21.33	22.32	23.39	25.68	32.81	34.08	35.47	35.47
All Corporates	0.36	0.55	0.93	1.32	1.32	1.53	1.75	2.98	3.44	3.68	4.29	5.42	6.22	6.93	7.37	8.61	10.52	10.86	11.23	11.23

Exhibit 47 –Cumulative Default Rates from 1 to 20 Years by Annual Cohort, 1970-2002

1976	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.67	1.67	1.67	1.67	1.67	1.67	1.67	1.67	1.67
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.99	0.99	0.99	0.99	0.99	0.99	2.14	2.14	3.33	3.33	3.33	3.33	3.33	3.33
A	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.64	0.64	0.64	1.31	1.31	2.43	2.43	2.83	4.08	4.08	4.57	4.57	5.62
Baa	0.00	0.27	0.56	0.56	0.87	0.87	2.22	2.92	3.64	4.76	5.15	5.99	5.99	6.97	9.06	10.69	11.25	11.25	11.25	11.25
Ba	1.02	2.09	3.21	3.21	3.83	4.50	7.35	8.10	8.10	9.73	15.81	18.75	19.84	20.99	22.19	29.66	31.00	32.47	32.47	32.47
B	0.00	0.00	3.64	3.64	3.64	8.12	17.54	17.54	17.54	17.54	17.54	17.54	17.54	17.54	30.23	45.73	45.73	45.73	45.73	45.73
Caa-C	0.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	-	-	-	-	-	-	-	-	-	-	-	-
Investment-Grade	0.00	0.11	0.23	0.23	0.35	0.35	0.99	1.51	1.78	2.19	2.62	3.06	3.69	4.02	5.04	6.10	6.28	6.49	6.49	6.93
Speculative-Grade	0.88	2.26	3.70	3.70	4.24	5.39	9.07	9.72	9.72	11.18	16.61	19.21	20.17	21.20	23.38	31.38	32.62	33.97	33.97	33.97
All Corporates	0.18	0.54	0.91	0.91	1.11	1.31	2.47	3.02	3.24	3.82	5.02	5.78	6.45	6.87	8.04	10.01	10.33	10.68	10.68	11.07

1977	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.67	1.67	1.67	1.67	1.67	1.67	1.67	1.67	1.67	1.67
Aa	0.00	0.00	0.00	0.00	0.00	0.92	0.92	0.92	0.92	0.92	0.92	2.00	2.00	3.12	3.12	3.12	3.12	3.12	3.12	3.12
A	0.00	0.00	0.00	0.00	0.00	0.00	0.60	0.60	0.60	1.24	1.24	3.01	3.01	3.77	4.96	4.96	5.43	5.43	6.43	6.43
Baa	0.28	0.57	0.57	0.57	0.57	1.93	2.64	3.36	4.50	4.90	5.74	5.74	6.73	8.31	9.94	10.51	10.51	10.51	10.51	10.51
Ba	0.52	1.63	1.63	2.24	2.89	5.67	6.40	6.40	7.98	13.87	16.69	17.72	18.82	19.97	27.19	28.49	29.92	29.92	29.92	29.92
B	3.28	6.73	6.73	10.97	15.54	25.78	25.78	25.78	25.78	25.78	25.78	25.78	25.78	39.27	56.62	56.62	56.62	56.62	56.62	56.62
Caa-C	50.00	50.00	50.00	50.00	50.00	50.00	50.00	-	-	-	-	-	-	-	-	-	-	-	-	-
Investment-Grade	0.11	0.22	0.22	0.22	0.22	0.84	1.35	1.61	2.01	2.43	2.86	3.78	4.10	5.09	6.11	6.30	6.49	6.49	6.93	6.93
Speculative-Grade	1.35	2.76	2.76	3.81	4.95	8.57	9.21	9.21	10.64	15.94	18.47	19.40	20.39	22.48	30.23	31.44	32.76	32.76	32.76	32.76
All Corporates	0.35	0.71	0.71	0.91	1.11	2.24	2.77	2.99	3.55	4.72	5.46	6.37	6.78	7.92	9.83	10.14	10.48	10.48	10.86	10.86

1978	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.52	1.52	1.52	3.05	3.05	3.05	3.05	3.05	3.05	3.05	3.05
Aa	0.00	0.00	0.00	0.00	0.83	0.83	0.83	0.83	0.83	0.83	1.77	1.77	1.77	1.77	1.77	1.77	1.77	1.77	1.77	1.77
A	0.00	0.00	0.00	0.00	0.00	0.61	0.61	0.61	1.27	1.27	2.73	2.73	3.92	4.74	4.74	5.23	5.23	6.27	6.27	6.27
Baa	0.00	0.00	0.00	0.00	1.32	1.67	2.38	3.12	3.50	4.74	5.18	6.13	7.64	9.74	10.28	10.28	10.28	10.28	10.28	10.28
Ba	1.09	1.09	1.09	1.75	4.53	6.00	6.00	9.17	15.00	16.86	17.89	18.98	21.28	28.49	29.79	32.66	32.66	32.66	32.66	32.66
B	5.41	5.41	11.71	15.04	22.27	22.27	26.72	26.72	32.35	38.50	38.50	38.50	47.29	60.47	60.47	60.47	60.47	60.47	60.47	60.47
Caa-C	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00
Investment-Grade	0.00	0.00	0.00	0.00	0.61	0.98	1.23	1.49	1.90	2.47	3.36	3.67	4.80	5.80	5.97	6.17	6.17	6.59	6.59	6.59
Speculative-Grade	1.79	1.79	2.80	3.88	7.32	8.54	9.18	11.86	18.26	20.63	21.50	22.43	25.39	32.80	33.96	36.50	36.50	36.50	36.50	36.50
All Corporates	0.35	0.35	0.54	0.73	1.84	2.35	2.67	3.32	4.68	5.52	6.41	6.81	8.18	10.04	10.35	10.84	10.84	11.21	11.21	11.21

Exhibit 47 –Cumulative Default Rates from 1 to 20 Years by Annual Cohort, 1970-2002

1979	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.43	1.43	1.43	2.88	2.88	2.88	2.88	2.88	2.88	2.88	2.88	2.88
Aa	0.00	0.00	0.00	0.82	0.82	0.82	0.82	0.82	0.82	1.74	1.74	1.74	1.74	1.74	1.74	1.74	1.74	1.74	1.74	1.74
A	0.00	0.00	0.00	0.00	0.60	0.60	0.60	1.25	1.25	2.69	2.69	3.47	4.27	4.27	4.75	4.75	5.77	5.77	5.77	5.77
Baa	0.00	0.30	0.30	1.60	1.94	2.29	3.02	3.02	4.23	4.67	5.62	8.15	10.26	10.81	10.81	10.81	10.81	10.81	10.81	10.81
Ba	0.49	0.49	1.05	3.41	5.88	9.14	11.86	18.25	19.81	20.66	21.58	24.46	31.61	32.70	35.06	35.06	35.06	35.06	35.06	35.06
B	0.00	6.45	9.85	17.21	17.21	21.69	26.58	38.33	45.18	45.18	45.18	56.14	56.14	56.14	-	-	-	-	-	-
Caa-C	0.00	0.00	0.00	0.00	0.00	0.00	0.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00
Investment-Grade	0.00	0.11	0.11	0.71	1.07	1.20	1.45	1.72	2.27	3.15	3.46	4.73	5.71	5.88	6.07	6.07	6.49	6.49	6.49	6.49
Speculative-Grade	0.42	1.31	2.26	5.26	7.37	10.75	13.68	21.16	23.22	23.97	24.77	28.21	34.74	35.76	37.97	37.97	37.97	37.97	37.97	37.97
All Corporates	0.09	0.36	0.54	1.60	2.29	3.01	3.74	5.27	6.07	6.92	7.31	8.91	10.70	11.00	11.48	11.48	11.83	11.83	11.83	11.83

1980	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.24	1.24	1.24	2.51	2.51	2.51	2.51	2.51	2.51	2.51	2.51	2.51	2.51
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.93	1.86	1.86	1.86	1.86	1.86	1.86	1.86	1.86	1.86	1.86	1.86	1.86
A	0.00	0.00	0.28	0.86	0.86	0.86	1.78	2.11	3.14	3.14	3.89	4.66	4.66	5.12	5.12	6.10	6.10	6.10	6.10	6.63
Baa	0.00	0.00	0.96	1.29	1.63	2.69	2.69	3.49	4.33	5.69	8.09	10.09	11.13	11.13	11.13	11.13	11.13	11.13	11.13	11.13
Ba	0.00	0.53	3.86	5.01	8.69	11.87	17.90	20.10	20.92	23.60	26.43	34.55	36.78	39.19	39.19	39.19	39.19	40.59	40.59	40.59
B	4.94	7.54	15.82	21.73	28.12	31.63	44.06	48.72	48.72	48.72	60.11	68.09	68.09	68.09	68.09	68.09	68.09	68.09	68.09	68.09
Caa-C	33.33	33.33	33.33	33.33	33.33	33.33	55.56	55.56	55.56	55.56	55.56	55.56	55.56	55.56	55.56	55.56	55.56	55.56	55.56	55.56
Investment-Grade	0.00	0.00	0.46	0.81	0.93	1.30	1.68	2.35	3.19	3.63	4.84	5.78	6.11	6.30	6.30	6.70	6.70	6.70	6.70	6.92
Speculative-Grade	1.61	2.47	6.52	8.41	12.42	15.57	22.84	25.29	25.96	28.17	32.10	39.88	41.82	43.92	43.92	43.92	43.92	45.12	45.12	45.12
All Corporates	0.34	0.52	1.71	2.36	3.23	4.13	5.78	6.77	7.57	8.30	9.94	11.91	12.47	12.93	12.93	13.27	13.27	13.45	13.45	13.64

1981	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	1.23	1.23	1.23	2.49	2.49	2.49	2.49	2.49	2.49	2.49	2.49	2.49	2.49	2.49
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.85	2.57	2.57	2.57	2.57	2.57	2.57	2.57	2.57	2.57	2.57	2.57	2.57	3.90
A	0.00	0.27	0.27	0.27	0.27	1.19	1.51	2.20	2.20	2.94	3.71	3.71	4.17	4.17	5.16	5.16	5.16	5.16	5.70	6.25
Baa	0.00	0.61	1.88	2.55	3.58	3.58	3.96	4.77	6.08	8.39	9.81	10.80	10.80	10.80	10.80	10.80	10.80	10.80	10.80	11.55
Ba	0.00	3.60	5.02	8.02	11.67	18.33	20.79	21.48	24.49	28.50	36.55	38.58	40.77	40.77	40.77	40.77	42.07	43.42	43.42	43.42
B	4.49	11.57	16.55	24.50	27.35	40.26	40.26	40.26	40.26	50.22	56.44	56.44	56.44	56.44	56.44	56.44	56.44	56.44	56.44	56.44
Caa-C	0.00	0.00	0.00	0.00	0.00	20.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00
Investment-Grade	0.00	0.33	0.78	1.01	1.37	1.74	2.25	3.07	3.50	4.68	5.44	5.76	5.94	5.94	6.33	6.33	6.33	6.33	6.55	7.22
Speculative-Grade	0.70	4.77	6.71	10.42	13.87	21.72	24.26	24.82	27.29	31.98	39.54	41.26	43.14	43.14	43.14	43.14	44.25	45.39	45.39	45.39
All Corporates	0.16	1.35	2.13	3.12	4.15	6.09	7.02	7.78	8.58	10.38	12.26	12.79	13.23	13.23	13.55	13.55	13.72	13.90	14.08	14.64

Exhibit 47 –Cumulative Default Rates from 1 to 20 Years by Annual Cohort, 1970-2002

1982	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	0.00	1.21	1.21	1.21	2.48	2.48	2.48	2.48	2.48	2.48	2.48	2.48	2.48	2.48	2.48	2.48
Aa	0.00	0.00	0.00	0.00	0.00	0.76	2.32	2.32	2.32	2.32	2.32	2.32	2.32	3.44	3.44	3.44	3.44	3.44	4.68	4.68
A	0.26	0.26	0.26	0.26	1.14	1.14	1.81	1.81	2.89	3.65	3.65	4.10	4.10	4.10	4.10	4.10	4.10	4.62	5.14	8.37
Baa	0.31	0.31	1.32	2.37	2.74	3.52	4.36	5.70	8.05	9.51	10.52	10.52	10.52	11.14	11.14	11.14	11.14	11.14	11.90	11.90
Ba	2.73	5.22	7.86	11.52	18.33	20.47	21.06	23.70	28.02	32.90	34.76	36.77	36.77	36.77	36.77	38.06	39.43	39.43	39.43	42.39
B	2.41	9.92	15.14	17.92	30.31	30.31	30.31	30.31	35.67	60.18	60.18	60.18	60.18	60.18	60.18	60.18	60.18	60.18	60.18	60.18
Caa-C	25.00	51.47	51.47	51.47	61.18	70.88	70.88	70.88	70.88	70.88	70.88	70.88	70.88	70.88	70.88	70.88	70.88	70.88	70.88	70.88
Investment-Grade	0.21	0.21	0.55	0.89	1.37	1.88	2.68	3.10	4.41	5.16	5.48	5.65	5.65	6.03	6.03	6.03	6.03	6.25	6.91	8.25
Speculative-Grade	3.55	7.65	10.55	13.95	21.61	23.82	24.32	26.51	30.74	37.60	39.17	40.87	40.87	40.87	40.87	41.95	43.09	43.09	43.09	45.56
All Corporates	1.04	2.03	2.97	4.03	6.15	7.03	7.77	8.54	10.39	12.22	12.74	13.16	13.16	13.48	13.48	13.64	13.82	13.99	14.54	16.01

1983	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Aaa	0.00	0.00	0.00	0.00	2.41	2.41	2.41	3.72	3.72	3.72	3.72	3.72	3.72	3.72	3.72	3.72	3.72	3.72	3.72	3.72
Aa	0.00	0.00	0.00	0.00	0.49	2.01	2.01	2.01	2.01	2.01	2.01	2.01	2.73	2.73	2.73	2.73	2.73	2.73	3.53	4.36
A	0.00	0.00	0.00	0.26	0.26	0.83	0.83	1.76	2.73	3.42	3.79	3.79	3.79	3.79	3.79	3.79	3.79	4.25	6.16	6.66
Baa	0.00	1.16	1.57	3.28	3.75	4.27	5.37	6.53	7.74	7.74	7.74	7.74	7.74	7.74	7.74	7.74	8.69	10.62	11.62	13.66
Ba	0.92	2.41	5.06	12.71	14.75	17.90	21.50	26.60	32.20	32.20	33.63	33.63	35.21	35.21	37.04	38.92	38.92	40.92	45.14	49.53
B	6.31	11.01	17.86	25.14	28.42	29.60	32.33	40.29	50.25	55.22	58.02	58.02	58.02	58.02	58.02	58.02	58.02	58.02	58.02	58.02
Caa-C	40.00	64.00	64.00	64.00	76.00	76.00	76.00	76.00	76.00	76.00	76.00	76.00	76.00	76.00	76.00	76.00	76.00	76.00	76.00	76.00
Investment-Grade	0.00	0.30	0.41	0.95	1.41	2.15	2.40	3.20	3.88	4.17	4.33	4.33	4.51	4.51	4.51	4.51	4.71	5.31	6.55	7.40
Speculative-Grade	3.83	6.99	11.01	18.32	21.19	23.49	26.67	32.71	39.61	41.22	43.01	43.01	44.01	44.01	45.18	46.41	46.41	47.72	50.47	53.30
All Corporates	0.96	1.96	2.99	5.08	6.07	7.13	7.94	9.66	11.34	11.83	12.23	12.23	12.52	12.52	12.68	12.84	13.00	13.68	15.07	16.14

1984	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19
Aaa	0.00	0.00	0.00	1.44	1.44	1.44	3.05	3.05	3.05	3.05	3.05	3.05	3.05	3.05	3.05	3.05	3.05	3.05	3.05
Aa	0.00	0.00	0.00	0.90	1.83	1.83	1.83	1.83	1.83	1.83	1.83	2.47	2.47	2.47	2.47	2.47	2.47	3.20	3.94
A	0.00	0.22	0.46	0.70	1.47	1.74	2.58	3.46	4.07	4.07	4.07	4.07	4.07	4.07	4.07	4.07	4.50	6.22	6.68
Baa	0.36	0.36	0.77	1.23	1.74	2.81	3.94	5.73	5.73	6.43	6.43	6.43	6.43	6.43	6.43	7.35	9.26	10.25	12.31
Ba	0.84	3.94	12.61	14.79	18.52	22.05	27.56	34.42	35.38	36.46	36.46	37.68	37.68	39.15	39.15	39.15	40.79	44.17	47.66
B	6.72	12.77	20.11	23.99	27.13	32.07	42.30	49.51	51.76	56.83	56.83	56.83	56.83	56.83	60.94	60.94	60.94	60.94	60.94
Caa-C	100.00	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Investment-Grade	0.10	0.19	0.40	0.94	1.64	2.00	2.75	3.54	3.82	3.97	3.97	4.14	4.14	4.14	4.14	4.33	4.91	6.09	6.91
Speculative-Grade	3.33	7.42	15.59	18.37	21.88	25.90	33.03	39.93	41.26	43.49	43.49	44.33	44.33	45.35	46.46	46.46	47.64	50.07	52.57
All Corporates	0.92	2.02	4.18	5.26	6.59	7.72	9.72	11.61	12.06	12.56	12.56	12.83	12.83	12.98	13.13	13.29	13.93	15.25	16.27

Exhibit 47 –Cumulative Default Rates from 1 to 20 Years by Annual Cohort, 1970-2002

1985	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
Aaa	0.00	0.00	0.00	0.00	0.00	1.61	1.61	1.61	1.61	1.61	1.61	1.61	1.61	1.61	1.61	1.61	1.61	1.61
Aa	0.00	0.00	0.00	0.79	0.79	0.79	0.79	0.79	0.79	0.79	1.39	1.39	1.39	1.39	1.39	1.39	2.06	2.76
A	0.00	0.21	1.32	2.27	2.52	3.56	4.38	4.67	4.67	4.67	4.67	4.67	4.67	4.67	4.67	5.07	6.29	6.72
Baa	0.00	1.20	1.20	1.71	2.79	3.35	5.13	5.77	6.47	6.47	6.47	6.47	6.47	6.47	8.47	10.55	11.63	13.89
Ba	1.41	6.70	9.29	12.76	18.30	23.89	30.72	32.22	33.06	33.06	35.00	35.00	36.12	36.12	36.12	37.47	41.73	44.64
B	8.22	17.65	23.84	27.26	31.51	43.36	50.12	52.39	57.68	57.68	57.68	57.68	57.68	61.91	61.91	61.91	61.91	61.91
Caa-C	0.00	0.00	0.00	33.33	33.33	33.33	33.33	33.33	33.33	33.33	100.00	-	-	-	-	-	-	
Investment-Grade	0.00	0.37	0.86	1.61	1.94	2.65	3.38	3.64	3.79	3.79	3.95	3.95	3.95	3.95	4.31	4.88	5.83	6.62
Speculative-Grade	3.67	10.33	14.18	17.92	22.96	30.44	37.08	38.73	40.56	40.56	42.69	42.69	43.51	44.41	44.41	45.42	48.63	50.82
All Corporates	1.00	3.07	4.45	5.96	7.40	9.58	11.50	12.02	12.47	12.47	12.99	12.99	13.13	13.28	13.57	14.18	15.43	16.41

1986	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.78	0.78	1.22	1.22	1.22	1.22	1.22	1.81	1.81	1.81	1.81	1.81	1.81	2.48	3.17
A	0.00	0.19	0.78	1.20	1.85	2.31	2.31	2.31	2.31	2.31	2.31	2.31	2.31	2.31	2.98	4.02	4.75
Baa	1.33	1.33	3.01	3.89	5.27	6.72	7.77	8.36	8.36	8.36	8.36	8.36	8.36	10.05	10.92	11.83	13.68
Ba	2.03	5.93	8.51	13.54	20.14	28.10	29.92	32.67	33.42	34.21	34.21	36.10	36.10	36.10	38.45	43.42	44.72
B	11.73	17.70	21.69	25.73	35.50	45.06	49.51	52.99	52.99	55.41	55.41	55.41	58.59	62.36	62.36	62.36	62.36
Caa-C	23.53	23.53	40.52	40.52	40.52	40.52	40.52	40.52	40.52	100.00	-	-	-	-	-	-	-
Investment-Grade	0.32	0.40	1.22	1.61	2.31	2.83	3.05	3.18	3.18	3.32	3.32	3.32	3.32	3.63	4.12	4.95	5.81
Speculative-Grade	5.64	10.21	13.49	18.11	25.60	33.86	36.39	39.27	39.80	41.53	41.53	42.89	43.66	44.49	46.22	49.90	50.85
All Corporates	1.90	3.29	4.80	6.28	8.61	10.85	11.55	12.22	12.33	12.76	12.76	13.00	13.13	13.51	14.17	15.38	16.22

1987	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.39	0.39	0.39	0.39	0.39	0.93	0.93	0.93	0.93	0.93	0.93	1.57	2.22
A	0.00	0.00	0.40	1.24	1.67	1.67	1.67	1.67	1.67	1.67	1.67	1.67	1.67	1.99	2.65	3.34
Baa	0.00	1.05	1.42	2.98	4.63	5.93	6.90	6.90	6.90	6.90	7.55	7.55	8.94	9.66	11.89	12.66
Ba	2.71	4.47	9.26	16.27	23.97	27.39	30.87	31.98	33.21	33.90	35.47	36.36	36.36	38.43	40.61	42.96
B	6.23	13.49	20.35	31.89	43.13	46.57	48.63	48.63	50.00	50.00	50.00	51.96	54.14	58.62	60.98	66.18
Caa-C	20.00	30.67	30.67	30.67	30.67	30.67	30.67	30.67	65.33	65.33	65.33	65.33	65.33	65.33	65.33	65.33
Investment-Grade	0.00	0.25	0.51	1.32	1.88	2.18	2.40	2.40	2.52	2.52	2.65	2.65	2.94	3.23	4.12	4.74
Speculative-Grade	4.23	8.13	13.59	22.09	30.85	34.21	37.17	37.91	39.56	40.02	41.06	42.25	42.91	45.66	47.84	50.97
All Corporates	1.50	3.01	4.97	8.13	10.99	12.08	12.96	13.13	13.59	13.69	14.00	14.21	14.55	15.23	16.28	17.25

Exhibit 47 –Cumulative Default Rates from 1 to 20 Years by Annual Cohort, 1970-2002

1988	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.32	0.66	0.66	0.66	0.66	0.66	1.13	1.13	1.13	1.13	1.13	1.67	2.23	2.79
A	0.00	0.38	0.98	1.39	1.39	1.39	1.39	1.39	1.39	1.39	1.39	1.39	1.39	2.02	2.36
Baa	0.00	0.33	1.03	2.48	3.64	4.48	4.48	4.48	4.48	5.05	5.05	5.66	6.28	8.22	9.56
Ba	1.24	6.52	12.88	20.67	23.72	26.93	27.85	28.86	29.99	31.27	31.99	32.78	34.49	39.11	42.18
B	6.36	13.43	26.06	37.28	41.44	46.54	47.40	50.43	50.43	51.70	57.65	59.34	62.96	64.96	69.34
Caa-C	28.57	28.57	28.57	28.57	28.57	28.57	28.57	64.29	64.29	64.29	64.29	64.29	64.29	64.29	64.29
Investment-Grade	0.00	0.31	0.81	1.32	1.59	1.79	1.79	1.90	1.90	2.03	2.03	2.16	2.42	3.24	3.81
Speculative-Grade	3.59	9.50	18.17	27.13	30.53	34.35	35.23	37.21	37.95	39.19	41.55	42.60	44.85	48.51	51.87
All Corporates	1.36	3.71	7.03	10.25	11.44	12.63	12.86	13.43	13.61	13.97	14.45	14.74	15.35	16.62	17.60

1989	1	2	3	4	5	6	7	8	9	10	11	12	13	14
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.61	0.61	0.61	0.61	0.61	0.61	1.06	1.06	1.06	1.06	1.06	1.57	2.09	2.63
A	0.00	0.18	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	1.42	1.72
Baa	0.59	1.22	1.87	2.91	2.91	2.91	2.91	2.91	3.39	3.39	3.90	4.44	6.64	8.37
Ba	2.98	9.99	18.12	20.83	24.01	24.42	25.34	26.88	28.62	30.60	31.33	33.69	37.88	42.52
B	8.95	23.13	33.59	38.66	44.31	46.36	50.37	50.37	52.52	56.48	57.96	61.13	62.86	66.57
Caa-C	25.00	43.75	57.81	57.81	57.81	57.81	57.81	57.81	57.81	57.81	57.81	57.81	57.81	57.81
Investment-Grade	0.29	0.51	0.82	1.07	1.07	1.07	1.17	1.17	1.28	1.28	1.40	1.64	2.63	3.26
Speculative-Grade	5.79	15.90	24.99	28.58	32.64	33.65	35.65	36.62	38.45	40.99	41.93	44.46	47.71	51.87
All Corporates	2.34	6.08	9.32	10.61	11.80	12.08	12.67	12.90	13.39	13.90	14.17	14.81	16.13	17.32

1990	1	2	3	4	5	6	7	8	9	10	11	12	13
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.00	0.00	0.37	0.37	0.37	0.37	0.37	0.37	0.82	1.28
A	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.26	0.53	0.81
Baa	0.00	0.62	0.62	0.62	0.62	0.62	0.62	0.62	0.62	1.13	1.66	4.35	6.58
Ba	3.35	11.84	14.39	17.38	18.15	19.43	20.35	22.38	24.08	24.70	27.35	32.31	35.42
B	16.18	27.57	34.52	39.65	41.34	44.06	44.87	46.84	50.59	53.63	57.00	58.91	65.23
Caa-C	58.82	67.06	67.06	67.06	67.06	100.00	-	-	-	-	-	-	-
Investment-Grade	0.00	0.14	0.14	0.14	0.14	0.23	0.23	0.23	0.23	0.34	0.56	1.35	2.04
Speculative-Grade	10.08	19.77	24.09	27.88	28.99	31.02	31.87	33.79	36.01	37.24	39.91	43.76	47.46
All Corporates	3.59	6.93	8.29	9.42	9.73	10.32	10.53	10.98	11.45	11.77	12.44	13.74	14.92

Exhibit 47 –Cumulative Default Rates from 1 to 20 Years by Annual Cohort, 1970-2002

1991	1	2	3	4	5	6	7	8	9	10	11	12
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.00	0.31	0.31	0.31	0.31	0.31	0.31	0.70	1.11
A	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.26	0.52	0.79
Baa	0.27	0.27	0.27	0.27	0.27	0.27	0.27	0.27	0.69	1.12	3.32	5.14
Ba	5.35	6.63	8.47	8.90	9.84	10.87	12.56	14.48	15.90	18.96	23.87	26.57
B	14.56	23.68	30.51	32.71	36.61	37.38	40.17	43.58	46.27	49.30	51.05	58.88
Caa-C	36.84	36.84	36.84	36.84	47.37	47.37	47.37	47.37	47.37	47.37	73.68	73.68
Investment-Grade	0.06	0.06	0.06	0.06	0.15	0.15	0.15	0.15	0.25	0.45	1.17	1.81
Speculative-Grade	10.40	15.11	19.06	20.22	22.60	23.49	25.49	27.81	29.57	32.43	36.59	40.61
All Corporates	3.23	4.59	5.67	5.97	6.60	6.80	7.23	7.67	8.06	8.71	9.96	11.08

1992	1	2	3	4	5	6	7	8	9	10	11
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.28	0.28	0.28	0.28	0.28	0.28	0.63	0.63
A	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.22	0.45	0.93
Baa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.38	0.77	2.80	4.08
Ba	0.30	1.00	1.00	1.90	2.38	3.46	5.26	6.60	8.77	13.35	16.65
B	9.03	17.54	20.91	25.64	28.00	30.77	34.15	36.75	42.64	44.32	51.87
Caa-C	26.67	32.10	32.10	40.09	40.09	52.07	52.07	52.07	52.07	76.03	76.03
Investment-Grade	0.00	0.00	0.00	0.08	0.08	0.08	0.08	0.16	0.34	0.99	1.48
Speculative-Grade	4.84	8.92	10.28	12.87	14.02	15.98	18.21	19.90	23.12	27.08	31.38
All Corporates	1.31	2.35	2.68	3.31	3.56	3.95	4.36	4.72	5.38	6.54	7.59

1993	1	2	3	4	5	6	7	8	9	10
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
A	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.19	0.59	1.00
Baa	0.00	0.00	0.25	0.25	0.25	0.54	1.13	1.74	2.99	3.99
Ba	0.55	0.55	2.63	3.38	4.65	6.09	7.14	8.87	13.12	15.75
B	5.71	9.90	15.27	17.11	20.01	22.61	27.54	34.03	37.73	43.15
Caa-C	28.57	28.57	42.18	50.44	50.44	50.44	50.44	50.44	75.22	75.22
Investment-Grade	0.00	0.00	0.06	0.06	0.06	0.14	0.29	0.52	1.01	1.43
Speculative-Grade	3.51	5.14	8.81	10.16	11.97	13.76	16.09	19.38	23.69	27.09
All Corporates	0.94	1.36	2.29	2.60	2.99	3.40	3.95	4.72	5.84	6.75

Exhibit 47 –Cumulative Default Rates from 1 to 20 Years by Annual Cohort, 1970-2002

1994	1	2	3	4	5	6	7	8	9
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
A	0.00	0.00	0.00	0.00	0.00	0.00	0.15	0.46	0.78
Baa	0.00	0.20	0.20	0.41	0.64	1.81	2.29	3.56	4.35
Ba	0.24	1.80	2.08	3.02	4.81	7.21	9.85	12.63	15.12
B	3.81	9.14	12.31	14.16	18.21	23.10	29.28	34.40	39.90
Caa-C	5.13	13.75	24.31	24.31	24.31	30.90	30.90	56.02	56.02
Investment-Grade	0.00	0.05	0.05	0.11	0.18	0.49	0.69	1.17	1.52
Speculative-Grade	1.94	5.36	7.25	8.50	11.03	14.43	18.18	22.23	25.66
All Corporates	0.56	1.55	2.05	2.40	3.02	3.97	4.86	6.01	6.92

1995	1	2	3	4	5	6	7	8
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
A	0.00	0.00	0.00	0.00	0.00	0.13	0.39	0.80
Baa	0.00	0.00	0.00	0.42	1.49	1.94	3.34	3.83
Ba	0.69	0.94	2.05	3.61	6.40	9.07	11.88	14.04
B	4.80	7.32	10.18	13.90	18.32	24.17	32.41	39.17
Caa-C	11.57	19.52	19.52	24.63	30.78	34.74	55.62	68.30
Investment-Grade	0.00	0.00	0.00	0.11	0.39	0.56	1.04	1.35
Speculative-Grade	3.32	5.08	6.94	9.69	13.36	17.46	23.31	27.81
All Corporates	1.03	1.55	2.07	2.87	3.96	5.02	6.68	7.88

1996	1	2	3	4	5	6	7
Aaa	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.00	0.00	0.00	0.00
A	0.00	0.00	0.00	0.00	0.11	0.34	0.58
Baa	0.00	0.00	0.17	0.71	1.27	2.61	3.21
Ba	0.00	0.72	2.34	5.62	7.87	11.61	13.45
B	1.44	4.43	9.24	13.02	19.07	26.36	34.02
Caa-C	13.99	20.24	27.41	40.61	46.55	67.11	72.17
Investment-Grade	0.00	0.00	0.05	0.19	0.40	0.87	1.14
Speculative-Grade	1.67	3.85	7.34	11.49	15.61	21.58	26.07
All Corporates	0.51	1.16	2.15	3.31	4.45	6.20	7.42

Exhibit 47 –Cumulative Default Rates from 1 to 20 Years by Annual Cohort, 1970-2002

1997	1	2	3	4	5	6
Aaa	0.00	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.00	0.00	0.00
A	0.00	0.00	0.00	0.10	0.31	0.52
Baa	0.00	0.14	0.73	1.34	2.46	3.12
Ba	0.19	1.47	5.26	8.34	11.34	13.71
B	2.11	7.42	11.93	17.71	27.78	34.85
Caa-C	14.67	27.31	39.59	50.10	72.64	76.85
Investment-Grade	0.00	0.04	0.21	0.43	0.84	1.13
Speculative-Grade	2.05	5.99	10.57	15.27	22.39	26.98
All Corporates	0.65	1.86	3.27	4.69	6.84	8.20

1998	1	2	3	4	5
Aaa	0.00	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.00	0.00
A	0.00	0.00	0.09	0.29	0.49
Baa	0.12	0.60	1.09	2.12	3.33
Ba	0.63	2.86	6.02	9.96	12.54
B	4.22	11.53	18.63	29.49	36.59
Caa-C	15.09	31.32	40.96	62.67	67.54
Investment-Grade	0.04	0.19	0.39	0.80	1.27
Speculative-Grade	3.43	9.12	14.64	23.09	27.96
All Corporates	1.23	3.23	5.15	8.11	9.91

1999	1	2	3	4
Aaa	0.00	0.00	0.00	0.00
Aa	0.00	0.00	0.00	0.00
A	0.00	0.00	0.18	0.38
Baa	0.10	0.63	1.41	2.68
Ba	1.01	3.18	6.47	8.97
B	5.92	14.74	25.62	34.69
Caa-C	20.44	31.50	52.58	59.09
Investment-Grade	0.03	0.22	0.55	1.06
Speculative-Grade	5.68	12.09	21.04	27.04
All Corporates	2.16	4.63	8.05	10.45

Exhibit 47 –Cumulative Default Rates from 1 to 20 Years by Annual Cohort, 1970-2002

2000	1	2	3
Aaa	0.00	0.00	0.00
Aa	0.00	0.00	0.00
A	0.00	0.17	0.35
Baa	0.38	0.87	2.21
Ba	0.89	2.78	4.63
B	5.44	16.04	25.29
Caa-C	19.65	43.46	53.36
Investment-Grade	0.13	0.37	0.91
Speculative-Grade	6.06	15.78	22.71
All Corporates	2.36	6.08	8.89

2001	1	2
Aaa	0.00	0.00
Aa	0.00	0.00
A	0.16	0.41
Baa	0.19	1.67
Ba	1.56	3.46
B	9.48	19.79
Caa-C	34.45	46.23
Investment-Grade	0.13	0.73
Speculative-Grade	10.60	18.46
All Corporates	3.80	6.86

2002	1
Aaa	0.00
Aa	0.00
A	0.16
Baa	1.22
Ba	1.53
B	5.11
Caa-C	29.45
Investment-Grade	0.49
Speculative-Grade	8.33
All Corporates	2.97

Fidelity Investments®

Statement for the Record

on

"Rating the Rating Agencies: the State of Transparency and Competition"

before the

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

April 2, 2003

Introduction

Fidelity Investments commends Chairman Baker, Ranking Member Kanjorski and other distinguished Members of the Subcommittee for their review of the role of rating agencies in the U.S. securities markets. We are pleased to have this opportunity to address the state of transparency and competition in the industry.

Fidelity Investments is one of the world's largest providers of financial services, with managed assets of $755.4 billion as of February 28, 2003. Fidelity offers investment management, retirement planning, brokerage, human resources and benefits outsourcing services to 18 million individuals and institutions as well as through 5,500 financial intermediaries. The firm is the largest mutual fund company in the United States and the No. 1 provider of workplace retirement savings plans in the country. Fidelity employs more than 28,000 people in various locations throughout the United States.

Through its fixed income division, Fidelity manages approximately $ 370 billion in bond, money market and other fixed income accounts, of which approximately $230 billion is invested in money market mutual funds. In such capacity, Fidelity is both a consumer and a recipient of credit ratings. When considering what debt obligations to purchase or sell on behalf of the mutual funds, Fidelity analysts review ratings from the national recognized statistical rating organizations (NRSROs). In addition, given the needs of certain purchasers of mutual funds, a number of our fixed income funds are regularly evaluated by the NRSROs and receive credit ratings. Accordingly, we are acutely aware of the increasing influence of NRSRO ratings and understand both their value and limitations in the investment decision-making process.

Maintaining the quality and integrity of credit ratings requires regulatory oversight

Fidelity believes that the NRSROs serve a valuable role in providing regulatory benchmarks and as peer credit analysts. However, we also recognize, given their increasing influence in the markets, certain areas for improvement.

For nearly a century, rating agencies have examined issuers of debt and published opinions as to the likelihood of the debt being paid on time. In recent years, NRSROs have achieved greater influence in the financial markets. This greater influence resulted in part from the increased use of the NRSRO concept in legislation and regulation. For example, SEC rules set minimal credit quality standards for the approximately $2.3 trillion in money market mutual fund assets. These rules employ the NRSRO rating as a benchmark for such credit quality standards. In addition, with the growth in investment grade bond funds, prospectuses can also use the NRSRO concept as a benchmark for credit quality. As a result, when an NRSRO lowers a credit rating of an issuer or instrument, regulatory requirements to either sell or decrease a position can follow.

Given the growing reliance by the securities markets and regulators on NRSROs, Fidelity recommends increased SEC oversight through a biennial or triennial NRSRO review process in which public comment and participation is solicited. Fidelity suggests that the SEC seek the views of key participants in the fixed income markets from which NRSROs gain their influence, but a minority of their revenue. Such forums would address weak spots such as deterioration in ratings quality, poor transparency, and potential conflicts as the rating agencies expand their business models. These public forums would help to highlight best practices and identify threats to the integrity of ratings early on. In addition, Fidelity recommends that the review process would result in the SEC requiring weak rating agencies to apply for re-certification of their NRSRO status, a more in depth and rigorous inspection process.

The rating agency processes are not broken

The NRSROs have done an effective job over the years, particularly given the increasing complexity in financial analysis. We have a great deal of respect for their work from our role as active consumers of their analysis, as peer analysts, and as participants in markets heavily affected by their ratings and commentary. As many have observed, there are areas of weakness, which surfaced in the recent market turmoil. Increased oversight is merited to safeguard a system that is not broken but strained. Areas of concern are subtle ones: reduced level of transparency, straying from established rating criteria, and expansion of business models that could create conflicts.

Increased oversight of rating agencies is merited

Fidelity recommends that the SEC review NRSROs on a biennial or triennial basis through written comment and public forums to solicit feed back from active fixed income market participants. The subject for comment would be various risk areas inherent in a system with few participants, large influence on the markets, for-profit business models despite quasi-regulatory roles, and business models reliant on issuers for payment of fees and not investors. Such forums could keep the SEC informed on ever more complex fixed income market developments and areas requiring greater scrutiny before serious problems arise.

It would be an effective way to provide a voice to investors heavily affected by NRSRO actions, but with little influence on their procedures and practices however detrimental. Moreover, Fidelity recommends that the SEC require weak rating agencies, which fail to meet established standards to apply for re-certification of their NRSRO status.

Risk areas to address in public comment and forums

Rating criteria -Are they appropriate? Are they up to date? Are they adhered to? Is the level of due diligence appropriately disclosed? Changing ratings in ways that surprise the market (inconsistent criteria, based on changed criteria not otherwise communicated, not well explained) add market volatility and can speed liquidity crises for companies.

Transparency - Are the rating criteria and individual rationales communicated on a timely and effective basis to the public? Has the agency kept its published methodologies and standards current as its practices evolve? Have the NRSROs clearly disclosed areas where they have reduced their due diligence or do investors presume certain levels of research the agencies have forgone?

Conflicts in business models - Several agencies have considered selling computer models that will help predict future movements in bond prices. We believe that this is a conflict, since the credit ratings they publish in part drive changing prices. They are also covering more sectors, with fewer analysts or with less rigor, eroding the quality of their ratings process.

Increased competition requires rigorous standards

We recommend that the SEC establish an NRSRO certification process for rating agencies seeking the NRSRO designation. This certification process should be modeled on existing SEC standards of designation as well as industry best practices. This should include both SEC review and a public comment process. This comment process should mirror the biennial or triennial NRSRO review, with fixed income market participants sharing in the discussion. Given the complexity of credit analysis and the need to cover a relatively large number of issuers well to maintain a meaningful rating system, rating agencies seeking the designed NRSRO status must establish a track record of quality analysis and clear communications over a period of time, including at least one business cycle. Weak competitors would reduce the reputation of the NRSRO status and cause market confusion. Competitors with less rigorous processes could also lead to ratings shopping by issuers, where weaker issuers would seek a higher rating from a competitor with lower standards. This could drive established agencies to loosen their criteria. Agencies must also be allowed to earn a decent return on the basic ratings business, to fund the increasingly expensive task of analyzing companies well and communicating their views effectively.

Conclusion

Credit rating agencies wield increasing influence over participants in and regulators of our nation's securities markets. Laws and regulations have endowed the ratings issued by a few rating agencies, the NRSROs, with special authority as benchmarks for minimal credit quality. New entrants are eager to gain the NRSRO status. Accordingly, Fidelity recommends that both existing NRSROs and rating agencies seeking to gain the NRSRO designation be subject to a biennial or triennial review, led by the SEC with input from market participants. We also suggest that both new entrants and existing NRSROs with weak standards be required to obtain certification or re-certification of their NRSRO status.

COMMENTS OF VICKIE A. TILLMAN
EXECUTIVE VICE PRESIDENT
STANDARD & POOR'S CREDIT MARKET SERVICES

SUBMITTED TO THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT-SPONSORED ENTERPRISES
U.S. HOUSE OF REPRESENTATIVES

HEARING ON: RATING THE RATING AGENCIES—
THE STATE OF TRANSPARENCY AND COMPETITION

APRIL 2, 2003

Standard & Poor's Ratings Services ("Standard & Poor's"), part of Standard & Poor's, a division of The McGraw-Hill Companies, Inc. ("McGraw-Hill"), appreciates the opportunity to share its views on the issues surrounding the role of credit rating agencies in the U.S. capital markets.

Introduction

Since beginning its credit rating activities in 1916, Standard & Poor's has rated hundreds of thousands of securities issues, corporate and governmental issuers and structured financings. Standard & Poor's began its ratings activities with the issuance of credit ratings on corporate and governmental debt issues. Responding to market developments and needs, Standard & Poor's also assesses the credit quality of, and assigns credit ratings to, financial guarantees, bank loans, private placements, mortgage- and asset-backed securities, mutual funds and the ability of insurance companies to pay claims, and assigns market risk ratings to managed funds.

Today, Standard & Poor's has credit ratings outstanding on approximately 150,000 securities issues of obligors in more than 50 countries. Standard & Poor's rates and monitors developments pertaining to these securities and obligors from operations in 21 cities in 16 countries around the world. With a U.S. staff of approximately 1,250, Standard & Poor's rates more than 99.2% of the debt obligations and preferred stock issues publicly traded in the United States.

Standard & Poor's believes that over the last century credit ratings have served the U.S. securities markets extremely well, providing an effective and objective tool in the market's evaluation and assessment of credit risk. Standard & Poor's recognizes the valuable role that credit rating agencies play in the U.S. securities markets and is committed to protecting and enhancing the reputation and future of its credit ratings business. In this regard, Standard & Poor's takes great care to assure that its credit ratings are viewed by the market as highly credible and relevant, and will continue to review its practices, policies and procedures on an ongoing basis and modify or enhance them, as necessary, to ensure that integrity, independence, objectivity, transparency, credibility and quality continue as fundamental premises of its operations.

Standard & Poor's also welcomes continued discussions with the Securities and Exchange Commission (the "Commission") on the role and function of credit rating agencies in the U.S. securities market, and looks forward to the Commission's forthcoming concept release addressing issues related to credit rating agencies. Standard & Poor's believes that key to preserving the valuable role of credit rating agencies in the U.S. capital markets is the continued availability of a regulatory framework that recognizes the market as the best judge of a credit rating agency's integrity, independence, objectivity, credibility and quality. Standard & Poor's supports a more open and transparent process to designate Nationally Recognized Statistical Rating Organizations ("NRSROs"), and believes that the applicable designation criteria should continue to focus first and foremost on a rating agency's market recognition, and on the independence, objectivity and transparency of a credit rating agency's rating process.

Role and Function of Credit Rating Agencies

Credit ratings are an important component of the capital markets and have functioned effectively in the United States for close to a century. The role of credit ratings is also growing and flourishing in many countries abroad with the development of global capital markets. Credit ratings help the market to evaluate and assess credit risk effectively and efficiently, price debt securities, benchmark issues and create a robust secondary market for those issues.

Critical to a credit rating agency's ability to serve this key role in the market is its meeting the highest standards of integrity, independence, objectivity, transparency, credibility and quality. Standard & Poor's credit ratings have achieved worldwide market recognition and acceptance — not only with issuers and investors, but also with bankers, financial intermediaries and securities traders — as easy to use tools for differentiating credit quality. Underlying the credibility of Standard & Poor's credit ratings is the market's recognition of the independence and objectivity of Standard & Poor's credit ratings and rating process, and its excellent track record and reputation.

Recent Initiatives and Enhancements. Despite the changing environment, Standard & Poor's core values remain the same: to provide high-quality, objective, rigorous analytical information to the marketplace. In this regard, Standard & Poor's continuously evaluates its practices and modifies or enhances them, as necessary, so that its credit ratings process is responsive to market needs. Recent initiatives undertaken by Standard & Poor's include:

- the addition of a specific liquidity analytics discussion to its research reports for all industrial credit ratings rated "A-" and below;
- the addition of accounting expertise to address the increasing significance and complexity of accounting matters in determining credit risk and to assist in developing training programs on a variety of accounting and financial reporting topics;

- the enhancement of focus on the role of corporate governance practices in its credit ratings analysis;
- the expansion of its recovery analytics to cover expected recovery ranges for all rated bank loans and selected bonds in some sectors;
- the introduction of new, innovative written reports, including "industry report cards," which are quarterly updates of industry and issuer credit trends by sector;
- the expansion of its existing training processes to include a curriculum-based training program to keep analysts abreast of new analytical techniques in today's complex and sophisticated markets;
- the introduction of new tools designed to provide ratings analysts with supplementary information such as modeling, credit statistics and market-based indicators; and
- continuous thought leadership on issues relevant to credit markets, recent examples of which include Standard & Poor's work on pension funding and its study on the impact of fair lending laws on securitization transactions.

What is a Credit Rating? In understanding the role of credit rating agencies in the securities markets, it is important to understand what a credit rating is. A Standard & Poor's credit rating represents Standard & Poor's opinion, as of a specific date, of the creditworthiness of an obligor in general or with respect to a particular financial obligation — indeed, this is specifically recognized by the Commission in its *Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, January 2003* ("SEC Rating Agency Report"). Standard & Poor's issuer- and issue-specific credit ratings can be either long-term or short-term, reflecting Standard & Poor's assessment as to a company's capacity to meet its financial commitments over a long-term or short-term time horizon. Standard & Poor's issues credit ratings in the form of symbols that are widely recognized and understood in the market. Most importantly, a credit rating is not investment advice or a recommendation and does not speak to the market price of the securities or the suitability of an investment for particular investors. Credit ratings are fundamentally different from recommendations made by equity or fixed-income analysts as to whether investors should buy, sell or hold a security, and Standard & Poor's does not serve as a fiduciary.

Standard & Poor's credit ratings are based principally on public information about an issuer and additional information that may be provided by the issuer, as well as other economic, financial and industry information that ratings analysts deem relevant and reliable. Standard & Poor's credit ratings necessarily embody assessments of future potential performance. However, since events occur that are unforeseeable or simply unknowable, Standard & Poor's regularly reviews its analyses. Once assigned, a credit rating is subject to ongoing review, or surveillance, and could be changed at any time based on newly available information. Credit ratings may also be suspended or withdrawn because of changes in the completeness, availability or reliability of information.

Standard & Poor's does not perform an audit of the rated company or otherwise undertake to verify information provided by the company; nor does Standard & Poor's audit or rate the work of the company's auditors or repeat the auditors' accounting review. Standard & Poor's relies on the integrity and quality of the company's publicly available financial reports and financial statements and expressly relies on the rated company to provide current and timely information — both at the time of the initial rating and on an ongoing basis. If an issuer refuses to provide requested information, Standard & Poor's may, depending on its view of the significance of the information requested, issue a lower rating, refuse to issue a rating or even withdraw an existing rating.

On a daily basis, Standard & Poor's issues between 500 and 1,000 rating actions around the globe. These actions include initial rating determinations, rating changes, CreditWatch listings, Outlook changes and rating affirmations. As these rating actions are Standard & Poor's opinions on creditworthiness as of specific dates, it is to be expected that there will be, from time to time, opinions that differ from those of Standard & Poor's and it is through this daily process that Standard & Poor's credit ratings are subject to constant scrutiny. Standard & Poor's focus, however, is on furnishing opinions that will, over time, prove to be as credible and relevant as possible without regard to whether others agree or disagree with its opinions. While there will be occasions when Standard & Poor's ratings are scrutinized with the benefit of hindsight, including as a result of unforeseeable or simply unknowable events, Standard & Poor's excellent track record demonstrates why its credit ratings work exceptionally well.

The excellent track record of Standard & Poor's credit ratings has been demonstrated by studies on rating trends, which have repeatedly shown that there is a clear correlation between initial ratings assigned by Standard & Poor's and the likelihood of default: the higher the initial rating, the lower the probability of default and vice versa. The information below shows the cumulative default history over the past 15 years of issuers rated by Standard & Poor's based upon the rating category they were initially assigned. This clearly demonstrates the very low probability of default of an issue initially rated in the "AAA" category (only 0.67% have defaulted in the past 15 years) contrasted with the much greater possibility of default for an issuer initially receiving Standard & Poor's lowest rating level of "CCC" (60.70% have defaulted in the past 15 years).

Rating Category	Percentage of Defaults Initially Rated in the Category
AAA	0.67
AA	1.30
A	2.88
BBB	9.77
BB	24.51
B	41.09
CCC	60.70

Rating Criteria and Methodology. Standard & Poor's credit rating business is based on the full and fair disclosure regime mandated by the U.S. federal securities laws. At the heart of the process which leads to a credit rating being issued by Standard & Poor's is an understanding between the company seeking the rating and Standard & Poor's itself. As set forth in Standard & Poor's detailed reports on rating criteria and methodologies and other publications, the company is obliged to furnish complete, timely and reliable information to Standard & Poor's on an ongoing basis. Clearly, the events of the last year or so have demonstrated the consequences for all market participants, including the credit rating agencies, when companies fail to meet their disclosure obligations or, worse, set out to defraud investors or rating agencies. The Congress and the Commission's initiatives over the last year to improve the quality, transparency and timeliness of public companies' disclosures should significantly enhance Standard & Poor's ability to evaluate a company's creditworthiness. Likewise, accounting standard initiatives to improve the transparency of financial statements should also benefit the analysis of creditworthiness.

Standard & Poor's ratings criteria and methodology, collectively, provide a framework for Standard & Poor's credit ratings process. Among other things, Standard & Poor's ratings criteria and methodology provide for specific credit analysis factors to ensure that all salient issues are considered during the credit rating process. The three main corporate credit analysis factors are: (1) the business risk of the issuer (*e.g.,* an issuer's economic, operational and competitive environment), (2) the financial risk of the issuer (*e.g.,* capital structure, financial policy, earnings, cash flow, debt, leverage and financial flexibility), and (3) the management risk of the issuer. Standard & Poor's ratings methodology also considers the industry in which an issuer conducts its business, such as consumer products and capital goods.

Standard & Poor's seeks to provide users with information to enable them to understand how Standard & Poor's analyzes creditworthiness. Standard & Poor's regularly publishes its ratings definitions, detailed reports on rating criteria and methodology and default studies demonstrating its track record, all of which are freely available to the public, in hard copy and on Standard & Poor's website. Standard & Poor's employs a consistent credit rating process, such as the use of rating committees in connection with initial ratings and rating actions and the monitoring of a company's ongoing creditworthiness through surveillance, across different types of ratings and different markets.

Information Flow in the Credit Rating Process

Sources of Information. Standard & Poor's ratings analysis relies principally on the public information provided by the issuer, including audited financial and other information contained in the issuer's annual, quarterly and current reports mandated by the U.S. federal securities laws and stock exchange and Nasdaq requirements, as well as press releases and other public disclosures of the issuer. Meetings with corporate management are typically part of the credit rating process. The purpose of such meetings is to review the company's key operating and financial plans, management policies and other credit factors that may have an impact on the company's creditworthiness.

As noted above, the rated companies are obliged to furnish complete, timely and reliable information to Standard & Poor's on an ongoing basis. Standard & Poor's also expects rated companies to provide prompt notice of all material changes to information previously provided to Standard & Poor's and any material financial and operational changes that could affect their creditworthiness.

Ongoing contact with management is also a routine component of the rating surveillance process. The primary analyst periodically contacts the rated company to discuss the company's performance and developments. If the company's performance or developments vary significantly from expectations or if a significant, new transaction or initiative is planned, Standard & Poor's will usually request a meeting with the company's management. The frequency or extent of contact with management varies with the company's risk profile, size, extent of debt outstanding and complexity. Dialogue with management is more frequent in response to significant industry events, material announcements by the company or plans by the company to pursue new financings.

In addition to information provided by the company, Standard & Poor's makes extensive use of primary and third party databases as sources of additional information. Third party data providers are a source of timely financial information on the domestic insurance and banking industries, the corporate sector and the asset-backed and residential mortgage sectors. Other sources of information include the Federal Deposit Insurance Corporation, the National Association of Insurance Commissioners, the United States Census Bureau, the Institute for Real Estate Management and the Mortgage Bankers' Association, among others.

Confidential Information. It is common during the credit rating process and ongoing surveillance for companies to provide Standard & Poor's with non-public information, such as budgets and forecasts, financial statements on a stand-alone basis, internal capital allocation schedules, contingent risks analyses and information relating to new financings, acquisitions, dispositions and restructurings. Protection of confidential information is critical to the success of Standard & Poor's business; issuers will not make such information available to Standard & Poor's if they have any concerns that Standard & Poor's will not ensure its confidentiality. Moreover, Standard & Poor's and its employees fully appreciate their obligation under the federal securities laws to protect the confidentiality of such information.

Standard & Poor's has a strict policy of mandating that such information be kept confidential. The Credit Market Services' Code of Ethics, to which Standard & Poor's employees are subject, contains detailed guidance for Standard & Poor's employees with respect to the protection of the confidentiality of information. The Code of Ethics includes a "need to know" provision providing that non-public information should only be discussed with employees involved in the specific analytic activity who need to know such information. Even when a rating is made public, Standard & Poor's policies prohibit the disclosure of confidential information in the published ratings rationale. Published rationales do, however, convey the consequences related to any non-public information considered by Standard & Poor's, thereby providing the basis for the rating decision without disclosing non-public information.

Noting the customary practice of issuers providing credit rating agencies with confidential information as part of the credit rating process, the Commission specifically excluded the transmission of confidential information to credit rating agencies from coverage under Regulation FD under the Securities Exchange Act of 1934. This exemption is consistent with the general exemption from Regulation FD for the communication of non-public information to a person who expressly agrees to maintain such information in confidence. The specific exemption from Regulation FD with respect to confidential information provided to credit rating agencies simply eliminated any question about the form of the confidentiality agreement between the parties.

Dissemination of Credit Ratings, Ratings Rationale and Rating Actions. Standard & Poor's long-standing policy has been to make its public credit ratings and the basis for such ratings generally available to the investing public without cost. Public credit ratings (which constitute 99% of Standard & Poor's credit ratings in the United States) are disseminated via real-time posts on Standard & Poor's website and through a wire feed to the news media as well as via subscription services such as Ratings Direct and Credit Wire. Subscribers do not have access to ratings or rating actions prior to the investing public.

Standard & Poor's places great importance on communication with the public. Following notification to the issuer, all changes to public credit ratings and all CreditWatch and Outlook listings are disseminated promptly through Standard & Poor's website, worldwide press releases to wire services and subscription services such as RatingsDirect and CreditWire. Standard & Poor's frequently publishes its rating rationale and the basis for credit rating changes through media releases. All media releases are posted on Standard & Poor's website. Additionally, any caller to Standard & Poor's Ratings Desk may request a rating and receive a report.

Other Publications. Standard & Poor's also regularly publishes reports and rationales that inform the market about an issuer's strengths and weaknesses, as well as key trends that could affect the issuer's creditworthiness. Around the world, Standard & Poor's annually publishes approximately 11,000 press releases, over 1,700 articles and commentary pieces on sector and industry trends, 51 editions of Credit Week (a weekly print publication on fixed-income securities) and 12 sector reports on 19 industry groups. Standard & Poor's holds over 200 telephone conferences with investors regarding fixed income topics, sponsors investor forums and conducts hundreds of print and broadcast interviews annually.

Potential Conflicts of Interest

As discussed at the outset, fundamental to any credit rating agency's credibility and the market's use of its credit ratings are both the reality of, and the public's belief in, the independence, objectivity and credibility of its credit ratings and rating process. Standard & Poor's is committed to protecting the value of its ratings franchise built over its 86-year history through uncompromising dedication to these principles, which are reflected both in the policies governing the conduct of Standard & Poor's credit ratings personnel, and the structure and operation of its credit ratings business. Standard & Poor's is reassured that there is no evidence of any perceived conflicts of interest undermining the integrity of its credit rating process. Indeed, as noted in the SEC Rating Agency Report, participants generally believed that any potential conflict of interest "has been effectively addressed by the credit rating agencies."

Credit Rating Process. Standard & Poor's credit rating process also serves to minimize the effects of any potential conflicts of interest. For example, Standard & Poor's credit ratings are assigned by rating committees and not by an individual. Standard & Poor's procedures also mandate that at least two analysts attend any meeting with a company's management.

Standard & Poor's also has had significant corporate infrastructure in place over the years dedicated to ensuring the independence, objectivity and consistency of its credit ratings — an important feature of which is the Analytical Policy Board. Chaired by the Chief Credit Officer, the Analytical Policy Board is designed to ensure the consistency of ratings criteria and methodologies used by Standard & Poor's and to review and approve new ratings criteria and methodologies. The Analytical Policy Board works to ensure consistency by reviewing and monitoring firm-wide criteria and analytical policies and by tracking the performance of credit ratings assigned by Standard & Poor's through default and transition studies, as well as through studies of the migration of rating categories. The Analytical Policy Board also, as a matter of policy, reviews sudden or multiple notch downgrades to identify criteria or policy changes that are needed. Members of the Analytical Policy Board include 11 senior level members of the industry and regional rating units, including the General Counsel for Standard & Poor's Credit Market Services unit and its Chief Accountant.

As an added measure, Standard & Poor's internally performs random audits of ratings files after credit ratings have been assigned to make sure that all documents required to assign such credit ratings have been collected.

Organizational Structure. Standard & Poor's credit ratings services operates as a standalone business, separate from Standard & Poor's non-ratings businesses. Strong operational safeguards and policies are in place to ensure operational independence of Standard & Poor's credit ratings services, both in fact and in appearance. Standard & Poor's policies restrict its credit ratings analysts from engaging, directly or indirectly, in any Standard & Poor's activities with respect to its non-ratings businesses, including any cross marketing of non-ratings services. In addition, as mentioned, there are strict firewalls to protect confidential information given to credit ratings personnel and to prevent transmission to any non-ratings personnel.

Codes of Conduct. All Standard & Poor's credit ratings personnel are subject to both Standard & Poor's Credit Market Services Guidelines and Procedures and Code of Ethics as well as McGraw-Hill's Code of Business Ethics.

These codes of conduct and guidelines include standards designed to promote:

- independence and objectivity in the credit rating process;
- honest and ethical conduct, including policies aimed at minimizing potential or perceived conflicts of personal and professional interests;
- compliance with applicable governmental rules and regulations; and
- protection of confidential information and avoidance of insider trading.

Standard & Poor's credit ratings personnel are subject to specific limitations on securities ownership and prohibitions against relationships that may give rise to a potential conflict of interest in the conduct of the employees' credit ratings work. Employees and their immediate families cannot own securities in companies with which they regularly interact or vote on during rating committee meetings. Employees are required to report all securities ownerships, all securities accounts and other potential conflicts of interest annually and to report any changes in the employees' portfolio information or potential conflict of interest within five business days of the transaction or the event triggering the potential conflict. In addition, Standard & Poor's employees are subject to provisions in McGraw-Hill's policies that restrict any employee whose duties include reporting on an industry or evaluating securities from having any relations with companies in these industries in such a way that might compromise or appear to compromise the objectivity of the employees' reports or evaluations. These policies also mandate advance disclosure to supervisors of any such potential relationships.

Standard & Poor's Code of Ethics requires that all non-public information relating to an issuer or an issue obtained by its credit ratings personnel in the course of their employment be kept confidential. The Code of Ethics includes detailed guidance for the protection of confidential information. Strict firewalls have been implemented to ensure the confidentiality of non-public client information made available to Standard & Poor's during the credit rating process. Such non-public information is not made available or used by any other McGraw-Hill business unit or any other non-ratings business of Standard & Poor's, nor is it made available to any third party without the issuer's consent.

McGraw-Hill's Code of Business Ethics requires the reporting of violations to appropriate compliance personnel and Standard & Poor's Guidelines and Procedures require annual affirmation of compliance. Failure to comply with Standard & Poor's policies could be sufficient reason for disciplinary action, including discharge and possible legal sanctions.

Credit Rating Fees. Since 1968, Standard & Poor's has charged issuers for its credit rating services. The practice was implemented because of increasing costs related to credit ratings surveillance and the growing need for more ratings coverage. Prior to that, Standard & Poor's provided its credit ratings services on the basis of subscription fees, which were not adequate to offset the increased costs of maintaining a high level of quality in this business.

The Commission's recent public hearings on rating agencies support Standard & Poor's view that issuer payment of rating fees should not raise conflict of interest concerns. As noted in the SEC Rating Agency Report, participants in the Commission's public hearings on rating agencies generally "did not believe that reliance by rating agencies on issuer fees leads to significant conflicts of interest, or otherwise calls into question the overall objectivity of credit ratings."

As noted above, Standard & Poor's credit rating process is designed to limit the opportunity for an individual, for whatever reason, to compromise the independence and credibility of a credit rating. No portion of an analyst's compensation is directly dependent on the performance of specific companies that an analyst rates or the amount of fees paid by that specific company to Standard & Poor's. Further, the influence of individual issuers on Standard & Poor's is limited as Standard & Poor's does business with over 37,000 issuers.

Most importantly, the ongoing value of Standard & Poor's credit ratings business is wholly dependent on continued market confidence in the credibility and reliability of its credit ratings. No single issuer fee or group of fees is or would ever be important enough to risk jeopardizing the agency's reputation and its future.

Competition and the NRSRO Designation Process

Today, credit rating agencies of any size or expertise and applying a wide variety of methods are free to develop and publish what the Commission has recently characterized as their "opinion, as of a specific date, of the creditworthiness of a particular company, security, or obligation." (SEC Rating Agency Report at page 5) That process of deciding what credit rating to assign has repeatedly been held entitled to strong First Amendment protections. Courts have held that credit rating agencies perform First Amendment protected functions when gathering information in connection with their credit ratings process and that, as a consequence, their ratings activities are fully entitled to the protections of the First Amendment. This includes protections from compelled disclosure of documents related to their newsgathering activities and application of the heightened liability standards generally afforded to publishers. Indeed, it is Standard & Poor's key role as a publisher of credit ratings and financial information that has been the basis for judicial recognition of its significant First Amendment protections.

Although Standard & Poor's generally has not advocated the use of NRSRO ratings in legislation and Commission rules, it recognizes that neither the Commission nor any other authorities have found a practical alternative for evaluating credit risks associated with debt and other rated securities for use in regulations. Indeed, credit ratings were developed in response to the demand of private market participants in the securities markets, and as yet the capital markets have not developed a widely accepted alternative measure to make such distinctions.

Standard & Poor's was one of the original NRSROs designated by the Commission in 1976. Its designation was based on the Commission's recognition of the widespread investor acceptance of its credit ratings, reflecting the market's confidence in Standard & Poor's independence, objectivity, credibility and transparency.

Standard & Poor's believes that the marketplace benefits from a variety of credible sources of credit information, and that the focus of any Commission regulatory initiative with respect to credit rating agencies should be on addressing concerns about the lack of transparency in the process for designating NRSROs. Standard & Poor's has consistently supported a more open, transparent designation process that would codify an administrative process providing for public notice and comment on future designations.

Great care, however, must be taken in codifying the NRSRO designation process to assure that designation criteria are not defined in a manner that interferes with or compromises the independence of the credit rating process. The primary criteria for a credit rating agency to be designated as an NRSRO should continue to be its ability to demonstrate pre-existing market recognition and financial market use of its credit ratings. In demonstrating that it meets these marketplace criteria, a credit rating agency could show evidence of the significance of the credit ratings to specific participants or segments of the market, the extent of dissemination of its ratings among investors, issuers, intermediaries and other market participants, including analysts and the financial and trade media. For example, the credit rating agency could provide evidence of the nature and number of U.S. subscribers it has for its ratings, the number of ratings assigned annually, the number of issuers or others who request that ratings be assigned, as well as evidence that securities rated by the credit rating agency are owned or traded by U.S. investors who are aware of the credit rating agency's rating of such securities.

In addition, Standard & Poor's believes it would be appropriate for the Commission, as part of its NRSRO designation process, to review information bearing on the credit rating agency's independence, objectivity, transparency and credibility. In that regard, the Commission could review the credit rating agency's policies regarding conflicts of interest and protection of confidential information, its practices with respect to the publication of credit ratings, its rating definitions and general descriptions of its rating criteria and methodology, its code of ethics and default studies demonstrating the track record of its credit ratings. In addition, such review could include consideration of factors bearing on economic and political independence — for example, ownership and organizational structure and lack of dependence on key customers.

The NRSRO designation process and the criteria for designation should not involve the Commission in the conduct of an NRSRO's business, interfere with its credit rating processes or methodologies or impose regulated entity status on a designated NRSRO. In the past, the Commission has proposed to codify as designation criteria: staffing, financial resources and organization adequate to ensure credible ratings, use of systematic rating procedures and contact with senior executives of rated companies. Any proposed inclusion of subjective criteria relating to resources, fees, methodologies and processes would neither assure market credibility and acceptance of credit ratings nor, given their necessarily vague and subjective nature, enhance the transparency of the designation process. Moreover, such criteria could suggest a role for the Commission in setting minimum capital, organizational or staffing requirements for NRSROs and risk governmental interference in the actual credit rating process or rating judgments.

There is no one model or methodology for producing sound credit ratings. Resources, procedures and form of organization are simply tools to use to build market credibility and recognition. Commission mandates with respect to NRSRO operations or rating methodologies could strike at the heart of the independence of the credit rating process and interfere with the credit rating agency's ability to serve the capital markets effectively. The financial markets have greatly benefited from the robust and healthy competition among the various NRSROs, each of which possesses a varied and constantly evolving operational and personnel structure, methodology, business focus and pool of resources. The Commission should take care not to insinuate itself, directly or indirectly, into the operations of an NRSRO or implement an NRSRO designation process that results in homogenization of credit ratings through government-prescribed minimum standards.

Conclusion

Given the vital role played by credit rating agencies in the securities markets, Standard & Poor's recognizes that the Congress as well as the Commission has a legitimate interest at this critical time for the U.S. securities markets in reviewing the conduct of credit rating agencies to ensure that the integrity of the credit rating process is not influenced by conflicts of interest, abuse of confidential information or other dishonest or fraudulent conduct. Standard & Poor's expects that upon completion of these reviews, the Congress and the Commission will find that the independence, objectivity and integrity that have been the hallmark of the U.S. credit rating industry have not been compromised.

Over the last century, credit rating agencies have served the U.S. capital markets, and, indeed, the capital markets around the world extremely well; the market's acceptance of their integrity, independence, objectivity and credibility has been critical to their valuable role in developing the market. Continuing this important role and extending the benefits of independent, credible rating services internationally, requires great care by the Congress and the Commission to assure that any legislative or regulatory initiative continues to preserve the independence of credit rating agencies and recognizes the market as the best judge of a credit rating agency's quality, objectivity and independence.

There is no demonstrated abuse or market failure that warrants abandoning the regulatory approach that has served investors' and the market's interests so well for so many years. Direct regulation or use of NRSRO designation criteria by the Commission that suggests a substantive role for government in the business operations of credit rating agencies or the substantive rating process are likely to be followed by other markets and implemented in a manner that results in a governmental intrusion into the actual rating process — a result that could erode the independence and, consequentially, the credibility of credit rating agencies.

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