S. HRG. 111–341

EXAMINING PROPOSALS TO ENHANCE THE REGULATION OF CREDIT RATING AGENCIES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

THE EXAMINATION OF THE PROPOSALS TO ENHANCE THE REGULATION OF CREDIT RATING AGENCIES

AUGUST 5, 2009

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C O N T E N T S

WEDNESDAY, AUGUST 5, 2009

WITNESSES

Additional Material Supplied for the Record

EXAMINING PROPOSALS TO ENHANCE THE REGULATION OF CREDIT RATING AGENCIES

WEDNESDAY, AUGUST 5, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 9:34 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order, and thank you, Secretary Barr, for being with us, and I thank my colleagues for being here this morning. The title of our hearing this morning is "Examining Proposals to Enhance the Regulation of Credit Rating Agencies," and let me just say briefly—I want to make a few brief opening comments, then turn to Senator Shelby and, with the approval of my colleague from Alabama, ask Jack Reed if he wants to make a quick opening—he has done a tremendous amount of work on this, as has Senator Shelby, by the way—some opening comments on this as well. We had planned to do this at the subcommittee level, but there was such interest in the subject matter that we made it a full Committee hearing.

I should just point out to my colleagues, beginning in March of 2006, under the leadership of Senator Shelby, we had a hearing in March on this subject matter, in September 2007, when I became Chairman, on the rating agencies. We had a hearing on the rating agencies April 22, 2008. We had hearings on March 10th and March 26th; they were broader hearings, but we spent a lot of time on the rating agency subject matter. So over the last 3 years—one, two, three, four, five—this will be the sixth hearing that focused a lot on rating agencies.

This will be our last hearing before coming back in September, and I just want to thank not only my colleagues, I want to thank our staffs. We have worked it pretty hard on this thing here. This is, I think, our 29th or 30th hearing since January 20th, and just this week alone, we had two. We have had 15 hearings on this subject matter alone in the last 4 weeks. And I know that is exhausting for staff, who have worked very hard for these things, and Members, I know with all the other work we have and all the other discussions going on, but it has been tremendously worthwhile, and virtually all of these have been to try and determine what is the best course for us to follow as we try and craft what will be maybe the most important piece of legislation this Committee will deal with or has dealt with in decades, and that is the modernization of financial regulations.

So it has been tremendously worthwhile, and I want to thank our witnesses as well, from the Administration as well as the private sector and academia and others who have come before the Committee. There are literally dozens who have who have shared their thoughts and ideas, and we are all very, very grateful for that input as we will now begin the process of trying to take those ideas and incorporate them into some sound legislative proposals.

Senator Shelby and I are determined to have this be a very inclusive process. For all of our colleagues who are interested, you are invited to be at that table as we try and bring these ideas together and come out with a proposal that we all can embrace. And there will be points when we will have some disagreements, I am sure, but at least as I have listened to all of this, I think we are going to be in agreement far more than disagreement on matters, and I find that very encouraging as we go forward.

So I wanted to share those thoughts, and I will ask the consent that the list of our hearings over 2009 be included in the record for those who may want to see it [*Ed. Note:* The list of hearings is provided on p. 124 in the Additional Material section of this hearing].

On the subject matter before us today, let me just say that this hearing on rating agencies—and, again, others may have different views on all of this, but there are two areas, we all know, that share in culpability for all the problems that we have seen unfold in our economy. But two areas alone I think deserve special recognition for the problems. One was, of course, the failure to regulate these brokers who were out marketing and promoting products that they knew were going to create a problems, that there was no way the borrowers were going to be able to meet the fully indexed price of these mortgages, and yet were luring people into it, getting paid, and selling off, and, of course, covering themselves financially, but literally knowing full well that this was going to create a bubble that was going to come back to haunt us. And the second is the rating agencies. This is to me stunning in a way that agencies that hold themselves out—in fact, I was looking this morning, just sharing with Senator Shelby here, and I will not—this is not the witnesses before us today that it fits, but a major rating agency—and let me just read—this is the Web site this morning. This is not the Web site of 4 years ago. The top of the Web site, the name of the agency: "Independent credit ratings, indices, risk evaluation, authoritative, objective, and credible." I mean, in a sense, first of all, risk evaluation, all they were doing is being paid by the very people they were rating. Never bothered to do due diligence at all to determine whether or not these products were as creditworthy as they were claiming to be. And yet still to this day it is suggesting somehow that they are independent, conducting risk evaluation at all. Quite the opposite.

And so this is an area where I think there is a lot of shared views on what we need to be doing. You will hear about that. But I was just this morning asked to pull up this Web site, and once again find that, despite all that has been said, despite six hearings on the subject matter—and none of us have yet the simple, quick answer on how we move in a different direction. But, clearly, the present situation cannot last.

So this is an area which will clearly be a part of our legislation and one that is deserving of some real attention in the coming days. But, again, I thank my colleagues for their work on this subject matter, and they ought to be—these companies need to be providing independent research and in-depth credit analysis on their Web sites, which is not the case today.

So let me turn to Senator Shelby for some opening comments and then Jack Reed for any thoughts he has, and then we will get to our witnesses.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

The nature of today's credit rating industry reflects decades of regulatory missteps rather than market preferences. Over the years, the Government granted special regulatory status to a small number of rating agencies and protected those firms from potential competitors.

Beginning in 1975, the Securities and Exchange Commission began embedding NRSRO ratings into certain key regulations. Once credit ratings acquired regulatory status, they crept into State regulations and private investment guidelines. The staff of the SEC controlled access to the prized National Recognized Statistical Rating Organization, or NRSRO, designation by subjecting potential entrants to a vague set of criteria and an incredibly slow timeline. The SEC did little to oversee the NRSROs once so designated. Nevertheless, because of the doors they open, ratings from an NRSRO became an excuse for some investors to stop doing their own due diligence that Senator Dodd alluded to.

Widespread overreliance on ratings meant that the effects of poor quality or inadequately updated ratings could ripple through the markets. By encouraging reliance on a small number of big credit rating agencies, bureaucrats at the SEC exposed the economic system to tremendous risk.

Our current financial crisis, which was caused in part by the credit rating agencies' failure to appreciate the risk associated with complex structured products, demonstrates just how big that systemic risk was. The troubles caused by the SEC's flawed regime, however, did not come as a surprise. Several years ago, when I was Chairman of this Committee, we acted to address the problem after the SEC failed to take action on its own. I felt then that the industry's heavy concentration and high profits were symptoms of an industry in serious need of reform.

We then passed the Credit Rating Agency Reform Act of 2006, as Senator Dodd mentioned. The act set forth clear standards for the NRSRO application process. It also gave the SEC authority to regulate disclosures and conflicts of interest, as well as unfair and abusive practices. Unfortunately, the law we passed in 2006 did not have time to take root before the problems that they were intended to remedy took their toll.

The SEC adopted rules pursuant to that legislation in June of 2007. Over the following months, the number of NRSROs doubled, just as the performance of many highly rated subprime securities revealed that such securities were not as safe as the rating agencies said they were. Today, we will consider a legislative proposal by the Administration and others to revisit the regulation of credit rating agencies.

In determining whether new legislative steps are required, I believe we should keep in mind that the 2006 reforms are still working their way through the system. That does not mean, however, that we should not consider further changes. Every option should be on the table. One option is to remove rating mandates from regulations. Another is materially improving disclosure. As with any regulatory reform, however, we must also be mindful of unintended consequences.

I strongly believe that the credit rating agencies played a pivotal role in the collapse of our financial markets. Any regulatory reform effort must take that into consideration, and I believe we will.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Shelby. And as I mentioned, I want to commend our colleague and the former Chairman of the Committee. Senator Shelby really was early on involved in the subject matter. He and Paul Sarbanes I think worked together on that matter and did great work. He has been followed in that effort by Jack Reed, and I want to thank Jack publicly here for, as the Subcommittee Chair, dealing with these matters, and he has worked very, very hard in developing some legislative proposals which we invite all of our colleagues to take a look at and to consider as part of our overall financial modernization bill. But he has been tremendously helpful, and I want to again publicly thank Jack Reed for his work.

Jack, any thoughts on this?

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you, Mr. Chairman. I want to thank you for not only holding this hearing, but also your efforts to reform financial institution regulation.

I particularly want to commend Senator Shelby because it was his leadership really in 2006 that first gave the SEC the clear authority to begin to regulate the credit rating agencies. In effect, the credit rating agencies are so central to investor decisions that it is comparable to the Good Housekeeping Seal of Approval. To expect a municipal finance director in a small town to be able to do due diligence, to make sure he has the AAA rating, is asking a lot. So we depend significantly on the rating agencies, and as evidence suggests, part of our current economic problems were a result of ratings that were not substantiated over the long run.

What I believe we have to do is to give legislative support to the SEC's efforts to focus on transparency through enhanced disclosure, and also to counteract the appearance or substance of conflict of interest. And the legislation that I propose and in many respects that is reflected in the Administration's proposal would do that.

There is one other issue that I have included in my legislation; that is, to change the pleading standard in securities cases so that a plaintiff could at least reach the discovery stage with respect to a credit rating agency to see if, in fact, their behavior was reckless. And we do not change the overall 10(b)-5 standard, which is a very,

very high bar for liability. But effectively today, under the securities laws, it is very difficult for a plaintiff to even get to discovery to see what, in fact, went on with the rating. And I think this was something that we should pursue.

Mr. Chairman, thank you and I look forward to the witnesses.

Chairman DODD. Thank you very much, Senator Reed, and we thank you again for your work in this matter. We look forward to your questions, again. And as I said at the outset, instead of helping people understand risk, it was hiding risk, in effect, too often and relying on the people who paid their salaries. And it has much to do with the market failure as anything else I can think of, the rating agencies, and the dependency that people had on them. So, clearly, there is a need for our attention.

So, with that, Mr. Barr, Mr. Secretary, we look forward to your testimony.

STATEMENT OF MICHAEL S. BARR, ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS, DEPARTMENT OF THE TREASURY

Mr. BARR. Thank you very much, Chairman Dodd, Ranking Member Shelby. It is a pleasure to be back here today with you and the other Members of the Committee to talk about the Administration's plan for financial regulatory reform.

As you know, on June 17th, President Obama unveiled a sweeping set of regulatory reforms to lay a foundation for a safer, more stable financial system. We have sent up draft legislation for your consideration in most of the areas covered by that proposal, and in the weeks since the release of those proposals, we have worked with you and your staffs on testimony and briefings on a bipartisan basis to explain and refine the legislation.

Today, I would like to focus on credit ratings and credit rating agencies and the role that they played in creating a system where risks built up without being accounted for or properly understood, and how these ratings contributed to a system that proved far too fragile in the face of changes in the economic outlook and uncertainty in our financial markets.

This Committee has provided strong leadership to enact the first registration and regulation of rating agencies in 2006 under Senator Shelby's leadership, and Chairman Dodd, Ranking Member Shelby, Senators Reed and Bunning have continued that tradition going forward. The proposals that I will discuss today build on that already strong foundation of this Committee's work.

It is worthwhile to begin our discussion of credit ratings with a basic explanation of the role they play. Rating agencies solve a basic market failure. In a market with borrowers and lenders, borrowers know more about their own financial prospects than lenders do. And especially in the capital markets, where a lender is likely purchasing a small portion of the borrower's debt in the form of a bond or asset-backed security, it can be inefficient for all lenders to get the information they need to evaluate the creditworthiness of the borrower. Lenders will not lend as much as they otherwise might, especially to lesser known borrowers such as smaller municipalities, or they will offer significantly higher rates. Credit rating agencies provide a rating based on scale economies, access to information, and accumulated experience.

At the same time, credit ratings played a key role, a key enabling role in the buildup of risk in our system and contributed to the deep fragility that was exposed in the past 2 years. The current crisis had many causes, but a major theme was that risk—complex and often misunderstood—built up in ways that supervisors, regulators, market participants did not, could not monitor, prevent, or respond to effectively. Rapid earnings from growth driven by innovation overwhelmed the will or the ability to maintain robust internal controls and risk management systems.

Rating agencies have a long track record evaluating the risks bonds, but evaluating structured financial products is a fundamentally different type of analysis. Asset-backed securities represent a right to the cash-flows from a large bundle of smaller assets.

Certain asset-backed securities also rely "tranching"—the slicing up of potential losses—and this process relies on quantitative models that can produce and did produce any desired probability of default. Credit ratings lacked transparency with regard to the true risks that a rating measured and the core assumptions that informed the rating and the potential conflicts of interest in generating that rating. This was particularly acute for ratings on asset-backed securities, where the concentrated systemic risk are quite different from the more idiosyncratic risks of corporate bonds and are much more sensitive to the underlying assumptions.

Investors relied on the rating agencies' assessment of risk across instruments, and they saw those risks as remarkably similar, despite the complex and different securities underlying the assets.

Ultimately, this led to serious overreliance on a system for rating credit that was neither transparent nor free from conflict. And when it turned out that many of the ratings were overly optimistic, to say the least, it helped bring down our financial system during the financial crisis.

We do need fundamental reform. The Administration's plan focuses on a series of additional measures in three key areas: transparency, reduction of rating shopping, and addressing conflicts of interest. It recognizes the problem of overreliance and calls for reducing the ratings usage wherever possible.

With respect to transparency, we would call first for better transparency in the rating agency process itself as well as stronger disclosure requirements in securitization markets more broadly. We would require transparency with respect to qualitative and quantitative information underlying the ratings so that investors can carry out their own due diligence more effectively.

Mr. Chairman, I see that my time is up. Would you mind if I take a couple more moments to outline the key proposals?

Chairman DODD. No. Go ahead.

Mr. BARR. Second, the use of an identical rating system between traditional corporate bonds and structured financial products allowed investors to use their existing standards with respect to ratings and allowed regulators to use existing guidelines without the need to consider the different risks posed by structured and unstructured products. Our proposals address this directly by requiring that rating agencies use rating symbols that distinguish between structured and unstructured financial products. The first point, transparency.

Second, on rating shopping, an issuer may attempt to shop among rating agencies by soliciting preliminary ratings from multiple agencies and enlisting the agency that provides the highest one. Our proposal would require instead that an issuer disclose all of the preliminary ratings it had received from different credit rating agencies, so investors could see how much the issuer had shopped and whether his final rating exceeded one of those preliminary rating. That should help deter rating shopping in the first place.

In addition, the SEC has proposed a beneficial rule that would require agencies to disclose the rating history so that markets can assess the long-term quality of ratings.

In addition, we strongly support a proposed SEC rule that would require issuers to provide the same data they provide to one credit rating agency to all other credit rating agencies to allow those agencies to provide additional independent analysis to the market and to improve the ability of competition in the marketplace in a beneficial, positive way.

Third, with respect to conflicts of interest, strong new transparency requirements with respect to payments, we would in addition ban rating agencies from providing consultant services to issuers that they also rate, and each rating agency would be required to disclose the fees that they were paid for a particular rating, as well as the total fees paid to the rating agency by the issuer over the previous 2 years.

Last, we need to strengthen and build on SEC supervision with a dedicated office focused on compliance and a requirement that the SEC evaluate the rating agencies' compliance with their own rules and their own methodologies.

In conclusion, we all know that markets rely on faith and trust. We need to restore honesty and integrity to our financial system, and the plan that we have set forth before you for consideration would lay a new foundation for financial regulation that, in our judgment, will once again help make our markets both vital and strong.

Thank you.

Chairman DODD. Well, thank you very much, Secretary Barr. We appreciate that very much. And let me just say we appreciate very much as well the Administration's continuing conversation with us in this Committee about your ideas. We welcome them. I know I speak for all of us here, Senator Shelby and I particularly. We look forward each week to the ideas that come up and the thoughts that are coming from the Administration, as well as from others. As I said earlier, this is a Committee that is open, and it is a dynamic process that we want to hear ideas as to how we ought to move forward.

But let me begin by raising the issue of, given the problems caused by faulty ratings and the need for strong Federal oversight—I think we have all come to that conclusion. The question is how do you do this. We all recognize the problem. Now what is the answer? And there are a lot of different views on what the answer ought to be.

In fact, I was just saying to Senator Shelby, I have talked to some people in the private sector who begin to raise the question of whether or not you even need ratings agencies. Today, given more transparency, the market in many ways could help you determine whether or not a given product is actually worthy of a AAA rating or something less than that. So there is an argument of saying maybe this is an archaic structure, although I do not believe that is a widely held view. There are those who embrace that view.

But I wanted to share with you a view that has been held by some in direct conflict with the proposal that the Administration has given us, and that is to create a new office within the SEC to conduct the oversight of rating agencies.

The Council of Institutional Investors' white paper that was prepared by Professor Frank Partnoy recommends creating, and I quote, "a single independent credit rating agency oversight board" to oversee registration, inspection standards, and enforcement actions related to the NRSROs, similar to the Public Company Accounting Oversight Board for accountants. Such an independent board could offer higher salaries to attract staff with greater expertise. Others have observed that the regulation could be moved to a systemic risk regulator, authority.

Please describe, if you would, how the Treasury determined which regulator among these options would be best to oversee the credit rating agencies. How is it you came to the SEC choice?

Mr. BARR. Mr. Chairman, I think that historically the SEC has had important functions in this area. This Committee's action under the leadership of Senator Shelby enhanced that authority to the SEC. We were attempting to build on that basic foundation in our legislative proposal.

Under our proposal, the SEC could delegate some of those functions to the Public Accounting Board as a way of recognizing their expertise. In our judgment, the SEC is able to attract quite highly talented individuals in this area, and having a dedicated office focused on this would advance the mission.

Chairman DODD. I want to raise a question here with you, which I was stunned by the question because I just assumed that this went on, but apparently it does not.

Credit rating agencies, I am told and they state, they do not undertake to verify the information that issuers provide them in making rating. This has led, obviously, to a perception among some that the rating agencies take the issuer's statements at face value and can choose to ignore other information they receive or are aware of about the issuers when producing a rating.

Do you feel it would be appropriate to require rating agencies in formulating their ratings to consider information that they receive about an issuer and find credible from outside sources? What I find stunning is I just assumed that went on. I am told it does not. So this is sort of a—I am answering my own question. But tell me why you think there should be a different answer than the one that I am suggesting in my questioning.

Mr. BARR. I would never be so foolish.

[Laughter.]

Mr. BARR. I hope.

Chairman DODD. You should not feel shy. Others do all the time.

Mr. BARR. So let me just say, we tried to draw a line in our proposal. We have tried to be quite clear that the Government should not be in the business of designing the methodologies for the rating agencies or validating them in any way, because we think that will just increase reliance on them.

We have been quite clear that they need to disclose whatever due diligence they do so that there is transparency so that investors know when they get a rating—the rating company would say, "We didn't do any due diligence on this rating," or the rating company would have to say, "The due diligence we did consisted of calling our buddy." Or hopefully when the transparency kicks in, the rating agency would have to say, "We did real due diligence. We had a third party, and they can certify they actually checked loan files."

And I think that with that level of transparency, it will be very hard for—harder for rating agencies to continue a practice of—at least a mixed practice with respect to the kind of due diligence they have done.

Chairman DODD. You said something in the first sentence or two in your answer to my question that we do not want to dictate or require rating agencies to conduct their due diligence. Forgive me, but I do not understand what you are saying at that point. If we do not require them to do due diligence, if we do not require them to at least consider information, credible information that may contradict the information they are receiving from the issuers paying them, how can we have any confidence if we do not require that as a matter of public policy?

Mr. BARR. I think there is room for lots of reasonable people to disagree about exactly where to draw the line on methodologies, Mr. Chairman, but I think the key principle is we want to be sure that there is transparency about whatever methods they used. We want to make sure that the SEC can examine whether the agencies have actually used the procedures they say they are using.

Chairman DODD. They say they are using, they say they are relying on the issuer, the one who is paying them. They can have all the transparency in the world. You telling me that you are relying on that information and that constitutes due diligence does not give me a great deal of confidence.

Mr. BARR. It does not give me any confidence, sir. I am not suggesting that. But I think that we should not inflate the confidence level that the rating agencies would have on the basis of that level of due diligence, and if the investor community can see, is required to be shown that the kind of due diligence that is being conducted is not really the diligence that ought to be due, I think it will have a significant salient effect on the process.

Chairman DODD. Senator Shelby.

Senator SHELBY. Secretary Barr, it would take a long stretch, wouldn't it, to bring a lot of confidence back into what we feel has been lost with the rating agencies, would it not?

Mr. BARR. I would agree with that, sir.

Senator SHELBY. Secretary Barr, S&P, Moody's, and Fitch have not, in most people's eyes, performed well in recent years. I think that is probably an understatement. Nevertheless, the SEC has ebbed a persistent confidence in these three firms—three firms—a sentiment that manifests itself in regulatory requirements that blessed the organizational structure, approach to ratings, and payment scheme of those firms. There seems to be similar bias in your draft legislation. I hope not.

What steps, if any, did you take, you and your team, to ensure that no particular organizational structure, approached to ratings, or payment model was favored over another and that the regulatory structure will accommodate innovative entrance into the rating? I have always advocated, gosh, three firms nominate—they do not have it all, thank God, have all the business, but there has not been enough competition there. You know, why should you just bless three firms?

Mr. BARR. Senator Shelby, we would agree with you there should be competition in this space, more entrants into the market. They should be done on a level playing field. We should have a diversity of approaches to a business structure so you have investor-pay and issuer-pay models that need to be accommodated in the system. And I think all that is absolutely critical.

Senator SHELBY. Something has gone wrong. We both agree with that. And so what we are trying to do is have a basic new approach to it to try to bring more transparency, a lot of transparency, eliminate conflicts of interest and all these things that were so rampant in this business. Do we agree on that?

Mr. BARR. Yes, I think those fundamental principles are embedded in our legislation. We would be in agreement about that.

Senator SHELBY. How is the decision to leave the NRSRO ratings embedded in the regulatory framework consistent with the goal of not affording regulatory privilege to a large entity?

Mr. BARR. Senator, I think that we share the goal of reducing reliance, both by private investors and by public regulators, on the rating system. And in our judgment, that requires methodically and carefully going through each way in which rating agencies' ratings are used by different regulators in different contexts.

There may be some areas where you can reduce reliance. There may be other areas where you can eliminate reliance. There may be some areas where you can use the rating but you have to require—you should require judgment, independent judgment, on top of that. And each of those contexts is quite, in our judgment, specific. We want to work our way through it. We are committed to doing that. The President's Working Group of Financial Markets has a team that is looking at this issue, again, regulation by regulation.

Senator SHELBY. Do you believe that one of the priorities at the SEC—one of the priorities, they have a lot—should be to straighten out the problems that we all deem necessary with the rating agencies?

Mr. BARR. I think it is one of the top priorities in reform, along with making sure we have resolution authority——

Senator SHELBY. Absolutely.

Mr. BARR. ——making sure we have a way of reducing systemic risk in the system and protecting consumers. So I think it is a critical part of the overall package.

Senator SHELBY. Heretofore, one of the factors that led this Committee to act in 2006 legislatively was the fact that the NRSRO policy decisions were being made at the SEC at the staff level rather than the Commission level, as you well know. Freestanding offices at the Commission, such as the Office of Compliance, Inspections, and Examinations, have not always been subject to the same level of scrutiny as the main divisions. You propose an office to be created, as I understand it, at the SEC dedicated to the NRSRO supervision. How would you ensure here sufficient accountability to the Commission, to the Securities and Exchange Commission?

Mr. BARR. Senator Shelby, that is an issue I would be happy to continue to work further with you and the SEC on. In our judgment, having a dedicated office would increase accountability to the Commission and to the Congress because you would know exactly who is responsible for that job.

Senator SHELBY. My last question, and my time is about up, you also propose—your proposal would authorize the Securities and Exchange Commission to delegate reviews of NRSROs to the Public Accounting Oversight Board. What is the PCAOB's expertise that makes it uniquely qualified for this task, and would you recommend that the PCAOB Board be structured to reflect the new responsibilities?

Mr. BARR. Senator, the——

Senator SHELBY. They are getting into a new field here, would they not?

Mr. BARR. There may be elements of supervision that could be delegated with respect to accounting methodologies and other matters, where they do have expertise. We have not considered restructuring the Board to accommodate that. I would view that as an available option to the SEC, but not integral to the proposal.

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman.

Thank you, Mr. Secretary. The issue that Chairman Dodd raised with respect to due diligence is embroached by the second panel, Professor Coffee and Mr. Joynt on behalf of Fitch. One suggests that we instruct—Professor Coffee—neutral clients and other institutional investors that they cannot rely on ratings to meet their fiduciary obligations unless there was, in fact, third-party due diligence. Mr. Fitch's approach is to ensure that the issuers and underwriters perform such due diligence. Do you have a position with respect to these two views or another view?

Mr. BARR. The Administration hasn't weighed in on the question whether there should be additional requirements outside of the rating agencies with respect to the purchasers of rated securitizations. I think that we would want to be careful, again, not to take steps that would suggest excessive confidence in the ratings themselves, and anything that we can do that improves due diligence by investors is likely to be in the right direction. But whether that needs to be a requirement on the purchaser or not, I frankly have not formed a developed view.

Senator REED. One of the aspects of the legislation I proposed is to at least adjust the pleading standards and effectively, a private right of action would be, I think, a stimulus for a lot of due diligence. Is that your position?

Mr. BARR. In our judgment, this presented a complicated question. On the one hand, the changing the pleading standard might increase the incentives for due diligence in the system. On the other hand, we were concerned that such a standard might increase reliance by the investor or public on the rating agencies and may provide further avenues for issuers to sue over corporate downgrades, which we thought would potentially pose a problem in the system. So in our judgment, this was a very close question and we did not include it in our legislative proposal.

Senator REED. Thank you. Mr. Joynt, on behalf of Fitch, in his testimony says a mandatory registration concept—your concept—is unnecessary and unwarranted, is not consistent with basic free speech principles. And then Rapid Ratings' testimony predicts that the proposal will force compliance costs, raise barriers to entry of new rating agencies, and essentially impede technology and innovation. How would you respond to these, first, that mandatory registration is unnecessary, and second, to——

Mr. BARR. In our judgment, the credit rating agencies shouldn't be able to opt out of having high standards and a level playing field. Consistent with our overall approach to financial regulatory reform, we don't think that financial institutions, credit rating agencies, or other participants in the system should get to choose their regulator or not. And so in our judgment, having high standards, a level playing field for competition was really important. I think, on the basis of the 2006 legislation, there is in place a system for encouraging new entrants into the credit rating agency process. Registration is not going to be a significant barrier to entry. We think competition is a good idea in this space if it is on a level playing field with high standards so there is no race to the bottom, the competition is based on everybody playing by the same rules.

Senator REED. Finally, Mr. Secretary, in the testimony of the succeeding panel, there is a question by Rapid Ratings about the rating symbol, distinguished between structured and nonstructured products. They suggest the problem is not that investors did not know they were buying structured products. They either knew and were happy to get the higher yield or they didn't understand the risks that they were buying. Essentially, the problem, they suggest, is not symbology, but accuracy. Again, how would you respond to that proposal?

Mr. BARR. I think the rating of a structured product is a fundamentally different exercise from the rating of a corporate bond. The distinguishing features need to be noted. It is not just the symbol that is used, but the underlying availability of qualitative and quantitative information that we would require disclosure on. The package of those reforms, I think, will enhance transparency in the market and make it less likely that garbage ratings can be invented.

Senator REED. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Corker.

Senator CORKER. Mr. Chairman, thank you, and Senator Reed, thank you for all of your effort in this regard.

Mr. Barr, thank you for being here. You are a very pleasant guy and I am hoping that over time, we will get this all in balance. I want to say, though, just in listening to testimony, it just seems a little schizophrenic in that this was the biggest regulatory failure in 30 years, and in essence, regulators outsourced their regulation to three for-profit entities. I mean, that is really what has happened here. We obviously realized they were doing no due diligence and basically taking what the issuers were saying.

In testimony in answering just a minute ago, you said that the Federal Government should not be in the business of designing what these guys do. But on the other hand, as it relates to consumer protection, you guys want to design the products that private companies are offering. I just find this almost an out-of-body thing. When we are looking at trying to fix the inconsistencies that led to this, on one hand, we are doing almost nothing but transparency, OK. On the other hand, we are getting into actually telling companies what products they are going to offer. This is just sort of an imbalanced approach, and I don't want to spend long on that, but I wonder if you want to rebut that at all.

Mr. BARR. Yes, Senator. You and I have had this exchange on previous occasions. In our judgment, we are not suggesting that the Government is going to be in the business of designing products. The legislation provides the authority to say there is a product in the marketplace that is a standard product, a 30-year fixed-rate mortgage or a 5–1 ARM, and when a customer is being offered a pay option ARM, the mortgage broker should show them——

Senator CORKER. And I understand all that——

Mr. BARR. ——what a 30-year fixed-rate mortgage looks like. And so we are not in the business of designing that product, either. We are saying there is a product in the marketplace and it is the standard product. How do we judge those?

We have, in that context, a large group of individuals who are not sophisticated investors, market participants. It is a fundamentally different context from the context of credit rating agencies, where the basic backdrop is the institutional investor market and sophisticated retail investors' participation. And so you would want to come up with standards that are appropriate to each of those marketplaces.

Senator CORKER. Well, I appreciate that. I do see, though, that you are basically keeping the same regulatory scheme and process and making people rely or pay for these.

Let me go down a little different path. Eric Dinallo, who is the Insurance Commissioner in New York, or has been up until recently, suggested that instead of the kind of scheme that we have now, since insurance companies in particular rely heavily on ratings, that the insurance entities in these States should actually pay for the ratings and they should be made available to all. That way, if credit rating agencies don't perform properly, they would be discarded. But in essence, it would be a whole different way of looking at it. Now, that may not be perfect, but I am just wondering if that kind of thinking makes any sense from your standpoint.

Mr. BARR. I do think it makes sense to have a diversity of payment models and investor-pay models and issuer-pay models. I think investor-pay models have some downsides once the rating occurs. There are concerns that the investor would have incentives to avoid downgrades on their own holdings. But I do think having a diversity of views, a diversity of approaches within the same basic legal structure makes a lot of sense.

I think we need to reduce reliance by regulated entities on ratings, but I think it is going to take the process a good bit of time to figure out how to replace that function in the regulatory structure with alternative judgments that can perform a similar function.

Senator CORKER. You know, I have issued bonds in the past and have had rating agencies rate them. I do want you to know all of them were paid in full.

[Laughter.]

Senator CORKER. But it is kind of an interesting process that you go through. I mean, you really do sort of look for the entity that is going to give you the rating, and then you pay them an up-front fee. And then, as the borrower, you sweat bullets ensuring you could pay everything back over time. I do wonder——

Mr. BARR. That is very old fashioned of you, Senator.

Senator CORKER. Yes. Thank you for that, actually.

[Laughter.]

Senator CORKER. I do wonder whether we should consider a different payment mechanism, where in essence the credit rating agencies have skin in the game over time. And then instead of being paid up front, they are paid based on how it performs. We have talked about that a little bit with mortgage brokers and others who have had no skin in the game. And I wonder if you might comment on that.

And I think some folks, some colleagues in the other body, on the other side of the aisle, have actually been promoting something called covered bonds, where in essence, instead of getting all of this risk off banks' balance sheets, they in essence are in the game all the way through. I wonder if you might comment on those two, and thank you for your testimony. In spite of some of the differences we have, and there is not time to enumerate all those right now, I do look forward to working with you and others to come up with something that is in the middle of the road.

Mr. BARR. Thank you, Senator. I think both suggestions hold out very good promise. One of the features of our legislative proposal would be to give the SEC authority to require trailer payments of the kinds that you have described for credit rating agencies. I think it is a terrific suggestion. And I think there is also enormous work that can be done with covered bonds. It is not going to be a replacement for securitization, but I think it is an additional promising avenue we would be happy to work with you on.

Senator CORKER. Thank you.

Chairman DODD. Thank you, Senator.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman.

I know a lot of my colleagues have brought up a number of the failings of the rating agencies, and clearly, in some of the products lines recently, that has been the case. This is perhaps non-PC, this point, but there has been value from the rating agencies. I think back in my tenure as Governor, and I think Senator Johanns would agree, there was sometimes validity in the rating agencies when you were looking at State bonds and others, that they did provide that independent arbiter service to kind of cut through the political clutter of both sides back and forth so somebody could come in and to some level of diligence, at least, assess what your State was doing or your locality was doing over a short-term or a long-term basis.

We did find usage of the rating agencies, that they did do due diligence, something that clearly I find what the Chairman and Senator Reed and Senator Shelby said is pretty amazing, as well, that they did not in so many of these corporate circumstances—although again, the idea of legislating that requirement, I think, Mr. Barr, you have raised some appropriate concerns about, because would that enhance, put that Government moral hazard thing that we all don't want to extend to a whole new set of organizations in terms of the rating agencies.

I want to ask two questions. One is, we have had mostly the issuer-paid funding model. The Administration's proposal is that an investor-paid funding model. I know certain investor-paid models are starting. Do you really think that marketplace approach, with the investor-funded rating agencies—I am asking you to make a prediction here now—do you think it will be successful? Do you think the market will respond to that?

Mr. BARR. I think there is an opportunity, Senator, to have a structure that has both models, investor-pay and issuer model, exist and thrive if there is the appropriate regulatory backstop of a level playing field. I think that the initiative to require an issuer to provide the basic information to all credit rating agencies when it provides it to one, so there can be true dissemination of information, true competition, will help significantly in this regard if moved forward. And having a level playing field for that kind of competition on the basis of high standards and meaningful disclosure, I think there is an opportunity for that model to work.

I think, frankly, we have so many challenges right now in restarting our financial markets, our securitization markets, and in laying a new foundation that it is not clear yet——

Senator WARNER. I didn't make a prediction, and I do understand this question of whether we should be blessing the methodologies. It is a real hard issue.

Let me, with only a minute-and-a-half left, go to my other question. You know, one of the things that we use these terms, Triple-A, Double-B, what have you, but one of the things that I have felt that investors have not had, and I am not sure I have had as somebody who has been on the issuer side and on the investor side, that we have ever kind of translated that into, all right, what does that mean in terms of the actual percentage chance of default, number one, or the second category, even if there is a default, what percentage of my investment could be truly in jeopardy, and should we, as we think about these terms, think about at least putting some commonly accepted standards around for investors.

You have got a Triple-A. What is your percentage of default risk? What percentage of your investment are you potentially going to lose—ten percent, 50 percent, 100 percent? We have started to talk a little bit about here between structured products and unstructured products, but should we actually try to translate these letter-grade ratings into actual percentage of risk of default or risk of amount of loss?

Mr. BARR. Yes, Senator. I think that is absolutely critical to demystifying the process, making it more transparent. In our proposal, we fully agree with you. There should be, in addition to the rating, a report that describes the probability of default, the loss given default, the variance, the reliability of the data, the underlying quality of the asset, all the information underlying the symbol so that investors in the market can make better judgments about how to evaluate the rating itself.

Senator WARNER. We would know what a Triple-A rating equates to, what a Double-B rating equates to in terms of both percentage chance of default and, you have got $100 invested, what percentage of that $100 you could lose if that default takes place——

Mr. BARR. That is right, and on an individual securitization basis, so you would be making a judgment——

Senator WARNER. All the way down to an individual securitized——

Mr. BARR. Correct.

Senator WARNER. Thank you, Mr. Chairman.

Chairman DODD. Very good question, Senator. Thank you very much for your thoughts on that.

Senator Johanns.

Senator JOHANNS. Thank you, Mr. Chairman.

Secretary Barr, good to see you again.

Mr. BARR. Good to see you.

Senator JOHANNS. I will say something that I think you will find very unusual. My colleague from Virginia was talking about working with the rating agencies as Governor. In our State, the State of Nebraska, we have no debt. I never worked with a rating agency in all the 6 years I was Governor because it wasn't relevant. We paid for everything, even highways. So that is one way of approaching this. Then you don't need rating agencies. Kind of an unusual phenomena that to pay for things, you would actually have two choices, cut spending or raise taxes, and we could use more of that out here in Washington.

But I did work with rating agencies as Mayor of Lincoln as we would issue bonds.

Let me ask you a little bit maybe of a mundane question, but maybe an important question. As you know, there has been, especially recently, some articles written about First Amendment protection for rating agencies. Historically, it was viewed that they were issuing an opinion and therefore they had the protection of the First Amendment if they were sued.

As you move down this pathway of additional regulation or, as Senator Corker points out, maybe rating agencies need to have some skin in the game, if you will, do you have any thoughts whatsoever about whether that moves a rating agency out from underneath the First Amendment protection? What would be your thoughts on that?

Mr. BARR. Senator, let me start by saying I am not an expert in the First Amendment, so my judgment, the judgment of the team when we were working on this was that there is lots of scope for appropriate regulatory requirements on the rating agencies, including all the ones that we have in our legislation and a number of the other proposals this Committee has considered that do not raise significant First Amendment concerns.

Senator JOHANNS. So you think they would—and I appreciate you are not a First Amendment lawyer. I am not, either, even though I am a lawyer. But you are thinking that they still will be able to defend their lawsuits by saying, we are protected by the First Amendment because this is an opinion?

Mr. BARR. Senator, I don't want to get too deep into this here, again, because I am not an expert in the First Amendment, but in our judgment, the range of proposals that we have put forth or that are in the Committee drafts of versions of this do not raise significant First Amendment concerns, in our judgment.

Senator JOHANNS. OK.

Mr. BARR. And so I would not have put that on the top of the list of issues and the tradeoffs that we have been discussing. I do not think that that is a significant issue in the tradeoffs.

Senator JOHANNS. OK. In your judgment, how have the rating agencies worked historically? We all know nothing was working very well over this past period of time, but historically, if you were to look at how they have done, what kind of mark would you give them?

Mr. BARR. I think in many areas, the rating agencies have performed quite important functions with respect to corporate issuance of municipal bonds. In many areas, they have significantly fallen down on the job in those same basic areas—corporates and municipals, sort of really quite straight-forward assessments that they have been significantly wrong on. And in the structured product area, I would say the evidence is really quite negative.

Senator JOHANNS. Here is my concern, and maybe it is a question based upon what Senator Corker was asking you again. But it seems to me that one of the risks that we run here is that we so gum up this system with additional regulations that, number one, no one could ever enter into competition. If you don't have a head start dealing with regulations, you are just not going to get in. So we exclude competition.

And then the second thing is, I just worry that what we end up with is literally a system where the consumer pays a heavier price for this. Somebody has to pay for the regulation. There just isn't any doubt about it.

Have you done any cost-benefit, any analysis of the impact on just the average guy out there who may be investing a bit of their retirement or whatever and the impact this will have?

Mr. BARR. Senator, I think, unfortunately, the whole country is paying the price. Every consumer is paying the price today of a significant failure of our financial regulatory system. So we are all paying for it now in spades. I think we need to have a system in the future in which the level playing field and high standards are established in a way that makes it much less likely we are going to blow up our financial system and cause this amount of harm to the average American homeowner, consumer, small business person. So in our judgment, the tradeoff isn't even close. The kind of approach that we are suggesting here is not a heavy regulatory burden, but it is an essential one.

Senator JOHANNS. Mr. Chairman, thank you very much.

Chairman DODD. Thank you, Senator Johanns.

I think it has been valuable, by the way, to have two former Governors, two former mayors on the Committee. And while I think there is a difference, obviously, in terms of rating agencies when it comes to municipal or public bonds as opposed to private securitizations, nonetheless, it is a valuable piece of information as we look at this, because obviously, when we talk about rating agencies, there is a tendency for all of us to focus in on the private side of this. But we ought to keep in mind the public entity side of this question, as well, and I hadn't really given that much thought. I am glad you raised it, as did Senator Warner and Senator Corker.

Senator Merkley, you are up next.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you for your testimony.

I believe that the proposal bans consulting fees by rating agencies and requires disclosure of payments. Certainly banning consulting fees addresses part of the conflict of interest. We still have kind of the fundamental notion that folks are getting paid for what they provide and the possibility of shopping between agencies and kind of getting a heads up on if we did purchase it, what your rating might be. So anything that we need to do that is kind of more fundamental in terms of having a different system for structuring payments for rating, doing it through a central fund that the folks pay into or some other—is there any ideas you have seriously considered that would more directly take on the conflict of interest?

Mr. BARR. Well, I think, Senator, we think conflicts of interest did play a role in this problem. We have a series of measures with respect to the banning of consulting payments, strengthening disclosure and management of conflicts, disclosing the fees paid by issuers, a look-back requirement with respect to the revolving door to make sure that revolving doors haven't influenced these structures, designation of a compliance officer, disclosure of the preliminary rating received to get at the rating shopping question that you described. And I think, fundamentally—and we share Senator Corker's judgment that having trailer payments could play a positive role in the basic structure.

Having a diversity of different business structures, both investor-pay and issuer-pay models, together with a requirement that the information provided to one agency is provided to all the others, will have a significant impact on the conflicts problem. It won't eliminate it, but it will have a significant impact.

Senator MERKLEY. All those are very good and well, but you didn't answer the question I asked, which was did you consider——

Mr. BARR. I tried.

Senator MERKLEY. ——changes in more—that went more to the heart of the structural conflict of interest of having the payments go directly from the bond issuer to the—and if you rejected such ideas, what did you consider and why did you reject them?

Mr. BARR. We looked at a range of models that had been proposed, from switching back to a full investor-pay model. We looked at the utility model that had been suggested. We looked at the roulette wheel model of using rating agencies that had been suggested. In our judgment, each of those suffered from some significant infirmities. If you used the utility model, for example, you are really just enshrining the rating agencies even more in the process and putting a Government seal of approval on them. If you use the roulette wheel model, you are reducing the incentives for meaningful competition and for better ratings. If you go fully to an investor-pay model, it is not obvious that the resulting conflicts are going to be, on balance, better.

And so our judgment was, better to have a diversity of payment schemes out there. Let us have a level playing field with competition, but on the basis of serious high standards. And let us provide information that is given to one agency to all the agencies so that there is a chance for them to show that their competitor isn't good at doing a rating.

Senator MERKLEY. Thank you. That is helpful, and I will have my team follow up to try to get a better understanding of the weaknesses of those other possibilities.

We have in the structured products world very complex CDOs and CDO-squared that made it virtually impossible for anyone to determine the underlying foundation for what went into a CDO-squared, and by that I mean situations where you had BBB bonds that you dedicated 60 percent of the revenue and suddenly you had AAA bonds coming out of the BBB portfolio, *et cetera.* And yet you are so far removed from whether they were liar loans, whether the loans had been thoroughly vetted in terms of the income of the individual, *et cetera*—underwritten, if you will.

So is there a level of complexity that should simply be banned in the interest of reducing systemic risk? Is there a level of slicing and dicing that gets to where you really cannot create—it is too messy, the path is too messy from the buyer back to the foundation that essentially they do not make sense to allow in the marketplace?

Mr. BARR. I think there are ways of getting at the basic problem of complexity in alternative strategies than a flat ban. So, for example, the securitization "skin in the game" requirement improved transparency in the securitization structure that we have proposed requirements with respect to transparency at the loan level for all investors in the underlying asset with respect to, say, a borrower FICO score, what broker originated the loan, what the compensation scheme was, all of which are designed to get at that set of concerns, and better qualitative and quantitative information underlying the rating on such a structured product would permit investors to go underneath and say, well, the reason that they have assigned this rating is because their view of the cash-flow distribution in the waterfall was this, their loss probability measurement, their loss severity measurement is that. And it is a way of unpacking the complexity into its component parts.

Senator MERKLEY. I appreciate your response. I am picturing what that sort of report might have looked like on some of those CDO-squared. It may have in itself——

Mr. BARR. I would not want to write it.

Senator MERKLEY. I am over my time, and so thank you very much.

Senator REED [presiding]. Thank you, Senator Merkley. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Secretary Barr, before getting into the subject of today's hearing, I have a question on a different matter. Yesterday, the *Wall Street Journal* had a front-page article about a meeting last Friday where Secretary Geithner attacked independent bank regulators for expressing their concern about Treasury's regulatory reform proposal. Were you at that meeting?

Mr. BARR. Yes.

Senator BUNNING. If you were, was the article accurate about what happened at the meeting?

Mr. BARR. I do not have the article in front of me, Senator. I would say we have an ongoing series of conversations with the financial regulators on a regular basis. We have frank and direct conversations with them on a regular basis.

Senator BUNNING. If I give you the article, would you refresh your memory?

Mr. BARR. I am happy to look at the article. I am trying to describe for you the discussion, if I could.

Senator BUNNING. All right. Go ahead.

Mr. BARR. The conversation that we had with them, the Secretary made clear the regulators are free to defend their own agency prerogatives. They are independent agencies. He expected that they would. He asked that they keep in mind, as they did that, the fundamental goals that we all share to protect consumers, to address systemic risk in our system, to make sure the Government had the tools they need to resolve financial firms in a crisis, and as they expressed their differences that we work together in the areas where we do have agreement.

We had a long conversation about the important roles of the council versus the independent regulators. We had a long discussion about micro prudential versus macro prudential regulation. It was the kind of conversation that we have had with them on many occasions.

Senator BUNNING. The same type of discussion from Secretary Geithner and you with the regulators that you have had in the past.

Mr. BARR. I will not characterize the exact verbiage that was used, but I would say that the frankness of the exchange——

Senator BUNNING. We are on television. I do not think you want to do that.

Mr. BARR. Senator, you know, you will not be surprised to learn that in Treasury, as occasionally up on the Hill, there is some colorful language that is sometimes used.

Senator BUNNING. I have been accused of that. I understand that completely. OK. Let us get to the current thing. Everybody agrees that the current rating agency model has failed—I think everybody up here does—especially for complex structure products. There also seems to be agreement that better competition will improve ratings. How we get better competition is a little more difficult question, but we must break the hold of the top two or three agencies if we are going to fix the ratings.

It seems to me that there are two changes that will go a long way to fixing the competition problem. First, we should eliminate any regulatory requirements to use rating agencies so that they will only be used if they add value. Second, we should require issuers to provide the same information about the securities to all investors and rating agencies, much like we do for publicly traded companies with regulatory FD. That way each agency will be able to compete based on the quality of their ratings, and we will break the monopoly of the issuer-pay model.

Let me start first with the first point, that we should eliminate all requirements to use rating agencies. Do you agree with that or not?

Mr. BARR. In our judgment, we need to go regulation by regulation. We agree with the basic goal of reducing reliance wherever possible. I think we need to go into the specific circumstances of how the SEC and the bank agencies and other agencies use the ratings. In some contexts, we can go to elimination. In other contexts——

Senator BUNNING. You do agree that there is a definite conflict of interest presently?

Mr. BARR. I am sorry. In the rating agency structure?

Senator BUNNING. When I would go to a rating agency—I am a private corporation. I come to a rating agency. I need $200 million in bonds. They say, "Yes, we will do this." They give me a BBB rating, and then they send me a bill for $250,000 for that rating. Don't you think that is a conflict?

Mr. BARR. I do think there are serious conflicts of interest present in the existing model. That is why we require a series of steps to reduce the conflicts, disclose the conflicts, manage the conflicts. We strongly agree with your suggestion that an issuer be required to provide information when it gives it to one agency to give it to all the credit rating agencies. I think that is a terrific proposal. It is part of our plan.

Senator BUNNING. Now, about the second point—and I am a little past my time—that all investors and rating agencies should have access to the same information about a security so they can perform their own analysis of it, do you agree with that?

Mr. BARR. I think when——

Senator BUNNING. You just said that.

Mr. BARR. I am sorry. Yes, when you give one rating agency the information, you should give it to all the other rating agencies as a way of enhancing competition. I do think that that is an important part of the plan.

Senator BUNNING. Do you think that it is absolutely necessary for an agency to rate every security or bond that is sold to the public entities? In other words, I am the city of Louisville, I am building an arena, and I apply to the IRS for a portion on it to be tax free, and I go to this agency and they say, "Well, we cannot do this." And all of a sudden someone intervenes, and all of a sudden they found their ability to do this. And I think that is absolutely the wrong way to do business. For, you know, a half-a-million dollars we get $4 million worth of bonds that are 80 percent tax free and 15 percent taxable. Do you think that is the right way to run the business?

Mr. BARR. I think there are enormous inefficiencies in our revenue bond system in the United States of which the rating process is one, but there are many, many others.

Senator BUNNING. Thank you.

Senator REED. Thank you very much, Senator Bunning.

Senator Schumer is next. He stepped out. Senator Shelby, do you have a question?

Senator SHELBY. I will just—do you believe, Mr. Secretary, that eliminating the conflict of interest—it is obvious to me and a lot of other people—by the rating agencies where they get paid for rating things, so to speak, and the cozy relationship there is very important in our regulatory overhaul?

Mr. BARR. I think we have to tackle the conflict of interest headon. I am not sure we can fully eliminate it, but I think we have to address it.

Senator SHELBY. How do we bring back what I thought we all benefited for a long time, and that is, securitization of mortgages? For years and years—I would not say every mortgage, you know, but there was as lot of confidence in the securitization process, and the securitization process basically worked. It basically worked. Now it is, for all intents and purposes, very small, if not dead.

How do we do that? Do we do it with covered mortgages? Do we do it with stringent ratings and trailing profits like Senator Corker alluded to earlier, or what? How do we do this? Because I do not know if the money is ever going to flow until we bring some confidence back into securitization. Maybe I am wrong.

Mr. BARR. Senator Shelby, I think it is a central question. I think that, in our judgment, one of the reasons it is so critical to move on financial regulatory reform this year is precisely that. I do not think we are going to see a revitalization of our securitization markets unless we have a new foundation of regulation that permits transparency in the system, restores honesty and integrity to the process that was so sorely lacking in the last bit of time.

So I think that, in our judgment, we need to move quickly on financial regulatory reform. We need to have transparency in the securitization structures. We need to improve regulation of credit rating agencies building on the 2006 law. We need to make sure we take care of the systemic risk problem and consumer protection. And we really have to move in a way that it is demonstrable to the markets that we are serious about reform.

Senator SHELBY. Thank you.

Senator REED. Thank you very much, Senator Shelby.

Senator Schumer.

Senator SCHUMER. Thank you. Thank you, Mr. Chairman. I want to thank you for holding this hearing. Thanks, Secretary Barr, for coming. Thanks, Senator Shelby, for asking that extra question. I appreciate it.

I have a little statement with a little proposal in there, and I am going to ask your opinion of it.

We had hoped, when we passed the Credit Rating Agency Act of 2006, the reform act of 2006, which required registration and oversight of credit rating agencies, that the rating agencies would be one of the cornerstones of strong credit markets. Instead, as has been said before, the credit rating agencies turned out to be one of the weakest links, and those need to be fixed, as you just said.

What we found out was that rating systems were filled with conflicts of interest. The worst of these conflicts were that issuers went shopping for ratings like they were shopping for used cars. If they did not like the answer they heard, they went somewhere else. Because the revenues of the rating agencies grew with the massive expansion of the securitization market, the rating agencies had every incentive to help issuers structure their products to get the ratings they wanted. The result: Rating agencies rubber stamped complex products they did not understand as investment grade, using flawed analytical models and methodologies with inadequate historical data that did not include the possibility of high mortgage defaults.

We cannot overestimate the impact this had on the financial crisis. Losses in structured finance securities alone led to $1.47 trillion in writedowns and losses at the largest financial institutions. And Senator Reed, our Chairman here, has introduced a bill on credit rating agencies, and the Administration has proposed new rules to address some of these conflicts of interest and the inability to evaluate ratings. And they are important proposals, but I wonder if the message is getting through.

Last month, I read an article how Moody's downgraded—after Moody's downgraded a collateralized debt obligation because the default rate of loans in the CDO rose 7 percent. Morgan Stanley repackaged it into new securities with AAA ratings. How can you get a AAA rating based on a CDO that has just been downgraded six levels? Where are the checks in the system?

That is why I am proposing, in addition to Senator Reed's bill and the Administration's proposal, which I think are very good, that for every ten rated products, the SEC would randomly assign a different rating agency, another rating agency to issue a second rating. I understand that issuers get two ratings, but this randomly assigned rating agency would act as a check on the first rating agency.

Furthermore, this check would help discourage ratings shopping and other conflicts of interest inherent in the system. We would learn who is better at ratings and who is worse and get rid of at least the conflicts of interest. I would not want to do it for every issue. That is too many, but just a certain amount. We propose one out of ten, maybe it should be a little less, a little more, but a significant amount so we get a pool of knowledge. And I think it would be prophylactic. If an agency knew that there was a one in ten chance when they got paid by the issuer that someone else was doing an independent rating, they would be more careful.

So the ratings are too much a part of our financial system to abandon them, but it is clear the system as it exists is broken, and I want to look forward to working with Chairman Dodd, Senator Reed on his excellent proposal, and the Administration to make sure that we can have faith that a AAA rating means what it says.

So my only question to you, Assistant Secretary, is: What do you think of this proposal of having the SEC randomly assigning a second rating agency? That would be done, by the way, concurrently with the first and come out at about the same time.

Mr. BARR. Senator Schumer, thank you for your longstanding work in this area. I would say we share the conceptual goal of having more than one agency rate issuance, particularly—it is a particularly acute problem in the structured finance area, but it exists elsewhere.

In our proposal, we suggest that one way to do that consistent with the direction of the SEC's proposal is to require that every issuer provide full information about their issuance to all the other credit rating agencies as a way of enhancing competition in the rating. There are significant incentives on the competitors to want to demonstrate their own prowess in rating in relation to their competitor who has been selected.

I think that one tradeoff that one might consider with respect to an assignment process is whether that assignment might provide a kind of seal of approval to the rating that would not be intended, it would be counter to the general thrust of what the Committee has been trying to do in this area. So that might be a competing concern on the other side with mandatory as opposed to competition for the rating.

Senator SCHUMER. Yes, but, OK, two points I would make. My time is up. But, number one, it would be done on a random basis and secretly, number one. And the pool would probably be a lot greater than just the Big Three. So you would have new entries with some incentive to just get it right and get it honest.

And, second, your proposal, of course, is not mandatory, and simply giving the information, if everyone is in the same boat—and just a few of them doing the same practice might prove to have the same discouraging effect of sort of paying for a good rating. That is what I would say. My time is up, but I would certainly want an answer——

Mr. BARR. I am happy to work with you.

Senator SCHUMER. ——to look at that.

Thank you, Mr. Chairman.

Senator REED. Thank you, Senator Schumer, and I have conferred with the Ranking Member, and, Mr. Secretary, I think we are ready to move to the next panel. Thank you very much.

Mr. BARR. Thank you so much for your time.

Senator REED. Thank you.

I would like to ask the second panel to come forward, please. Thank you, gentlemen. Let me introduce the panel and then begin to recognize our witnesses.

Our first witness is Mr. Stephen W. Joynt. He is the President and CEO of Fitch Ratings as well as the CEO of Fitch Group, Inc., the parent company of Fitch Ratings Algorithmics and Fitch Training.

Our next witness is Mr. James H. Gellert. He is the President and CEO of Rapid Ratings.

Our next witness is Professor John C. Coffee, Jr., the Adolf A. Berle Professor of Law at Columbia University Law School. He has testified before this Committee on numerous occasions and has been a valuable source of counsel in many different situations. Thank you, Professor Coffee.

Our next witness is Dr. Lawrence J. White. Dr. White is the Arthur E. Imperatore Professor of Economics at New York University

Stern School of Business, as well as Deputy Chair of the Economics Department at Stern. He has served on the senior staff of the President's Council of Economic Advisers and as the Director of the Economic Policy Office, Antitrust Division of the United States Department of Justice. Thank you, Doctor.

Finally, our last witness is Mr. Mark Froeba. Mr. Froeba is the principal at PF2 Securities Evaluations, Inc. He has served as senior vice president with Moody's Derivatives Group and as vice president and senior credit officer at Moody's. Thank you very much, Mr. Froeba.

Mr. Joynt, your testimony, please. Could you turn the microphone on, please, and lean in?

STATEMENT OF STEPHEN W. JOYNT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FITCH RATINGS

Mr. JOYNT. Thank you, Senator Reed, Senator Shelby, Members of the Committee. Thank you for the opportunity to appear at the hearing today. I would like to spend a few minutes summarizing my prepared statement.

While overall macroeconomic conditions remain difficult, it seems the period of the most intense market stress has passed. This is due to both a variety of Government initiatives here and abroad aimed at restoring financial market stability as well as actions taken by companies individually to shore up their balance sheets and reduce risk.

Having said that, important sectors in the fixed-income markets remain effectively closed, and certain asset classes, such as commercial mortgage-backed securities, are experiencing greater performance strain on their underlying assets.

During this time, the focus of Fitch Ratings has been on implementing a broad range of initiatives that enhance the reliability and transparency of our opinions and related analytics. More specifically, our primary focus is on vigorously reviewing our analytical approaches and changing ratings to reflect the current risk profile of the securities that we rate. In many cases, that continues to generate significant numbers of downgrades in structured securities, but also affects other sectors, such as banks and insurance.

We are releasing our updated ratings and research transparently and publicly, and we are communicating directly with the market the latest information and analysis that we have.

In parallel, we have been introducing a range of new policies and procedures—and updating existing ones—to reflect the evolving regulatory frameworks within which credit rating agencies operate globally. In each of these areas, we have been as transparent as possible, broadly engaging with all market participants, including policy makers and regulators. I am happy to expand on these topics as we proceed.

That said, the focus of today's hearing is clearly on where do we go forward from here. Senator Reed has introduced a bill, which we are happy to speak to. The House held a hearing in May. The SEC, I think, considered important new rules at their roundtable discussion in April. There is a Treasury proposal that we will speak about, and also outside the U.S., we have been in discussions with the EU, and they have recently enacted a registration and oversight system as well that applies to rating agencies.

As this Committee considers these topics, we would like to offer our perspective on several important issues. Let me reiterate that we are committed to engaging on all of these matters in a thoughtful, balanced, constructive, and non-self-serving manner. At the same time, some perceptions and proposals continue to circulate that could use clarification.

Transparency is a recurring theme of the discussions about rating agencies, and at Fitch, we are committed to being as transparent in everything we do. All of Fitch's ratings' supporting rationale and assumptions and related methodologies and a good portion of our research are freely available to the market in real time. We do not believe that everyone should agree with all of our opinions, but we are committed to ensuring the market has the opportunity to discuss them.

Some market participants have noted that limits on the amount of information that is disclosed to the market by issuers and underwriters has made the market overreliant on rating agencies, particularly for analysis and evaluation of structured securities. The argument follows that the market would benefit if additional information on structured securities were made broadly and readily available to all investors, thereby enabling them to have access to the same information as mandated rating agencies in developing their own thinking and research.

Fitch fully supports the concept of greater disclosure of such information. We also believe that responsibility for disclosing that information should rest with issuers and underwriters. It is their transactions, and they should be disclosing all the pertinent information to all investors.

A related benefit of additional issuer disclosure is that it addresses the issue of rating shopping. Greater disclosure would enable nonmandated NRSROs to issue ratings on structured securities if they so choose, providing the market with a greater variety of opinion and an important check on perceived ratings inflation.

Discussion of additional information is of questionable value without accuracy and reliability of the information. That goes to this question of due diligence. We have taken, rating agencies, a number of steps to increase our assessments of the quality of the information that we are provided with, and we have adopted policies that we will not rate issues if we deem the quality of the information to be insufficient. The burden of due diligence, in my opinion, though, belongs with issuers and underwriters. Congress should mandate that the SEC enact rules that require issuers and underwriters to perform such due diligence and make public their findings and enforce the rules that they enact.

In terms of regulation more broadly, Fitch supports fair and balanced oversight and registration of credit rating agencies and believes the market will benefit from globally consistent rules for credit rating agencies that foster transparency, disclosure of ratings and methodologies. We believe that oversight requirements should be applied consistently and equally to all NRSROs.

One theme in the discussion of additional regulation is the desire to impose more accountability on rating agencies. While ultimately the market imposes accountability for our ratings, for the reliability and performance of our ratings and our research, if the market does not have confidence in us, the value of Fitch's franchise will be diminished.

While we understand and agree with the notion that we should be accountable for what we do, we disagree with the idea that the imposition of greater liability will achieve that. Some of the discussion on liability is based on misperceptions. Rating agencies today, like accountants and officers and directors and securities analysts, may be held liable for securities fraud to the extent rating agencies intentionally or recklessly make material misstatements or omissions.

Beyond the standard of existing securities law that applies to all fundamentally, we struggle with the notion of what it is we should be liable for. Specifically a credit rating is an opinion about future events, and the likelihood of an issuer that he might meet his credit obligations. Imposing a specific liability standard for failing to accurately predict the future strikes us as an unwise approach.

Congress should also consider some practical consequences of imposing additional liability. They were mentioned earlier. Expanded competition might be inhibited from smaller agencies, but that may be addressed. All rating agencies also may be motivated to just try to provide the lowest securities ratings just to mitigate liability, which does not encourage accuracy.

I see I am past my time.

Senator REED. Thank you very much, Mr. Joynt.

Let me also say that all your statements will be made part of the record, and if you would like to summarize them, that is perfectly fine. And the statements of the Members will be made part of the record.

Mr. Gellert, please.

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

Mr. GELLERT. Thank you. Senators, thank you for inviting us to join you today. Rapid Ratings is a subscriber-paid firm or otherwise known as an investor-paid firm. We utilize a proprietary software-based system to rate the financial health of thousands of public and private companies and financial institutions quarterly. We use only financial statements, no market inputs, no analysts, and have no contact in the rating process with issuers, with bankers, or with advisers. Our ratings far outperformed the traditional issuer-paid rating agencies in innumerable cases such as Enron, GM, Delphi, Pilgrim's Pride, the entire U.S. homebuilding industry, and others.

Currently, we are not a NRSRO. We have not applied for the NRSRO status, and we do not have immediate plans to do so. At present, there are too many mixed messages coming from the SEC, Treasury, and Congress for me to recommend to our shareholders that the designation is in their best interests.

Of course, the Treasury proposal's requirement that all ratings firms must register is an unwelcomed development. It runs counter to the goal of positive change for the industry, not to mention elements of the Credit Rating Agency Reform Act of 2006.

We do believe that reform in our industry is necessary and must happen with a sense of urgency. But we caution that, if not done properly, this reform may have counterproductive and unintended consequences.

We also believe that competition in this industry, and the level playing field for current and new players, is essential. Equivalent disclosure of information is needed. Rules that do not disproportionately penalize small players are needed. An environment where the new innovate and where the old can have their behavior modified is needed. All should be primary goals of legislation.

The SEC has been wrestling with new rules and rule amendments and has made some headway in areas curbing the issuer-paid conflicts. We do not agree with all of the elements of the SEC's initiatives, but the Commission has taken some positive steps to stop the more egregious behavior of the issuer-paid agencies. As detailed in my written submission, our views on the new Treasury proposal are not quite as balanced.

Together, the SEC and Treasury initiatives are positively addressing rating shopping, conflict and fee disclosure, transparency issues, and are at least flirting with removing the NRSRO designation from SEC regulations. For our complete comment on these, again, I would like to refer you to our written submission.

On the critical side, the recent Treasury proposal, despite its positives, threatens to erect more hurdles to competition in this industry, further solidifying the entrenched position held by S&P, Moody's, and Fitch. A few items.

Methodology disclosure: Rules in the Treasury proposal on transparency of ratings methodology could come dangerously close to meaning ratings firms would have no intellectual property protection.

Ratings disclosure: Requiring subscriber-based rating agencies to disclose their history of ratings and ratings actions can undermine the subscriber-based business model, which is predicated on selling current and past ratings to investors. The Treasury proposal covers all types of rating agencies and for 100 percent of their ratings. This erects a major barrier for subscriber-paid firms by interfering with their revenue model.

Requiring NRSRO registration: Requiring registration of all companies issuing ratings is perhaps the most counterproductive initiative of all. Not only does forcing registration run counter to the 2006 Act, it could create a flood of new NRSROs captured by the sweeping dragnet. Investors will not have the inclination to look at all of these firms and will tend to remain with the providers they know best, the Big Three.

Further, registration would impose all of the increased direct and indirect costs on firms that would otherwise choose not to be an NRSRO. This will force some out of business, it will create disincentives for new entrants, and it will stifle potential innovation and positive competition.

So the Treasury proposal would require firms to register, subject them to high compliance costs, put at risk some firms' intellectual property, and hinder their revenue-generating ability. All in all, regulatory protection for S&P, Moody's, and Fitch, and anything but a level playing field.

The Big Three agencies have lobbied heavily to promote the notion that one-size-fits-all regulation is fair because all business models carry conflicts of interest and that theirs is no worse than any other. Can conflicts occur in other business models? Sure, theoretically. Have conflicts in subscriber-paid models contributed to any financial disasters? No. This red herring cannot drive new legislation. The problem is not the potential behavior of the subscriber-paid rating agencies. Rather, it is the misbehaviors of the issuer-paid rating agencies that have already occurred.

Effective legislation and regulatory framework must focus on reforming the issuer-paid model and the model's most negative features, providing oversight of the NRSROs that prevent the self-interested behavior that contributed to the current financial crisis and creating an even playing field for competition. The latter has two major components, fostering, or at least not inhibiting, new players, methodologies, and innovation; and equivalent disclosure of data used by issuer-paid agencies.

For true reform to have a fighting chance, these themes must be protected by the legislative framework for the ratings industry. We must be critically aware of how the unintended consequences of poorly implemented regulations can leave us with a broken system that has proven it is not so deserving of protection. Innovation and responsible alternatives to a *status quo* have been hallmarks of the American financial system. These should be fostered by those looking to return confidence and integrity to this industry. Thank you.

Senator REED. Thank you very much, Mr. Gellert. I would just take the opportunity that your comment about registration of all rating agencies is the Treasury proposal, it is not my proposal.

Mr. GELLERT. Excuse me.

Senator REED. Just clarifying.

[Laughter.]

Mr. GELLERT. Fair enough.

Senator REED. The privilege of the Chair. Forgive me.

Mr. GELLERT. Well exercised.

Senator REED. Professor Coffee.

STATEMENT OF JOHN C. COFFEE, JR., ADOLF A. BERLE PROFESSOR OF LAW, COLUMBIA UNIVERSITY LAW SCHOOL

Mr. COFFEE. I am honored, Chairman Reed and fellow Members of the Committee, to be back before this Committee, but I am in the very embarrassing position of having to begin by commending and congratulating the Chairman, because what we are looking at in the Treasury bill is 95 percent what was in the Reed bill. The Reed bill, introduced in April, was substantial, constructive, well crafted, and I think it does just about everything that you can do through administrative regulation to deal with this problem.

The problem is, there are dimensions to this whole area that are beyond simply administrative regulation and that is what the Treasury bill in particular leaves out. Thus, because—there is a shortfall, because not all of the provisions in the Reed bill are in the Treasury bill and because there needs to be a consideration of some issues beyond administrative regulation. I would have to say there is a shortfall in the Treasury regulation, and I would have to predict that we will see a persistence of the *status quo,* dysfunctional and perverse as it is, if all we do is what is in the Treasury bill.

In this regard, I think there are two distinctive critical features about credit rating agencies which distinguish them from all of the other gatekeepers in the financial markets that have to be focused on.

One, credit rating agencies do not perform due diligence. Accountants are bean counters. They go out and count the beans. Credit rating agencies give ratings based on hypothetical assumed facts, and thus you are getting hypothetical ratings. I think that has to be corrected.

Second, the credit rating agencies today do not face any meaningful risk of liability. Because, as I look at the future, even though I wish to encourage the user-pay system, I think the issuer-pays model will persist and predominate. There is going to remain a built-in conflict of interest, and when you have a built-in conflict of interest, the other professions have found that the only thing that keeps the professional honest is the threat of litigation. The accountants have learned, painfully, how to steer a course between acquiescence to the client and maintaining high integrity and litigation is one of the forces that maintains that equilibrium.

Therefore, based on that diagnosis, what do I think we should do? I think the first thing we have to focus on is how to encourage third-party due diligence. The Treasury bill does this, largely adopting many of your provisions. The problem is that it does this by requiring disclosure when you decide to use a third-party due diligence firm, and it requires certification by that firm to the SEC.

That raises the cost of using a third-party due diligence firm and I think there would be many underwriters, at least if we get back into a bull market at some point in the future, that will simply opt not to use the third-party due diligence firm. They did this in the past. These due diligence firms were widely employed in the 1990s, and as the market grew bubbly, they dropped their use because they kept learning disquieting facts that they didn't want to hear about. So you can put in boilerplate disclosure that says, we are not using a third-party due diligence firm, and hope that in that more favorable market, you can get away with this, and I think you probably would be able to get away with this.

How, then, should we deal with encouraging third-party due diligence? I would suggest that we look here at a different level of regulation. No one has been talking much about regulating the users of this information, and the users now are closely regulated by rules that I think are over-broad and ill conceived. Let me give you one example.

Rule 2(a)(7) of the SEC under the Investment Company Act tells money market funds that they cannot buy securities unless they are eligible securities, and to be an eligible security, you have to have a requisite rating from an NRSRO rating agency. We could deregulate much of that, but many of the users of this information do want to rely on an NRSRO rating. They have made that very clear to the SEC.

What I think we should say is that to the extent you choose to rely on an NRSRO rating, it has to be a rating that is based upon third-party due diligence that verified the essential facts. That way, we have at least something that is not illusory, that is not a hypothetical rating, and that way—because this rule already exists. I am not proposing new rules. I am proposing making the existing rule meaningful by making it based on third-party due diligence.

There are other of these rules, but they are in my statement and I won't take it further. The point in doing this is by focusing on the user, we are not regulating the rating agency and that allows us to sidestep some arguable constitutional problems about whether we are overly regulating commercial speech. I don't think we are, but we aren't doing it at all if we regulate the user and say, you only get the right to do this if you use one of these techniques and you have good due diligence.

Now, let me move on to this issue of liability because I see the business-pays model as persisting. I think we need some risk. In 10 seconds, let me just say that my proposal is not to open the flood gates. It is really your proposal. I think you struck a very sensible compromise, because it doesn't really increase the likelihood of litigated outcomes.

It simply says, your proposal, your bill in April contains a provision that says if credit rating agencies—they can be found to have acted recklessly if they give an opinion, a rating, without conducting some due diligence or receiving due diligence from a third-party expert. This does not subject them to liability. It just tells them there is one easy, safe strategy for avoiding liability and that is to make sure that the underwriter pays for and gives you a third-party due diligence report that covers the critical facts in your model.

This will not produce a rash of litigation. It will produce behavior that avoids litigation and thus this is another technique to get the critical core of due diligence back into the ratings process.

Thank you. I apologize for overstepping my time.

Senator REED. Thank you, Professor Coffee.

Professor White.

STATEMENT OF LAWRENCE J. WHITE, LEONARD E. IMPERATORE PROFESSOR OF ECONOMICS, NEW YORK UNIVERSITY

Mr. WHITE. Thank you, Mr. Chairman, Members of the Committee. My name is Lawrence J. White. I am a Professor of Economics at the NYU Stern School of Business. During 1986 to 1989, I was a board member on the Federal Home Loan Bank Board. Thank you for the opportunity to testify today on this important topic.

I have appended to the statement for the Committee a longer statement that I delivered at the Securities and Exchange Commission's roundtable on the credit rating agencies on April 15, 2009, which I would like to have incorporated for the record into the statement that I am presenting today.

The three large U.S.-based credit rating agencies—Moody's, Standard and Poor's, and Fitch—and their excessively optimistic ratings of subprime residential mortgage-backed securities in the middle years of this decade clearly played a central role in the financial debacle of the past 2 years. Given this context, it is understandable that there would be strong political sentiment, as expressed in the proposals by the Obama administration as well as by others, for more extensive regulation of the credit rating agencies in hopes of forestalling future such debacles.

The advocates of such regulation want figuratively to grab the rating agencies by the lapels, to shake them and shout, "Do a better job." This urge for greater regulation is understandable, but it is misguided and potentially quite harmful.

The heightened regulation of the rating agencies is likely to discourage entry, rigidify a specified set of structures and procedures, and discourage innovation in new ways of gathering and assessing information, new technologies, new methodologies, new models, including new business models, some of which have been talked about earlier this morning, and it may not even achieve the goal of inducing better rating from the agencies. It may well be a fool's errand. Ironically, it will also likely create a new protective barrier around the incumbent rating agencies.

There is a better route. That route starts with a recognition that the centrality of the three major rating agencies for the bond information process was mandated by more than 70 years—it goes back to the 1930s—of prudential financial regulation of banks and other financial institutions, in essence, regulatory reliance on ratings, in essence, an outsourcing or delegating of safety judgments to these third-party credit rating agencies.

For example, the prohibition on banks holding speculative bonds, as determined by the rating agencies' ratings, imbued these third-party judgments about the creditworthiness of bonds with the force of law. This problem was compounded when the SEC created the category of Nationally Recognized Statistical Rating Organization, NRSRO, in 1975, and then the SEC subsequently became a barrier to entry into the rating business.

As of year-end 2000, there were only three NRSROs: Moody's, Standard and Poor's, and Fitch. It should thus come as no surprise that when this literal handful of rating firms stumbled, and stumbled badly, in their excessively optimistic ratings of the subprime residential mortgage-backed securities, the consequences were quite serious.

The recognition of the role of financial regulation enforcing the centrality of the major rating agencies then leads to an alternative prescription. Eliminate the regulatory reliance on ratings, as Senator Bunning suggested earlier this morning. Eliminate their force of law, and bring market forces to bear.

Since the bond markets are primarily institutional markets, as Assistant Secretary Barr mentioned earlier today, and not a retail securities market, where retail customers do need more help, market forces can be expected to work, and the detailed regulation that has been proposed would be unnecessary. Indeed, if regulatory reliance on ratings were eliminated, the entire NRSRO superstructure could be dismantled, and the NRSRO category could be eliminated.

Now, let us be clear. The regulatory requirements that prudentially regulated financial institutions must maintain safe bond portfolios should remain in force. That is terrifically important. But the burden should be placed directly on the regulated institutions to demonstrate and justify to their regulators that their bond portfolios are safe and appropriate, either by doing the research themselves or by relying on third-party advisors who might be the incumbent rating agencies, or might be new firms that none of us have discovered yet, but could come forth in this more open environment.

Since financial institutions could then call upon a wider array of sources of advice on the safety of their bond portfolios, the bond information market would be opened to innovation and entry and new ideas in ways that have not been possible since the 1930s.

Now, my longer statement goes into greater detail, but since it was done on April 15, before the Obama administration's proposals were proposed, I just want to mention a few things about those proposals. I will be very brief, Mr. Chairman.

Senator REED. Thank you, Professor.

Mr. WHITE. Again, it is understandable they want to do something, but I think the efforts go in the wrong direction and the dangers are substantial because they are going to raise barriers to entry and reduce innovation, reduce the possibility of new ideas. Something that is especially dangerous is something that Mr. Gellert mentioned a few minutes ago: the requirement that all credit rating agencies, whether you are just an independent guy offering some advice to a hedge fund or whether you are a fixed-income analyst at a financial services firm, must register as an NRSRO. This strikes me as something that is going to discourage entry, discourage those new ideas, and that can't be a direction we want to go.

So let me just say again that the proposals really are wrongheaded and that we really do have a superior route to go, which is a greater reliance on the market for information which an institutional bond market can use and use effectively.

Thank you for this opportunity, and I will be happy to answer any questions.

Senator REED. Thank you.

Mr. Froeba.

STATEMENT OF MARK FROEBA, J.D., PRINCIPAL, PF2 SECURITIES EVALUATIONS, INC.

Mr. FROEBA. Senator Reed, Senator Shelby, and Members of the Committee, my name is Mark Froeba. Thank you for giving me this opportunity to talk about rating agency reform.

Let me give you a brief summary of my background. I am a 1990 graduate of the Harvard Law School. Barack Obama was 1 year behind me. What a difference a year makes.

[Laughter.]

Mr. FROEBA. In 1997, I left the tax group at Skadden, Arps in New York where I had been working in part on structured finance securities to join the CDO group at Moody's and I worked there for just over 10 years, all of that time in the CDO group.

Since the beginning of the subprime crisis, there have been many proposals for rating agency reform. Most of them are well intentioned. However, few seem likely to accomplish real reform. Real reform, in my opinion, must achieve two clear policy goals. It must first prevent another rating-related financial crisis like the subprime crisis, and it must also restore investor confidence in the quality and reliability of credit ratings.

In my opinion, the rating agency reform provisions of the Investor Protection Act of 2009 are not sufficient in themselves to accomplish either of these goals. However, the Act's rulemaking authority could be used to expand their effectiveness.

Why are the reform provisions in themselves, in my opinion, insufficient? First, they are not the product of a complete investigation into what actually happened at the rating agencies. Without a proper investigation of what happened, not conducted on a theoretical level or in discussions with senior managers, but with the analysts who actually assigned the problem ratings in question, we cannot be sure the proposed legislation provides solutions designed to fix the problems.

The best way to illustrate my second reason for questioning the sufficiency of this proposal is to ask you a simple question. If the Investor Protection Act of 2009 had been enacted just as it is 5 years ago, do you think it would have prevented the subprime crisis? In my opinion, the answer to this question is no. That does not mean that the proposals are bad, it just means that they do not advance what should be the central policy goal of reform, preventing a future crisis.

If these proposals are uncertain to prevent a future crisis and restore confidence in credit ratings, what reforms could achieve these goals? I have, you will not be surprised to hear, six proposals, and I am going to speak really fast or skip some.

First, put a firewall around rating analysis. The agencies have already separated their rating and nonrating businesses. This is fine, but not enough. The agencies must also separate the rating business from rating analysis. Investors need to believe that rating analysis generates a pure opinion about credit quality, not one even potentially influenced by business goals, like building market share. Even if business goals have never corrupted a single rating, the potential for corruption demands a complete separation of rating analysis from bottom-line analysis.

Investors should see that rating analysis is kept safe from interference by any agenda other than getting the answer right, and the best reform proposal will exclude business managers from involvement in any aspect of rating analysis and critically also from any role in decisions about analyst pay, performance, or promotions.

Second, prohibit employee stock ownership and change the way rating analysts are compensated. There is a reason why we don't want judges to have a stake in the matters before them, and it is not just to make sure judges are fair. We do this so litigants have confidence in the system and trust its results. We do this even if some or all judges could decide cases fairly without such a rule.

The same should be true for ratings. Even if employee stock ownership has never actually affected a single rating, it provokes doubt that the ratings are disinterested and undermines investor confidence. Investors should have no cause to question whether the interests of rating agency employees align more closely with agency shareholders than investors. Reform should ban all forms of employee stock ownership, direct and indirect, by anyone involved in rating analysis.

The same concerns arise with respect to annual bonus compensation and 401(k) contributions. As long as these forms of compensation are allowed to be based upon how well the company performs and are not limited to how well the analyst performs, there will always be doubts about how the rating analyst's interests align.

Third, create a remedy for unreasonably bad ratings. Essentially, expand the liability of the agencies. I am going to skip my discussion of that because some of that discussion has already occurred.

My fourth proposal is to change the antitrust laws so agencies can cooperate on standards. When rating agencies compete over rating standards, everybody loses. Giving them the capacity to get together to talk about rating standards may expand our ability to prevent the kind of problems that we have had. Imagine how different the world would be today if the agencies could have joined forces 3 years ago to refuse to securitize the worst of the subprime mortgages.

My other proposals are to create an independent professional organization for rating analysts, and also to introduce investor-pay incentives into the issuer-pay framework, neither of which I have time to discuss, but they are described in my statement. Thank you.

Senator REED. Thank you very much, Mr. Froeba.

Thank you all. This has been a very, I think, informative panel.

Let me pose a question to all the panel members. I think I know Dr. White's answer.

[Laughter.]

Senator REED. The Investor Working Group chaired by former SEC Chairman Donaldson and Arthur Levitt has recommended that myriad statutes and rules that require a certain investor to hold only securities with specific ratings should be eliminated over time to clarify that reliance on a rating does not satisfy due diligence efforts. I think Secretary Barr suggested that in one of his responses, and this is an issue, frankly, that Senator Bunning has raised directly, which is the reliance on these ratings, and the Secretary suggests that on a case by case, they were going to walk through the statutes. Just your reaction, Mr. Joynt, and down the line.

Mr. JOYNT. So this has come up in the SEC hearings, as well, and my response there, the same response today, which is I think it is healthy to go back and look at each of the regulations individually. I think it would not be helpful to have some kind of a blanket dismissal of all uses of ratings and regulations.

I think, and I have been around a long time, I can think of why some of those ratings were put into regulation and they were for positive and constructive reasons, to try to limit risk and to be used as handy benchmarks for other regulators and boards of directors and other things. But to not go back and look at them, I think is a mistake. To look at them may help eliminate some of the use of ratings in regulation or even update them, because ratings have changed over time. They don't necessarily all mean the same things to all the same people.

I still believe, though, that if ratings were eliminated in regulation, they will be often and frequently used by many institutional investors, boards of directors, and investors, because I believe they have value independent of whether they are forced to be used by regulation.

Senator REED. Thank you.

Mr. Gellert.

Mr. GELLERT. I think looking at removing the NRSRO designation and regulations is actually quite a good idea. I agree that they can't all just be stripped out immediately because that can be disruptive, but looked at in a methodical way relatively expeditiously is probably a benefit. I think the Treasury plan calls for a 30-month review of this. I think that is probably a bit more time than anyone really needs to get started or at least to be able to make the statement that this is a road we are marching down.

But I would point out that it is not just that there is a tendency for institutional investors to overrely, or a potential for them to overrely and essentially outsource their own credit work. It presents an opportunity to arbitrage the system, because a security that meets a certain standard by their regulatory oversight but has a higher yield, as we saw during this crisis, is something that they can buy and will buy because it is beneficial to them for returns. So, in a handful of ways, it can be complicated, but I do think it is a good initiative.

Senator REED. Professor Coffee.

Mr. COFFEE. I was sort of discussing this in my remarks, because I gave you the example of Rule 2(a)(7), which says money market funds, you can only buy eligible securities and they have to have an investment-grade rating from an NRSRO. I would change that. I would change it in the following way. I would not wholly abolish the rule, because we can't dare deregulate all money market funds that came this close to failure last fall. There have to be some restrictions. Professor White also, I think, agreed with that.

I would give institutional investors——

Mr. WHITE. There you are, putting words in my mouth again, Jack.

[Laughter.]

Mr. COFFEE. Anyway, I would give institutional investors a choice. They could do it themselves. They could say, we are going to conduct our own due diligence and we will have our own prudent man fiduciary obligations when we do that, or we can rely on a credit rating, but only a credit rating that is supported by due diligence so that the critical facts on which the model relies have been verified by someone who is a professional.

I know what will happen if given this choice. All of the smaller institutions would prefer to rely on the rating agency because the SEC proposed this last fall, and when they proposed this, they nearly got assaulted with pitchforks by the institutional investor community, which said, we don't want to take personal liability. But I think they should have the choice.

I think to encourage competition, we should say, you can do your own form of due diligence, but you have greater legal responsibility if you do it yourself, or you can rely on those NRSRO ratings which are supported by legitimate verification. Given that choice, I think the world will be better off and I think it would encourage some competition.

Senator REED. Professor White, I think I know where you come down on the big issue, but let me pose a slightly different question, and if my time runs out, we will do a second round, but I want to recognize Ranking Member Shelby.

There is an economic, I think, advantage, particularly for a small entity, that the Treasurer of Pawtucket, Rhode Island, who wants to make an investment, to have something that is shorthand, you know, triple-A, A-minus, *et cetera,* and I would think systemically and throughout the economy that the rating agencies have provided some value over time. It is not just a complete sort of desert out there.

So just the issue of—I mean, I think the approach is sort of sequentially looking where we can change, and then a final point tying into what Professor Coffee said is that even if we eliminate the requirements, the presumption would be that issuers would still probably be paying and that, given the choice, most people would go to the rating agencies. So just your quick comment on that.

Mr. WHITE. All right. Thank you, Senator. First, you know, your larger issue, the larger question you asked about should we strip out the regulatory reliance on ratings, and my short answer is, as my grandmother would have said, from your lips to God's ear, or perhaps President Obama's ear.

But let me now address the issue you just raised. When I advocate eliminating regulatory reliance, first, it can't be done overnight. That is right. Of course, you need notice and comment, *et cetera.* But also, it would be replaced by placing the direct burden on the bond manager at a bank, at a pension fund, at a money market mutual fund, to justify the safety of his or her bond portfolio. That is terrifically important.

And the bond manager justifies the safety of the bond portfolio to the regulator either by doing the research him or herself, but not everybody is going to be able to do that, especially the smaller institution, or relying on an advisor. The advisor could be one of the incumbent rating firms. It might be a paid consultant. It might be a special advisory firm that comes into the market. Of course, that reliance ought to be approved by the regulator, but you open up the process.

Now, those money market mutual fund responses to the SEC's proposals, ah, they were bleating and saying, oh, not us. Not us. We couldn't do the research ourselves. OK, fine. You can't do the research yourself, but if you don't even have the expertise to be able to figure out who is a reliable advisor and who is not, you shouldn't be running a bond fund in the first place and the SEC ought to use its regulatory powers to remove somebody who does not have the expertise even to figure out who is a reliable advisor or who is not. Again, this is an institutional market. It is not a retail market.

Senator REED. Thank you, Mr. Froeba. I have a question, but it will be in the second round. Thank you.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Joynt, one of the issues that was identified by the SEC staff in last year's report on credit rating agencies was that the growth and complexity of complex structured products overwhelmed the rating agencies. What steps have you taken to ensure that the next complex product—and there will be some—that is sold in the financial markets does not outpace perhaps your firm's analytic capabilities in the way that the CDOs and the CLOs did?

Mr. JOYNT. A complex question, but in today's market environment, there is very little in the way of new complex instruments being issued. So in some way we have sort of a time to reassess.

Some of the most complex instruments in the markets, CDO-squared and CPDOs, I think we took almost 6 months to analyze CPDOs before deciding that we could not rate them with our highest rating, and that was a very difficult process of analysts, modelers, and experienced people with judgment trying to think about the subjective aspects of the risk.

It was mentioned earlier ratings have reflected the probability of loss, but some of these products where it was more important to think about the severity of the loss, how much you might lose when they go bad, and ratings were not and had not and have not been structured to address that, and maybe they need to be. We are working on that now as well.

So I would say we have a healthy degree of skepticism about the complexity of the instruments. Today we have been asked to rate some resecuritizations that were mentioned earlier as well. We have only been willing to rate one class of security rather than tranche securities because in the tranching process they are creating strips that, if the probability of loss is wrong, you will have great severity. So we are uncomfortable assigning ratings of that type today.

So today I would say we are pausing and reassessing how we do the analysis and what the ratings mean.

Senator SHELBY. OK. Professor White, you pointed out that credit rating agencies include disclaimers with their ratings, telling users not to rely on credit rating agencies in making investment decisions. Likewise, the SEC has directed money market funds not to rely solely on ratings by Nationally Recognized Statistical Rating Organizations in making their investment decisions.

Does the fact that regulations require ratings send a signal that contradicts these disclaimers?

Mr. WHITE. It sure sounds and looks like a contradiction to me. On the one hand, you have regulations that say pay attention to the ratings, and on the other hand, you have the kind of disclaimer—I will quote it directly. This is the S&P disclaimer. "Any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision."

Senator SHELBY. Well, why do you want them then if——

Mr. WHITE. Well, I do not know whether to laugh or cry, and that is why I would step away, and say "do not rely." If you want to voluntarily do so, fine, and you get to decide. Since you are an institutional investor, you have some memory, you have some judgment. You can figure out who has been the reliable provider of information, and who has not; who has the business model that you can trust and who, oh, I am not so sure.

That is something that institutional investors should be expected to be able to do.

Senator SHELBY. Professor Coffee, do you have a comment on that?

Mr. COFFEE. Well, my great fear is that the *status quo* will persist, and the way in which it is most likely to persist is if we deregulate some of these rules, what we will get is most institutional investors continue to rely on NRSRO ratings, figuring that is the safest if they ever were to get sued.

What I think we should do simultaneously is give them more options. Let them do it themselves or go to consultants. But to the extent that they are relying on the NRSRO alternative, we should upgrade that alternative by insisting on due diligence so it is not an illusory opinion. That way you give them more options, but they are higher-quality options.

Senator SHELBY. Professor White, Mr. Joynt defends ratings as a common, independent risk benchmark that should be retained in regulations. Do the failures of the rating agencies over the last several years call into question their value as a benchmark?

Mr. WHITE. Even the executives of the ratings agencies acknowledge they made mistakes, they stumbled badly. So certainly over the past few years, they have not been very good.

Quite honestly, I am agnostic about the whole issue of what business model, whether it is investor pay or issuer pay, is the right model. I think that is something that the institutional bond investor can figure out.

It is important to remember that the issuer-pay model had been around for 30 years, from the early 1970s, and really there had not been major problems.

Senator SHELBY. What happened?

Mr. WHITE. And then comes the whole structured finance market where there are only a handful of issuers, only a handful of NRSROs that the issuers can go to. The money is very good, and they stumbled, they succumbed. They got careless.

Senator SHELBY. Greed?

Mr. WHITE. Greed was there all the time. But there was concern about reputation before, and somehow that got swamped. The model failed this time around. But it worked for 30 years. That is why I am agnostic. This is something that institutional participants can figure out on their own, with oversight by the prudential regulators to make sure that at the end of the day they have safe and sound bond portfolios.

Senator SHELBY. Is it possible that ratings for certain instruments, such as more traditional bonds we have talked about, have a greater value as benchmarks than ratings provided for more complex and newer structured products, such as CDOs and CLOs?

Mr. WHITE. They are clearly simpler to rate. The entities are more transparent, and the problems were fewer. So, yes, certainly the history tells us they were better benchmarks.

Senator SHELBY. Mr. Gellert, I have a question for you. You note that the inclusion of ratings in regulations, quote, your language, "has given the Big Three a *de facto* legal and statutory power over many institutional investors and other financial institutions." You recommend that references be removed from regulations. We have been getting into this.

Do you believe that the Government's removal of ratings from its regulations would create incentives for the private sector to conduct better or greater due diligence?

Mr. GELLERT. I think it absolutely will. Just outside of the legal liability issue, there will be the marketing issues and the investor reporting issues for these institutions, because the focus will come on them to understand better what types of credit work they are doing internally. This ability to arbitrage the system would go away to some extent. But there is no question that by embedding, really the Big Three's, but the NRSROs in various regulations gives them undue power over the investment decisions and risk management decisions of the institutional investor community.

Senator SHELBY. How do we bring securitization back? How do we do this? I mean, it is based on trust, and maybe it is a brick at a time. But it worked so well for so long. Professor Coffee, do you have a comment?

Mr. COFFEE. I think this is a case where innovation was corrupted. We had a much simpler kind of asset-backed securitization in the 1990s——

Senator SHELBY. And it worked, didn't it?

Mr. COFFEE. It worked better when it was simpler. Once we started bringing in the CDO-squared, no one could understand it. And if there is one rule I would suggest to you, it is that if it is too opaque to be understood, it really should not be issued. And I think the market is going to insist on that. We will probably have simpler kinds of asset-backed securitizations which are more credible and which the rating agency can more credibly signal and sample the quality of the underlying collateral. Otherwise, we will see frozen housing finance——

Senator SHELBY. Without that, there is no trust out there, is there?

Mr. COFFEE. There is no trust because everyone can see that no one understands this, including the rating agency.

Senator SHELBY. Thank you, Mr. Chairman.

Senator REED. Thank you, Senator Shelby.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank each of you for your testimony. I really think it has been most enlightening. I think each of you have shed a little different light on the issue, and I really appreciate that, especially on this issue.

Mr. Joynt, you probably deserve a badge of courage in showing up. I want to thank you for that. And I also want to thank you for taking time in your offices to walk through the issue with us. I know that in a market economy this has affected you guys downwardly. I know a lot of employees have left the firm as a result just to less work, and I know this is not a good time for rating agencies. But I want to ask this question.

If you listened, I think we were all sort of shocked that there was no due diligence really performed, and I think each person has alluded to that in a different way. What is the value proposition that the credit agencies, the three large ones, provide the public?

Mr. JOYNT. So the dialogue about due diligence, if we focus on corporate issuers, I think if you think about the rating agencies that have recently started up or become NRSROs, almost all of them are focused on corporate issuers. None are focused on structured finance, Realpoint only on CMBS. I think that is because there is disclosure of good information; they are able to do ratings and get investors to pay. They do not need any special information.

So that is the process I think about when I think about securitization and structured finance as well. There should be enough public disclosure for many rating agencies, and investors also, to be able to use the public information, that it should be reputable, that an issuer and/or his banker has put together as a part of arranging a financing. And so I see them as having the due diligence.

The function of the rating agency, Fitch's rating agency, is to analyze that information, think forward about the potential risk of default and ramifications for investors, and try to order that for investors through our rating system, and then publish our research that tells them all the factors.

I think that function—which allows many investors that cannot analyze the wide variety of financings that we can because we have a staff of 1,900 people—and I think that provides a valuable function. So it should not be the only thing that investors should be looking at. I certainly agree with the idea that investors are responsible for their own analysis.

Senator CORKER. So one of the things we talked about in your office was really to focus on the toxic asset issue, which has kind of come and gone, but how do you actually value those? That is where we spent most of our time. And you guys shared with me that you could tell by zip codes what the default rates were going to be and all of those kinds of things.

So moving away from the corporate side and looking at the CDOs and these other instruments we are talking about, those kind of things were not done on the other hand when you rated these particular securities. Is that correct?

Mr. JOYNT. No. For mortgage-backed securities, that is the kind of analysis we would do. We would not go out and verify the individual loan information provided in the package. But in looking at the history and frequency of defaults and severities and problems, we could do that as a part of our modeling.

Unfortunately, the history is not representative of what was going to happen and has subsequently happened.

Senator CORKER. But on those, then, understanding that you look at corporate financial statements and those kind of things, but on these other types of asset-backed securities, it is hard to understand, in fairness, what the value proposition is that you offer if they are not really being offered by a company and you are not actually going out and checking the parts of the country that they are being offered from. It is hard to understand that there is really any value proposition that is being offered by the credit rating agency.

Mr. JOYNT. I do not see it that way, so I think originators and servicers put together financial packages and package them into transactions that we can look at the companies, the origination, the servicer, the accounting firm that signed off on their financials, and try to think about whether those are representative of what is being presented and then analyze that compared to the history and what we would project the losses to be.

Senator CORKER. So it is really more—the companies, of course, have no skin in the game. They are out of there after it is done, mostly. I know some of them have kept pieces, but the companies—so when you look at the companies, they are not standing behind it like might be the case with a covered bond. So——

Mr. JOYNT. That is true.

Senator CORKER. OK.

Mr. JOYNT. But I do not think they are not—it has not been my experience, although we have had quite bad experience that some of the large important financial institutions doing securitizations are not appreciative of the fact that their name is on the securitization if they would have originated the product. And so I think they are quite involved and/or are servicing the product. So I believe they have—not all firms, and some firms, of course, have entirely disappeared, so obviously they were doing quite a poor job and either did not care about their reputation or just failed.

Senator CORKER. Mr. Chairman, I am going to ask one more question if that is OK.

We are going to miss Senator Bunning in about a year-and-a-half.

[Laughter.]

Senator BUNNING. What makes you think I will be missed?

Senator CORKER. I am going to miss you.

The whole issue, I think one of the things that we have talked about some in the past is the business model, and that is that in the event you actually had to do due diligence and have these third-party efforts take place—which, by the way, I think should have to happen if somebody is going to rely upon it. But, in essence, it would really price you ought to the market in a way, would it not? Would you speak to that a little bit? And if you had to really do due diligence and you had to really know what was in that package, you could not charge the fee that you now charge and make any money. And I think you alluded to that in our conversations that that would be very problematic.

Mr. JOYNT. Well, we are not staffed in that way to go audit or check every one of the loan packages put together on every single family loan that would go into a financing. So we are not staffed that was at all. We are not staffed with a national network of auditors or even a system of local auditors. So that is certainly true.

For CMBS, it is a little bit different where we have been able to send analysts to look at large properties. We are still not conducting what—I am very careful about this word "due diligence" around lawyers, because I am not a lawyer, but we certainly conduct an amount of diligent investigation into what we are looking at for individual properties in commercial real estate. But for consumer assets, broadly spread, we have used a more actuarial approach, assuming that the facts in the files are correct.

Senator CORKER. And everyone on the panel agrees that there should be no regulatory mandate to have to use, even State government, city government, any type of government entity should not be mandated to have to have a rating to buy a security. Does everyone agree with that? Everybody agrees with——

Mr. COFFEE. I think that there could be other options.

Senator CORKER. But we should not build in having to use credit rating agencies and automatically causing people to believe that some work was actually done, due diligence-wise?

Mr. COFFEE. I think that what some of us are saying is that you could certainly have alternatives that did not involve the use of an NRSRO agency. But to the extent that there already is this reputational capital out there in the public's mind and they are going to want you to have an NRSRO rating, some of us want to make that real and not illusory by insisting on due diligence. And that due diligence, to answer your earlier question, would probably be paid for by the underwriters. If the underwriters could get this market jump-started again, they would be happy to pay the cost of due diligence.

Senator CORKER. Thank you all. I appreciate it.

Senator REED. Thank you, Senator Corker.

Senator Bunning.

Senator BUNNING. Thank you. Five minutes turns into 10 in a big hurry up here, and that is the only reason—since some of us have another meeting to go to.

This is for anyone who would like to answer it. During the housing boom—the boom—rating agencies rated mortgage-backed securities without verifying any of the information about the mortgages. If they had, maybe they would have detected some of the fraud and bad lending practices.

Do you think rating agencies should be required to verify the information provided to them by the issuer? And I am going to give you a caveat. The first mortgage that I ever took, I had to take three of my Federal tax returns in with me to verify that I had the income that I wrote on my application. You do not have to do any of those things right now, and I am asking if you think we ought to have a little more verification of what is on the list that the person who is looking for the mortgage at the time—and that is how we got into all this mischief with mortgage-backed securities being sold into the market without any verification, even though they were AAA rated.

Mr. COFFEE. Let me say you are right, Senator. You probably wanted to hear that. You are right. And I have some charts in my statement that show that the percentage of liar loans, no-document and low-document loans, in subprime mortgages went from in the year 2001 about 28 percent to the year 2006 about 51 percent. That is a very sharp jump, and no one noticed because no one really wanted to look. The loan originators had no interest because they got rid of the entire loan.

Senator BUNNING. But the Federal Reserve was responsible for overseeing the banks that made those loans, and/or the mortgage brokers, we gave that power to the Fed and just because they did not write any regulations, we ran into all this mischief. And so the housing bubble and the bursting of it was caused by some not doing their homework.

Mr. COFFEE. Again, you are right, Senator.

Senator BUNNING. Well, I do not want to be right, because we are in a hell of a mess. If we were to require issuers to disclose information to all rating agencies, should that disclosure apply to securities that have already been rated so that we can get more opinions on the toxic securities already in the system? Please.

Mr. GELLERT. The short answer is yes. The percentage of new issues, particularly in the structured business now, is infinitesimal compared to what is outstanding and on people's books. So back to your prior questions of how do we get the securitization market moving again, we have to be able to provide to the market greater insight into what is already out there. And to just provide the detailed due diligence information and supporting information of structured products that come to market today is insufficient.

And I would just add that one of the areas that gets short shrift when we discuss structured products is the collateralized loan obligation asset class. It is equally if not more important than the CDOs and other securitized, or structured products, and the information availability is much smaller. And it is much more tightly controlled by the rating agencies that currently do rate——

Senator BUNNING. I only have 5 minutes. I am not trying to cut you off, but I want to ask—because do you think—this is a question for anybody. Do you think the rating agencies should be able to be sued for errors in their ratings?

Mr. COFFEE. Because I am probably the one most associated with saying there has to be some litigation remedy, let me say I do not think it should go that far. I do not think there should be a cause of action for negligence. I do not think misjudgments should produce litigation. I think it should be for being reckless. And when you give a rating with knowing any facts at all, then it is reckless.

Senator BUNNING. Well, then, that is a cause of——

Mr. COFFEE. I think you went beyond that and said should you just be sued because you made a misjudgment.

Senator BUNNING. No, no. If you find negligence, then there is a cause of action.

Mr. COFFEE. Well, not under the Federal securities laws, and I do not think we should try to increase anything in Federal law that would create a negligence-based cause of action against the rating agencies.

Senator BUNNING. OK. Then, how about this question: Do you think that issuers who relied on flawed ratings to sell their product should be able to be sued for using those flawed ratings?

Mr. COFFEE. I think they are going to be sued directly because they made fraudulent misstatements, and that is how they are being sued. I do not think—I think the plaintiffs' bar regards the rating agencies as a possible additional party to throw in, but they have very modest expectations of what they can get from them, and they have not gotten any significant settlements.

Senator BUNNING. Well, the question—I am over time. Thank you.

Senator REED. If you want to take some more time?

Senator BUNNING. Well, the only thing I wanted to ask is if here we have a situation where they were not given enough information or they did not investigate far enough with the mortgage-backed securities, and they accepted the fact that these were legitimate mortgage-backed securities by the banks, then I see where they would not be held responsible. But if they did not go into the details of what kind of mortgages they were selling or were being sold, then I think they should be held responsible.

Mr. COFFEE. And I think that is the line between negligence and recklessness.

Senator BUNNING. Thank you. Thank you very much.

Senator REED. Thank you, Senator Bunning.

Mr. Froeba, again, thank you for your testimony but also for your insights, because you actually were sort of there in the middle of this while at an opportune level, not at the top, not at the bottom, but right where the work was being done.

You mentioned of your six proposals—you suggested the test, and it is interesting test: Would it avert the problems we saw? And you have suggested that the proposals before us will not accomplish that. Of those six, what is the most critical thing that from your view we would have to—or one or two that we would have to incorporate in our reforms?

Mr. FROEBA. In some ways, the most important would be the hardest to implement, and that is the idea that you separate the analytical function from the management function. Just as in the court system or at a university, you want your professors, you want your judges to be independent of the people who are sort of managing the process. At the rating agency, you want the analysis to be independent of the business decisions. And I think that is probably the key, also the most difficult.

Another really important one is affecting the way analysts are paid. I think analysts should not be—their pay, their compensation, their reward should not have anything to do with how the company does, because the best answer from the analysts may impact company revenue negatively. You want to encourage them to give that negative answer despite the impact it may have to their own financial situation. So those two are important. I think expanding liability is key.

And, finally, the one that is probably, forgive me for saying it so informally—the weirdest proposal is that the rating agencies be allowed to cooperate. If the rating agencies had gotten together 5 years ago and said we are not going to allow for the securitization of liar loans, if they had been able to get together and agree that they were all going to do that and they would not feel undercut by the competitors, I think we would have seen much of this subprime crisis averted.

Senator REED. Thank you.

Professor Coffee, I just wanted to follow up on Senator Bunning's line of questioning about liability. As you pointed out, the standard for liability under the securities laws is essentially recklessness, it is a very——

Mr. COFFEE. "Extreme recklessness."

Senator REED. "Extreme recklessness." It is a very high threshold, as it should be. The proposal I have made is not to change that liability standard but to change explicitly the pleading standard. And I wanted you to—if that is your understanding since you have looked at the legislation, if that is the case. And, also, the rationale is that until you get to discovery, it is awful hard to understand what was done on a factual basis, and just your comments on that.

Mr. COFFEE. I agree with what you are saying, and I think it is a sound proposal. I also think that it will produce very few litigated losses for the credit rating agencies because you give them in your statute a kind of safe harbor. If they get independent due diligence done by a professional, they are going to be safe. So it tells them they can avoid litigation if they do what we want them to do, which is bring in due diligence. But everything you said is correct.

Senator REED. Let me, another point, too, and I think it is important, because we specifically point out that their ratings would not be considered a forward-looking statement for purposes of Section 21(e) of the Securities Act, which is the same protection we give to accountants, *et cetera*. That is, I think, important because without that they are a liability for "projecting the future forecasting" would be, I think, inordinate. Is that another point you would——

Mr. COFFEE. I agree with that, too, because we are really talking about historical information. If you knew, or should have known if you had looked, that half these mortgages were already in default, that is not forward-looking. That is really historical facts.

Senator REED. Secretary Barr suggested one issue, which would be suits by corporate issuers against a rating agency for a downgrade. And I guess the question—that was one reason why he suggested the Administration has not incorporated this proposal. Let me link two questions together. How likely is that, or your comments on that? But, second, you know, one of the issues, I think, in response to the exchange with Mr. Gellert was this notion of there are a lot of mortgage-backed securities out there, we should share the information with the rating agencies. I would think that the accountants who have to certify would have a responsibility at this juncture to do exactly what the rating agencies might be able to do, which is to go in there and say, "My God, none of these loans are paying," and we have to mark down this item.

So two comments to that, and then, Mr. Gellert, you can comment.

Mr. COFFEE. Well, let me say on the first point, which is the litigation question about the corporate issuer, I know a lot about this kind of litigation. Those suits were originally brought as defamation suits, and they all lost. And that is when courts started talking about the First Amendment because defamation triggers the First Amendment. None of those suits have won at all. And in the securities law area, there are other problems. The issuer did not purchase or sell. It does not have 10(b)-5 standing. And the issuer did not really rely on this because the issuer knows more about itself than anyone else, so it cannot say it was misled by the rating.

That is, I think, a phantom fear that issuers will be able to sue rating agencies, but if you are concerned about it, you can expressly deal with that and make sure the statute does not apply to them.

Senator REED. Mr. Gellert, just a quick point about the accountants. Maybe I am imprecise in my analysis, but shouldn't they have a responsibility now if it is publicly traded, if the bank is holding this mortgage-backed security and it is underwater, don't they have to write it down?

Mr. GELLERT. Responsibilities of accountants, sir, are well beyond my expertise.

Senator REED. OK. That is fair.

Mr. GELLERT. And certainly have been well covered over the past years. I certainly understand the point, and I certainly believe that the more information that is available, the more parties can be involved in opining, and that may extend and possibly should extend beyond those who are in, these intermediary roles and should extend all the way to the institutional investors who ultimately are making decisions and buying these instruments.

Senator REED. That is a fair point. Thank you. Thank you all. Senator Corker, do you have a question?

Senator CORKER. Yes, sir. I again thank all of your for your testimony. Mr. Joynt, back to you again.

There has been some discussion about changing the compensation, and, by the way, I want you to know I am one of those that is slow to sort of mandate how we do those kind of things. But just going to the business model side of it, is that something that is farfetched? Or do you think any of the credit rating agencies have thought, well, you know, we will take a bigger fee, but we will take it over time based on performance? Has any of that had any kind of serious discussion at all at your company level or, to your knowledge, Standard & Poor or others?

Mr. JOYNT. So the best discussion about that I think was at the SEC hearing, and then maybe in subsequent conversations where they are trying to think about a better or different payment model. It is very difficult for me and our firm to think about how we would adopt a separate kind of payment or fee structure without having it coordinated with others, so it would be quite problematic.

You might not realize, but today, when we rate structured financings, for example, we do not take in all the income immediately. We defer a portion of the fee into the future to pay for surveillance, continuing surveillance, because if we are not rating any new issues, we still have analysts to follow the outstanding transactions. So that could be changed into some kind of success fee or some—there are alternatives, I think, that the SEC continues to progress and try to think about what could be workable.

Senator CORKER. So then in answering the question that way, you actually would not be opposed to that being mandated by the Government or the SEC, as long as everyone was doing it.

Mr. JOYNT. I am open to the dialogue about it. Each time we get a dialogue, there have been weaknesses in each one of the other ideas, and, of course, it could be quite a dramatic change in kind of the profile for an agency like Fitch. So, for example, in the roulette wheel alternative, if ten rating agencies decide they would like to rate a structured financing, I guess each one would only get chosen one-tenth of the time. That is quite different from today's business dynamic for our firm.

So I think, you know, while we are open to the dialogue, I would have to at least consider how it would impact our business fortunes.

Senator CORKER. Professor Coffee, when Professor White—and I have enjoyed all the dialogue a great deal. But when he was talking about the particular bond manager assuming the liability of—you were shaking your head in the opposite direction his was shaking, and I just wondered if you wanted to respond to that.

Mr. COFFEE. I mean, I don't really want to delay this hearing further. The change to an issuer-pays model was the early 1970s. Asset-backed securitizations don't really become significant before about 1990. What was happening was that the Big Two back then—Fitch wasn't really one of the Big Three at that point—really were break-even marginal companies, and as the cost became more expensive—let us forget the structure of finance—the cost could be as high as three-quarters of a million dollars to rate a very complicated structured finance offering, or at least that is the fee charged in a slightly competitive market.

That is such a high cost that I don't think that can easily be dealt with under a user-pay system. You can't put all that front-end work in hoping you will get paid later on as a developing start-up company. That is why they have primarily focused on corporate bonds rather than on this complex structured finance field.

But all I was just agreeing with is why the system broke down. It broke down well before structured finance, and frankly, every other gatekeeper you can think of, accountants, investment bankers, lawyers, they are paid by their client, also. It has got certain efficient properties.

Senator CORKER. So it was obviously magnified and multiplied with all of these complex securities, but when you say it broke down well before, expand on that a little bit.

Mr. COFFEE. Around 1972 or 1973, Moody's and Standard and Poor's started insisting that issuers pay them for the rating process. In the old days, Moody's put out a book, Moody's Bible, and in the world we get into by the 1970s, that is a very slow process of publishing a book and there is what the economists would call a public goods problem here or a free rider problem. If you sell just one copy of the book, 10,000 people can read it and they gain the same information. So you had to find some way that you could force people to subscribe to you and the marketplace didn't react well to insisting upon you pay a subscription fee.

Senator CORKER. And yet you have said that you know that is not going to change.

Mr. COFFEE. I think the issuer-pays model, which is the model we moved to in the 1970s, will be the predominant model as far forward as I can see. I certainly wish to encourage user-pays. I think they are a very important check and balance on the system. But I think they will primarily be a check and balance on the system and most of the business will be done under an issuer-pays business model.

Mr. GELLERT. A comment, Senator?

Senator CORKER. Yes, sir?

Mr. GELLERT. I would just like to point out that if you look at the newer agencies, or firms, be they NRSROs or not, they are almost entirely subscription-based or user-based businesses. No one else is coming into the market and saying, let us startup a new issuer-paid. And the reason for that is that the market share is so unbelievably tightly held by three players. So for competitive reasons, for all of the regulatory reasons that we have already discussed, breaking into that business as a new player is a relatively futile effort.

But I would just add to Professor Coffee's comments that one of the reasons that we start out as—a firm like us, like Rapid Ratings—starts out rating individual corporations, is, yes, they are simpler than trying to rate structured products, but the availability of information is completely different. We rate entirely based on disclosed, publicly available financial information for public companies, and private companies, it is the data that is provided to us by our customers under contract and confidentiality agreement, with full understanding on a bilateral basis that we are not conducting due diligence for them, but if they are a bank that has a lending relationship, they supply that information, if it is a corporation that has a counterparty risk relationship, they are receiving that information, they supply it to us. It is about availability of information.

So new competitors, regardless of the revenue model, are not going to break into—with a couple of very small exceptions, and Real Point happens to be one of them—are going to break into the structured business when the payment, as Professor Coffee just mentioned, needs to be a front-loaded payment and the information is simply not being shared.

Senator CORKER. I appreciate your comments earlier about the unintended consequences of making everyone register. I think that was a valuable contribution. But let us move down that path just a little bit, the one you are on.

We visited the offices of Second Market. I know that they are setting up a sort of a public auction process for securities and they are doing a great job and they are being very successful, and I hope they are because they have come up with a brilliant idea. At the same time, as I looked at what they were disclosing on some of these—again, as you have just mentioned, there is not as much information as one would like—if one—and I have read op-eds recently and publications where disclosure on these securities ought to be broadly given—if that was the case, are you saying that an entity like yours actually would rate many of these more complex securities? I mean, that is a lot of work for all these securities being offered. Is that something you say you would pursue?

Mr. GELLERT. I am saying that we would have the choice, and that would be a business choice that we would have, and we would make it as we make any other business choice. There are other independent, non-NRSRO research firms that are staffed not in an analytical, quantitative way that we are, but staffed with enough people to be able to execute that type of analysis—not on all structured products, of course, but on individual asset class by asset class, CLOs being one of them—and be able to provide an extremely good alternative despite the fact that not all of us would be staffed and certainly would be able to say, day one, we will go ahead and we will get into the market to do all of—to wholesale—get into the structured product rating business.

Senator CORKER. You wanted to mention something.

Mr. FROEBA. Yes. I just wanted to say you can combine issuer-pay and investor-pay. They don't have to be exclusive. And you would do it by simply giving the investors the opportunity to pick which agency an issuer uses. It is the power of the issuer to decide who would rate that became the source of, I think the big problems in the last few years. They could pit the agencies against each other. And if you just take that power away from them, much of the problem is solved. Combine the two. It can't be done. I don't think it would be insurmountable.

Senator CORKER. Mr. Chairman, thank you, and each of you. One of the great privileges we have here is to hear from intelligent people like you often and we thank you very much. I appreciate it.

Senator REED. Thank you, Senator Corker.

Gentlemen, thank you for excellent testimony. My colleagues may have additional questions and I would ask them to submit them by August 12 and ask you to respond as quickly as you can. All statements of my colleagues will be made part of the record and your statements will be made fully part of the record.

Thank you very much, and the hearing is adjourned.

[Whereupon, at 12:17 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Thank you, Mr. Chairman.

The nature of today's credit rating industry reflects decades of regulatory missteps rather than market preferences. Over the years, the Government granted special regulatory status to a small number of rating agencies and protected those firms from potential competitors.

Beginning in 1975, the Securities and Exchange Commission began embedding NRSRO ratings into certain key regulations. Once credit ratings acquired regulatory status, they crept into State regulations and private investment guidelines.

The staff of the SEC controlled access to the prized "nationally recognized statistical rating organization" or NRSRO designation by subjecting potential entrants to a vague set of criteria and an incredibly slow time line.

The SEC did little to oversee NRSROs once so designated. Nevertheless, because of the doors they opened, ratings from an NRSRO became an excuse for some investors to stop doing their own due diligence.

Widespread overreliance on ratings meant that the effects of poor quality or inadequately updated ratings could ripple through the markets.

By encouraging reliance on a small number of big credit rating agencies, bureaucrats at the SEC exposed the economic system to tremendous risk.

Our current financial crisis, which was caused in part by the credit rating agencies' failure to appreciate the risks associated with complex structured products, demonstrates just how big that systemic risk was.

The troubles caused by the SEC's flawed regime, however, did not come as a surprise.

When I was Chairman of this Committee, we acted to address the problem after the SEC failed to take action on its own. I felt that the industry's heavy concentration and high profits were symptoms of an industry in serious need of reform.

We then passed the Credit Rating Agency Reform Act of 2006. The Act set forth clear standards for the NRSRO application process. It also gave the SEC authority to regulate disclosures and conflicts of interest, as well as unfair and abusive practices.

Unfortunately, the law that we passed in 2006 did not have time to take root before the problems that they were intended to remedy took their toll.

The SEC adopted rules pursuant to that legislation in June of 2007. Over the following months, the number of NRSROs doubled, just as the performance of many "highly rated" subprime securities revealed that such securities were not as safe as the rating agencies said they were.

Today, we will consider a legislative proposal by the Administration to revisit the regulation of credit rating agencies.

In determining whether new legislative steps are required, we should keep in mind that the 2006 reforms are still working their way through the system. That doesn't mean, however, that we shouldn't consider further changes. Every option should be on the table.

One option is to remove rating mandates from regulations. Another is materially improving disclosure. As with any regulatory reform, however, we must also be mindful of unintended consequences.

I strongly believe that the credit rating agencies played a pivotal role in the collapse of our financial markets. Any regulatory reform effort must take that into consideration.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR JACK REED

I am very pleased Chairman Dodd and Ranking Member Shelby have chosen to have a hearing examining proposals to enhance the regulation of credit rating agencies. I want to thank all of our witnesses for taking time out of their busy schedules today to testify on this important issue.

As most of you know, in late May I introduced S. 1073, the Rating Accountability and Transparency Enhancement (RATE) Act. The purpose of the RATE Act is to strengthen the Securities and Exchange Commission's (SEC) oversight of credit rating agencies and improve the accountability and accuracy of credit ratings.

Credit ratings have taken on systemic importance in our financial system, and have become critical to capital formation, investor confidence, and the efficient performance of the United States economy. However, during the past year we have witnessed a significant amount of market instability stemming in part from the failure of these agencies to accurately measure the risks associated with mortgage-backed securities and other more complex products.

As the Chairman of the Securities, Insurance, and Investment Subcommittee, I held a hearing in September of 2007 to examine the role of credit rating agencies in the mortgage crisis, and these issues were also addressed at a hearing by the full Committee last year. From these hearings, it is clear that problems at credit rating agencies contributed to the significant financial sector instability our country has been experiencing. In fact, an SEC investigation last summer found that credit rating agencies such as Moody's, Standard & Poor's, and Fitch Ratings conducted weak analyses and failed to maintain appropriate independence from the issuers whose securities they rated.

According to a mortgage industry trade publication, the three major credit rating agencies have each downgraded more than half of the subprime mortgage-backed securities they originally rated between 2005 and 2007. Ratings agencies made these mistakes in part because of conflicts of interest and other problems with internal controls, underscoring the need for enhanced oversight of this industry.

Credit rating agencies are in the business of providing investors with unbiased analysis, but the current incentive structure gives them too much leeway to hand out unjustifiably favorable ratings. Let's be clear: Not every rating is suspect and these firms provide crucial information for investors and the marketplace, but credit rating agencies like any other industry should be held accountable if they knowingly or recklessly mislead investors. My bill includes carefully crafted language that provides investors and other credit rating users with the ability to pursue 10(b)5 fraud claims under Federal securities laws. As we will discuss at this morning's hearing, my bill does not change the fraud standard. Rather it tailors the pleading standard so that investors can take action when a rating agency recklessly fails to review key information in developing the rating.

The RATE Act would also give the SEC strong new authority to oversee and hold rating agencies accountable for conflicts of interest and other internal control deficiencies that have weakened ratings in the past.

It also enhances disclosure requirements to allow investors and others to learn about the methodologies, assumptions, fees, and amount of due diligence associated with ratings. And it requires rating agencies to notify users and promptly update ratings when model or methodology changes occur. Finally, the bill requires ratings agencies to have independent compliance officers, and to take other actions to prevent potential conflicts of interest.

I am pleased that the credit rating agency draft legislation that the Administration has transmitted to Congress includes many of my provisions to improve the accountability and transparency of credit ratings, and I look forward to working with everyone on the Committee on this issue as we move forward with drafting a regulatory modernization bill.

PREPARED STATEMENT OF MICHAEL S. BARR

ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS,
DEPARTMENT OF THE TREASURY

AUGUST 5, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify before you today about the Administration's plan for financial regulatory reform.

On June 17, President Obama unveiled a sweeping set of regulatory reforms to lay the foundation for a safer, more stable financial system; one that properly delivers the benefits of market-driven financial innovation while safeguarding against the dangers of market-driven excess.

In the weeks since the release of those proposals, the Administration has worked with Congress in testimony and briefings with your staff to explain and refine our legislation.

Today, I want to first speak in broad terms about the forces that led us into the current crisis and the key objectives of our reform proposal. I will then turn to discuss the role that third party credit ratings and rating agencies played in creating a system where risks built up without being accounted for or properly understood. And how these ratings contributed to a system that proved far too fragile in the face of changes in the economic outlook and uncertainty in financial markets.

This Committee provided strong leadership to enact the first registration and regulation of rating agencies in 2006, and the proposals that I will discuss today build on that foundation.

Where Our Economy Stands Today

President Obama inherited an economic and financial crisis more serious than any President since Franklin Roosevelt. Over the last 7 months, the President has responded forcefully with a historic economic stimulus package, with a multiprong effort to stabilize our financial and housing sectors, and, in June, with a sweeping set of reforms to make the financial system more stable, more resilient, and safer for consumers and investors.

We cannot be complacent; the history of major financial crises includes many false dawns and periods of optimism even in the midst of the worst downturns. But I think you will agree that the sense of free fall that surrounded the economic statistics earlier this spring has now abated. Even amidst much continued uncertainty, we must reflect on the extraordinary path our economy and financial system have taken over the past 2 years, and take this opportunity to restore confidence in the system through fundamental reform. We cannot afford to wait.

Forces Leading to the Crisis

At many turns in our history, we have seen a pattern of tremendous growth supported by financial innovation. As we consider financial reform, we need to be mindful of the fact that those markets with the most innovation and the fastest growth seemed to be at the center of the current crisis.

But in this cycle, as in many cycles past, growth often hid key underlying risks, and innovation often outpaced the capacity of risk managers, boards of directors, regulators, rating agencies, and the market as a whole to understand and respond.

Securitization helped banks move credit risk off of their books and supply more capital to housing markets. It also widened the gaps between borrowers, lenders, and investors—as lenders lowered underwriting standards since the securitized loans would be sold to others in the market, while market demand for securitized assets lowered the incentives for due diligence.

Rapidly expanding markets for hedging and risk protection allowed for better management of corporate balance sheets, enabling businesses to focus on their core missions; credit protection allowed financial institutions to provide more capital to business and families that needed it, but a lack of transparency hid the movement of exposures. When the downturn suddenly exposed liquidity vulnerabilities and large unmanaged counterparty risks, the uncertainty disrupted even the most deeply liquid and highly collateralized markets at the center of our financial system.

It is useful to think about our response to this crisis in terms of cycles of innovation. New products develop slowly while market participants are unsure of their value or their risks. As they grow, however, the excitement and enthusiasm can overwhelm normal risk management systems. Participants assume too soon that they really "know how they work," and these new products, applied widely without thought to new contexts—and often carrying more risk—flood the market. The cycle turns, as this one did, with a vengeance, when that lack of understanding and that excess is exposed. But past experience shows that innovation survives and thrives again after reform of the regulatory infrastructure renews investor confidence.

Innovation creates products that serve the needs of consumers, and growth brings new players into the system. But innovation demands a system of regulation that protects our financial system from catastrophic failure, protects consumers and investors from widespread harm and ensures that they have the information they need to make appropriate choices.

Rather than focus on the old, "more regulation" versus "less regulation" debate, the questions we have asked are: why have certain types of innovation contributed in certain contexts to outsized risks? Why was our system ill-equipped to monitor, mitigate and respond to those risks?

Our system failed to provide transparency in key markets, especially fast developing ones. Rapid growth hid misaligned incentives that people didn't recognize. Throughout our system we had inadequate capital and liquidity buffers—as both market participants and regulators failed to account for new risks appropriately. The apparent short-term rewards in new products and rapidly growing markets created incentives for risk-taking that overwhelmed private sector gatekeepers, and swamped those parts of the system that were supposed to mitigate risk. And households took on risks that they did not fully understand and could ill-afford.

Our proposals identify sweeping reforms to the regulation of our financial system, to address an underlying crisis of confidence—for consumers and for market participants. We must create a financial system that is safer and fairer; more stable and more resilient.

Protecting Consumers

We need strong and consistent regulation and supervision of consumer financial services and investment markets to restore consumer confidence. In early July, we delivered the first major portion of our legislative proposals to the Congress, proposing to create a Consumer Financial Protection Agency (CFPA).

We all aspire to the same objectives for consumer protection regulation: independence, accountability, effectiveness, and balance—a system that promotes financial inclusion and preserves choice. The question is how to achieve that. A successful regulatory structure for consumer protection requires mission focus, marketwide coverage, and consolidated authority.

Today's system has none of these qualities. It fragments jurisdiction and authority for consumer protection over many Federal regulators, which have higher priorities than protecting consumers. Banks can choose the least restrictive supervisor among several different banking agencies. Nonbank providers avoid Federal supervision altogether; no Federal consumer compliance examiner ever lands at their doorsteps. Fragmentation of rule writing, supervision, and enforcement leads to finger-pointing in place of action and makes actions taken less effective.

The President's proposal for one agency for one marketplace with one mission—protecting consumers—will resolve these problems. The Consumer Financial Protection Agency will create a level playing field for all providers, regardless of their charter or corporate form. It will ensure high and uniform standards across the market. It will support financial literacy for all Americans. It will prohibit misleading sales pitches and hidden traps, but there will be profits made on a level playing field where banks and nonbanks can compete on the basis of price and quality.

If we create one Federal regulator with consolidated authority, then we will be able to leave behind regulatory arbitrage and interagency finger pointing. And we will be assured of accountability.

Our proposal ensures, not limits, consumer choice; preserves, not stifles, innovation; strengthens, not weakens, depository institutions; reduces, not increases, regulatory costs; empowers, not undermines, consumers; and increases, not reduces, national regulatory uniformity.

Systemic Risk

Much of the discussion of reform over the past 2 years—both in our proposals and among other commentators—has focused on both the nature of and proper response to systemic risk.

To address these risks, our proposals focus on three major tasks: (1) providing an effective system for monitoring risks as they arise and coordinating a response; (2) creating a single point of accountability for tougher and more consistent supervision of the largest and most interconnected institutions; and (3) tailoring the system of regulation to cover the full range of risks and actors in the financial system, so that risks can no longer build up completely outside of supervision and monitoring.

Many have asked whether we need a "systemic risk regulator" or a "super regulator" that can look out for new risks and immediately take action to address them or order other regulators to do so. That is not what we are proposing. We cannot have a system that depends on the foresight of a single institution or a single person to identify and prevent risks. That's why we have proposed that the critical role of monitoring for emerging risks and coordinating policy responses be vested in a Financial Services Oversight Council.

At the same time, a council of independent regulators with divergent missions will not have operational coherence and cannot be held accountable for supervision of individual financial firms. That's why we propose an evolution in the Federal Reserve's power to provide consolidated supervision and regulation of any financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed. The financial crisis has demonstrated the crucial importance of having a consolidated supervisor and regulator for all "Tier 1 Financial Holding Companies," with the regulator having the authority and responsibility to regulate these firms not just to protect their individual safety and soundness but to protect the entire financial system.

This crisis has also clearly demonstrated that risks to the system can emerge from all corners of the financial markets and from any of our financial institutions. Our approach is to bring these institutions and markets into a comprehensive system of regulation, where risks are disclosed and monitored by regulators as necessary. Secretary Geithner has testified about the need to bring all over-the-counter derivatives markets into a comprehensive regulatory framework. In the next few days we will deliver legislative text to this Committee that would accomplish that goal. We have delivered proposed legislation that would strengthen the regulation of securitization markets, expand regulatory authority for clearing, payment, and settlement systems, and require registration of hedge funds.

Basic Reform of Capital, Supervision, and Resolution Authority

As Secretary Geithner has said, the three most important things to lower risk in the financial system are "capital, capital, capital." We need to make our financial system safer and more resilient. We cannot rely on perfect foresight—whether of regulators or firms. Higher capital charges can insulate the system from the build-up of risk without limiting activities in the markets. That's why we have launched a review of the capital regime and have proposed raising capital and liquidity standards across the board, including higher standards for financial holding companies, and even higher standards for Tier 1 Financial Holding Companies—to account for the additional risk that the largest and most interconnected firms could pose to our system.

Making the system safe for innovation means financial firms should raise the amount of capital that they hold as a buffer against potential future losses. It also means creating a more uniform system of regulation so that risks cannot build up due to inadequate regulatory oversight. To strengthen banking regulation, we propose removing the central source of arbitrage among depository institutions. Our proposed National Bank Supervisor would consolidate the Office of Thrift Supervision and the Office of the Comptroller of the Currency. We will also close loopholes in the Bank Holding Company Act that allow firms to own insured depository institutions yet escape consolidated supervision and regulation.

Financial activity involves risk, and the fact is that we will not be able to identify all risks or prevent all future crises. We learned through painful experience that during times of great stress, the disorderly failure of a large, interconnected institution can threaten the stability of the entire financial system. While we have a tested and effective system for resolving failing banks, there is still no effective legal mechanism to resolve a nonbank financial institution or bank holding company. We have proposed to fill this gap in our legal framework with a mechanism modeled on our existing system under the We have proposed to fill this gap in our legal framework with a mechanism modeled on our existing system under the Federal Deposit Insurance Corporation (FDIC).

Finally, both our financial system and this crisis have been global in scope. Our solutions have been and must continue to be global. International reforms must support our efforts at home, including strengthening the capital framework; improving oversight of global financial markets; coordinating supervision of internationally active firms; and enhancing crisis management tools. We will not wait for the international community to act before we reform at home, but nor will we be satisfied with an international race to the bottom on regulatory standards.

Credit Ratings and Fragility

It's worthwhile to begin our discussion on credit ratings with a basic explanation of the role that they play in our economy. Rating agencies solve a basic market failure. In a market with borrowers and lenders, borrowers know more about their own financial prospects than lenders do. Especially in the capital markets, where a lender is likely purchasing just a small portion of the borrower's debt in the form of a bond or asset-backed security—it can be inefficient, difficult and costly for a lender to get all the information they need to evaluate the credit worthiness of the borrower. And therefore lenders will not lend as much as they could, especially to lesser known borrowers such as smaller municipalities; or lenders will offer higher rates to offset the uncertainty. Credit rating agencies provide a third party rating based on access to more information about the borrower than a lender may be able to access, and on accumulated experience in evaluating credit. By issuing a rating of the creditworthiness of a borrower, they can validate due diligence performed by lenders and enhance the ability of borrowers to raise funds. Further, the fact the credit rating agencies rate a wide variety of credit instruments and companies allowed debt investors to have the benefit of a consistent, relative assessment of credit risk across different potential investments.

This role is critical to municipalities and companies to access the capital markets, and rating agencies have facilitated the growth of securitization markets, increasing the availability of mortgages, auto loans, and small business loans.

Credit ratings also played an enabling role in the buildup of risk and contributed to the deep fragility that was exposed in the past 2 years. As I discussed before, the current crisis had many causes but a major theme in each was that risk—complex and often misunderstood—was allowed to build up in ways that the supervisors and regulators were unable to monitor, prevent or respond to effectively. Earnings from rapid growth driven by innovation overwhelmed the will or ability to maintain robust internal risk management systems.

As the Members of this Committee know, the highest rating given by rating agencies is "triple-A." An easy way to understand the importance of a triple-A rating for a borrower or an investor is that this label is the same one given to the U.S. Government. It means that the rating agency estimates that the probability of default—or the debt investor losing money—in the following year is extremely remote.

The "triple-A" designation was therefore highly valued, but perversely, rather than preserve this designation for the few, the amount of securities and borrowers that were granted this designation became much more prevalent as borrowers and issuers were able to convince the rating agencies that innovation in the structured credit market allowed for the creation of nearly riskless credit investments. Market practices such as "ratings shopping" before contracting for a rating, and the creation of consulting relationships may have contributed to conflicts of interest and upward pressure on ratings.

Rating agencies have a long track record evaluating the risks of corporate, municipal, and sovereign bonds. These ratings are based on the judgment of rating agencies about the credit worthiness of a borrower and are usually based on confidential information that is not generally available to the market, including an assessment of the borrower's income, ability to meet payments, and their track record for doing so.

Evaluating a structured finance product is a fundamentally different type of analysis. Asset-backed securities represent a right to the cash flows from a large bundle of smaller assets. In this way an investor can finance a small portion of hundreds or thousands of loans, rather than directly lending to a single borrower. This structure diversifies the investor's risk with respect to a given borrower's default and averages out the performance of the investment to be equal to a more general class of borrowers. It also allows more investors to participate in the market, since the investor's capital no longer needs to be tied to the origination of a loan.

Certain asset-backed securities also relied on a process of "tranching"—slicing up the distribution of potential losses to further modify the return of the security to meet the needs of different investors. This process relied on quantitative models and therefore could produce any probability of default. Credit ratings lacked transparency with regard to the true risks that a rating measured, the core assumptions that informed the rating and the potential conflicts of interest in the generation of that rating. This was particularly acute for ratings on asset-backed securities, where the concentrated systematic risk of senior tranches and resecuritizations are quite different from the more idiosyncratic risks of corporate bonds. As we discovered in the past 2 years, the risks of asset-backed securities are much more highly correlated to general economic performance than other types of bonds. The more complicated products are also sensitive to the assumptions in the quantitative models used to create these products.

Investors, as described earlier, relied on the rating agencies' ability to assess risk on a similar scale across instruments. They therefore saw highly rated instruments and borrowers as generally similar even though the investments themselves ranged from basic corporate bonds to highly complex bonds backed by loans or other asset-backed securities. Investors, and even regulatory bodies, rather than using ratings as one of many tools in their credit decisions, began to rely entirely on the ratings and performed little or no due diligence. Further, investors ventured into products they understood less and less because they carried the "seal of approval" from the rating agencies. This reliance gave the ratings agencies an extraordinary amount of influence over the fixed income markets and the stability of these markets came to depend, to a large degree, on the robustness of these ratings.

Ultimately, this led to a toxic combination of overreliance on a system for rating credit that was not transparent and highly conflicted. Many of the initial ratings made during this period turned out to be overly optimistic. When it became clear that "triple A" securities were not as riskless as advertised, it caused a great amount of disruption in the fixed income markets.

One of the central examples of these problems is in the market for Collateralized Debt Obligations or "CDOs." These products are created by pooling a group of debt instruments, often mortgage loans, then slicing up the economic value of the cash flows to create tailored combinations of risk and return. The senior tranches would have the first right to payments, while the most junior tranche—often called the "equity" tranche—would not be paid until all others had been paid first. These new products were highly complex and difficult for most investors to evaluate on their own. Rating agencies stepped into this gap and provided validation for the sale of these products, because their quantitative models and assumptions often determined that the most senior tranches could be rated triple-A. Without this designation, many pension funds, insurance companies, mutual funds, and banks would never have been willing to invest. Many investors did not realize that the ratings were highly dependent on the economic cycle or that the ratings for many CDOs backed by subprime mortgage bonds assumed that there would never be a nationwide decline in housing prices. This complexity was often ignored as the quarterly issuance of CDOs more than quadrupled from 2004 to mid-2007, reaching $140 billion in the second quarter of 2007.[1] But following a wave of CDO downgrades in July 2007, the market for CDOs dried up and new issuance collapsed as investors lost confidence in the rating agencies and investors realized they themselves did not understand these investments.

The reforms proposed by this Administration recognize the market failure that the credit rating agencies help to remedy, but also address the deep problems caused by the manner in which these agencies operated and the overreliance on their judgments.

Reform of the Credit Rating System

This Committee, under the leadership of Senator Shelby, Senator Dodd, and others, took strong steps to improve regulation of rating agencies in 2006. That legislation succeeded in increasing competition in the industry, in giving much more explicit authority to the SEC to require agencies to manage and disclose conflicts of interest, and helping ensure the existence and compliance with internal controls by the agencies.

This authority has already been used by the SEC over the past year to strengthen regulation and enforcement. The Administration strongly supports the actions that the SEC has taken and we will continue to work closely with the SEC to support strong regulation of credit rating agencies.

But flaws and conflicts revealed in the current crisis highlight the need for us to go further as more needs to be done.

Our legislative proposal directly addresses three primary problems in the role of credit rating agencies: lack of transparency, ratings shopping, and conflicts of interest. It also recognizes the problem of overreliance on credit ratings and calls for additional study on this matter as well as reducing the overreliance on ratings. While there were clear failures in credit rating agency methodologies, our proposals continue to endorse the divide established by this Committee in 2006: The Government should not be in the business of regulating or evaluating the methodologies themselves, or the performance of ratings. To do so would put the Government in the position of validating private sector actors and would likely exacerbate over-reliance on ratings. However, the Government should make sure that rating agencies perform the services that they claim to perform and our proposal authorizes the SEC to audit the rating agencies to make sure that they are complying with their own stated procedures.

Lack of Transparency

The lack of transparency in credit rating methodologies and risks weakened the ability of investors to perform due diligence, while broad acceptance of ratings as suitable guidelines for investment weakened the incentives to do so. These two trends contributed significantly to the fragility of the financial system.

Our proposals address transparency both in the context of rating agency disclosure as well as stronger disclosure requirements in securitization markets more generally. An agency determines a rating with a proprietary risk model that takes account of a large number of factors. While we do not advocate the release of the proprietary models, we do believe that all rating agencies should be required to give investors a clear sense of the variety of risk factors considered and assumptions made.

For instance, there are a number of ways to obtain a high rating for an asset-backed security that are not transparent to investors. First, there is the quality of the underlying assets—a bundle of prime mortgage loans will have higher credit worthiness than a bundle of subprime mortgage loans, all things being equal. Second, the rating agency could consider the quality and reliability of the data—fully documented mortgages or consumer credit instruments with a longer performance history (like auto loans) give greater certainty to the rating. Finally, if the security uses tranching or subordination, then giving a greater proportion of the economic value to a certain class of investors will raise the credit rating for that class. In the current system, there is no requirement that these factors be disclosed or compared for investors along with the credit rating.

[1] SIFMA, CDO Global Issuance Data.

Our proposals would require far more transparency of both qualitative and quantitative information so that investors can carry out their own due diligence more effectively. To facilitate investor analysis, we will require that each rating be supported by a public report containing assessments of data reliability, the probability of default, the estimated severity of loss in the event of default, and the sensitivity of a rating to changes in assumptions. The format of this report will make it easy to compare these data across different securities and institutions. The reports will increase market discipline by providing clearer estimates of the risks posed by different investments.

The history of rating agencies assessments in corporate, municipal, and sovereign bonds allowed them to expand their business models to evaluate structured finance products without proving that they had the necessary expertise to evaluate those products. The use of an identical rating system for corporate, sovereign, and structured securities allowed investors to purchase these products under their existing investment standards with respect to ratings. The identical rating systems also allowed regulators to use existing guidelines without the need to consider the different risks posed by these new financial instruments. Our proposals address the disparate risks directly by requiring that rating agencies use ratings symbols that distinguish between structured and unstructured financial products. It is our hope that this will cause supervisors and investors to examine carefully their guidelines to ensure that their investment strategy is appropriate and specific.

Ratings Shopping

Currently, an issuer may attempt to "shop" among rating agencies by soliciting "preliminary ratings" from multiple agencies and enlisting the agency that provides the highest preliminary rating. Consistently, this agency also provides a high final rating.

A number of commentators have argued that either the existence or threat of such "ratings shopping" by issuers played an important role in structured products leading up to the crisis. A recent Harvard University study contains supporting evidence, finding that structured finance issues that were only rated by a single rating agency have been more likely to be downgraded than issues that were rated by two or more agencies.[2] Our proposal would shed light on this practice by requiring an issuer to disclose all of the preliminary ratings it had received from different credit rating agencies so that investors could see how much the issuer had "shopped" and whether the final rating exceeded one or more preliminary ratings. The prospect of such disclosures should also deter ratings shopping in the first place. In addition, the SEC has proposed a beneficial rule that would require agencies to disclose the rating history—of upgrades and downgrades—so that the market can assess the long-term quality of ratings.

As an additional check against rating shopping, the Administration supports a proposed SEC rule that would require issuers to provide the same data they provide to one credit rating agency as the basis of a contracted rating to all other credit rating agencies. This will allow other credit rating agencies to provide additional, independent analyses of the issuer to the market. Such "unsolicited" ratings, have been ineffective because investors understand that these unsolicited ratings are not based on the same information as the fully contracted ratings, especially for structured products that are often complex and require detailed information to assess. By requiring full disclosure to all rating agencies, this rule would limit any potential benefit from rating shopping and should increase the amount of informed, but independent, research on credit instruments.

Conflicts of Interest

Our proposals include strong provisions to prevent and manage conflicts of interest, which we identify as a major problem of the current regime. Many of our proposals are aligned with specific provisions proposed by Senator Reed. Our approach is to solve these problems within the current framework rather than prohibiting specific models of rating agency compensation as some have advocated. Both issuer pay and investor pay models exist today and we do not believe it is the place of Government to prescribe allowable business models in the free market. Our proposal will make it simple for investors to understand the conflicts in any rating that they read and allow them to make their own judgment of its relevance to their investment decision.

Most directly, we would ban rating agencies from providing consulting services to issuers that they also rate. While these consulting contracts do not currently form a huge proportion of the revenue of the top rating agencies, they are an undeniable

[2] Benmelech and Dlugosz 2009, "The Credit Rating Crisis."

source of conflict since they allow for issuers and raters to work closely together and develop economic ties that are not related to the direct rating of securities. For instance, today a rating agency may consult with an issuer on how to structure and evaluate asset-backed securities, and then separately be paid by the issuer to rate the same securities created. This Committee was at the center of a similar effort that banned these types of cross-relationships for audit firms in the passage of the Sarbanes-Oxley Act of 2002, which also required a study of issues with credit rating agencies. Today, we propose that these cross-relationships be simply prohibited.

Our proposals also strengthen disclosure and management of conflicts of interest. The legislation will prohibit or require the management and disclosure of conflicts arising from the way a rating agency is paid, its business relationships, its affiliations, or other sources. Each rating will be required to include a disclosure of the fees paid for the particular rating, as well as the total fees paid to the rating agency by the issuer in the previous 2 years. This disclosure will give the market the information it needs to assess potential bias of the rating agency. The legislation also requires agencies to designate a compliance officer, with explicit requirements that this officer report directly to the board or the senior officer, and that the compliance officer have the authority to address any conflicts that arise within the agency. Rating agencies will be required to institute reviews of ratings in cases where their employees go work for issuers, to reduce potential conflicts from a "revolving door."

Strengthen and Build on SEC Supervision

Under the authority created by this Committee in 2006, the SEC has already begun to address many problems with rating agencies. The Treasury supports these actions and has included in our legislative proposal additional authority to strengthen and support SEC regulation of rating agencies.

The Commission has allocated resources to establish a branch of examiners dedicated specifically to conducting examination oversight of credit rating agencies, which would conduct routine, special, and cause examinations. Our proposed legislation would strengthen this effort and create a dedicated office for supervision of rating agencies within the Commission. Under the legislation, the SEC will require each rating agency to establish and document its internal controls and processes—and will examine each rating agency for compliance.

In line with the principle of consistent regulation and enforcement, our proposal will make registration mandatory for all credit rating agencies—ensuring that these firms cannot evade our efforts to strengthen regulation.

In response to the credit market turmoil, in February the SEC took a series of actions with the goal of enhancing the usefulness of rating agencies' disclosures to investors, strengthening the integrity of the ratings process, and more effectively addressing the potential for conflicts of interest inherent in the ratings process for structured finance products.

Specifically, the SEC adopted several measures designed to increase the transparency of the rating agencies' rating methodologies, strengthen the rating agencies' disclosure of ratings performance, prohibit the rating agencies from engaging in certain practices that create conflicts of interest, and enhance the rating agencies' recordkeeping and reporting obligations to assist the SEC in performing its regulatory and oversight functions. We support these measures.

Conclusion

In the weeks since we released our plan for reform, we have been criticized by some for going too far and by some for not going far enough. These charges are stuck in a debate that presumes that regulation—and efficient and innovative markets—are at odds. In fact, the opposite is true. Markets rely on faith and trust. We must restore honesty and integrity to our financial system. These proposals maintain space for growth, innovation, and change, but require that regulation and oversight adapt as well. Markets require clear rules of the road. Consumers' confidence is based on the trust and fair dealing of financial institutions. Regulation must be consistent, comprehensive, and accountable. The President's plan lays a new foundation for financial regulation that will once again help to make our markets vital and strong.

Thank you very much.

PREPARED STATEMENT OF STEPHEN W. JOYNT

PRESIDENT AND CHIEF EXECUTIVE OFFICER,
FITCH RATINGS

AUGUST 5, 2009

While overall macroeconomic conditions remain difficult, it seems the period of the most intense market stress has passed. This is due to both a variety of Government initiatives here and abroad aimed at restoring financial market stability as well actions taken by companies individually to shore up their balance sheets and reduce risk. Having said that, important sectors in the fixed income markets remain effectively closed and certain sectors, such as commercial mortgage-backed securities, are experiencing greater performance strain on their underlying assets.

During this time, the focus of Fitch Ratings has been on implementing a broad and deep range of initiatives that enhance the reliability and transparency of our rating opinions and related analytics. More specifically, our primary focus is on vigorously reviewing our analytical approaches and changing ratings to reflect the current risk profile of securities we rate. In many cases, that continues to generate a significant number of downgrades in structured securities, but also affects other sectors, such as banks and insurance. We are releasing our updated ratings and research transparently and publicly and we are communicating directly with the market the latest information and analysis we have.

In parallel, we have been introducing a range of new policies and procedures—and updating existing ones—to reflect the evolving regulatory frameworks within which credit rating agencies operate globally.

In each of these areas, we have been as transparent as possible and broadly engaged with a wide range of market participants, including policy makers and regulators. We are happy to expand upon any of these topics.

That said, the primary focus of today's hearing is to examine proposals to enhance the regulation of credit rating agencies, or "where do we go from here." Clearly, credit rating agencies continue to be a topic of interest in the market and in the regulatory communities. Senator Reed has introduced a bill this year—the "Rating Accountability and Transparency Enhancement Act of 2009." The House Financial Services Committee held a hearing in May 2009 on topics similar to today's hearing. The SEC has issued new rules and considered many important questions in its roundtable discussion in April. Most recently the Treasury sent legislation to Congress that reflected the Administration's perspectives on credit rating agency reform. Outside of the U.S., the EU recently enacted a registration and oversight system and related rules for credit rating agencies. Other nations are considering similar measures.

As this Committee considers these topics, we would like to offer our perspective on several important issues. The bodies referenced above have touched on many of these themes in their proposals and discussions. Let me reiterate that Fitch is committed to engaging on all of these matters in a thoughtful, balanced, constructive, and non-self-serving manner. At the same time, some perceptions and proposals continue to circulate that warrant further consideration, clarification, or in some cases "reality checking."

Managing Conflicts of Interest. The majority of Fitch's revenues are fees paid by issuers for assigning and maintaining ratings. This is supplemented by fees paid by a variety of market participants for research subscriptions. The primary benefit of this model is that it enables Fitch to be in a position to offer analytical coverage on every asset class in every capital market—and to make our rating opinions freely available to the market in real time, thus enabling the market to freely and fully assess the quality of our work. Fitch has long acknowledged the potential conflicts of being an issuer-paid rating agency. Fitch believes that the potential conflicts of interest in the "issuer pays" model have been, and continue to be, effectively managed through a broad range of policies, procedures, and organizational structures aimed at reinforcing the objectivity, integrity, and independence of its credit ratings, combined with enhanced and ongoing regulatory oversight. In recent months, Fitch has introduced new policies, and revised many existing ones, focused on these issues. A few examples of our relevant policies and procedures are below:

- Business development is separated from credit analysis, to keep each group focused on its core task.
- Employees involved in the assignment of the resulting ratings do not handle fees discussions for an issuer or transaction.
- No analyst or group of analysts is directly compensated on the revenues related to their ratings.

- Rating analysts are prohibited from advising issuers and underwriters on structuring transactions and focus solely on developing and communicating our opinion on the credit fundamentals associated with a given structure.
- Ratings are determined using a committee structure, not by a single analyst. These committees include a mandatory independent member.
- Cross-group committees and an independent internal review function review all ratings criteria.
- Fitch has introduced the new role of group credit officer in each of its rating groups.
- Fitch has established and enforces a Code of Conduct (consistent with IOSCO's and updated in February 2009) and ancillary policies to specifically address potential conflicts.
- Fitch has relocated all of its nonrating operations into a separate division, Fitch Solutions, which operates behind a firewall.

No payment model would be completely immune to conflicts of interest, whether from investors, issuers, governments, or regulators. An "investor pays" model also contains direct conflicts, given that most major investors have a vested financial interest in the level of ratings and many are rated entities. A move to a complete "investor pays" model, by definition making the ratings a subscription product, could also remove ratings from the public domain. This would conflict with investor and policy makers' call for ratings to be broadly available, thereby allowing the market to openly judge ratings performance.

Disclosure of Ratings Methodologies. The definitions for all of Fitch's ratings and rating scales are regularly reviewed and updated, publicly disclosed and freely available on our Web site. The most recent update to our ratings definitions is set forth in a March 2009 report entitled "Definitions of Ratings and Other Scales." In addition, the criteria that details Fitch's analytical approach to rating issues and issuers in every region and asset class are also regularly reviewed and updated, and freely available on our Web site on a centralized "criteria homepage." In select cases where Fitch is considering what it believes to be a material shift in our thinking regarding our analytical approach to a given sector, we normally release our thinking to the market as an "exposure draft." In such a case, we solicit feedback from market participants and engage in transparent discussions about our approach—such as one-on-one meetings, webcasts and conference calls—and we have done so repeatedly in the last few years. In addition, the processes we follow internally in developing and approving such methodology updates are also fully codified, consistent with SEC and IOSCO rules, and freely available. Finally, we develop and publish an enormous number of rating commentaries (over 15,000 in 2008) and research reports that summarize our opinions on issues, issuers and market sectors as part of our efforts to ensure the market is aware of our perspective. Those in the market that allege that our ratings are a "black box" must not be fully aware of the information we make available, or they do not fully appreciate the concept that the rating itself is not a simplistic mathematical output, but rather a committee decision based on a range of quantitative and qualitative factors. For every rating action we take, we publish the corresponding rationale and make that freely available to the market. We do not believe that everyone will agree with all of our opinions, but we are committed to ensuring the market has the opportunity to discuss them.

Issuer Disclosure and Due Diligence in Structured Finance. Some market participants, in reviewing the performance of ratings in structured finance markets, have noted that limits on the amount of information that is disclosed to the market by issuers and underwriters has made the market over-reliant on rating agencies for analysis and evaluation of structured securities. The argument follows that the market would benefit if additional information on structured securities (such as asset specific data on residential and commercial mortgage backed securities) were made broadly and readily available to investors, thereby enabling them to have access to the same information that mandated rating agencies have in developing and maintaining our rating opinions. Fitch fully supports the concept of greater disclosure of such information. A related benefit of additional issuer disclosure is that it addresses the issue of ratings shopping. Greater disclosure would enable nonmandated NRSROs to issue ratings on structured securities if they so choose, thus providing the market with greater variety of opinion and an important check on any perceived "ratings inflation." We also believe that responsibility for disclosing such information should rest fully with the issuers and the underwriters, not with rating agencies. Quite simply, it is their information on their transactions, so they should disclose it.

Furthermore, Fitch notes that the disclosure of additional information is of questionable value if the accuracy and reliability of the information is suspect. That goes to the issue of due diligence. While rating agencies have taken a number of steps to increase our assessments of the quality of the information we are provided in assigning our ratings, including adopting policies that state that we will not rate issues if we deem the quality of the information to be insufficient, due diligence is a specific and defined legal concept. Due diligence is not currently, nor should be, the responsibility of credit rating agencies. Consistent with existing securities laws, the burden of due diligence belongs on issuers and underwriters. In that regard, we support the concept that issuers and underwriters ought to be required to conduct rigorous due diligence on the underlying assets that comprise asset backed and mortgage backed securities offered or sold in the U.S. Fitch believes Congress should consider amending the securities law to require such due diligence on underlying assets for all ABS and MBS securities offered or sold in the U.S., whether or not the securities are registered under Section 5 or sold pursuant to an exemption from such registration. Congress ought not to hold rating agencies responsible for such due diligence or for requiring that others do it. Rather, Congress should mandate that the SEC enact rules to require issuers and underwriters to perform such due diligence—make public the findings—and enforce the rules they enact.

Regulation and Transparency. Stated simply and clearly, Fitch supports fair and balanced oversight and registration of credit rating agencies and believes the market will benefit from globally consistent rules for credit rating agencies that foster transparency, disclosure of ratings and methodologies, and management of conflicts of interest.

The dialogue on changes to rating agency regulation continues to follow two primary—and not necessarily consistent—themes. The first is the imposition of additional rules and regulations that are manifested in a range of new or enhanced policies and procedures. This has been the primary thrust of recent SEC rulemaking and of the recently passed EU rules. Fitch is or will be fully compliant with these new rules.

At the same time, a number of commentators have spoken on the topic of the market's perceived over-reliance on credit ratings. To a certain extent, we agree with this premise, insofar as some market participants clearly used ratings as a substitute for—as opposed to a complement to—their own fundamental credit analysis. One proposed remedy for this is to eliminate the use of ratings in regulation or to eliminate the NRSRO concept altogether. While deceivingly simple, we believe this proposal warrants several comments. Ratings have been used constructively in many places in regulation, as they are an important common benchmark. From a regulatory point of view, the question of what would be used in place of credit ratings is rarely answered satisfactorily. Simply having regulators "do it themselves" has a range of practical implications and unintended consequences. As does the notion of allowing regulated financial entities to assess the credit risk of the securities completely on their own without reference to any independent external risk benchmarks. In many cases, if you eliminate the use of "NRSRO" ratings in regulation, company and industry participants will likely develop or maintain their own guidelines and use credit ratings anyway. We believe they will default to the largest "brand name" rating agencies (Moody's and S&P), which is not a positive if one of your objectives is increasing competition and thereby fostering a better work product. Note that the SEC proposed a variation on this theme in 2008 with respect to money market funds and their use of ratings but chose not to move forward, in part based on significant feedback supporting the use of ratings in money market regulations from the fund industry itself. Some have suggested replacing ratings with market prices for debt—either bond spreads or CDS spreads. While these may reflect the market's sense of price at a given point, recall from the events of the last 2 years that not all securities are liquid, that bid-ask spreads can widen materially in times of stress and that market prices by definition are inherently more volatile than a fundamentally driven credit rating. However, if one is serious about eliminating ratings in regulation, we suggest you transition to elimination over an intermediate time frame with careful consideration of each regulation, rather than wholesale elimination. A better solution is continued recognition and oversight of NRSROs with the goal of improving the performance and usefulness of ratings.

Speaking of competition and regulation, the SEC also has approved a wide range of new NRSROs. Some are established with global reach, resources and coverage, while others are focused geographically or by sector, have modest resources, and/or coverage and ratings history that are more limited. Given the divergent profiles, it is quite a challenge to consider the issues we are discussing today. For example, we do not believe the definitions and meanings of ratings are all the same among NRSROs, let alone the levels of the ratings themselves. We also believe it is significant that a verifiable record of performance is not publicly available from all NRSROs and that not all ratings are publicly available in real time. Specifically, the market benefits from the differences of opinion as expressed by the different ratings assigned by credit rating agencies. Usually, the initial rating assigned by Fitch will be proven reliable. The same is of course true of any other agency. However, if some NRSROs need not disclose all of their ratings, that dynamic merely allows them to "cherry-pick" the selected ratings where they believe they were "first" or "better" without the obligation to provide the information that enables the market to fully compare and contrast the opinions and performance of the NRSROs based on all of their ratings. If a goal is improvement of the reliability of credit ratings through increased competition and transparency, we believe all oversight requirements should be applied consistently and equally to all NRSROs.

A final point on regulation: The Treasury's proposal includes the concept of mandatory registration for credit rating agencies. Fitch, along with the other recognized NRSROs, is already registered and subject to explicit SEC regulatory oversight. We believe the mandatory registration concept is unnecessary and unwarranted and is not consistent with basic free speech principals. [1]

Accountability and Liability. While we understand and agree with the notion that we should be accountable for what we do, we disagree with the idea that the imposition of greater liability will achieve that. Some of the discussion on liability is based on misperceptions, and those points are noted below. More fundamentally, we struggle with the notion of what it is that we should be held liable for. Specifically, a credit rating is an opinion about future events—the likelihood that an issue or issuer will meet its credit obligations as they come due. Imposing a specific liability standard for failing to accurately predict the future in every case strikes us as an unwise approach.

The first misconception is that rating agencies are free from liability and hide behind the First Amendment to shield them from legitimate securities law liability. Rating agencies may be held liable for securities fraud just as any person or entity may be (including accountants, lawyers, officers, directors, and securities analysts) to the extent that a rating agency intentionally or recklessly makes a material misstatement or omission in connection with the purchase or sale of a security. Of course, a plaintiff must prove securities fraud against a rating agency just as against any other defendant. The reality of U.S. securities law is that any plaintiff may make a claim against a rating agency under the antifraud provisions of the securities law, just as they can against accountants, lawyers, officers, directors and securities analysts, but they must prove their claims to the standard required under the securities law.

Some also have criticized rating agencies for what they perceive as taking undue advantage of the First Amendment and its protection of free speech. We believe this is an overblown argument that fails to acknowledge key facts about the nature of ratings. We publish all of our ratings, accompanied by detailed published commentary about the companies and securities we rate. Fitch's ratings are available free to anyone who has access to the Internet. The companies and securities we rate are of significant interest to investors of all types and other parties interested in the securities and the capital markets. Hundreds of investors, fiduciaries, government entities and other interested parties subscribe to our published commentary and thousands access our Web site daily. We believe Fitch enjoys the same free-speech rights as any other person or entity to comment on matters of public interest and to "make informed, thoughtful predictions about the future. That is no different from what newspapers or scholars do." [2] We further believe that the manner in which we are paid and the nature of the securities we rate do not affect the essence of what we do or the free-speech rights we enjoy in connection with our work. [3]

A second misconception centers on where the responsibility for full and complete disclosure about companies and securities, and appropriate due diligence to ensure the accuracy and adequacy thereof, should be placed. As discussed above, these obligations are today, and have been since the enactment of the earliest U.S. securities law, the sole responsibility of issuers, their officers and directors and underwriters.

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[1] *See,* Written Statement of Eugene Volokh, Gary T. Schwartz Professor of Law, University of California, Los Angeles, School of Law before Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Committee on Financial Services at Approaches To Improving Credit Rating Agency Regulation, May 19, 2009, at pp. 9–10 available at *http://www.house.gov/apps/list/hearing/financialsvcs_dem/volokh.pdf* ("Professor Volokh Statement").

[2] Nathan Koppel, "Credit Raters Plead the First; Will It Fly?" *The Wall Street Journal,* April 21, 2009, C1 (quoting Professor Eugene Volokh).

[3] *See,* Professor Volokh Statement, at pp. 2–3.

The obligation to enforce these responsibilities falls squarely on the shoulders of the Securities and Exchange Commission and the courts.

Some have proposed that rating agencies should be liable not merely for material misstatement, but for the investigation of rated securities and the verification of information. In one proposed bill, rating agencies would be liable for knowingly or recklessly failing to conduct such investigation or verification, which will cause rating agencies to be judged by whether, in hindsight, they could have reasonably done more. Because a plaintiff could base a claim on "you had to have known more could be done," the effect is negligence based private rights of action. Even a requirement to plead with particularity might not be at all protective in this context. In hindsight, it will always look like a rating agency could have reasonably foreseen future problems with different assumptions and stress testing.

While we believe some proposals are ill advised, Fitch has been and will continue to be constructively engaged with policy makers and regulators as they consider important ideas and questions about the oversight of credit rating agencies. Fitch has taken a number of important analytical and procedural steps already and we acknowledge there is more to do. We remain committed to enhancing the reliability and transparency of our ratings, and welcome all worthwhile ideas that aim to help us achieve that.

PREPARED STATEMENT OF JAMES H. GELLERT

PRESIDENT AND CHIEF EXECUTIVE OFFICER,
RAPID RATINGS INTERNATIONAL, INC.

AUGUST 5, 2009

Overview

Rapid Ratings International, Inc. (Rapid Ratings) would like to thank the U.S. Senate Committee on Banking, Housing, and Urban Affairs for inviting us to provide testimony to the critical subject of Rating Agency regulation.

This is an essential topic for the global financial markets, U.S. citizens and residents who have been directly and indirectly affected by the actions of the large, incumbent rating agencies, and those newer ratings firms, like ours, that have built a viable alternative to the *status quo.*

Rapid Ratings is a subscriber-paid firm. We utilize a proprietary, software-based system to rate the financial health of thousands of public and private companies and financial institutions quarterly. We use only financial statements, no market inputs, no analysts, and have no contact in the rating process with issuers, bankers or advisors. Our ratings far outperformed the traditional issuer-paid rating agencies in innumerable cases such as Enron, GM, Delphi, Parmalat, LyondellBasell, Pilgrim's Pride, Linens 'N Things, and almost the entire U.S. Homebuilding industry.

Currently, we are not a Nationally Recognized Statistical Rating Organization (NRSRO). We have not applied for the NRSRO status and do not have immediate plans to do so. At present, there are too many mixed messages coming from the SEC, Treasury and Congress for me to recommend to our shareholder that the designation is in their best interests. The Treasury proposal's requirement that all ratings firms would be required to register is another curve ball in an already changing playing field.

That said, we believe that reform in our industry is necessary and must happen with a sense of urgency. However, we caution that speed for speed's sake may have significant, and counterproductive, unintended consequences.

U.S. legislation and regulations have both global and national effects, hard lessons reinforced over the last 2 years. Despite years of legislative action on corporate governance, Sarbanes Oxley (2002), and the Credit Rating Agency Reform Act (2006), through a combination of conflict of interest, self-interest and, unfortunately, entrenched regulatory protection, issuer-paid rating agencies (principally S&P, Moody's, and Fitch (the "Big Three")) facilitated a toxic asset flood that deluged the global markets, contributing to the worst economic crisis in 80 years.

The SEC has been wrestling with new rules and rule amendments and has made some headway in areas of curbing conflicts of interest. Though not attacking and seeking to end the clearly conflicted issuer-pay revenue model, the Commission is taking some positive initiatives to curb the more egregious behavior evidenced by these conflicts. The new Department of Treasury proposal, however, takes multiple steps in the wrong direction and threatens to further solidify the entrenched position held by the Big Three, erecting further hurdles to competition in this industry. The Treasury proposals are misdirected in 5 areas:

1. *One-size does not fit all:* Proposals designed to fix major deficiencies in the issuer-paid business model should not be loaded indiscriminately on to subscriber-paid agencies, thus increasing their costs, increasing barriers to entry, and reducing competition.
2. *Disclosure rules affecting intellectual property:* The new rules must avoid requiring the forced disclosure of proprietary intellectual property. Appropriate safeguards must be introduced to protect intellectual property.
3. *Accuracy:* It is unreasonable to believe the SEC can effectively be the arbiter on accuracy in the ratings industry. The market will decide very effectively which ratings are more accurate through usage of competing credit rating agencies (CRAs), as long as there are not barriers to entry protecting S&P, Moody's, and Fitch, and disadvantaging new entrants or small rating agencies.
4. *Forcing NRSRO registration* on all companies issuing ratings will force compliance costs on new CRAs thus erecting further barriers, potentially force small CRAs out of business and deter potential new capital sources entering this industry, all thereby undermining the growth of innovative and more accurate ratings technology. The vast number of firms captured by this sweeping net would not only confuse users of ratings, potentially hundreds of new agencies would be designated that would not have qualified as NRSROs under the Credit Rating Agency Reform Act of 2006. All of these would fuel the use of the largest brand names, and solidify regulatory protection of S&P, Moody's, and Fitch.
5. *Rating Disclosure:* Requiring subscriber-based rating agencies to disclose their history of ratings can undermine the subscriber-based business model which is predicated on selling current and past ratings to investors. The Treasury proposal covers all types of rating agencies and for 100 percent of their ratings. This erects a major barrier to competition by subscriber-based CRAs against the issuer-paid CRAs by stripping them of their revenues. This proposal may violate antitrust laws because the proposal undermines competition. [1]

The Big Three have lobbied heavily to promote the notion that all business models carry conflicts of interest and therefore that theirs is no worse than any other. Can conflicts occur in other business models? Sure. Have conflicts in other business models contributed to a catastrophic financial disaster that taxpayers will be paying for dearly for years to come? No. This red herring cannot drive new legislation. The problem is not the potential behavior of the subscriber-paid rating agencies; rather it is the misbehaviors of the issuer-paid rating agencies that have already occurred.

Effective legislation and regulatory framework must focus on reforming the issuer-paid model's most negative features, providing oversight of the NRSROs that prevent the self-interested behavior that contributed to the current financial crises and creating an even playing field for competition. The latter has two major components: fostering (or at least not inhibiting) new players, methodologies, and innovation; and, equivalent disclosure of data used by other NRSROs for rating the highly complex instruments The Big Three have demonstrated are in dire need of alternative sources of opinion.

Innovation and responsible alternatives to a *status quo* are both highly American traits. For true reform to have a fighting chance, these themes must be protected by the legislative framework for the ratings industry and we must be critically aware of how the unintended consequences of poorly implemented regulations can leave us with a broken system that has proven it is not deserving of protection.

Much of the current legislative effort, including the SEC's newest Rule Amendments, reproposed rule amendments, Treasury's proposal and initiatives which we understand are underway on the Hill, are all concentrating on largely the same group of issues:

- Ratings shopping
- The consultative relationships between the issuer-paid rating agencies and issuers and their bankers
- Access to the information used in due diligence of structured products
- Disclosure of ratings history and actions
- Ratings symbology for structured product ratings
- New payment structures for ratings

[1] *Spectrum Sports, Inc. v. McQuillan:* "The purpose of the [Sherman] Act is not to protect businesses from the working of the market; it is to protect the public from the failure of the market. The law directs itself not against conduct which is competitive, even severely so, but against conduct which unfairly tends to destroy competition itself."

- What entities should register as NRSROs
- The existence of ratings in regulations

Largely neglected in the proposals, rules and acts are the following:

- Should the issuer-paid revenue model be abolished?
- The consequences of rules targeting essentially three issuer-paid firms on the subscriber-paid businesses that are growing to provide competition and alternatives to investors
- Accuracy of ratings

Answers and Comments

In the following pages I hope to provide comments on the strengths and weaknesses of the various proposals, detailed comments about the Treasury proposal specifically and broad thoughts on the state of rating agency regulation.

Some of the Committee's specific questions I have repeated and answered below and others are addressed directly and indirectly in the collection of comments given in the following pages. I would be pleased to address any item here in greater detail in a subsequent submission at the Committee's request.

1. ***Q: What is your assessment of the effectiveness, including the strengths and weaknesses, of the Federal regulation of credit rating agencies (including the performance of regulators)?***

   A: Federal regulation has not been successful in protecting institutional and individual investors from capital loss associated with rating agency behavior. The Big Three issuer-paid agencies through a combination of conflict of interest, self-interest and entrenched regulatory protection, facilitated a toxic asset flood that deluged the global markets, contributing to the worst economic crisis in 80 years. All of this occurred despite years of theoretically increased Federal regulation on corporate governance, Sarbanes Oxley (2002) and the Credit Rating Agency Reform Act (2006).

   The payment, communication, consulting, collaboration and ratings shopping that have long underpinned the special relationship between issuers and the Big Three issuer-paid agencies are inarguably conflicts of interest. This does not mean that every rating is tainted or designed in some way to mislead the public. But these elements of the issuer-paid model have been allowed to remain in the past and are only now being addressed in the recent SEC rule changes, re-proposed rules and the recent Treasury proposal. *The core problem, the issuer-paid revenue model, continues to be fundamentally unchallenged. Instead, the collection of regulatory efforts is attempting to curb the most egregious behavior of the issuer-paid agencies -- in other words, the symptoms, not the cause.*

Despite the absence of a fundamental change to the industry, many of the recent real and proposed changes can achieve some positive results and are strengths of the recent regulatory actions. There are fundamental weaknesses as well. Many of these are addressed in the material below.

2. ***Q: What are your views on the strengths and weaknesses of the legislative reforms affecting credit rating agency regulation proposed by the Department of the Treasury, in Subtitle C of Title IX of Treasury's recent proposal?***

A: The Treasury's proposals are a mix of positive steps and disturbing developments. As a whole, the intent seems to be to increase supervision, disclosure and oversight of the agencies and to curb conflicted, poor behavior. That is hard to disagree with. The proposal though, if enacted as written, would have the counterintuitive result of further solidifying the Big Three's oligopoly and creating another set of regulatory hurdles to increased competition and innovation in the industry. Also, the proposals omit comment on a highly topical subject – legal liability of rating agencies, other than fines if there is failure to comply with the rules.

Clearly, any regulatory regime has compliance costs. Those compliance costs can be barriers to entry and serious barriers to entry for smaller new entrants. What is most troubling to us is imposing compliance procedures and costs on a subscriber-paid rating agency which were designed to address serious flaws in the issuer-paid rating agencies. That approach, which is currently being contemplated, will thwart competition and innovation in the ratings industry.

These and other critical issues in the proposal warrant a topic by topic review (descriptions in italics are taken from Treasury's July 21, 2009 press release titled "Administration's Regulatory Reform Agenda Moves Forward: Credit Rating Agency Reform Legislation Sent to Capitol Hill"):

a. **Conflicts of Interest**

   i. ***Bar Firms From Consulting With Any Company That They Also Rate**: Credit ratings agencies will face similar restrictions to other professional service providers, like accountants, and will be prohibited from providing consulting services to companies that contract for ratings.*

Comment: This is, of course, a logical suggestion, and the SEC has already been making efforts in this area. In the absence of fundamental change to the issuer-paid business model itself, this is one of the larger steps that regulators can make to address poor behavior. Locking in relationships with additional service is an anti-competitive practice that is one of many that need to be stopped. Anti-trust action will eventually be required if the current rules are ineffective.

ii. ***Strengthen Disclosure And Management Of Conflicts Of Interest**: The legislation will prohibit or require the management and disclosure of conflicts arising from the way a rating agency is paid, its business relationships, affiliations or other conflicts.*

Comment: There are perfectly reasonable proposals in the plan including disclosure of fees an agency has billed an issuer in the past and disclosure of affiliations between a person associated with an agency and a person associated with an issuer. But, these are relatively light and knowing whether an issuer and an agency have a long standing relationship or not is not terribly relevant. What merits attention are explicit and implicit quid pro quos.

There is however curious language in page 5 of the proposed Act text: Section (4) Commission Rules "The rules issued by the Commission under paragraph (3) shall include – (A) the establishment of a system of payment for each nationally recognized statistical rating organization that requires that payments are structured to ensure that the nationally recognized statistical rating organization conducts accurate and reliable surveillance of ratings over time, as applicable, and that incentives for accurate ratings are in place;"

It is difficult to understand why an NRSRO would need a new incentive for accuracy unless the business model is compromised by conflicts and the threat of serious large scale competition is minimal. The wording of the Act may inadvertently reflect the complacency towards accuracy that sadly exists in the market. An agency shouldn't be compensated for ratings yet require new incentives to produce accurate ratings. The default standard should be to achieve accuracy and the issuer-paid rating agencies are not even close to being market leaders in producing accurate ratings.

"Accuracy" of course is difficult to define and is addressed further below.

iii. ***Disclose Fees Paid By An Issuer Along With Each Rating Report**: Each rating report will disclose the fees paid by the issuer for a particular* *rating, as well as the total amount of fees paid by the issuer to the rating agency in the previous two years.*

Comment: Issuers typically fall into two categories: an individual industrial or financial institution (issuing plain vanilla debt or structured products) or a special purpose issuance vehicle (typically issuing structured products). Historically, vanilla bond (or, non structured product) issuers have chosen to be rated by both S&P and Moody's. Fitch has less market share in the vanilla bond market and therefore is considered a second tier below S&P and Moody's. Conventional bond market wisdom says that both ratings are needed for maximum potential liquidity in a bond, and therefore the best possible pricing at issue. Institutional investors often wonder about an issuer that only chooses to get one of the two ratings. In these circumstances, investors are often concerned that perhaps an issuer received a poor rating indication from the missing agency, and thus the issuer opted to go to market without that rating.

Structured products more commonly would only carry one of the three ratings, where Fitch has a better reputation and is therefore a viable alternative to S&P and Moody's.

Given the limited number of rating agency choices historically, the length of relationship with an issuer and fees paid for ratings are not terribly meaningful statistics. While fee disclosure may be eye-opening to some industry watchers, it won't deter the large agencies from keeping their fee structure or revenue model.

iv. ***Look-Back Requirement To Address The Conflicts From A "Revolving Door":*** *If a rating agency employee is hired by an issuer and if the employee had worked on ratings for that issuer in the preceding year, the rating agency will be required to conduct a review of ratings for that issuer to determine if any conflicts of interest influenced the rating and adjust the rating as appropriate.*

Comment: This is an interesting provision and is the first time we have seen regulation covering the migration of personnel from the ratings agencies to issuers and, more importantly, to the banks providing rating agency advisory services to issuers.

v. ***Designate A Compliance Officer****: Each rating agency will be required to designate a compliance officer – reporting directly to the board or the senior officer of the firm – with direct responsibility over compliance with internal controls and processes. The compliance officer will not be* *allowed to engage in any rating activities, marketing, sales, or setting of compensation; and will be required to submit a report annually to the SEC.*

Comment: The Big Three will see this simply as a cost of doing business. Given their respective sizes as companies, this additional cost is *de minimus* and, might eventually be passed through to the issuers in the form of rate increases.

b. **Transparency & Disclosure**

i. ***Require Disclosure of Preliminary Ratings to Reduce "Ratings Shopping":*** *Currently, an issuer may attempt to "shop" among rating agencies by soliciting 'preliminary ratings' from multiple agencies and then only paying for and disclosing the highest rating it received for its product. We would shed light on this practice by requiring an issuer to disclose all of the preliminary ratings it had received from different credit rating agencies so that investors will see how much "shopping" happened and whether there were discrepancies with the final rating.*

Comment: This proposal is not relevant to subscriber-paid CRAs like Rapid Ratings. Addressing ratings shopping is a positive development for certain. However, ratings shopping is only one manifestation of the collaborative process of working through structures between agency(ies) and issuer. While the issuers may not be soliciting multiple opinions from agencies on the nuances of their structure, they can certainly glean insight from the dialogue with a single agency that assists in structuring a transaction "correctly" to achieve a certain ratings threshold.

ii. ***Require Different Symbols To Be Used To Distinguish The Risks Of Structured Products****: One of the challenges in the current crisis was that investors did not fully realize that the risks posed by structured products such as asset-backed securities are fundamentally different from those posed by corporate bonds, even with similar credit ratings. Our proposal requires rating agencies to use different symbols for structured finance products as an indication of these disparate risks.*

Comment: This is a counterproductive initiative. The problem is not that investors did not know they were buying structured products (in theory corrected by having a new ratings symbol that alerts them); they either knew and were happy to get the higher yield on a highly rated product and/or did not understand the risk of what they were buying (often because they were too complicated) but were allowed to buy the security BECAUSE it was rated. The problem, in the current regulatory effort, is about the "accuracy" of the ratings, not their symbology. No institutional investor bought a structured bond thinking it was a plain vanilla instrument. What the market needs is to have risks of securities rated on a common basis, to provide an adequate apples-to-apples perspective on investment risks. We do not need yet another confusing ratings scale or it will be arbitraged by players (agencies or otherwise) who wish to obscure the relativity of instruments. This proposal is a classic case of window dressing and it is an unnecessary distraction.

iii. ***Require Qualitative And Quantitative Disclosure Of The Risks Measured In A Rating****: Agencies will be required to provide a much fuller picture of the risks in any rated security through the addition of qualitative and quantitative disclosure of the risks and performance variance inherent in any given security. Ratings cannot be a substitute for investor due diligence. Therefore, to facilitate investor analysis, we will require that each rating also include a clear report containing assessments of data reliability, the probability of default, the estimated severity of loss in the event of default, and the sensitivity of a rating to changes in assumptions. This report will present information in a way that makes it simple to compare this data across different securities and institutions. This additional information will increase market discipline by providing clearer estimates of the risks posed by different investments.*

Comment: The devil is in the details on this set of initiatives and requirements. If the NRSRO would be required to establish process and procedures (and then to follow them strictly, disclosing variances and compliance) that seems like a logical development. If, however, the language will be interpreted to mean disclosure of proprietary intellectual property, this seems to tread on very dangerous ground.

c. **Strengthen SEC Authority and Supervision**

i. ***Establish a Dedicated Office for Supervision of Rating Agencies****: Our legislative proposal establishes a dedicated office within the SEC to strengthen supervision of rating agencies and to carry out the enhanced regulations required.*

Comment: The SEC was essentially moving in this direction prior to the Treasury proposal. The questions will surround the SEC's budget and staffing ability for carrying out these new oversight functions. For instance, as one practical problem, hiring officials who have rating agency experience would seem logical. Will the look-back provision need to cover ex rating agency professionals working at the SEC as well as issuers and their underwriters?

More importantly, and more troubling, is the treatment of ratings accuracy. On page 10 of the proposal, "(p) Nationally Recognized Statistical Organization Regulation," it reads "The Commission shall establish an office that administers the rules of the Commission…and to ensure that credit ratings issued by such registrant are accurate…" How is the SEC going to opine on ratings accuracy? The staffing requirements for the SEC to begin rating all issuers to determine the accuracy of agency ratings is massive and a poor use of the commission's time. If the SEC had the desire or the capacity to become the arbiter of what ratings are good and what ratings are not, we certainly would not be in the current financial crises we find ourselves. It is unreasonable to believe the SEC can take on this role. This is a role for the market. Rating users will weed out the inaccurate ratings and embrace the accurate ratings as long as there are no artificial, including regulatory, impediments to their selection of rating agencies.

ii. ***Mandatory Registration****: Unlike the current voluntary system of registration, our proposal would make registration mandatory for all credit rating agencies. This will bring all ratings firms into a strengthened system of regulation.*

Comment: This is truly one of the most surprising, and frankly short-sighted, proposals that have emerged from any front in this current wave of legislative initiatives. It is also counter to one of the significant elements (though not one without its critics) of the Credit Rating Agency Relief Act of 2006, the requirement that new applicants be in business for three years prior to applying.

There are a number of significant problems with this initiative:

- Currently, rating firms have the option to apply for NRSRO status or not. As with Rapid Ratings, some choose not to apply for any one of a number of reasons. Requiring registration, while the hard and soft costs and risks of being an NRSRO are currently unquantifiable as the landscape is changing, is a major hurdle to newer players and is likely a complete disincentive to the de novo firm, as qualified and competent as they may be.

- If the current Treasury proposal language is enacted and interpreted literally, it could be forcing the disclosure of proprietary intellectual property; a precedent we cannot imagine was intended. On Page 2 of the Act:

REVIEW OF INTERNAL PROCESSES FOR DETERMINING CREDIT RATINGS.—

(A) IN GENERAL.—Credit ratings by, and the policies, procedures, and methodologies employed by, each nationally recognized statistical rating organization shall be reviewed by the Commission to ensure that—

(i) The nationally recognized statistical rating organization has established and documented a system of internal controls, due diligence, and implementation of methodologies for determining credit ratings…

(ii) The nationally recognized statistical rating organization adheres to such system; and

(iii) The public disclosures of the nationally recognized statistical rating organization required under this section about its ratings, methodologies, and procedures are consistent with such system.

Subtitle C of Title IX: "Investor Protection Act of 2009".

Rapid Ratings utilizes a proprietary intellectual property that we do not disclose. We give valuable insights into the methodology but we do not provide certain elements of our process to the public. We recognize that some potential subscribers could choose not to do business with us for this reason, but we have not encountered one yet. If we are required to provide that methodology into the public domain, we lose a competitive advantage. Nevertheless, this disclosure is a business decision to protect an asset of the company and is not something we or others like us should have to disclose by fiat. The protection of property rights is an essential component of any strategy for introducing effective competition.

For new players considering entering the ratings business, in concept a good development if they bring something additive to the industry, this disclosure might be a prohibitive hurdle. Deterring new players is of course another way of protecting the current ones.

If joining the ranks of the NRSROs is something a company like Rapid Ratings may elect to do, as under the CRARA of 2006, a high "cost" of being an NRSRO is something we can calculate and decide on based on a risk-reward scenario. If we are required to register AND forced to disclose our intellectual property, that is a very serious problem.

This concept, we understand, was contemplated for the CRARA of 2006 and ultimately dropped.

Where would one draw the line on defining rating agencies? If we follow the Securities Exchange Act of 1934 Section 3(a)(61) definition:

(61) CREDIT RATING AGENCY.--The term "credit rating agency" means any person--

(A) Engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company;

(B) Employing either a quantitative or qualitative model, or both, to determine credit ratings; and

(C) Receiving fees from either issuers, investors, or other market participants, or a combination thereof

Section 3(a)(61) Securities Exchange Act of 1934.

Certainly the definition could be interpreted as incorporating every independent research business, Sell-Side research division, select institutional investors, brokers, etc. One purpose of the various qualifications required in the CRARA of 2006 was to ensure that NRSROs were "nationally recognized," or had at least a modicum of credentials for the job. Under the Treasury's proposed rule, the market would be flooded with NRSROs, devaluing the designation by definition. Further, Institutional investors will not have the patience to sort through the products and ratings of potentially hundreds of new players. The certain outcome of this would be institutional investors' flocking to the names they know best already: S&P, Moody's and Fitch.

Another result of this initiative is that only new players with massive balance sheets will be interested in entering the ratings business. Innovation typically comes from smaller players. If the Treasury's proposed scenario is realized, the small players will avoid entering and the market will lose something it desperately needs – innovation. And with innovation comes increased accuracy.

Inadvertently, this mandatory registration will further solidify the S&P, Moody's and Fitch oligopoly.

iii. ***SEC Examination of Internal Controls and Processes**: The SEC will require each rating agency to document its policies and procedures for the determination of ratings. The SEC will examine the internal controls, due diligence, and implementation of rating methodologies for all credit rating agencies to ensure compliance with their policies and public disclosures.*

Comment: These levels of oversight, if the SEC has proper staffing and funding to carry them out, can help to provide a confidence level in the regulatory regime covering the agencies. Holding the NRSROs accountable for their stated controls and processes will be a challenging job but essential for improvement in the industry. That being said, these are still relatively small costs for the Big Three to maintain compliance. This is neither a punishment nor and discouraging development for the large agencies. It will, however, be factored into every NRSROs legal risk management plans. Failure to comply with controls and processes can expose an agency to potential suits by all too willing potential claimants.

d. **Reduce Reliance on Credit Rating Agencies**

i. ***PWG Review of Regulatory Use of Ratings****: Treasury will work with the SEC and the President's Working Group on Financial Markets to determine where references to ratings can be removed from regulations.*

Comment: The use of the NRSRO designation in federal regulations and various statues only further embeds rating agencies into the fabric of the financial and legal markets. Loan documentation, some bond indentures and even some corporate internal risk management procedures are keyed off of NRSROs (read Moody's and S&P).

To reduce over-reliance, one must first address reliance. Congress, Treasury and the SEC can jointly support a reduction (if not total elimination) of NRSRO reference in regulations. Even if it is phased in slowly, the market will respond to the gesture and "lead by example" sentiment.

ii. ***SEC Recently Requested Public Comment on Whether to Remove References to Ratings in Money Market Mutual Fund Regulation****: As part of a comprehensive set of money market fund reform proposals, the SEC requested public comment on whether to eliminate references to ratings in the regulation governing money market mutual funds, as a way to reduce reliance on ratings. Treasury will work with the SEC to examine opportunities to reduce reliance and increase the resilience of the money market mutual fund industry.*

Comment: The money market funds were some of the most vocal speaking out against the removal, when the rule amendments were originally proposed by the SEC last June. This will be a major battle. The embedding of NRSRO terminology over the decades in hundreds of state and federal regulations affecting the investment behavior of banks, insurance companies, pension funds and mutual funds (i.e. the bulk of the investor side of the market) has created a significant level of dependence on an external referee (i.e. S&P and Moody's) to call line fouls and fair balls so that portfolio managers have a credible scapegoat if something goes wrong. The inclusion of the designation in regulations has given the

Big Three a de facto legal and statutory power over many institutional investors and other financial institutions.

iii. ***Require GAO Study On Reducing Reliance****: In addition to regulatory efforts to reduce reliance on credit ratings, this legislation would require the GAO to study and issue a report on the reliance on ratings in federal and state regulations.*

Comment: The GAO is being given a deadline of 30 months to complete this review. We would strongly suggest a shorter time frame.

e. **Strongly Support SEC Actions on Credit Rating Agencies**

i. ***Enable Additional Ratings On Structured Products****: Because structured products are often complex and require detailed information to assess, it can be difficult for a rating agency to provide "unsolicited ratings" – ratings on products it was not paid to rate. These ratings, while in existence previously, were ineffective because investors understood that these unsolicited ratings did not benefit from the same information as the fully contracted ratings. The SEC has proposed a rule that would require issuers to provide the same data they provide to one credit rating agency as the basis of a rating to all other credit rating agencies. This will allow other credit rating agencies to provide additional, independent analysis to the market.*

Comment: This is critically important and likely the area where one of the most productive changes can be brought to the ratings industry. The Big Three have lobbied and worked hard to keep ring fenced the structured product ratings business now for years and the information upon which these structures are based. The CRARA's (2006) application by asset class provision was a boon to the incumbent agencies as it essentially allowed them to maintain a private playground in structured products, with now quite obvious and public results.

The SEC's efforts to create equivalent disclosure of the data underlying structured products ratings is a major step in the right direction for allowing competitive ratings of product and analysis into the market. The complexity of instruments is now notorious and the need for new players to join the Big Three in rating them based on the same due diligence data supplied by those who paid for the ratings originally is critical. These comments apply to providing maintenance ratings on existing securities as well as on new securities – as there are plenty of illiquid structured securities on books around the world and currently only a trickle of new issuance (some of which is really a repackaging of tranches of existing securities).

All involved in weighing in on legislative change must focus on this topic closely. It is not as sexy as many other big headline initiatives, and it is extraordinarily complex, but critical. We also strongly urge legislators and regulators to consider the need to fully address the need for equivalent disclosure of assets underlying collateralized loan obligations (CLOs), not currently in the SEC's domain. While Rapid Ratings does not currently rate these structured products, we know the access to this data, which is entirely controlled now by banks and any of the Big Three hired to rate these instruments, is absolutely essential for anyone to rate these securities on an unsolicited basis.

ii. ***Require Disclosure of Full Ratings History****: The SEC has proposed to require NRSROs to disclose, on a delayed basis, ratings history information for 100% of all issuer-paid credit ratings.*

Comment: As of December, the SEC's new rule amendments require issuer-paid businesses to provide 10% of their ratings for free. In December, the Commission also put out for comment again the question of whether or not this disclosure should apply to subscriber-paid rating agencies too and whether or not this disclosure requirement should actually be for 100%.

The Treasury proposal covers all types of rating agencies and for 100% of their ratings. Rapid Ratings' position is that disclosure of ratings actions and history for subscriber-paid firms should be purely voluntary and not mandated by Federal legislation. In short, we get paid for our ratings from subscribers (largely investors) and that is our primary source of revenue. Competing against well-funded, established players is difficult enough without having our source of revenue taken away because we are forced to give away our ratings history for each company. Prior to the Treasury proposal, and in an environment where the NRSRO application is voluntary, disclosing ratings was a choice any firm like ours could evaluate and assess. We have been strong critics of this possible initiative in the SEC's deliberations. Now, with Treasury's wishing to force registration, the combination of these two elements is truly troubling. This is one key area where we have concerns about the thoroughness of their analysis.

Even with an embargo of, say one year, we would still be giving away for free valuable data. For example, of the companies that have defaulted in

2008-2009 (1st half), Rapid Ratings was downgrading those companies approximately 10% per year for the past three years. Thus, two years of declines of these names would be available as early warning signs for users free of charge. That would devastate and cannibalize our earnings potential. We would be forced to give away our competitive advantage in the market.

This is yet another disincentive for new players to compete in the industry and is a boon for the issuer-paid businesses.

In an ironic, well-kept secret, the issuer-paid agencies actually have very thriving subscriber-paid revenue streams. While it is still a much smaller part of their businesses, the Big Three get great mileage out of stating they provide their ratings for free when in fact they do so only in pretty superficial ways today. The SEC, Treasury and the Committee should not be deceived by this. The "free" ratings have time limits and anyone or any firm wanting notifications of updates/changes or more than just a few ratings has/have to pay (a lot) for a subscription. In other words, the Big Three are getting it both ways - from the issuers and the users - money market funds, mutual funds, asset managers, - anyone who invests in bonds and needs to keep track of the ratings on their holdings are compelled to buy a subscription service. Very few users take advantage of the "free" rating.

Perhaps the Committee might want to query the Big Three as to what amount or percentage of their revenues come from ratings subscription based services vs. issuer-paid services.

iii. ***Strengthen Regulation and Oversight of Credit Rating Agencies****: In response to the credit market turmoil, in February the SEC adopted several measures to increase the transparency of the rating agencies' methodologies, strengthen disclosure of ratings performance, prohibit certain practices that create conflicts of interest, and enhance recordkeeping and reporting obligations to assist the SEC in performing its regulatory and oversight functions. The SEC has allocated resources to establish a branch of examiners dedicated specifically to conducting examination oversight of rating agencies.*

Comment: As discussed above in "Establish A Dedicated Office For Supervision Of Rating Agencies," We do not believe the SEC wants to determine what is a good rating and what is not. The market should decide this issue.

3. ***Q: What are your legislative recommendations to enhance the regulation of the credit rating agency industry?***

A: Our recommendations are largely interspersed through the answers above. As a broad requirement though, the legislative environment must address the fundamental problems of information availability, containing conflicted behavior and accountability by NRSROs while creating a playing field that allows for competition instead of quashing it. Legislation also needs to emphasize ratings accuracy – not by charging the SEC with being able to determine what is accurate and what is not, but by allowing for accuracy to come through innovation, competition and ubiquitous access to information. Our key concerns are:

- **One-size does not fit all:** Proposals designed to fix major deficiencies in the issuer-paid business model should not be loaded on to subscriber-paid agencies, thus increasing their costs, increasing barriers to entry and reducing competition.
- **Disclosure Rules Affecting Intellectual Property:** The new rules must avoid requiring the forced disclosure of proprietary intellectual property. Appropriate safeguards must be introduced to protect intellectual property.
- **Accuracy:** It is unreasonable to believe the SEC can effectively be the arbiter on accuracy in the ratings industry. The market will decide very effectively which ratings are more accurate through usage of competing CRAs, as long as there are not barriers to entry protecting S&P, Moody's and Fitch and disadvantaging new entrants or small rating agencies.
- **Forcing NRSRO registration** on all companies issuing ratings will force compliance costs on new CRAs thus erecting further barriers, potentially force small CRAs out of business and prevent potential new capital sources entering this industry, all thereby undermining the growth of innovative and more accurate ratings technology. The vast number of firms captured by this sweeping net would not only confuse users of ratings, potentially hundreds of new agencies would be designated that would not have qualified as NRSROs under the Credit Rating Agency Reform Act of 2006. All of these would fuel the use of the largest brand names, and solidify regulatory protection of S&P, Moody's and Fitch.
- **Rating Disclosure:** Requiring subscriber-based rating agencies to disclose their history of ratings can undermine the subscriber-based business model which is dependent on selling current and past ratings to investors for survival. The Treasury proposal covers all types of rating agencies and for 100% of their ratings. This erects a major barrier to competition by subscriber-based CRAs

against the issuer-paid CRAs by stripping them of their revenues. This proposal may violate anti-trust laws because the proposal undermines competition.[2]

4. ***Q: Do you have recommendations to improve the performance of the Securities and Exchange Commission in its oversight of ratings agencies or of ratings agency analysts in their formulation of ratings?***

   A: We would be happy to provide additional information on this topic in a subsequent submission

5. ***Q: Do you feel that credit rating agencies should be required to consider in the rating process any relevant and credible information that comes to their attention from sources other than an issuer?***

   A: We believe that, if a rating agency's business model is to provide qualitative assessments of an entity or pool of assets collateralizing a structured product, it should take into account all data it can reasonably attain and qualify as being reliable. Relying only on the information provided by an issuer takes the issuer-paid conflict to an entirely new level.

6. ***Q: Do you have views on the appropriate scope of legal liability to which credit rating agencies should be subject?***

   A: We understand the Big Three's use of the First Amendment as a first level of protection against suits. Their thinking is that the frivolous suits are best caught in this net and it saves them the trouble and expense of having to fight everyone on an individual basis. Given litigious tendencies, there is merit for all ratings firms to have this level of protection.

   Ultimately, we believe that NRSROs should be held accountable for compliance with their internal procedures, as monitored by the SEC, and SEC regulations for disclosure, compliance, etc. We do believe strongly that ratings are opinions and not recommendations and should not be construed as investment advice.

   We are conscious of an irony as well. Subscription-paid ratings firms enter into subscription contracts with subscribers. These agreements state clearly that ratings are opinions and not recommendations and our users indemnify us in this regard. This

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[2] Spectrum Sports, Inc. v. McQuillan: "The purpose of the [Sherman] Act is not to protect businesses from the working of the market; it is to protect the public from the failure of the market. The law directs itself not against conduct which is competitive, even severely so, but against conduct which unfairly tends to destroy competition itself."

protection of both the firm and the subscriber can be achieved because we have the commercial relationship directly with the user of the ratings. With issuer-paid agencies and with subscriber-paid firms, IF public disclosure of ratings actions is indeed mandated, anyone (understanding the distinction between opinion and investment advice or not) can have access to these ratings and use them properly or not. The public disclosure of ratings ironically creates more chance for misunderstanding of the nature of ratings and their misuse as opinions and increases the liability for the rating agency.

7. ***Q: Under what circumstances do you feel that the SEC should revoke the registration of a Nationally Recognized Statistical Rating Organization?***

   A: For the SEC's oversight to have any teeth there must be penalties for non compliance by NRSROs of whatever rules are ultimately in place. We understand there are voices for NRSROs to meet minimum accuracy standards in order to maintain their status. This has a certain appeal but begs the questions of who or what is the benchmark for accuracy against which all others will be measured.

8. ***Q: To what degree, if any, should ratings be embedded in regulatory requirements?***

   A: One of the major reasons the Big Three oligopoly has remained so solid for years is that there is such an extensive web of laws and statues that embed the NRSRO designation. While wholesale removal of these references may not be feasible across all regulations, a phased removal from at least the SEC regulations would send a reasonable signal to the market that the SEC is serious about reducing reliance (and, more to the point, over-reliance) on these ratings.

9. ***Q: What should be done to foster competition and heightened quality in credit ratings?***

   A: covered extensively elsewhere in this document.

Additional Topics of Importance to this Debate

The following are some additional thoughts on two significant topics related to this broad discussion.

1. **Conflicts of Interest – are all models conflicted?**
   Central to the issuer-paid rating agencies' argument for defending their conflicted business model is that the subscriber-paid rating agency business model is also conflicted, suggesting that a modified version of the status quo is the only real alternative. Business as usual and ratings rules entropy are their target goals, and they are succeeding. S&P, Moody's and Fitch, are paid by companies (vanilla bonds, commercial paper, etc) and conduit vehicles (structured products) to provide ratings on securities. The communication, consulting, collaboration and ratings shopping that have long underpinned this relationship between issuer and agency is inarguably a conflict of interest. This does not mean that every rating is tainted or designed in some way to mislead the public. As demonstrated last year by an SEC investigation and in the House Oversight Committee hearings, this conflict is too often a practical hindrance to truthful and objective execution of their obvious fiduciary duty. The infamous S&P email correspondence that said that a security "could be structured by cows and we would rate it" to maintain market share and the CEO of Moody's statement that sometimes they "drank the Kool-Aid" of issuers and bankers representing them, are evidence enough of this claim.

   S&P, Moody's and other defenders of the conflicted issuer-paid model have continually proffered the argument that the primary alternative, subscriber-paid agencies are also conflicted. The argument is that one of these firms will be unduly influenced by a phantom, substantial investor client that has investment positions the agency will wish to support and release ratings that grind the subscriber's ax, lest the agency risk losing that subscriber's business. In comments to the SEC Roundtable to Examine Oversight of Credit Rating Agencies in April, of which Rapid Ratings was an invited participant, S&P and Moody's heads commented, respectively, "every business model has positive and negative aspects" and "conflicts are inherent and must be properly managed for any model." Regarding the new Treasury initiatives, Michael Barr, Assistant Treasury Secretary for financial institutions, was reported on July 22nd as justifying the decision not to heed calls for a fundamental overhaul because "there were conflicts inherent in alternative models too." Assuming the report is accurate, the scales of justice in this case are not balanced if this is the logical foundation for new legislation.

   People interested in rating agency reform need to see very clearly into the irony of this situation – the issuer-paid agencies are drawing an analogy between their daily business model and the potential for a subscriber-paid agency to falsify a rating to benefit a paying customer, an act of fraud and fiduciary malfeasance. There is no evidence or claim we know of that any subscriber-paid agency has ever actually overridden their ratings to benefit a subscriber. In Rapid Ratings' case it would be impossible because all of our ratings are generated by computer algorithms based on empirical and published financial statements (not assumptions and projections) and no analyst opinions are involved. Could other subscriber-paid rating agencies be conflicted? There is a remote chance, but it is highly unlikely; even the mere suspicion that this occurred would be the agency's death knell. The issuer-paid agencies have little substance with which to defend their own model (which, importantly, they switched to from the subscription model in the 1970s because, amongst other reasons, it is more profitable) and therefore are attempting to rely on the shaky argument that their competition is also conflicted. So it is clear that their strategy is that the best defense is an offense. If government wishes to perpetuate the issuer-paid business model, so be it. But, let's not miss the irony of the issuer-paid agencies' shifting public attention away from their committed sins to the uncommitted sins of very small competitors paid by investors who are seeking protection from fiduciary irresponsibility.

2. Competition

"Competition" in the ratings business is a word that tends to be under-appreciated and underserved yet is perhaps the biggest recipient of lip-service anyway. The SEC has stated a desire to have 30 NRSROs in coming years and the Treasury proposal (generously interpreted) seeks to force competition by requiring registration of all possible parties. The Big Three even say they welcome competition. Some academic research of late has said that more competition has actually been bad for the ratings business. In the 2005-2006 debate over rating agency reform, in the House one opponent to the bill said that more NRSRO competition would create a financial disaster like the S&L crises years ago.

Competition for competition's sake is not the answer. Competition that effects change though innovation, greater ratings accuracy and the establishment of viable alternatives to the status quo is the answer. The recent Treasury proposal takes a bludgeon to the issue of competition and, if passed through Congress, would serve as a massive disincentive to small and large competitor alike. Imagine the NRSRO landscape without new innovators, without new capital being applied to "fix" that which has been highlighted as being wrong, without creating any checks and balances on the Big Three's ratings accuracy.

Rapid Ratings is only one competitor in the ratings business. We have brought innovation to the space and automation that makes us the most scalable player in the industry. Our ratings accuracy typically surpasses the Big Three and often leads credit default swaps and share price movements of companies. Soon we will be rating more industrial companies than any of the Big Three, and we do all of this without getting paid by issuers but by using a proprietary econometric system to evaluate financial health, not default risk.

3. **Value of Innovation**
   Innovations and competition in the ratings business can yield better results than the ratings available from the traditional issuer-paid CRAs. Rapid Ratings has an excellent track record in labeling companies as higher risk months and years before they default, typically one to three years ahead of traditional agencies, and generally ahead of market signals such as share prices and credit default swap spreads by months and sometimes years. The Big Three agencies provide highly lagged indicators of risk that follow and rarely lead market signals. Rapid Ratings generally outperforms market signals. Models that incorporate market signals, by definition, have a difficult time outperforming those market signals. It is not difficult for most models to outperform S&P, Moody's and Fitch.
   a. in high profile anecdotal corporate collapses such as Enron, GM, Delphi, Parmalat, LyondellBasell, Pilgrim's Pride, Levitt Corp and WCI
   b. in US bank collapses such as Wachovia Corp., Wilshire Financial Services Group, Indymac Bancorp Inc, Imperial Credit Industries, Cityscape Financial, Bear Stearns, and Downey Financial Corp., and
   c. in the deterioration of entire sectors as in the US homebuilding industry, where Rapid Ratings warned of decline in early 2006 (and subsequently downgraded companies including, notably, Lennar, Centex, Beazer, Pulte, KB, Ryland, Hovnanian, DR Horton, MDC, Meritage, Standard-Pacific, and Toll Bros).

   But it is not just the accuracy of the measurement and categorization of risk which differentiates the value of Rapid Ratings' Financial Health Ratings (FHRs™), a material innovation in the ratings industry. Rapid Ratings also generally provides an early warning of slippage from one risk category and rating level to another long before collapse or default, or an early warning of recovery, helping clients to be pro-active in dealing with counterparties, borrowers and investments.

Conclusion

Additional thoughts on many of the topics above as well as specific analysis of the SEC's recent initiatives can be found in our submission to the "SEC Roundtable to Examine Oversight of Credit Rating Agencies" April 15, 2009. Our submission is linked here: http://www.sec.gov/comments/4-579/4579-20.pdf

Thank you again for inviting me to present my views. Rapid Ratings looks forward to working with the Committee and the SEC in any way possible to assist in the reforms to come. I am happy to follow up with additional material and to answer any questions that come from your review of this submission.

PREPARED STATEMENT OF JOHN C. COFFEE, JR.

ADOLF A. BERLE PROFESSOR OF LAW,
COLUMBIA UNIVERSITY LAW SCHOOL

AUGUST 5, 2009

Chairman Dodd, Ranking Member Shelby, and fellow Senators: I am honored to be back before this Committee to discuss the proposed "Investor Protection Act of 2009" and its provisions in Subtitle C (Improvement to the Regulation of Credit Rating Agencies). Frankly, I have Yogi Berra's sense of "déjà vu all over again" in reviewing this legislation, because it borrows very heavily from legislation introduced earlier this year by Senator Reed, which he called the "Rating Accountability and Transparency Enhancement Act of 2009." Senator Reed (and his staff) crafted an important and constructive piece of legislation, and the Administration has wisely adopted most of it.

Nonetheless, there are two respects in which the Administration's proposals in my judgment fall short. Unless these two problems are better addressed, I am afraid that the current and unsatisfactory *status quo* will persist. Credit rating agencies are unlike the other major gatekeepers of the financial markets (*e.g.,* accountants, investment banks, and securities analysts) in two critical respects:

1. Unlike other gatekeepers, the credit rating agencies do not perform due diligence or make its performance a precondition of their ratings. In contrast, accountants are, quite literally, bean counters who do conduct audits. But the credit rating agencies do not make any significant effort to verify the facts on which their models rely (as they freely conceded to this Committee in earlier testimony here). Rather, they simply accept the representations and data provided them by issuers, loan originators, and underwriters. The problem this presents is obvious and fundamental: no model, however well designed, can outperform its information inputs—"Garbage In–Garbage Out." Although the Administration's bill does address the need for due diligence, its current form (unlike the Reed bill) may actually discourage third party due diligence. Ultimately, unless the users of credit ratings believe that ratings are based on the real facts and not just a hypothetical set of facts, the credibility of ratings, particularly in the field of structured finance, will remain tarnished, and private housing finance in the U.S. will remain starved and underfunded because it will be denied access to the broader capital markets.
2. Credit rating agencies have long and uniquely been immune from liability to their users. Unlike accountants or investment banks, they have never been held liable. At the same time, because the "issuer pays" business model of the ratings agencies seems likely to persist (despite the creative efforts of many who have sought to develop a feasible "user pays" model), we have to face the simple reality that the rating agencies have a built-in bias: they are a watchdog paid by the entities they are expected to watch. Because the ratings agencies receive an estimated 90 percent of their revenues from issuers who are paying for their ratings,[1] the agencies will predictably continue to have a strong desire to please the client who pays them. Moreover, the market for ratings has become more competitive, and the latest empirical research finds that, with greater competition, there has come an increased tendency to inflate ratings.[2] This is predictable—unless there is some countervailing pressure on the gatekeeper. In the case of accountants and underwriters, there clearly is such countervailing pressure in the form of the threat of liability under the Federal securities laws. But that threat has never had any discernable impact on the credit rating agencies. Let me make clear that I do not want to subject credit rating agencies to class action litigation every time a rating proves to be inaccurate. Rather, the goal should be more modest: to use a litigation threat to induce the rating agencies not to remain willfully ignorant and to insist that due diligence be conducted and certified to them with regard to structured finance offerings.

[1] *See,* Frank Partnoy, "How and Why Credit Rating Agencies Are Not Like Other Gatekeepers", (*http://ssrn.com/abstract=900257*) (May 2006).

[2] *See,* Bo Becker and Todd J. Milbourn, "Reputation and Competition: Evidence From the Credit Rating Industry", (Harv. Bus. School Fin. Working Paper No. 09-051) (2008) (available at *http://ssrn.com/abstract=1278150*) (finding that the percentage of investment grade ratings went up and the percentage of noninvestment grade ratings went down after competition intensified in the industry, beginning in the late 1990s).

I. The Disappearance of Due Diligence

A rapid deterioration in underwriting standards for subprime mortgage loans occurred over a very short period, beginning around 2001. As the chart set forth below shows, low or no-document loans (also known in today's parlance as "liar's loans") rose from 28.5 percent in 2001 to 50.7 percent in 2005.[3]

Underwriting Standards in Subprime Home-Purchase Loans, 2001-2006

	Low/No-Doc Share	Debt Payments/ Income	Loan/Value	ARM Share	Interest-Only Share
2001	28.5%	39.7%	84.0%	73.8%	0.0%
2002	38.6%	40.1%	84.4%	80.0%	2.3%
2003	42.8%	40.5%	86.1%	80.1%	8.6%
2004	45.2%	41.2%	84.9%	89.4%	27.3%
2005	50.7%	41.8%	83.2%	93.3%	37.8%
2006	50.8%	42.4%	83.4%	91.3%	22.8%

Source: Freddie Mac, obtained from the International Monetary Fund.

Concomitantly, interest-only loans (on which no amortization of principal occurred) rose from 0 percent in 2001 to 37.8 percent in 2005. These changes should have prompted the ratings agencies to downgrade their ratings on securitizations based on such loans—but they didn't. As the housing bubble inflated, the ratings agencies slept.

Two explanations are possible for their lack of response: (1) the ratings agencies willfully ignored this change, or (2) they managed not to learn about this decline, because issuers did not tell them and they made no independent inquiry. Prior to 2000, the ratings agencies did have a reliable source of information about the quality of the collateral in securitization pools. During this period prior to 2000, investment banks did considerable due diligence on asset-backed securitizations by outsourcing this task to specialized "due diligence" firms. These firms (of which Clayton Holdings, Inc. was probably the best known) would send squads of loan reviewers (sometimes a dozen or more) to sample the loans in a securitized portfolio, checking credit scores and documentation. But the intensity of this due diligence review declined over recent years. The *Los Angeles Times* quotes the CEO of Clayton Holdings to the effect that:

> Early in the decade, a securities firm might have asked Clayton to review 25 percent to 40 percent of the subprime loans in a pool, compared with typically 10 percent in 2006 . . . [4]

The President of a leading rival due diligence firm, the Bohan Group, made an even more revealing comparison:

> By contrast, loan buyers who kept the mortgages as an investment instead of packaging them into securities would have 50 percent to 100 percent of the loans examined, Bohan President Mark Hughes said.[5]

In short, lenders who retained the loans checked the borrowers carefully, but the investment banks decreased their investment in due diligence, making only an increasingly cursory effort as the bubble inflated.

The actual loan reviewers employed by these firms also told the above-quoted *Los Angeles Times* reporter that supervisors in these firms would often change documentation in order to avoid "red-flagging mortgages." These employees also report regularly encountering inflated documentation and "liar's loans," but, even when they rejected loans, "loan buyers often bought the rejected mortgages anyway."[6] In short, even when the watchdog barked, no one at the investment banks truly paid attention, and no one told the rating agencies.

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[3] *See,* Allen Ferrell, Jennifer Bethel, and Gang Hu, "Legal and Economic Issues in Litigation Arising From the 2007–2008 Credit Crisis", (Harvard Law & Economics Discussion Paper No. 612, Harvard Law School Program in Risk Regulation Research Paper No. 08-5) at Table 4.

[4] *See,* E. Scott Reckard, "Subprime Mortgage Watchdogs Kept on Leash; Loan Checkers Say Their Warnings of Risk Were Met With Indifference", *Los Angeles Times,* March 17, 2008, at C-1.

[5] *Id.*

[6] *Id.*

If mortgage-backed securitizations are again to become credible, ratings agencies must be able to distinguish (and verify) whether an asset pool consists mainly of “liar’s loans” or is instead composed of loans made to creditworthy borrowers. This requires the restoration of due diligence—presumably by independent, third party due diligence firms.

Both the Administration bill and the earlier Reed bill make an effort to restore due diligence, but the impact of the Administration’s bill is uncertain and possibly even counterproductive. In proposed Section 932(s)(3)(D) (“Transparency of Credit Rating Methodologies and Information Reviewed”), the Administration bill requires disclosure of:

> whether and to what extent third party due diligence services have been utilized, and a description of the information that such thirty party reviewed in conducting due diligence services.

Then, in Section 932(s)(5) (Due Diligence Services), the Administration bill requires that where

> third-party due diligence services are employed by a nationally recognized statistical rating organization or an issuer or underwriter, the firm providing the due diligence services shall provide to the [NRSRO] written certification of the due diligence, which shall be subject to review by the Commission.

This makes great sense—except for the fact that it is optional. The issuer or underwriter (who will likely be the parties retaining and compensating the due diligence firm) may decide that it is easier not to retain such an outside firm than to have to describe its procedures and the information it reviewed and then provide a certification to the ratings agency. In full compliance with §932(s)(3)(D), it could answer that third party firms were not used. To make this appear more palatable, the underwriter might describe some internal review procedures that were followed by its own staff (which would not trigger any mandatory certification to the rating agency). In short, given the choice, issuers and underwriters might prefer the easier course of doing nothing, and thus the current opacity surrounding structured finance offerings would persist. To be sure, some rating agencies might insist on third party due diligence (at least for a period of time), but they might thereby place themselves at a competitive disadvantage and lose business until they gave in.

How then can the use of third party due diligence be more effectively encouraged? One very feasible approach might be to focus on the users of credit ratings, for example by instructing mutual funds and other institutional investors that they could not rely on a rating issued by an NRSRO for purposes of their own need to comply with their own “prudent man” fiduciary obligations unless the ratings was explicitly based on third party due diligence. This would avoid any conceivable Constitutional issue, because Congress would not be mandating procedures for the NRSRO, but instead would be telling institutional investors what they needed to rely upon. To illustrate this approach, let me give two examples: Under current Rule 3a-7 under the Investment Company Act exempts fixed-income securities issued by a special purpose vehicle from the Investment Company Act if, at the time of sale, the securities are rated in one of four highest categories of investment quality by an NRSRO. [7] Congress could simply instruct the SEC that such an exemption should also require that the requisite investment grade rating be based on third party due diligence that was certified to the rating agency pursuant to Section 932(s)(5). Similarly, Rule 2a-7 (“Money Market Funds”) under the same Act defines an “Eligible Security” as one that has a specified rating given by an NRSRO. [8] If this rule required that the rating be based in addition on a due diligence certification, money market funds would be effectively required to demand that NRSROs receive such certifications. The attraction of this approach is that it does not mandate what the NRSRO must do, but instead tells the users of ratings what they must have. Effectively, issuers, underwriters and NRSROs would know that they had to use a due diligence firm to verify the critical information assumed by the rating agency’s model in they intended to sell the offering to these institutions.

A second approach to this same end could be achieved through the reformulation of liability rules, as next described.

II. Using Liability To Compel Due Diligence

The most serious failing in the proposed legislation is that it ducks the issue of enforcement and relies solely on SEC monitoring and disclosure. Even if we assume

[7] *See,* 17 C.F.R. §270.3a-7.
[8] *See,* 17 C.F.R. §270.2a-7.

that the SEC will always be vigilant (which may be a heroic assumption after the Madoff debacle), the SEC is not given any clear authority to mandate due diligence. Moreover, over the last decade, we have seen the rating agencies behave in a manner that approached willful ignorance about changes in the credit environment that were clear to almost everyone else.

Here, a balance must be struck. Ratings agencies appear never to have been held liable under the Federal securities laws.[9] Even in the Enron litigation, a proceeding in which underwriters paid over $7 billion in settlements, the credit rating agencies escaped liability.[10] Although it is not possible to be aware of every possible settlement in Federal or State court, recent surveys by legal scholars continue to reach this same conclusion. *See, e.g.,* Frank Partnoy, Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective (Council of Institutional Investors White Paper April 2009) at 14–15; Kenneth Kettering," Securitization and Its Discontents: The Dynamics of Financial Product Development", 29 *Cardozo L. Rev.* 1553, 1687–93 (2008); Arthur R. Pinto, "Control and Responsibility of Credit Rating Agencies in the U.S.", 54 *Am. J. Comp. L.* 341, 351–356 (2006). As a Congressional staff study found in 2002, the rating agencies that qualify as NRSROs are legislatively shielded from liability under the Federal securities laws.[11] The First Amendment defense is only one of many defenses relied upon by the industry, and probably not the most important. Yet, although many tort law theories have been attempted by plaintiffs, "the only common element . . . is that the rating agencies win."[12] Since the 2006 legislation, the ratings industry now takes the position that that legislation preempted State tort law and thus precludes even fraud actions based on the common law.[13] In short, while a settlement may have been paid somewhere in the recent flurry of litigation, the risk of liability for ratings agencies remains remote.

This does not mean, however, that we should seek to maximize liability. Clearly, the rating agencies cannot be insurers of credit quality and could conceivably be drowned under a sea of liability if the liability rules were greatly liberalized. Precisely for that reason, Senator Reed's bill struck a very sensible compromise in my judgment. It created a standard of liability for the rating agencies, but one with which they easily could comply (if they tried). Specifically, his bill contained a Section 4 ("State of Mind in Private Actions") that permitted an action against a credit rating agency where:

> the complaint shall state with particularity facts giving rise to a strong inference that the [rating agency] knowingly or recklessly failed either to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk, or to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that it considered to be competent and that were independent of the issuer and underwriter.

This language does not truly expose rating agencies to any serious risk of liability—at least if they either conduct a reasonable investigation themselves or obtain verification from others (such as a due diligence firm) that they reasonably believed to be competent and independent.

Given the express certification requirement in the proposed legislation, this language could be picked up and incorporated into an updated revision of the above language in the Reed bill, so that a rating agency would be fully protected when

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[9] Recently, a number of securities class actions have included rating agencies as defendants. In a few cases, Federal courts have refused to grant motions to dismiss sought by the ratings agency. *See, e.g.,* In re Moody's Corp. Sec. Litig., 599 F. Supp. 2d 493 (S.D.N.Y. 2009); In re National Century Financial Enterprises Inc. Invest. Litig., 580 F. Supp. 2d 630 (S.D. Ohio 2008). But this simply means that the plaintiff has survived the first round in a long fight. My discussions with plaintiffs attorneys suggest that they see the underwriters as the "deep pocket" defendant in these cases and are not expecting significant contributions from the rating agencies, given the many legal obstacles to suing them.

[10] *See, Newby v. Enron Corporation,* 511 F. Supp. 2d 741, 815–817 (S.D. Tex. 2005).

[11] *See,* Staff of the S. Comm. on Governmental Affairs, 107 Cong., Report: Financial Oversight of Enron: The SEC and Private-Sector Watchdogs (Comm. Print Oct. 8, 2002) at 104–05. In particular, Rule 436(g) under the Securities Act of 1933 specifically exempts the ratings agencies from liability as an expert under Section 11 of that Act.

[12] *See,* Frank Partnoy, "The Paradox of Credit Ratings", In *Ratings, Rating Agencies, and the Global Financial System,* (Richard Levich, *et al.,* eds. 2002) at 79; *See,* also *First Equity Corp. v. Standard & Poor's Corp.,* 869 F.3d 175 (2d Cir. 1999) (rejecting common law theories under New York and Florida law).

[13] *See,* Section 15E(c)(2) of the Securities Exchange Act of 1934 (discussed *infra*), 15 U.S.C. §78o-7(c)(2).

it received such a certification from an independent due diligence firm that covered the basic factual elements in its model. Arguably, this entire liability provision could be limited to structured finance offerings, which is where the real problems lie.

The case for this limited litigation threat is that it is unsafe and unsound to let rating agencies remain willfully ignorant. Over the last decade, they have essentially been issuing hypothetical ratings in structured finance transactions based on hypothetical assumed facts provided them by issuers and underwriters. Such conduct is inherently reckless; the damage that it caused is self-evident, and the proposed language would end this state of affairs (without creating anything approaching liability for negligence).

III. Drafting Suggestions

There are some ambiguities and inconsistencies in the draft bill that should be corrected:

1. First, there is a clear inconsistency between the amendment to Section 15E(c)(2), which would continue to state that:

> Notwithstanding any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings.

and proposed Section 932(r), which provides that:

> The Commission shall prescribe rules . . . with respect to the procedures and methodologies, including qualitative and quantitative models, used by [NRSROs] that require each [NRSRO] to . . .

This conflict is dangerous, and it might be cured in part by stating in §15E(c)(2) that: "except as otherwise specifically provided in this title, neither the Commission nor any State . . . may regulate . . . ." Even more importantly, Congress should realize that, whatever it may have intended, the ratings industry is arguing in court that this language in Section 15E(c) also preempts common law claims for fraud and negligence. If Congress did not intend to preempt the common law, it should correct this looming misinterpretation and limits its preemption provision so that it does not reach the common law. If fraud can be proven under State law or Blue Sky statutes, such an action should not be preempted.

2. Under existing Section 15E(d), the SEC may censure, suspend (and now fine) an NRSRO for limited reasons only. The last and residual clause (Section 15E(d)(5)) says that such discipline or suspension may be invoked if the NRSRO "fails to maintain adequate financial and managerial resources to consistently produce credit ratings with integrity." This is too high a standard and also too narrow a standard. With the revisions to be made by this legislation, an NRSRO will also be expected to maintain conflict of interest policies and to comply with the SEC's new procedural and disclosure rules under Sections 932 and 933. Hence, this Section should be broadened to read:

> (5) failed to (i) operate in substantial compliance with the rules promulgated by the Commission, (ii) maintain adequate financial and managerial resources to consistently produce credit ratings with integrity, or (iii) demonstrate sufficient competence or accuracy to justify continued reliance by investors upon its ratings.

The last clause would also entitle the Commission to discipline, suspend, or revoke the registration of a ratings agency that was systematically inaccurate or inferior over a sustained period. An incompetent ratings agency does not merit tenure.

3. Proposed §934 requires the SEC to adopt rules requiring issuers to disclose "preliminary credit ratings received" from NRSROs. Because the term "preliminary credit rating" is not defined, this rule could be easily sidestepped if the NRSRO gave the issuer instead a general (or even a specific) description of how it would evaluate the issuer's credit, but not an actual or tentative rating. Hence, it would be advisable to broaden this section so that it required disclosure of "preliminary credit ratings or any other assessment or information that informed the issuer of the likely range within which it would be rated or the likely outcome of the rating process."

4. If we want the ratings agency to rely on more than the facts provided by the issuer or underwriter, consideration should be given to expanding the required disclosures under §932(s)(3)(E). For example, the new form specified by that Section should require disclosure of:

> (E) a description of all relevant data, from whatever source learned or received, about any obligor, issuer, security, or money market instrument that was used and relied upon, or considered but not relied upon, for the

purpose of determining the credit rating, indicating the source of such information;

This is an admittedly broad provision, but aimed at making it more difficult for the rating agency to ignore information from third parties.

5. Consideration should be given to requiring the new compliance officer (which each NRSRO will be required to employ under this legislation) to provide any credible information that it learns indicating fraudulent or unlawful behavior to an appropriate law enforcement agency and/or the SEC. This is in effect a mandatory whistle-blowing provision, and exceptions could be created to cover circumstances when the compliance officer concluded that the information was false or unreliable.

PREPARED STATEMENT OF LAWRENCE J. WHITE

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AUGUST 5, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee: My name is Lawrence J. White, and I am a Professor of Economics at the NYU Stern School of Business. During 1986–1989 I served as a Board Member on the Federal Home Loan Bank Board. Thank you for the opportunity to testify today on this important topic. I have appended to this statement for the Committee a longer Statement that I delivered at the Securities and Exchange Commission's (SEC) "Roundtable" on the credit rating agencies on April 15, 2009, which I would like to have incorporated for the record into the statement that I am presenting today.

The three large U.S.-based credit rating agencies—Moody's, Standard & Poor's, and Fitch—and their excessively optimistic ratings of subprime residential mortgage-backed securities (RMBS) in the middle years of this decade played a central role in the financial debacle of the past 2 years. Given this context and history, it is understandable that there would be strong political sentiment—as expressed in the proposals by the Obama administration, as well as by others—for more extensive regulation of the credit rating agencies in hopes of forestalling future such debacles. The advocates of such regulation want (figuratively) to grab the rating agencies by the lapels, shake them, and shout "Do a better job!"

This urge for greater regulation is understandable—but it is misguided and potentially quite harmful. The heightened regulation of the rating agencies is likely to discourage entry, rigidify a specified set of structures and procedures, and discourage innovation in new ways of gathering and assessing information, new technologies, new methodologies, and new models (including new business models)—and may well not achieve the goal of inducing better ratings from the agencies. Ironically, it will also likely create a protective barrier around the incumbent credit rating agencies.

There is a better route. That route starts with the recognition that the centrality of the three major rating agencies for the bond information process was mandated by more than 70 years of prudential financial regulation of banks and other financial institutions. In essence, regulatory reliance on ratings—for example, the prohibition on banks' holding "speculative" bonds, as determined by the rating agencies' ratings—imbued these third-party judgments about the creditworthiness of bonds with the force of law! This problem was compounded when the SEC created the category of "nationally recognized statistical rating organization" (NRSRO) in 1975 and subsequently became a barrier to entry into the rating business. As of year-end 2000 there were only three NRSROs: Moody's, Standard & Poor's, and Fitch. [1]

It should thus come as no surprise that when this (literal) handful of rating firms stumbled badly in their excessively optimistic ratings of the subprime RMBS, the consequences were quite serious.

This recognition of the role of financial regulation in forcing the centrality of the major rating agencies then leads to an alternative prescription: Eliminate regulatory reliance on ratings—eliminate the ratings' force of law—and bring market forces to bear. Since the bond markets are primarily institutional markets (and not a retail securities market, where retail customers are likely to need more help), market forces can be expected to work—and the detailed regulation that has been proposed would be unnecessary. Indeed, if regulatory reliance on ratings were eliminated, the

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[1] Because of subsequent prodding by the Congress, and then the specific barrier-reduction provisions of the Credit Rating Agency Reform Act of 2006, there are now ten NRSROs.

entire NRSRO superstructure could be dismantled, and the NRSRO category could be eliminated.

The regulatory requirements that prudentially regulated financial institutions must maintain safe bond portfolios should remain in force. But the burden should be placed directly on the regulated institutions to demonstrate and justify to their regulators that their bond portfolios are safe and appropriate—either by doing the research themselves, or by relying on third-party advisors. Since financial institutions could then call upon a wider array of sources of advice on the safety of their bond portfolios, the bond information market would be opened to innovation and entry in ways that have not been possible since the 1930s.

My appended April 15 Statement for the SEC provides greater elaboration on many of these points. Since that Statement preceded the Obama administration's specific proposals for further regulation of the credit rating agencies, I will expand here on the drawbacks of those proposals.

The proposals—as found initially in the Administration's Financial Regulatory Reform: A New Foundation (p. 46) that was released in mid June, and then in the specific legislative proposals that were released on July 21—are devoted primarily to efforts to increase the transparency of ratings and to address issues of conflicts of interest. The latter arise largely from the major rating agencies' business model of relying on payments from the bond issuers in return for rating their bonds.[2] These proposals expand and elaborate on a set of regulations that the SEC has recently implemented.

Again, the underlying urge to "do something" in the wake of the mistakes of the major credit rating agencies during the middle years of this decade is understandable. Further, the "issuer pays" business model of those rating agencies presents an obvious set of potential conflict-of-interest problems that appear to be crying out for correction.[3]

Nevertheless, the dangers of the proposals are substantial. They ask the SEC to delve ever deeper into the processes and procedures and methodologies of credit ratings—of providing judgments about the creditworthiness of bonds and bond issuers. In so doing, the proposals (if enacted) are likely to rigidify the industry along the lines of whatever specific implementing regulations that the SEC devises, as well as raising the costs of being a credit rating agency. In so doing, the proposals will discourage entry and innovation in new ways of gathering and assessing information, in new methodologies, in new technologies, and in new models—including new business models.

There is one especially worrisome provision in the specific legislation that was proposed in July (and that was absent in the earlier June proposals) that is guaranteed to discourage entry: the requirement that all credit rating agencies should register as NRSROs with the SEC. This requirement would seem to encompass the independent consultant who offers bond investment recommendations to clients (such as hedge funds or bond mutual funds), as well as any financial services company that employs fixed income analysts whose recommendations become part of the services that the company offers to clients.

This provision, if enacted, will surely discourage entry into the broader bond information business, as well as encouraging the exit of existing providers of information. Ironically, it will likely become a new protective barrier around the incumbent credit rating agencies (when, again ironically, the Credit Rating Agency Reform Act of 2006 was intended to tear down the earlier barrier to entry that the SEC had erected when it create the NRSRO category in 1975). This can't be a good way of encouraging new and better information for the bond market.

Further, it is far from clear that the proposals will actually achieve their goal of improving ratings. One common complaint against the large agencies is that they are slow to adjust their ratings in response to new information.[4] But this appears

[2] It is worth noting that three smaller U.S.-based NRSRO rating agencies have "investor pays" business models and that the "investor pays" model was the original model for John Moody and for the industry more generally, until the major rating agencies switched to the "issuer pays" model in the early 1970s.

[3] It is important to remember, however, that the major credit rating agencies switched to the "issuer pays" model in the early 1970s, and that the serious problems only arose three decades later. Apparently, the agencies' concerns for their long-run reputations and the transparency and multiplicity of issuers prior to the current decade all served to keep the potential conflict-of-interest problems in check during those three intervening decades.

[4] This complaint has been present for decades. It surfaced strongly in the wake of the Enron bankruptcy in November 2001, with the revelation that the major rating agencies had maintained "investment grade" ratings on Enron's debt until 5 days before that company's bank-

Continued

to be a business culture phenomenon for the agencies (which was present, as well, in the pre-1970's era when the rating agencies had an "investor pays" business model). As for the kind of over-optimism about the RMBS in this decade that subsequently created such serious problems, the rating agencies were far from alone in "drinking the Kool-Aid" that housing prices could only increase and that even subprime mortgages consequently would not have problems. It is far from clear that the proposed regulations would have curbed such herd behavior. Also, the incumbent rating agencies are quite aware of the damage to their reputations that have occurred and have announced measures—including increased transparency and enhanced efforts to address potential conflicts—to repair that damage.

The Obama administration's proposals do—briefly—entertain the possibility of reducing regulatory reliance on ratings. But this seems to be largely lip service, embodied in promises that the Administration will examine the possibilities. The only specific provision on this point in the proposed legislation is a requirement for the U.S. Government Accountability Office (GAO) to undertake a study and deliver a report. Also, the reference in the proposals is to "reduction" rather than to elimination; and there seems to be no recognition that even a reduction of regulatory reliance on ratings would represent a movement in the opposite direction from increasing the regulation of the credit rating agencies.

In sum, the proposals of the Obama administration with respect to the reform of the credit rating agencies are deeply flawed and wrongheaded. There is a better route: Eliminate regulatory reliance on ratings—eliminate the force of law that has been accorded to these third-party judgments. The institutional participants in the bond markets could then more readily (with appropriate oversight by financial regulators) make use of a wider set of providers of information, and the bond information market would be opened to new ideas and new entry in a way that has not been possible for over 70 years.

Thank you again for the opportunity to appear before this Committee, and I would be happy to respond to any questions from the Committee.

Attachment

STATEMENT BY LAWRENCE J. WHITE* FOR THE SECURITIES AND EXCHANGE COMMISSION "ROUNDTABLE TO EXAMINE OVERSIGHT OF CREDIT RATING AGENCIES"

Washington, DC——April 15, 2009

Summary

The three major credit rating agencies—Moody's, Standard & Poor's, and Fitch—played a central role in the subprime mortgage debacle of 2007–2008. That centrality was not accidental. Seven decades of financial regulation propelled these rating agencies into the center of the bond information market, by elevating their judgments about the creditworthiness of bonds so that those judgments attained the force of law. The Securities and Exchange Commission exacerbated this problem by erecting a barrier to entry into the credit rating business in 1975. Understanding this history is crucial for any reasoned debate about the future course of public policy with respect to the rating agencies.

The Securities and Exchange Commission has recently (in December 2008) taken modest steps to expand its regulation of the industry. Further regulatory efforts by the SEC and/or the Congress would not be surprising.

There is, however, another direction in which public policy could proceed: Financial regulators could withdraw their delegation of safety judgments to the credit rating agencies. The goal of safe bond portfolios for regulated financial institutions would remain. But the financial institutions would bear the burden of justifying the safety of their bond portfolios to their regulators. The bond information market would be opened to new ideas about rating methodologies, technologies, and business models and to new entry in ways that have not been possible since the 1930s.

> "an insured State savings association . . . may not acquire or retain any corporate debt securities not of investment grade." 12 Code of Federal Regulations §362.11

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ruptcy filing. More recently, the major agencies had "investment grade" ratings on Lehman Brothers' debt on the day that it filed for bankruptcy.

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> "any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision." The usual disclaimer that is printed at the bottom of Standard & Poor's credit ratings

Introduction

The U.S. subprime residential mortgage debacle of 2007–2008, and the world financial crisis that has followed, will surely be seen as a defining event for the U.S. economy—and for much of the world economy as well—for many decades in the future. Among the central players in that debacle were the three large U.S.-based credit rating agencies: Moody's, Standard & Poor's (S&P), and Fitch.

These three agencies' initially favorable ratings were crucial for the successful sale of the bonds that were securitized from subprime residential mortgages and other debt obligations. The sale of these bonds, in turn, were an important underpinning for the U.S. housing boom of 1998–2006—with a self-reinforcing price-rise bubble. When house prices ceased rising in mid 2006 and then began to decline, the default rates on the mortgages underlying these bonds rose sharply, and those initial ratings proved to be excessively optimistic—especially for the bonds that were based on mortgages that were originated in 2005 and 2006. The mortgage bonds collapsed, bringing down the U.S. financial system and many other countries' financial systems as well.

The role of the major rating agencies has received a considerable amount of attention in Congressional hearings and in the media. Less attention has been paid to the specifics of the regulatory structure that propelled these companies to the center of the U.S. bond markets. But an understanding of that structure is essential for any reasoned debate about the future course of public policy with respect to the rating agencies. [1]

Background

A central concern of any lender—including investors in bonds—is whether a potential or actual borrower is likely to repay the loan. Lenders therefore usually spend considerable amounts of time and effort in gathering information about the creditworthiness of prospective borrowers and also in gathering information about the actions of borrowers after loans have been made.

The credit rating agencies offer judgments—they prefer the word "opinions" [2]—about the credit quality of bonds that are issued by corporations, governments (including U.S. State and local governments, as well as "sovereign" issuers abroad), and (most recently) mortgage securitizers. These judgments come in the form of ratings, which are usually a letter grade. The best known scale is that used by S&P and some other rating agencies: AAA, AA, A, BBB, BB, *etc.,* with pluses and minuses as well. [3] Credit rating agencies are thus one potential source of such information for bond investors; but they are far from the only potential source.

The history of the credit rating agencies and their interactions with financial regulators is crucial for an understanding of how the agencies attained their current central position in the market for bond information.

Some History

John Moody published the first publicly available bond ratings (mostly concerning railroad bonds) in 1909. Moody's firm [4] was followed by Poor's Publishing Company in 1916, the Standard Statistics Company in 1922, [5] and the Fitch Publishing Company in 1924. [6] These firms' bond ratings were sold to bond investors, in thick rating manuals. In the language of modern corporate strategy, their "business model" was one of "investor pays." In an era before the Securities and Exchange Commission (SEC) was created (in 1934) and began requiring corporations to issue standardized

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[1] Overviews of the credit rating industry can be found in, *e.g.,* Cantor and Packer (1995), Partnoy (1999, 2002), Richardson and White (2009), Sylla (2002), and White (2002, 2002–2003, 2006, 2007).

[2] The rating agencies favor that term because it allows them to claim that they are "publishers" and thus enjoy the protections of the First Amendment of the U.S. Constitution (*e.g.,* when the agencies are sued by investors and issuers who claim that they have been injured by the actions of the agencies).

[3] For short-term obligations, such as commercial paper, a separate set of ratings is used.

[4] Dun & Bradstreet bought Moody's firm in 1962; subsequently, in 2000, Dun & Bradstreet spun off Moody's as a free-standing corporation.

[5] Poor's and Standard merged in 1941, to form S&P; S&P was absorbed by McGraw-Hill in 1966.

[6] Fitch merged with IBCA (a British firm) in 1997, and the combined firm was subsequently bought by FIMILAC, a French business services conglomerate.

financial statements, Moody and the firms that subsequently entered were clearly meeting a market demand for their information services.

A major change in the relationship between the credit rating agencies and the U.S. bond markets occurred in the 1930s. Eager to encourage banks to invest only in safe bonds, bank regulators issued a set of regulations that culminated in a 1936 decree that prohibited banks from investing in "speculative investment securities" as determined by "recognized rating manuals." "Speculative" securities were bonds that were below "investment grade." Thus, banks were restricted to holding only bonds that were "investment grade" (*e.g.,* bonds that were rated BBB or better on the S&P scale).[7]

This regulatory action importantly changed the dynamic of the bond information market. Banks were no longer free to act on information about bonds from any source that they deemed reliable (albeit within constraints imposed by oversight by bank regulators). They were instead forced to use the judgments of the publishers of the "recognized rating manuals" (*i.e.,* Moody's, Poor's, Standard, and Fitch). Further, since banks were important participants in the bond markets, perforce other participants would want to pay attention to the bond raters' pronouncements as well.

On the regulatory side of this process, rather than the bank regulators' using their own internal resources to form judgments about the safety of the bonds held by banks (which the bank regulators continued to do with respect to the other kinds of loans made by banks), the regulators had effectively delegated—"outsourced" (again using the language of modern corporate strategy)—to the rating agencies their safety judgments about bonds that were suitable for banks' portfolios. Equivalently, the creditworthiness judgments of these third-party raters had attained the force of law.

In the following decades, the insurance regulators of the 48 (and eventually 50) States followed a similar path: The State regulators wanted their regulated insurance companies to have adequate capital (in essence, net worth) that was commensurate with the riskiness of the companies' investments. To achieve this goal, the regulators established minimum capital requirements that were geared to the ratings on the bonds in which the insurance companies invested—the ratings, of course, coming from that same small group of rating agencies. Once again, an important set of regulators had delegated their safety decisions to the credit rating agencies. And in the 1970s, Federal pension regulators pursued a similar strategy.

These additional delegations of safety judgments to the rating agencies meant that the latter's centrality for bond market information was further strengthened.

The SEC crystallized the rating agencies' centrality in 1975. In that year the SEC decided to set minimum capital requirements for broker-dealers (*i.e.,* securities firms). Following the pattern of the other financial regulators, it wanted those capital requirements to be sensitive to the riskiness of the broker-dealers' asset portfolios and hence wanted to use bond ratings as the indicators of risk. But it worried that references to "recognized rating manuals" were too vague and that a "bogus" rating firm might arise that would promise "AAA" ratings to those companies that would suitably reward it and "DDD" ratings to those that would not; and if a broker-dealer chose to claim that those ratings were "recognized," the SEC might have difficulties challenging this assertion.

To deal with this problem, the SEC created a wholly new category—"nationally recognized statistical rating organization" (NRSRO)—and immediately "grandfathered" Moody's, S&P, and Fitch into the category. The SEC declared that only the ratings of NRSROs were valid for the determination of the broker-dealers' capital requirements. The other financial regulators soon adopted the SEC's NRSRO category and the rating agencies within it as the relevant sources of the ratings that were required for evaluations of the bond portfolios of their regulated financial institutions.[8]

Over the next 25 years the SEC designated only four additional firms as NRSROs;[9] but mergers among the entrants and with Fitch caused the number of NRSROs to return to the original three by year-end 2000. In essence, the SEC had become a significant barrier to entry into the bond rating business, because the

[7] This rule still applies to banks today. This rule did not apply to savings institutions until 1989. Its application to savings institutions in 1989 forced them to sell substantial holdings of "junk bonds" (*i.e.,* below investment grade) at the time, causing a major slump in the junk bond market.

[8] Also, in the early 1990s, the SEC again made use of the NRSROs' ratings when it established safety requirements for the short-term bonds (*e.g.,* commercial paper) that are held by money market mutual funds.

[9] The SEC bestowed the NRSRO designation on Duff & Phelps in 1982, on McCarthy, Crisanti & Maffei in 1983, on IBCA in 1991, and on Thomson BankWatch in 1992.

NRSRO designation was important for any potential entrant. Without the NRSRO designation, any would-be bond rater would likely be ignored by most financial institutions; and, since the financial institutions would ignore the would-be bond rater, so would bond issuers. [10]

In addition, the SEC was remarkably opaque in its designation process. It never established criteria for a firm to be designated as a NRSRO, never established a formal application and review process, and never provided any justification or explanation for why it "anointed" some firms with the designation and refused to do so for others.

One other piece of history is important: In the early 1970s the basic business model of the large rating agencies changed. In place of the "investor pays" model that had been established by John Moody in 1909, the agencies converted to an "issuer pays" model, whereby the entity that is issuing the bonds also pays the rating firm to rate the bonds.

The reasons for this change of business model have not been established definitively. Among the candidates are:

a. The rating firms feared that their sales of rating manuals would suffer from the consequences of the high-speed photocopy machine (which was just entering widespread use), which would allow too many investors to free-ride by obtaining photocopies from their friends;
b. The bankruptcy of the Penn-Central Railroad in 1970 shocked the bond markets and made issuers more conscious of the need to assure bond investors that they (the issuers) really were low risk, and they were willing to pay the credit rating firms for the opportunity to have the latter vouch for them (but that same shock should have also made investors more willing to pay to find out which bonds were really safer, and which were not);
c. The bond rating firms may have belatedly realized that the financial regulations described above meant that bond issuers needed the "blessing" of one or more NRSROs in order to get their bonds into the portfolios of financial institutions, and the issuers should be willing to pay for the privilege; and
d. The bond rating business, like many information industries, involves a "two-sided market," where payments can come from one or both sides of the market; in such markets, which side actually pays can be quite idiosyncratic. [11]

Regardless of the reason, the change to the "issuer pays" business model opened the door to potential conflicts of interest: A rating agency might shade its rating upward so as to keep the issuer happy and forestall the issuer's taking its rating business to a different rating agency. [12]

Recent Events of the Current Decade

The NRSRO system was one of the less-well-known features of Federal financial regulation, and it might have remained in that semisecretive state had the Enron bankruptcy of November 2001 not occurred. In the wake of the Enron bankruptcy, however, the media and then Congressional staffers noticed that the three major rating agencies had maintained "investment grade" ratings on Enron's bonds until 5 days before that company declared bankruptcy. This notoriety led to the Congress's "discovery" of the NRSRO system and to Congressional hearings in which the SEC and the rating agencies were repeatedly asked how the latter could have been so slow to recognize Enron's weakened financial condition. [13]

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[10] The SEC's barriers were not absolute. A few smaller rating firms—notably KMV, Egan-Jones, and Lace Financial—were able to survive, despite the absence of NRSRO designations. KMV was absorbed by Moody's in 2000.

[11] Other examples of "two-sided" information markets include newspapers and magazines, where business models range from "subscription revenues only" (*e.g.,* Consumer Reports) to "a mix of subscription revenues plus advertising revenues" (most newspapers and magazines) to "advertising revenues only" (*e.g.,* The Village Voice, some metropolitan "giveaway" daily newspapers, and some suburban weekly "shoppers").

[12] Skreta and Veldkamp (2008) develop a model in which the ability of issuers to choose among potential raters leads to overly optimistic ratings, even if the raters are all trying honestly to estimate the creditworthiness of the issuers. In their model, the raters can only make estimates of the creditworthiness of the issuers, which means that their estimates will have errors. If the estimates are (on average) correct and the errors are distributed symmetrically (*i.e.,* the raters are honest but less than perfect), but the issuers can choose which rating to purchase, the issuers will systematically choose the most optimistic. In an important sense, it is the issuers' ability to select the rater that creates the conflict of interest.

[13] The rating agencies were similarly slow to recognize the weakened financial condition of WorldCom, and were subsequently grilled about that as well.

The Sarbanes-Oxley Act of 2002 included a provision that required the SEC to send a report to Congress on the credit rating industry and the NRSRO system. The SEC duly did so; but the report simply raised a series of questions rather than directly addressing the issues of the SEC as a barrier to entry and the enhanced role of the three incumbent credit rating agencies, which (as explained above) was due to the financial regulators' delegations of safety judgments (and which the SEC's NRSRO framework had strengthened).

In early 2003 the SEC designated a fourth NRSRO (Dominion Bond Rating Services, a Canadian credit rating firm), and in early 2005 the SEC designated a fifth NRSRO (A.M. Best, an insurance company rating specialist). The SEC's procedures remained opaque, however, and there were still no announced criteria for the designation of a NRSRO.

Tiring of the SEC's persistence as a barrier to entry (and also the SEC's opaqueness in procedure), the Congress passed the Credit Rating Agency Reform Act (CRARA), which was signed into law in September 2006. The Act specifically instructed the SEC to cease being a barrier to entry, specified the criteria that the SEC should use in designating new NRSROs, insisted on transparency and due process in the SEC's decisions with respect to NRSRO designations, and provided the SEC with limited powers to oversee the incumbent NRSROs—but specifically forbade the SEC from influencing the ratings or the business models of the NRSROs.

In response to the legislation, the SEC designated three new NRSROs in 2007 (Japan Credit Rating Agency; Rating and Information, Inc. [of Japan]; and Egan-Jones) and another two NRSROs in 2008 (Lace Financial, and Realpoint). The total number of NRSROs is currently ten.

Finally, in response to the growing criticism (in the media and in Congressional hearings) of the three large bond raters' errors in their initial, excessively optimistic ratings of the complex mortgage-related securities (especially for the securities that were issued and rated in 2005 and 2006) and their subsequent tardiness in downgrading those securities, the SEC in December 2008 promulgated regulations that placed mild restrictions on the conflicts of interest that can arise under the rating agencies' "issuer pays" business model and that required greater transparency in the construction of ratings.[14] Political pressures to do more—possibly even to ban legislatively the "issuer pays" model—remain strong.

An Assessment

It is clear that the three dominant credit rating firms have received a considerable boost from financial regulators. Starting in the 1930s, financial regulators insisted that the credit rating firms be the central source of information about the creditworthiness of bonds in U.S. financial markets. Reinforcing this centrality was the SEC's creation of the NRSRO category in 1975 and the SEC's subsequent protective barrier around the incumbent NRSROs, which effectively ensured the dominance of Moody's, S&P, and Fitch. Further, the industry's change to the "issuer pays" business model in the early 1970s meant that potential problems of conflict of interest were likely to arise, sooner or later. Finally, the major agencies' tardiness in changing their ratings—best exemplified by the Enron incident mentioned above[15]—has been an additional source of periodic concern.[16]

The regulatory boosts that the major rating agencies received, starting in the 1930s, were certainly not the only reason for the persistent fewness in the credit rating industry. The market for bond information is one where economies of scale, the advantages of experience, and brand name reputation are important features.

[14] *See,* Federal Register, 74 (February 9, 2009), pp. 6456–6484.

[15] Most recently, the major rating agencies still had "investment grade" ratings on Lehman Brothers' commercial paper on the day that Lehman declared bankruptcy in September 2008.

[16] This delay in changing ratings has been a deliberate strategy by the major rating agencies. They profess to try to provide a long-term perspective—to "rate through the cycle"—rather than providing an up-to-the-minute assessment. But this means that these rating agencies will always be slow to identify a secular trend in a bond's creditworthiness, since there will always be a delay in perceiving that any particular movement isn't just the initial part of a reversible cycle but instead is the beginning of a sustained decline or improvement. It may be that this sluggishness is a response to the desires of their investor clients to avoid frequent (and costly) adjustments in their portfolios; *See, e.g.,* Altman and Rijken (2004, 2006); those adjustments, however, might well be mandated by the regulatory requirements discussed above. It may also be the case that the agencies' ratings changes are sluggish (especially downward) so as not to anger issuers (which is another aspect of the potential conflict-of-interest problem). And the absence of frequent changes also allows the agencies to maintain smaller staffs. Except for the regulatory mandates, however, the agencies' sluggishness would be inconsequential, since the credit default swap (CDS) market provides real time market-based judgments about the credit quality of bonds.

The credit rating industry was never going to be a commodity business of thousands (or even just hundreds) of small-scale producers, akin to wheat farming or textiles. Nevertheless, the regulatory history recounted above surely contributed heavily to the dominance of the three major rating agencies. The SEC's belated efforts to allow wider entry during the current decade were too little and too late. The advantages of the "Big Three's" incumbency could not quickly be overcome by the entrants (three of which were headquartered outside the U.S., one of which was a U.S. insurance company specialist, and three of which were small U.S. firms).

It is not surprising that a tight, protected oligopoly might become lazy and complacent. The "issuer pays" model opened the door to potential abuses. Though this potential problem had been present in the industry since the early 1970s, the relative transparency of the corporations and governments whose debt was being rated apparently kept the problem in check. Also, there were thousands of corporate and Government bond issuers, so the threat of any single issuer (if it was displeased by an agency's rating) to take its business to a different rating agency was not potent.

The complexity and opaqueness of the mortgage-related securities that required ratings in the current decade, however, created new opportunities and apparently irresistible temptations.[17] Further, the rating agencies were much more involved in the creation of these mortgage-related securities: The agencies' decisions as to what kinds of mortgages (and other kinds of debt) would earn what levels of ratings for what sizes of "tranches" (or slices) of these securities were crucial for determining the levels of profitability of these securitizations for their issuers. Finally, unlike the market for rating corporate and Government debt, the market for rating mortgage-related securities involved only a handful of investment banks as securitizers with high volumes. An investment bank that was displeased with an agency's rating on any specific security had a more powerful threat—to move all of its securitization business to a different rating agency—than would any individual corporate or Government issuer.

Fueling the Subprime Debacle

The U.S. housing boom that began in the late 1990s and ran through mid 2006 was fueled, to a substantial extent, by subprime mortgage lending.[18] In turn, the securitization of the subprime mortgage loans, in collateralized debt obligations (CDOs) and other mortgage-related securities, importantly encouraged the subprime lending.[19] And crucial for the securitization were the favorable ratings that were bestowed on these mortgage-related securities.

Favorable ratings were important for at least two reasons: First, as has been discussed above, ratings had the force of law with respect to regulated financial institutions' abilities and incentives (via capital requirements) to invest in bonds.[20] More favorable ratings on larger fractions of the tranches that flowed from any given package of mortgage securities thus meant that these larger fractions could more readily be bought by regulated financial institutions Second, the generally favorable reputations that the credit rating agencies had established in their corporate and Government bond ratings meant that many bond purchasers—regulated and non-regulated—were inclined to trust the agencies' ratings on the mortgage-related, even (or, perhaps, especially) if the market yields on the mortgage-related securities were higher than on comparably rated corporate bonds.

Driving all of this, of course, was the profit model of the securitizers (packagers) of the mortgages: For any given package of underlying mortgages (with their contractually specified yields) to be securitized, the securitizers made higher profits if they attained higher ratings on a larger percentage of the tranches of securities that were issued against those mortgages. This was so because the higher rated tranches

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[17] The Skreta and Veldkamp (2008) model predicts that greater complexity of rated bonds leads to a greater range of errors among (even honest) raters and thus to the ability of the issuers to select raters that are even more optimistic.

[18] The debacle is discussed extensively in Gorton (2008), Acharya and Richardson (2009), Coval, *et al.* (2009), and Mayer, *et al.* (2009).

[19] This importance extended to the development of other financing structures, such as "structured investment vehicles" (SIVs), whereby a financial institution might sponsor the creation of an entity that bought tranches of the CDOs and financed their purchase through the issuance of short-term "asset-backed" commercial paper (ABCP). If the CDO tranches in a SIV were highly rated, then the ABCP could also be highly rated. (Interest rate risk and liquidity risk were apparently ignored in the ratings.)

[20] For banks and savings institutions, in addition to the absolute prohibition on holding bonds that were below investment grade, there was a further important impact of ratings: Mortgage-backed securities (MBS)—including CDOs—that were issued by nongovernmental entities and rated AA or better qualified for the same reduced capital requirements (1.6 percent of asset value) as applied to the MBS issued by Fannie Mae and Freddie Mac the instead of the higher (4 percent) capital requirements that applied to mortgages and lower rated mortgage securities.

would carry lower interest rates that needed to be paid to the purchasers of/investors in those tranches, leaving a greater spread for the securitizers. It is not surprising, then, that the securitizers would be prepared to pressure the rating agencies, including threats to choose a different agency, to deliver those favorable ratings.

A Counterfactual Musing

It is worth "musing" about how the bond information industry's structure would look today if financial regulators hadn't succumbed (starting in the 1930s) to the temptation to outsource their safety decisions and thus allowing the credit rating agencies' judgments to attain the force of law. Suppose, instead, that regulators had persisted in their goals of having safe bonds in the portfolios of their regulated institutions (or that, as in the case of insurance companies and broker-dealers, an institution's capital requirement would be geared to the riskiness of the bonds that it held) but that those safety judgments remained the responsibility of the regulated institution, with oversight by regulators. [21]

In this counterfactual world, banks (and insurance companies, *etc.*) would have a far wider choice as to where and from whom they could seek advice as to the safety of bonds that they might hold in their portfolios. Some institutions might choose to do the necessary research on bonds themselves, or rely primarily on the information yielded by the credit default swap market. Or they might turn to outside advisors that they considered to be reliable—based on the track record of the advisor, the business model of the advisor (including the possibilities of conflicts of interest), the other activities of the advisor (which might pose potential conflicts), and anything else that the institution considered relevant. Such advisors might include the credit rating agencies. But the category of advisors might also expand to include investment banks (if they could erect credible "Chinese walls") or industry analysts or upstart advisory firms that are currently unknown.

The end-result—the safety of the institution's bond portfolio—would continue to be subject to review by the institution's regulator. [22] That review might also include a review of the institution's choice of bond-information advisor (or the choice to do the research in-house)—although that choice is (at best) a secondary matter, since the safety of the bond portfolio itself (regardless of where the information comes from) is the primary goal of the regulator. Nevertheless, it seems highly likely that the bond information market would be opened to new ideas—about ratings business models, methodologies, and technologies—and to new entry in ways that have not actually been possible since the 1930s.

It is also worth asking whether, in this counterfactual world, the "issuer pays" business model could survive. The answer rests on whether bond buyers are able to ascertain which advisors do provide reliable advice (as does any model short of relying on Government regulation to ensure accurate ratings). If the bond buyers can so ascertain, [23] then they would be willing to pay higher prices (and thus accept lower interest yields) on the bonds of any given underlying quality that are "rated" by these reliable advisors. In turn, issuers—even in an "issuer pays" framework—would seek to hire these recognized-to-be-reliable advisers, since the issuers would thereby be able to pay lower interest rates on the bonds that they issue.

That the "issuer pays" business model could survive in this counterfactual world is no guarantee that it would survive. That outcome would be determined by the competitive process.

Conclusion

Whither the credit rating industry and its regulation? The central role—forced by seven decades of financial regulation—that the three major credit rating agencies played in the subprime debacle has brought extensive public attention to the industry and its practices. The Securities and Exchange Commission has recently (in December 2008) taken modest steps to expand its regulation of the industry. Further regulatory efforts by the SEC and/or the Congress would not be surprising.

There is, however, another direction in which public policy could proceed. That direction is suggested by the "counterfactual musing" of the previous section: Financial regulators could withdraw their delegation of safety judgments to the credit rat-

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[21] This oversight would be an appropriate aspect of the safety-and-soundness regulation of such institutions. For a justification of safety-and-soundness regulation for these kinds of institutions, *see,* White (1991).

[22] Again, this is necessary because the regulator has the goal that the regulated institution should maintain a safe bond portfolio (or have appropriate capital for the risks).

[23] This seems a reasonable assumption, since the bond market is, for the most part, one where financial institutions are the major buying and selling entities. It is not a market where "widows and orphans" are likely to be major participants.

ing agencies.[24] The policy goal of safe bond portfolios for regulated financial institutions would remain. But the financial institutions would bear the burden of justifying the safety of their bond portfolios to their regulators. The bond information market would be opened to new ideas about rating methodologies, technologies, and business models and to new entry in ways that have not been possible since the 1930s.

Participants in this public policy debate should ask themselves the following questions: Is a regulatory system that delegates important safety judgments about bonds to third parties in the best interests of the regulated institutions and of the bond markets more generally? Will more extensive SEC regulation of the rating agencies actually succeed in forcing the rating agencies to make better judgments in the future? Would such regulation have consequences for flexibility, innovation, and entry in the bond information market? Or instead, could the financial institutions be trusted to seek their own sources of information about the creditworthiness of bonds, so long as financial regulators oversee the safety of those bond portfolios?

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[24] The SEC proposed regulations along these lines in July 2008; *See,* Federal Register, 73 (July 11, 2008), pp. 40088–40106, 40106–40124, and 40124–40142. No final action has been taken on these proposals.

PREPARED STATEMENT OF MARK FROEBA, J.D.

PRINCIPAL, PF2 SECURITIES EVALUATIONS, INC.

AUGUST 5, 2009

Chairman Dodd, Senator Shelby, and Members of the Committee: My name is Mark Froeba and I am a lawyer based in New York City. I am pleased to be here today and it is an honor to testify before you on the important topic of rating agency reform. Thank you for giving me this opportunity.[1]

Let me give you a brief summary of my background. I am a 1990 graduate of the Harvard Law School. In 1997, I left the tax group at Skadden, Arps in New York, where I had been working in part on structured finance securities, to join the CDO group at Moody's. I worked at Moody's for just over 10 years, all of that time in the CDO group. I left Moody's in 2007 as a Senior Vice President. At that time, I was Team Leader of the CLO team, cochair of most CLO rating committees and jointly responsible for evaluating all new CLO rating guidelines.

Since the beginning of the subprime crisis, there have been many proposals for rating agency reform. Most of these proposals are well-intentioned and would probably do little harm. However, few seem likely to accomplish real reform. Real reform must achieve two clear policy goals:

- PREVENT another rating-related financial crisis like the subprime crisis;
- RESTORE investor confidence in the quality and reliability of credit ratings.

In my opinion, the rating agency reform provisions of the Investor Protection Act of 2009 are not sufficient—in themselves—to accomplish either of these goals. However, the Act's rule-making authority could be used to expand their effectiveness. Why are the reform provisions in themselves insufficient?

First, they are not the product of a complete investigation into what actually happened at the rating agencies. If you repair damage to a ceiling caused by a leaky roof but don't repair the roof, the damage will just keep coming back. In this case, as long as we do not have a precise understanding of how things went so wrong, we cannot really be confident the reform proposals will do what is needed to prevent things from going wrong again. (Of course, this cuts both ways. Just as we do not know without an investigation whether the reform proposals go far enough, we also do not know whether they go too far.)

It is true that some work has been done to discover what actually happened at each of the rating agencies, but much could still be learned, especially from the analysts who assigned the problem ratings. Any thorough investigation must include confidential interviews with as many of these analysts as possible from each of the major rating agencies. By these interviews, investigators will gain an intimate knowledge of how each rating agency actually worked, not how it was supposed to work on paper. More importantly, they will uncover exactly what the people closest to the process think caused so many ratings to be so significantly wrong. What questions should be asked?

- Who is responsible for what happened and why?
- Was there ever any pressure exerted upon you or your colleagues, direct or indirect, to subordinate rating analysis to business considerations?
- If so, how was the pressure exerted?

Even if these questions seem to insinuate malfeasance, they are questions the rating agencies will welcome because the answers they expect will do much to restore confidence in their integrity.

In summary, without a proper investigation of what happened—not conducted on a theoretical level, or in discussions with senior managers but with the analysts who actually assigned the ratings in question—we cannot be sure the proposed legislation provides solutions designed to fix the real problems.

The best way to illustrate my second reason for questioning the sufficiency of this proposal is to ask you a simple question. If Investor Protection Act of 2009 had been enacted, just as it is, 5 years ago, do you think it would have prevented the subprime crisis? In my view, the answer to this question is very clearly "No." That does not mean that these proposals are bad. It just means that they do not advance what should be one of the central policy goals of rating agency reform: preventing

[1] The opinions and views expressed in this document are those of Mark Froeba, who is appearing before the Committee on his own behalf and as a private citizen, and are not intended to represent the views or opinions of any organization.

a future crisis in the financial system triggered at least in part by problem credit ratings.

If these reform proposals are uncertain to prevent a future crisis and to restore confidence in the credit ratings, what reforms could achieve these goals?

To answer this question, we should first consider the regulatory context in which the rating agencies found themselves just before the subprime crisis. First, they enjoyed an effective monopoly on the sale of credit opinions. Second, and more importantly, they enjoyed the benefit of very substantial Government-sanctioned demand for their monopoly product. (A buggy whip monopoly is a lot more valuable if Government safety regulations require one in every new car). Third, the agencies enjoyed nearly complete immunity from liability for injuries caused by their monopoly product. Fourth, worried about the monopoly power created by the regulations of one branch of Government, another branch encouraged vigorous competition among the rating agencies. This mix of regulatory "carrots" and "sticks" in the period leading up to the subprime meltdown may have contributed to making it worse than it might have been. Thus, a third goal of rating agency reform should be to untangle these conflicting regulatory incentives. Here are some proposals that I believe will help with all three reform goals.

First, put a "fire wall" around ratings analysis. The agencies have already separated their rating and nonrating businesses. This is fine but not enough. The agencies must also separate the rating business from rating analysis. Investors need to believe that rating analysis generates a pure opinion about credit quality, not one even potentially influenced by business goals (like building market share). Even if business goals have never corrupted a single rating, the potential for corruption demands a complete separation of rating analysis from bottom-line analysis. Investors should see that rating analysis is virtually barricaded into an "ivory tower," and kept safe from interference by any agenda other than getting the answer right. The best reform proposal must exclude business managers from involvement in any aspect of rating analysis and, critically also, from any role in decisions about analyst pay, performance, and promotions.

Second, prohibit employee stock ownership and change the way rating analysts are compensated. There's a reason why we don't want judges to have a stake in the matters before them and it's not just to make sure judges are fair. We do this so that litigants have confidence in the system and trust its results. We do this even if some or all judges could decide cases fairly without the rule. The same should be true for ratings. Even if employee stock ownership has never actually affected a single rating, it provokes doubt that ratings are disinterested and undermines investor confidence. Investors should have no cause to question whether the interests of rating agency employees align more closely with agency shareholders than investors. Reform should ban all forms of employee stock ownership (direct and indirect) by anyone involved in rating analysis. These same concerns arise with respect to annual bonus compensation and 401(K) contributions. As long as these forms of compensation are allowed to be based upon how well the company performs (and are not limited to how well the analyst performs), there will always be doubts about how the rating analysts' interests align.

Third, create a remedy for unreasonably bad ratings. As noted above, the rating agencies have long understood (based upon decisions of the courts) that they will not be held liable for injuries caused by "bad" ratings. Investors know this. Why change the law to create a remedy if bad ratings arguably cause huge losses? The goal is not to give aggrieved investors a cash "windfall." The goal is to restore confidence—especially in sophisticated investors—that the agencies cannot assign bad ratings with impunity. The current system allows the cost of bad ratings to be shifted to parties other than the agencies (ultimately to taxpayers). Reform must shift the cost of unreasonably bad ratings back to the agencies and their shareholders. If investors believe that the agencies fear the cost of assigning unreasonably bad ratings, then they will trust self interest (even if not integrity) to produce ratings that are reasonably good.

My former Moody's colleague, Dr. Gary Witt of Temple University, believes that a special system of penalties might also be useful for certain types of rated instruments. Where a governmental body relies upon ratings for regulatory risk assessment of financial institutions—*e.g.,* the SEC (broker-dealers and money funds), the Federal Reserve (banks), the NAIC (insurance companies) and other regulatory organizations within and outside the U.S.—the Government has a compelling interest and an affirmative duty to regulate the performance of such ratings. Even if other types of ratings might be protected from lawsuits by the first amendment, these ratings are published specifically for use by the Government in assessing risk of regulated financial institutions and should be subject to special oversight, including the measurement of rating accuracy and the imposition of financial penalties for poor performance.

Fourth, change the antitrust laws so agencies can cooperate on standards. When rating agencies compete over rating standards, everybody loses (even them). Eight years ago, one rating agency was compelled to plead guilty to felony obstruction of justice. The criminal conduct at issue there related back to practices (assigning unsolicited ratings) actually worth reconsidering today. Once viewed as anticompetitive, this and other practices, if properly regulated, might help the agencies resist competition over rating standards. Indeed, the rating problems that arose in the subprime crisis are almost inconceivable in an environment where antitrust rules do not interfere with rating agency cooperation over standards. Imagine how different the world would be today if the agencies could have joined forces 3 years ago to refuse to securitize the worst of the subprime mortgages. Of course, cooperation over rating analysis would not apply to business management which should remain fully subject to all antitrust limitations.

Fifth, create an independent professional organization for rating analysts. Every rating agency employs "rating analysts" but there are no independent standards governing this "profession": there are no minimum educational requirements, there is no common code of ethical conduct, and there is no continuing education obligation. Even where each agency has its own standards for these things, the standards differ widely from agency to agency. One agency may assign a senior analyst with a Ph.D. in statistics to rate a complex transaction; another might assign a junior analyst with a BA in international relations to the same transaction. The staffing decision might appear to investors as yet another tool to manipulate the rating outcome. Creating one independent professional organization to which rating analysts from all rating agencies must belong will ensure uniform standards—especially ethical standards—across all the rating agencies. It would also provide a forum external to the agencies where rating analysts might bring confidential complaints about ethical concerns. An independent organization could track and report the nature and number of these complaints and alert regulators if there are patterns in the complaints, problems at particular agencies, and even whether there are problems with particular managers at one rating agency. Finally, such an organization should have the power to discipline analysts for unethical behavior.

Sixth, introduce "investor-pay" incentives into an "issuer-pay" framework. Students of the history of rating agencies know that, at one point, rating agencies were paid by investors not by issuers of the securities rated by the agency. Investors subscribed to periodic rating reports and these subscription fees paid for the ratings. By the late 1960s this business model was not working and the agencies gradually shifted away from an investor-pay model to an issuer-pay model. In this model, the party or entity applying for a rating pays for the rating.

Critics fault this model because it shifts the attention (and allegedly, the allegiance) of the rating agencies not only away from the ultimate consumer of the rating, the investor, but also toward the party whose interests may strongly conflict with the investor, the issuer. According to this view of the process, the power of the issuer to take the rating business to a competitor became the tool by which the rating agencies were induced to compete with each other on rating standards. For example, an issuer tells rating agency (X) that its competitor (Y) has lowered its subordination levels for some structured security, *e.g.,* from 4.5 percent to 4.3 percent. The issuer urges X to change its standards or lose the issuer's business. Of course, at the same time, the issuer is telling Y that X has lowered subordination levels and urging Y to adopt the lower standards. It isn't hard to see how a spiral of declining rating standards could be triggered under this model.

There are those who believe that real rating agency reform requires a return to an investor-pay model. But there may be a third way, a business model that preserves the issuer-pay "delivery system" (the issuer still gets the bill for the rating) but incorporates the incentives of the investor-pay model. How would this work?

First, issuers seeking a credit rating would be required to provide the same information to every rating agency that has "registered" to rate a particular type of security or transaction. Thus, if there are five rating agencies registered to rate CDOs, all five would receive exactly the same information about a new CDO from the issuer. Second, the potential investors in the new security or transaction would decide which agencies get paid to rate the security. During the marketing phase of the transaction, investors would compare the ratings proposed by all of the rating agencies and the investors would then select the agencies to rate the transaction. It would be at this point that the rating agencies would once again be competing with each other for the interest of the investors. The issuers' power to corrupt the process by selecting the rating agency would be eliminated. Finally, every rating agency would be free to publish ratings of the transaction, regardless of whether it was selected to be paid for the rating by investors.

It would also be possible to use such a system to create demand for ratings from new rating agencies. To do so, investors (or issuers if they are still making the selection) would be required to pick two agencies for every transaction: (1) only one from the list of agencies with more than 50 percent market share for the asset type in question and (2) one or more from the list of agencies with less than 50 percent market share for the asset type in question. In this way, newer agencies would have an easier time breaking into a business with extremely high barriers to entry.

These and other reforms are necessary not only to restore investor confidence in ratings (without regard to whether they actually redress past malfeasance) but also to prevent future ratings-related financial crises.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BENNETT FROM MICHAEL S. BARR

Q.1. Pursuant to proposed section 1002(9) of the President's White Paper on Financial Regulatory Reform, would CFPA's authority extend to those who market financial products and services? For example, could a newspaper be covered under the "direct or indirect" language if it allows an advertisement for a financial activity to be placed within it? Similarly, would a Web site Portal (such as Yahoo!) be covered if it features advertising of financial products or services? Lastly, would a broker be covered if it provided a list to a financial institution for direct marketing purposes?

A.1. Under the proposed CFPA Act, the CFPA would have limited jurisdiction to regulate persons engaged in a "financial activity, in connection with the provision of a consumer financial product or service." The wide range of persons and entities described in your questions typically are currently subject to Federal regulation and enforcement by the Federal Trade Commission (FTC) under the FTC Act or must comply with "enumerated consumer laws," authorities that would be transferred to the CFPA. In this way, the proposed CFPA Act would not alter the basic landscape governing existing Federal laws regarding consumer financial products or services that currently apply to those persons and entities.

We believe that reform of the Federal regulatory structure for consumer protection for financial products and services requires three elements: mission focus, marketwide coverage, and consolidated authority. The authorities for rulemaking, supervision, and enforcement for consumer financial products and services are presently scattered among a number of different Federal agencies, including the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Federal Deposit Insurance Corporation, the Federal Trade Commission, the Department of Housing and Urban Development, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision, and the National Credit Union Administration.

Our proposal to establish the CFPA is not designed to establish a new layer of Federal authority on top of this presently balkanized Federal structure. Rather, the proposed CFPA Act is intended to consolidate Federal authority over the marketplace for consumer financial products and services to ensure consistent standards and a level playing field across the marketplace.

Accordingly, many of the persons or entities described in your question would be "covered persons" in connection with the provision of consumer financial products or services. For example, banks that extend credit to consumers to be used primarily for personal, family, or household purposes would be "providing consumer financial products and services" within the meaning of the proposed CFPA Act. Likewise, a consumer reporting agency would be a covered person when providing consumer reports (including credit scores) or "identity theft products," such as credit monitoring services—both of which would be "financial product[s] or service[s]" under the proposed CFPA Act—to consumers to be used primarily for personal, family, or household purposes. Similarly, under our proposal, a retailer that sells "prepaid gift cards" (which would be a type of "stored value" product) to consumers to be used primarily for personal, family, or household purposes would be a "covered person" with respect to that activity, but not with respect to the sale of other, nonfinancial products or services.

In general, the following entities, as described in your question, would be subject to the jurisdiction of the CFPA under an "enumerated consumer law," under the proposed CFPA Act in connection with providing a covered financial product or service to consumers to be used primarily for personal, family, or household purposes, or under two or more of those laws, with respect to the following products or services: banks (deposit products (CDs; savings accounts); demand deposit accounts; home mortgage loans (first or second liens, as well as home equity loans); credit card loans; financial lease structures; personal loans; student loans; vehicle financing (auto, motorcycle, and boat loans); sales of credit insurance products; sales of mortgage life insurance products; financial advice and educational publications; appraisal services; money transfer and payments; ACH activity; checks and check processing; and reporting information about customers to other lenders); retailers (credit card loans; other unsecured loans (*e.g.,* deferred payment plans); financial leasing arrangements; leasing of property to consumers to be used primarily for personal, family, or household purposes, including communication equipment, photocopies, vehicles, audio-visual equipment, subject to certain conditions as described in the proposed CFPA Act; sale of prepaid gift cards; and ATM services); retailers or specialized merchandise and services (secured financing; unsecured financing; extended payment plans; and financial leasing of real and personal property); consumer reporting agencies (consumer reports; identity theft products (*e.g.,* monitoring) and processing and transmission of credit scores); insurance companies and insurance agents (credit insurance products; financial advice and publications; sales of covered insurance products; and financial advice, unless an insurance company or insurance agent is subject to an exemption as a person regulated by the Securities and Exchange Commission (SEC) or a person regulated by the Commodity Futures Trading Commission (CFTC)); stockbrokers, if not subject to an exemption under the proposed CFPA Act as a person regulated by the SEC or a person regulated by the CFTC (financial advice; brokering loans (*e.g.,* home mortgages to clients); brokering deposits; sweeps; and sales of unregistered or exempt securities); attorneys (providing financial advice, which we presume is outside the scope of the attorney–client relationship; real estate settlement services conduct outside the scope of the attorney–client relationship; and acting as custodians); manufacturers (financing of products (*e.g.,* homes; automobiles and other vehicles; appliances; computers); and leasing of real and personal property to consumers to be used primarily for personal, family, or household purposes, subject to certain conditions as described in the proposed CFPA Act); real estate agents (financial advice; financing assistance and referrals; title insurance agency and underwriting; and providing real estate settlement services); educational institutions (originating/brokering student loans; providing financial advice to individual consumers, as described in the proposed CFPA Act); hospitals, physicians, and other medical service providers (arranging for financing of medical services; collection of unpaid bills, to the extent that the debt collection relates to a consumer financial product or service, such as a credit extended by the medical service provider itself to finance the medical services; dealing in or transmitting consumer credit information; and leasing of medical equipment to consumers to be used primarily for personal, family, or household purposes, subject to certain conditions as described in the proposed CFPA Act); accountants (providing tax planning and/or personal tax-preparation services).

Although the proposed CFPA would be authorized to regulate essential aspects of the marketplace for "consumer financial products and services," the CFPA would not have unlimited authority under the proposed CFPA Act and there would be no basis for many of the entities described in your question to be regulated as "covered persons." For example, the proposed CFPA Act would not regulate retailers with respect to the provision of typical "refer-a-friend" programs, which customarily involve only the processing of personally identifiable information, such as an e-mail address, disclosed by a consumer herself for marketing purposes, and do not involve the provision of "financial data processing" services by retailers to consumers. Neither lay-away plans nor extended warranties, which typically are governed under State laws as part of sales transactions for the products themselves, are listed in the Act's definition of "financial activity." Attorneys who communicate with consumers as agents of financial services providers (and are not providing services to consumers such as acting as a mortgage broker) would not be subject to the jurisdiction of the CFPA because, in that capacity, the attorneys would be providing services to the providers, not to consumers. Moreover, the provision of real estate settlement services by an attorney to a consumer within the scope of the attorney–client relationship should not be regulated by the CFPA because the proposed CFPA Act is not intended to alter the regulation of the practice of law by the State courts. Even though an educational institution that originates or brokers loans to students to be used primarily for personal, family or household purposes would be a "covered person" with respect to those activities, processing "grant applications" or offering "study abroad programs" are activities outside the scope of the proposed CFPA Act.

In addition, the following entities, as described in your question, would not be subject to the jurisdiction of the CFPA, either under either an enumerated consumer law or under the proposed CFPA Act, with respect to the following products or services: banks (factoring; sales of annuities; and sales of investment products (other than interest-bearing deposits, such as CDs)); retailers (consumer deposits, assuming that a retailer is prohibited by law from accepting "deposits" and that the deposits described in your question refer to a deposit for the purchase of a commercial product or service; refer a friend programs; exchanges of customer lists, unless such an exchange is covered by the requirements under the Gramm-Leach-Bliley Act (GLBA); the use of "vanity" cards or similar payment plans, including "lay-away" plans; and discount cards) retailers or specialized merchandise and services; insurance companies and insurance agents (except with respect to credit insurance products, financial advice and publications, sales of covered insurance products, and financial advice, as discussed above); stockbrokers, if covered by an exemption under the proposed CFPA Act as a person regulated by the SEC or a person regulated by the CFTC (financial advice; brokering deposits in money market mutual funds, such as sweeps products; and sales of unregistered or exempt securities); attorneys (real estate settlement services conducted within the scope of the attorney–client relationship; collection of own debts, unless the debt collection relates to a consumer financial product or service, such as a credit extended by an attorney herself to finance her legal services; takers and holders of deposits, assuming that an attorney is prohibited by law from accepting "deposits" and that the deposits described in your letter refer to deposits in connection with purchases of legal services; and subletting office space); manufacturers (deposit-taking activities, assuming that a manufacturer is prohibited by law from accepting "deposits" and that the deposit-taking activities described in your letter refer to deposits for purchases of commercial products or services); real estate agents (sales of real property; "deposit taking activities," assuming that a real estate agent is prohibited by law from accepting "deposits" and that the deposit-taking activities described in your letter refer to the receipt of deposits for purchases of property, such as receipt of a check of a consumer-payor as a deposit for the consumer's purchase of a house); educational institutions (providing financial literacy training/information to students, unless the training is provided to a particular consumer on individual financial matters, as described in the proposed CFPA Act; study abroad programs; processing grant applications; and tuition/scholarship grants); hospitals, physicians, and other medical service providers (deposit-taking activities, assuming that a hospital, physician, or medical service provider is prohibited by law from accepting "deposits" and that the deposit-taking activities described in your letter refer to the receipt of deposits for purchases of medical services; and processing insurance-related payments and activities); accountants (except with respect to providing tax planning and/or personal tax-preparation services, as described above).

The CFPA will not regulate the media or subject the media to fees.

A "broker" providing a "list to a financial institution for direct marketing purposes" (or another party not affiliated with the broker) would be covered by the notice and opt-out requirements of the GLBA, as applicable, if the list contains nonpublic personal information about consumers, and potentially may be subject to the Fair Credit Reporting Act (FCRA) for such activity.

Q.2. Under proposed section 1002(9), would a credit card payment processor, or money transmitter, that arranges a payment in connection with the delivery of a financial product or service that violates a regulation promulgated by CFPA be liable for monetary damages or any other punitive action? Does one need to establish scienter on the part of the transmitter or processor, or is mere involvement in the processing a sufficient nexus?

A.2. Under the proposed CFPA Act, the CFPA would be authorized to enforce the requirements of the CFPA Act with respect to a credit card payment processor or money transmitter, each a "covered person," in accordance with the provisions of the CFPA Act, which would include civil money penalties for violations under certain circumstances. However, the proposed CFPA Act expressly provides that "[n]othing [in the section regarding remedies] shall be construed as authorizing the imposition of exemplary or punitive damages." Depending on the circumstances of a violation, or the remedies sought, "mere involvement" by a covered person in a violation should not be a sufficient basis to support the imposition of a sanction under the proposed CFPA Act.

Q.3. The "business of insurance" appears to be excluded from the definition of "financial activity" in the bill, though the exceptions from that exclusion (credit insurance, mortgage insurance, and title insurance) suggest that the CFPA would still have jurisdiction over conventional insurance companies if their business includes financial activities enumerated in proposed section 1002(18)(0). Is that correct? Please specify to what extent, if at all, a conventional insurance company would still find itself subject to potential regulation by the CFPA.

A.3. Under the proposed CFPA Act, a conventional insurance company would be subject to the jurisdiction of the CFPA with respect to the provision of credit, mortgage, or title insurance products or services to consumers to be used primarily for personal, family or household purposes. In addition, a conventional insurance company would be subject to the jurisdiction of the CFPA, like any other person, if the insurance company engages in activities "in connection with the provision of a consumer financial product or service," such as extending credit or providing other consumer financial products or services to consumers to be used primarily for personal, family or household purposes, or otherwise falls within the definition of a "covered person."

Q.4. In establishing the CFPA, the proposal seeks " . . . to promote transparency, simplicity, fairness, accountability, and access in the market for consumer financial products or services." (Section 1021(a)). Yet the definitional reach of "consumer financial products or services" is broad, in that it includes "any financial product or services to be used by a consumer primarily for personal, family or household purposes." (Section 1002(8)). A "financial product or service," in turn, "means any product or service that, directly or indirectly, results from or is related to engaging in 1 or more financial activities" (Section 1002(19)), while the definition of "financial activities," includes:

- Deposit-taking;
- Extending credit and servicing loans;
- Check-guaranty services;
- Collecting, analyzing, maintaining, and providing consumer report information;
- Collection of any debts;
- Providing real estate settlement services;
- Leasing personal or real property or acting as agent, broker, or adviser relating thereto;
- Acting as an investment adviser;
- Acting as a financial adviser;

- Financial data processing;
- Money transmitting;
- Sale or issuance of stored value cards;
- Acting as a money services business;
- Acting as a custodian;
- "Any other activity that the Agency defines, by regulation, as a financial activity." (Section 1002(18)).

In light of the potentially all-encompassing nature of the regulatory regime to be established by the proposed CFPA, I would ask for clarifications on the precise nature of the services and products to be included within the scope of the jurisdictional ambit of this new proposal. To this end, I respectfully request guidance as to whether the following activities are intended to be within the regulatory oversight of the CFPA.

A. *In the case of banks:* I would ask for confirmation that all the following activities would be covered:

- Deposit products (CD's; savings accounts)
- Demand deposit accounts
- Home mortgage loans (fist, second, home equity)
- Credit card loans
- Financial lease structures
- Personal loans; student loans
- Vehicle financing (auto, motorcycle, and boat loans)
- Sales of annuities
- Sales of investment products
- Sales of credit insurance products
- Sales of mortgage life insurance products
- Financial advice and educational publications
- Appraisal services
- Factoring
- Money transfer and payments
- ACH activity
- Checks and check processing
- Reporting information about customers to other lenders

B. *In the case of retailers (general merchandise; convenience stores; service stations):* it would be helpful to know if the following would be covered, as well as to understand if further examples of possible jurisdiction may exist:

- Credit card loans
- Other unsecured loans (*e.g.,* layaway and other deferred payment plans)
- Financial leasing arrangements
- Consumer deposits
- Refer a friend programs
- Exchanges of customer lists
- Retailers who use "vanity" cards and any other payment plans, including "lay-away" plans

- Leasing of property, including communication equipment, photocopies, vehicles, audio-visual equipment
- Sale of prepaid gift cards
- Discount cards
- ATM services

C. *In the case of retailers of specialized merchandise and services (e.g.,* automobiles and other vehicles, new and used; home improvements; home security devices; computers; cell phones): please explain if these products would, in fact, be covered, and whether other examples of possible jurisdiction should be considered:

- Secured financing
- Unsecured financing; extended payment plans
- Financial leasing of real and personal property
- Extended product warranties

D. *In the case of credit reporting agencies:* please specify whether other areas of activity beyond the following should be deemed covered:

- Consumer reports
- Identity theft products (*e.g.,* monitoring)
- Processing and transmission of Credit scores

E. *For insurance companies and insurance agents:* please advise if additional activities need to be studied as within the scope of H.R. 3126:

- Credit insurance products
- Financial advice and publications
- Sales of covered insurance products
- Financial advice

F. *In the case of stockbrokers:* please provide examples of the following potentially covered activities:

- Financial advice
- Brokering loans (*e.g.,* home mortgages to clients)
- Brokering deposits; sweeps
- Sales of unregistered or exempt securities

G. *For attorneys:* please explain if there may be areas of additional activity that may be regulated by the CFPA:

- Communicating with consumers as agents of financial services providers
- Providing financial advice or education
- Real estate settlement services
- Collection of own debts
- Takers and holders of deposits
- Acting as custodians
- Subletting office space

H. *For manufacturers:* please confirm and expand, as may be needed, on the following areas of conduct that may be regaled under the terms of H.R. 3126:

- Financing of products (*e.g.,* homes; automobiles and other vehicles; appliances; computers)
- Extended warranties
- Leasing of real and personal property
- Deposit-taking activities

I. *In the case of real estate agents:* please confirm that the following constitute certain topics for possible regulation by the CFPA:

- Sales
- Financial advice
- Financing assistance and referrals
- Deposit-taking activities
- Title insurance agency and underwriting
- Providing real estate settlement services

J. *For educational institutions:* please provide further specific examples beyond those areas of activity set forth below:

- Originating/brokering student loans
- Providing financial literacy training/information to students
- Providing financial advice
- Study abroad programs
- Tuition/scholarship, student loan financing programs
- Grant applications

K. *In cases of hospitals, physicians, and other medical service providers:* please provide guidance in confirming that these activities may be subject to regulatory scrutiny by the Agency, and please also advise me of additional areas of potential activity under H.R. 3126:

- Arranging for financing of medical services
- Collection of unpaid bills
- Deposit-taking activities
- Dealing in or transmitting consumer credit information
- Processing insurance-related payments and activities
- Leasing of medical equipment

L. *For accountants:* please confirm whether the following constitute certain topics for possible regulation by the CFPA:

- Providing tax planning and/or personal tax-preparation services

A.4. Please see response to Question 1 above.

Q.5. Under proposed section 1012, the governing board of the CFPA would be composed of five members serving staggered terms, all appointed by the President, without any requirement that they represent any political party other than that of the President. Please provide the public policy justification for this departure from the practice of the Securities and Exchange Commission (SEC) and the Federal Trade Commission.

A.5. Under the proposed CFPA Act, the five-member Board of the CFPA would be comprised of four members appointed by the President for terms of 5 years, by and with the consent of the Senate, and the head of the agency responsible for regulating national banks. The proposal recommends this structure so that the focus on appointing Board members can be on expertise in the consumer financial marketplace, rather than be constrained by party affiliation. The requirement of advice and consent of the Senate will help balance the Board. The 5-year terms of the Board members would be staggered, which will help ensure continuity across different administrations. The CFPA Board would be similar in structure to the Federal Reserve Board, whose members serve for staggered terms and are not subject to requirements relating to political affiliation.

Q.6. Under proposed section 1018(c), a "Victims Relief Fund" is set up within the Treasury, into which civil penalties paid to the Treasury pursuant to CFPA enforcement actions would be placed and from which the CFPA could withdraw funds for distribution to "victims" at its sole discretion. Please provide precedents for this provision.

A.6. Current Federal laws may not provide an exact precedent for the CFPA Civil Penalty Fund. However, the fund is designed to compensate victims of misconduct in the provision of consumer financial products or services which is the subject of judicial or administrative actions taken by the CFPA and which result in civil penalties being assessed against covered persons. Civil penalties could be imposed by the CFPA under the proposed CFPA Act, the authorities transferred from other Federal agencies, or the enumerated consumer laws which the CFPA would be authorized to enforce.

Q.7. Under proposed section 1054, the CFPA would be authorized to represent itself in Federal or State court, including the U.S. Supreme Court. Please confirm that Attorney General Holder has agreed with this policy and provide a list of other independent agencies that also have the authority to represent themselves in the same fashion. Also, does "all appropriate legal or equitable relief" (Section 1054(a)) contemplate seeking monetary damages in addition to civil penalties? If so, why is this language different (in that the word "monetary" is used) from the language that applies to State Attorneys General in proposed section 1042(a)(1)?

A.7. The Office of the Comptroller of the Currency ("OCC" or "Comptroller") and the Federal Reserve Board are authorized to represent themselves in Federal or State courts. Federal law currently authorizes the OCC to "act in the Comptroller's own name and through the Comptroller's own attorneys in enforcing any provision of this title, regulations thereunder, or any other law or regulation, or in any action, suit, or proceeding to which the [Comptroller] is a party." 12 U.S.C. §93(d). Similarly, the Federal Reserve Board is authorized to "act in its own name and through its own attorneys in enforcing any provision of this title, regulations promulgated hereunder, or any other law or regulation, or in any action, suit, or proceeding to which the [Federal Reserve Board] is a party and which involves the [Federal Reserve Board's] regulation or supervision of any bank, bank holding company . . . or other entity, or the administration of its operations." 12 U.S.C. §248(p).

Section 154(a) of the proposed CFPA Act would authorize the CFPA to "seek all appropriate legal or equitable relief," but "monetary damages," as customarily awarded under the common law, should not be available to the CFPA because the agency typically would not be able to plead and prove an injury to the agency itself that would warrant such damages. However, section 155(a)(2) of the proposed CFPA Act contemplates that the CFPA could seek, and a court may mandate, the "payment of damages," such as to a consumer, arising from a violation. The use of the word "monetary" in section 142 is intended to generally describe a category of relief available for a State attorney general or State regulator to recover under applicable State law, such as a civil money penalty.

Q.8. Proposed Subtitle D of the legislative proposal does not include an express prohibition against private rights of action and/or class actions, yet section 1064(l) of the bill includes a ban on private rights of action for transferred employees. Would either or both remedies be possible under this proposal?

A.8. The proposed CFPA Act does not afford a private right of action against a covered person, including through a class action.

Q.9. Proposed section 1025 would authorize the CFPA to "prohibit or impose conditions or limitations" on existing arbitration agreements if, in the exercise of its sole discretion, the CFPA were to determine that such agreements are not "in the public interest" or "for the protection of consumers." What specific legal standards would apply in order to decide what constitutes "the public interest" or the "protection of consumers" under this proposed section?

A.9. Under the proposed CFPA Act, the CFPA, through the notice-and-comment rulemaking process, would establish the standards for the "public interest" and the "protection of consumers" relevant to the type or class of binding arbitration agreement regarding future disputes, as would be further defined by the CFPA, that may warrant an appropriate condition, limitation, or prohibition, if any.

Q.10. We note that proposed Section 1022 appears to provide an exception to coverage by the CFPA for "a person regulated by" the SEC. Please confirm that this exception is effective only with respect to the "functions" of the covered entity that are actually regulated by the SEC.

A.10. Section 101(27) of the proposed CFPA Act provides that the term "person regulated by the Securities and Exchange Commission" is limited "only to the extent that the person acts in a registered capacity."

Q.11. In proposed section 1023, the CFPA reserves to itself the authority to issue regulations that determine "the confidential treatment of information" it obtains pursuant to its duties as outlined in the bill. Does that authority extend to the possible public release of proprietary information gathered from "covered persons" and/or otherwise confidential financial information obtained under proposed section 1022 or any other provision of this proposal?

A.11. We expect that under the proposed CFPA Act the CFPA will adopt strong confidentiality rules designed to strictly limit the disclosure of confidential information about a covered person, consistent with the standards adopted by the banking agencies to protect confidential supervisory information. Moreover, section 123(b) is not intended to override the application of the Freedom of Information Act (FOIA); as a result, the CFPA, like the Federal banking agencies, generally would be required to disclose information relating to a covered person in accordance with the FOIA, but would be permitted by the FOIA to withhold information relating to a covered person that falls within an exemption of the FOIA, such as the exemption for information contained in or related to examination reports of the covered person. Nevertheless, under section 123(b) of the proposed CFPA Act, the CFPA may, in accordance with confidentiality rules prescribed by the agency, publicly disclose proprietary information obtained from "covered persons" in connection with the exercise of the agency's authorities under the proposed CFPA Act.

Q.12. Please clarify the extent to which online and offline privacy regulation would fall within the jurisdictional responsibility of the CFPA. Please provide specifics relative to what privacy statutes would be subject to CFPA supervision and regulation and which ones would not.

A.12. The proposed CFPA Act would transfer to the CFPA responsibility for rulemaking and primary enforcement of the notice and opt-out provisions of the GLBA, 15 U.S.C. §§6802–6809, but not the data security provisions of section 501 of the GLBA. 15 U.S.C. §6801. The proposed CFPA Act calls for these financial privacy issues to transfer to the CFPA because it will have exclusive authority over a wide range of issues involving notices that are provided to consumers in connection with obtaining financial products or services. Accordingly, transferring to the CFPA the authority to administer these parts of the GLBA privacy provisions will facilitate the purpose of consolidating Federal authority over notices for consumer financial products and services, including issues relating to disclosures of personally identifiable financial information. In addition, to the extent that the FCRA is characterized as a privacy statute, the proposed CFPA Act would transfer to the CFPA responsibility for rulemaking and primary enforcement of the "privacy" provisions of the FCRA, such as the limits on use of information by affiliates for marketing purposes under section 624. 15 U.S.C. §1681s-3. However, the data security provisions of the FCRA, such as the disposal requirements under section 628, 15 U.S.C. §1681w, would not be transferred from the Federal Trade Commission and the Federal functional regulators to the CFPA under the proposed CFPA Act.

Q.13. With respect to "financial data processing," as defined in proposed section 1002(18)(J), does any level of direct or indirect involvement in the transmission or processing of this data suffice for purposes of being subject to the terms of H.R. 3126?

A.13. Not all persons that process financial data would be "covered persons" under the proposed CFPA Act. More specifically, even though a person that engages in "financial data processing" would be engaging in a financial activity covered under the proposed CFPA Act, that activity, by itself, is not sufficient to be covered by the Act. For example, a person that performs data processing activities for persons for business purposes (as opposed to personal, family, or household purposes) would be acting outside the scope of the proposed CFPA Act. On the other hand, a person engaged in "financial data processing" would be a "covered person" under the proposed CFPA Act if the activity is "in connection with the provision of a consumer financial product or service." A person also would be covered if it provides financial data processing to a covered person, "in connection with the provision of a consumer financial product or service," and "provides a material service to, or processes a transaction on behalf of, [that covered person]."

Q.14. The proposal goes to great length to underscore the active involvement of the States, both with respect to enforcing the law, as reflected in this proposal, and with respect to initiating their own efforts at consumer protection. Since Federal preemption currently exists, under certain circumstances, and since any such preemption would be abolished under this proposal, would this bill, in effect, reinstate any preexisting State laws and/or regulations that have been set aside or rendered inapplicable by virtue of Federal preemption?

A.14. In large measure, the Administration's proposed CFPA Act would preserve the *status quo* with respect to the relation of State laws to Federal laws governing the provision of consumer financial products and services. In general, the proposed CFPA Act would not annul, alter, or affect the application of a State law, except to the extent that a State law is inconsistent with the Act, and then only to the extent of such an inconsistency. A State law that affords greater protection to consumers would not be inconsistent with the proposed CFPA Act and, therefore, would continue to apply.

Since the adoption of the first major Federal financial consumer protection law, the Truth in Lending Act, in 1969, Congress has with limited exceptions explicitly allowed the States to adopt laws to protect financial consumers so long as these laws do not conflict with Federal statutes or regulations. Federal law thus establishes a floor, not a ceiling. We propose to preserve that arrangement. It reflects a decades-long judgment of Congress, which we share, that States should retain authority to protect the welfare of their citizens with respect to consumer financial services. Federal law ensures all citizens a minimum standard of protection wherever they reside. Citizens of a State, however, should be able to provide themselves—through their legislators and governors—more protection.

The continued ability of citizens to protect themselves through their States is crucial to ensuring a strong Federal standard. Because Washington, DC, is not the source of all wisdom, State initiatives can be an important signal to Congress and Federal regulators of a need for action at the Federal level. Even with the best of intentions and the best of staff, it is impossible to simply mandate that Federal laws or rules remain updated, since practices change so quickly. States are much closer to abuses as they develop, and are able to move much more quickly when necessary. For example, the States were far ahead of the Federal Government in regulating subprime mortgages. If States were not permitted to take initiative, the Federal Government would lose a critical source of information and incentive to adjust standards over time to address emerging issues.

If the CFPA is created and endowed with the authorities we have proposed, we expect it will promote regulatory consistency even while it respects the role of the States. Many of the State laws that have created the concern for nonuniformity can be attributed in large part to the absence of Federal leadership. The Federal Reserve had authority to regulate subprime mortgages since 1994. It signaled publicly in 2001, however, that it was willing to regulate only a small portion of the subprime market. It is hardly surprising that more than one half of the States then moved to adopt their own predatory mortgage lending laws.

We believe a strong and independent CFPA that is assigned a clear mission to keep protections up-to-date with changes in the marketplace will reduce the need for State action and increase legal uniformity. If States retain the ability to keep the CFPA on its toes and the CFPA has the authority it needs to follow the market and keep protections up-to-date, then the CFPA will be more likely to set a high standard that will satisfy a substantial majority of States.

To be sure, federally chartered institutions have recently enjoyed immunity from certain State consumer protection laws, and we propose to change that to ensure a level playing field. National banks must already comply with a host of State laws, such as those dealing with foreclosures, debt collection, privacy, and discrimination. Under our proposal, federally chartered depository institutions and their State-incorporated subsidiaries would be subject to nondiscriminatory State consumer protection and civil rights laws to the same extent as other financial institutions. We also propose that States be able to enforce these laws, as well as regulations of the CFPA, with respect to federally chartered institutions, subject to appropriate arrangements with prudential supervisors.

We would preserve preemption where it is critical to the Federal charter. Our proposal explicitly does not permit the States to discriminate against federally chartered institutions. Discriminatory State laws would continue to be preempted. Moreover, we do not seek to overturn preemption of State laws limiting interest rates and fees (the Smiley and Marquette decisions). National banks would continue to enjoy an effective immunity from State usury laws. Nor do we seek to disturb the OCC's exclusive authority over national banks with respect to prudential regulation and supervision. In this way, we would preserve the value of the national bank charter.

We would be happy to work with Congress to establish a reasonable transition period for implementation of the new National Bank Act preemption standards.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BENNETT FROM STEPHEN W. JOYNT

Q.1. As we move forward on strengthening the regulation of credit rating agencies, it is important that we do not take any action to weaken pleading and liability standards of the Private Securities Litigation Reform Act of 1995. This Committee worked long and hard, and in a completely bipartisan fashion, to craft litigation that would help prevent abusive "strike" suits by trial lawyers. These suits benefited no one but the lawyers who orchestrated these suits. This was a real problem then, and could become a real problem again if we dilute the current standard that applies to all market participants. Perpetrators of securities fraud, and those who act recklessly, can be sued under the law we passed in 1995.

Is there any justification for now altering this standard just for credit rating agencies?

A.1. No. Altering the pleading and liability standards of the PSLRA just for credit rating agencies is neither warranted nor justified. In passing the PSLRA in 1995, Congress struck a delicate balance between two important competing goals: to curb frivolous, lawyer-driven litigation while preserving investors' ability to recover on meritorious claims. Consistent with these principles, under current law, credit rating agencies are liable for securities fraud. A claim for securities fraud levied against a credit rating agency by an investor will survive a motion to dismiss provided the investor is able to plead the elements of securities fraud, in particular facts from which a reasonable person could strongly infer the agency acted intentionally or recklessly to a degree sufficient to meet the scienter requirement as interpreted by the courts.

Q.2. Will the threat of class action litigation, and the costs of endless discovery, be at cross-purpose with the goal of fostering greater competition in credit rating markets?

A.2. Amending the pleading standards of the PSLRA to allow strike suits against credit rating agencies is most certainly at cross-purpose with the goal of fostering greater competition in credit rating markets. Congress adopted the PSLRA to curb the practice of plaintiffs filing complaints for securities fraud against firms whether or not there was evidence of fraud in the hope that they would find evidence to support their claims through the discovery process.

Congress acted in recognition of the fact that such lawsuits require firms to expend huge sums defending or settling claims of securities fraud, regardless of guilt, among other things, making it more difficult for smaller firms to compete. Rolling back the PSLRA reforms as they apply to credit rating agencies will place a substantial burden on all agencies, and possibly overwhelm newer entrants to the market. Ratings are forward-looking assessments of future performance. Whenever actual performance is out of line with a forward-looking assessment, in hindsight, to an investor it will always look like the NRSRO could have reasonably foreseen future problems with better stress testing, *etc.*

Q.3. Would this potential create a disproportionate burden for smaller players in the industry?

A.3. The burden placed on any one agency will depend on the size of agency's revenue base, the volume and types of credit rating products offered by the agency, and the markets in which it operates. Agencies with a smaller revenue base are typically able to support a smaller cost base and consequently are likely to bear a disproportionate burden.

Q.4. Do you believe that the threat of harassment litigation could act as a barrier to entry to those considering entry into the rating agency business?

A.4. Yes. Smaller agencies considering application for NRSRO status reasonably can be expected to be deterred by the threat of excessive litigation costs. The threat of harassment litigation can also reasonably be expected to have a chilling effect on agencies seeking to better serve investors through the assignment of agency initiated ratings.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BENNETT FROM JAMES H. GELLERT

Q.1. As we move forward on strengthening the regulation of credit rating agencies, it is important that we do not take any action to weaken pleading and liability standards of the Private Securities Litigation Reform Act of 1995. This Committee worked long and hard, and in a completely bipartisan fashion, to craft litigation that would help prevent abusive "strike" suits by trial lawyers. These suits benefited no one but the lawyers who orchestrated these suits. This was a real problem then, and could become a real problem again if we dilute the current standard that applies to all market participants. Perpetrators of securities fraud, and those who act recklessly, can be sued under the law we passed in 1995.

Is there any justification for now altering this standard just for credit rating agencies?

A.1. Senator Bennett, I agree that there are broad implications for the treatment of liability standards for the ratings agencies, and more widely for participants in the securities industry. The rating agencies are popular targets currently and the popular ground swell for them to be accountable for their alleged mistakes leading to the subprime crises is likely to grow, not diminish.

I believe the focus on liability runs the risk of being disproportionately central to attempts to "fix" the ratings business. This isn't to say that malfeasance or negligence should be acceptable; it is simply to note that the threat of liability has rarely been an effective deterrent for bad behavior in the finance industries.

Q.2. Will the threat of class action litigation, and the costs of endless discovery, be at cross-purpose with the goal of fostering greater competition in credit rating markets?

A.2. Anything that increases the costs of entering the ratings business has the risk of hindering competition. A basic challenge to building any new business is projecting costs. The specter of the costs associated with internal and external counsel necessary to protect against class action litigation and discovery is ominous and difficult to project. Ironically, the firms that benefit the most from a new and more litigious ratings environment are the Big Three, S&P, Moody's and Fitch, and these are the ones theoretically most in the crosshairs of this initiative. All three of these firms continue to generate large profits from their businesses and two of the three have massive multination corporations backing them. Increased legal costs are rounding errors in their businesses and are cheap prices for them to pay for further solidifying their oligopoly.

Q.3. Would this potential create a disproportionate burden for smaller players in the industry?

A.3. The costs of insurance, not to mention actual legal costs, could exponentially increase the costs of running a competing firm in the earlier years of development. It would almost certainly become the largest cost line-item in our firm's budget, since we use no analysts and do not have the commensurately high personnel costs that a traditional firm would have.

As I have outlined in my written testimony, the NRSRO designation is currently the supposed carrot on the stick for aspiring ratings firms. All of the direct and contingent costs associated with increased legal liability create further disincentive to firms like Rapid Ratings and make applying for NRSRO status less appealing. This isn't to avoid responsibility, this is to avoid the potentially punishing costs to which we'd be subject with the NRSRO status. This is a dramatic unintended consequence of the currently contemplated increased liability standards and other rule revisions being contemplated.

Q.4. Do you believe that the threat of harassment litigation could act as a barrier to entry to those considering entry into the rating agency business?

A.4. Absolutely.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BENNETT FROM JOHN C. COFFEE, JR.

Q.1. As we move forward on strengthening the regulation of credit rating agencies, it is important that we do not take any action to weaken pleading and liability standards of the Private Securities Litigation Reform Act of 1995. This Committee worked long and hard, and in a completely bipartisan fashion, to craft litigation that would help prevent abusive "strike" suits by trial lawyers. These suits benefited no one but the lawyers who orchestrated these suits. This was a real problem then, and could become a real problem again if we dilute the current standard that applies to all market participants. Perpetrators of securities fraud, and those who act recklessly, can be sued under the law we passed in 1995.

Is there any justification for now altering this standard just for credit rating agencies?

A.1. Answer not received by time of publication.

Q.2. Will the threat of class action litigation, and the costs of endless discovery, be at cross-purpose with the goal of fostering greater competition in credit rating markets?

A.2. Answer not received by time of publication.

Q.3. Would this potential create a disproportionate burden for smaller players in the industry?

A.3. Answer not received by time of publication.

Q.4. Do you believe that the threat of harassment litigation could act as a barrier to entry to those considering entry into the rating agency business?

A.4. Answer not received by time of publication.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BENNETT FROM LAWRENCE J. WHITE

Q.1. As we move forward on strengthening the regulation of credit rating agencies, it is important that we do not take any action to weaken pleading and liability standards of the Private Securities Litigation Reform Act of 1995. This Committee worked long and hard, and in a completely bipartisan fashion, to craft litigation that would help prevent abusive "strike" suits by trial lawyers. These suits benefited no one but the lawyers who orchestrated these suits. This was a real problem then, and could become a real problem again if we dilute the current standard that applies to all market participants. Perpetrators of securities fraud, and those who act recklessly, can be sued under the law we passed in 1995.

Is there any justification for now altering this standard just for credit rating agencies?

Will the threat of class action litigation, and the costs of endless discovery, be at cross-purpose with the goal of fostering greater competition in credit rating markets?

Would this potential create a disproportionate burden for smaller players in the industry?

Do you believe that the threat of harassment litigation could act as a barrier to entry to those considering entry into the rating agency business?

A.1. Since I am not a lawyer (and do not practice law without a license) and I have only a modest familiarity with the Private Securities Litigation Reform Act of 1995, I am really not qualified to answer these questions. However, I do believe that a blanket First Amendment protection for rating agencies is too broad—while I recognize that an increased level of liability to damages from lawsuits will make life more difficult for credit rating agencies, especially smaller firms and potential entrants. Accordingly, there needs to be a better balance than is present now in encouraging rating agencies to take the appropriate level of care in supporting their judgments.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BENNETT FROM MARK FROEBA

Q.1. As we move forward on strengthening the regulation of credit rating agencies, it is important that we do not take any action to weaken pleading and liability standards of the Private Securities Litigation Reform Act of 1995. This Committee worked long and hard, and in a completely bipartisan fashion, to craft litigation that would help prevent abusive "strike" suits by trial lawyers. These suits benefited no one but the lawyers who orchestrated these suits. This was a real problem then, and could become a real problem again if we dilute the current standard that applies to all market participants. Perpetrators of securities fraud, and those who act recklessly, can be sued under the law we passed in 1995.

Is there any justification for now altering this standard just for credit rating agencies?

A.1. Yes, there is ample justification for altering the pleading and liability standards just for the credit rating agencies. Here are three arguments in support of changing these standards.

First, the major rating agencies have enjoyed the privilege of a Government-sponsored monopoly for many years. In order to reduce the negative consequences of this monopoly, the Government also encouraged competition among the agencies. There is overwhelming circumstantial evidence that the agencies responded by competing with each other not on price or efficiency or productivity or quality but, instead, on rating standards, revising rating methodologies and standards whenever necessary to build or maintain market share and revenue. Changing pleading and liability standards for the agencies would provide a key restraint should rating standards ever again end up in competitive free fall. Fear of liability will curb the appetite for market share, dampen the negative effects of competition, improve rating quality and, thereby, ultimately make lawsuits less necessary. The rating agencies, in exchange for continuing to enjoy the privilege of a Government-sponsored monopoly, should be subjected to easier pleading and liability standards at least where litigants claim that bad ratings have injured them.

Second, when the rating agencies generate bad credit opinions, they have nothing at risk except their reputations. Other market participants involved in the transactions that failed in the subprime crisis, *e.g.,* investment banks, investors, and collateral managers, all had some financial stake in these transactions. When these participants got it wrong, they were punished by financial losses, in some cases even to the point of bankruptcy. Having a significant financial risk is enough to warrant separate pleading and liability standards for these market participants. If reputation risk alone once provided the rating agencies with the same kind of incentives as financial risk, Enron taught them a new lesson. The bankruptcy of Enron within only days of losing its investment-grade ratings did severe damage to the reputation of the agencies but did little to hurt their business. In the aftermath of Enron, the rating agencies enjoyed some of their most profitable years ever. Thus, fear of reputation damage after Enron did nothing to check the ratings that caused the subprime crisis. It would be very difficult now to overstate the damage that the subprime crisis has done to the reputation of the rating agencies. If they all survive the current crisis unscathed—as seems almost certain—they will be taught a lesson very dangerous to world financial system: no matter how bad their ratings, no matter how damaged their reputations, they will not fail and the rating business will not go away because there is nowhere else for it to go. Without incentives that are far more potent than reputation risk, we cannot expect the rating agencies to reform themselves and impose greater quality and accuracy on their ratings.

Third, the rating agencies have long enjoyed near complete immunity from liability for bad ratings. This immunity is based upon an old line of cases that found the rating business—assigning and reporting ratings—to be a form of journalism subject to free speech protections. More than 40 years ago, this finding had some merit. The rating agencies assigned ratings to bonds and then reported all of their ratings in periodicals sold to subscriber/investors. Bond issuers paid the rating agencies nothing. However, the rating agencies largely abandoned this model 40 years ago. The new model shifts the cost of the rating from subscriber/investors (eager for the most accurate rating) to bond issuers (eager for the highest rating). It is easy to see how the new model changed the rating agencies' incentives. It is also difficult to imagine how real journalism could make a similar business-model switch. (It would be as if each newspaper story were commissioned by the subject of the story, based solely upon facts submitted by the subject, and published only upon the subject's approval of the story and payment of a fee for its writing and publication.) Eventually, the courts will discover that the credit rating business is no longer anything like a form of journalism and should not be entitled to free speech protections. This will not happen overnight and may be a long and expensive process. In the meantime, the financial markets need help restoring their confidence in the quality and integrity of credit ratings assigned today. Changing the pleading and liability standards just for the agencies is an important first step in this process.

Q.2. Will the threat of class action litigation, and the costs of endless discovery, be at cross-purpose with the goal of fostering greater competition in credit rating markets?

A.2. No. Some of the newly formed rating agencies are adopting an investor-pay business model. These new agencies will enjoy the same free speech protections that have so far shielded the major rating agencies from litigation. If investor-pay rating agencies continue to enjoy this protection while issuer-pay agencies lose it, the result will be a very strong incentive for new agencies to adopt the investor pay model. Second, even now the rating business enjoys very high profit margins. Unlike other businesses with such high profit margins, the rating business has virtually no costs for research and development or advertising. Even if current profit margins were cut in half by litigation costs, they would remain very attractive compared to other businesses and a strong enticement to the creation of new rating agencies. If the risk of litigation materially improves rating quality and integrity (and thereby prevents another ratings driven financial crisis like the second subprime crisis), this benefit will far outweigh whatever costs litigation imposes.

Q.3. Would this potential create a disproportionate burden for smaller players in the industry?

A.3. No. Small players will not be attractive targets for harassment litigation not only because they do not have the "deep pockets" attractive to such litigation but also because they have no history of bad ratings. They will only be at risk of such litigation during the next Enron or subprime crises. In a normal rating environment, it often takes years for a transaction to go bad and for ratings to appear wrong. New agencies should not face a litigation burden for quite some time. In the meantime, the biggest burden for smaller players in the industry will be lack of demand for their ratings. Unless Government policy vigorously encourages the use of ratings from new rating agencies, the new agencies may never survive long enough to suffer the litigation burden implied by this question.

Q.4. Do you believe that the threat of harassment litigation could act as a barrier to entry to those considering entry into the rating agency business?

A.4. No. The threat of harassment litigation will do two things. First, as noted above, it will create a strong incentive for new agencies to adopt the investor-pay model. Under this model, rating agencies should continue to enjoy significant free speech protection against liability for ratings and considerable immunity from litigation. Thus, the potential for harassment litigation could have the positive effect of inducing more new agencies to adopt the issue-pay model. Second, litigation targeting the rating agencies will be related to bad ratings assigned in the past. New agencies will not be subject to such litigation. Thus, in theory they will have a competitive advantage over existing rating agencies which must incorporate the cost of this litigation into their rating fees.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Hearings Before the Committee on Banking, Housing, and Urban Affairs (January–August 2009)

Date	Hearing Title
January 13	Nomination of Shaun Donovan
January 15	Nominations of Mary Schapiro, Christina D. Romer, Austan D. Goolsbee, Cecilia E. Rouse, and Daniel K. Tarullo
January 27	The Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform
February 4	Modernizing the U.S. Financial Regulatory System
February 5	Pulling Back the TARP: Oversight of the Financial Rescue Program
February 10	Oversight of the Financial Rescue Program: A New Plan for the TARP
February 12	Modernizing Consumer Protection in the Financial Regulatory System: Strengthening Credit Card Protections
February 24	Federal Reserve's First Monetary Policy Report for 2009
February 26	Homeowner Affordability and Stability Plan
March 3	Consumer Protections in Financial Services: Past Problems, Future Solutions
March 5	American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation
March 10	Enhancing Investor Protection and the Regulation of Securities Markets—Part I
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March 17	Perspectives on Modernizing Insurance Regulation
March 18	Lessons Learned in Risk Management Oversight at Federal Financial Regulators
March 19	Modernizing Bank Supervision and Regulation—Part I
March 19	Current Issues in Deposit Insurance
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March 31	Lessons From the New Deal
April 16	A 21st Century Transportation System: Reducing Gridlock, Tackling Climate Change, and Growing Connecticut's Economy
April 23	Nominations of Ronald Sims, Fred P. Hochberg, Helen R. Kanovsky, David H. Stevens, Peter Kovar, John D. Trasviña, and David S. Cohen
May 6	Regulating and Resolving Institutions Considered "Too Big To Fail"
May 7	Strengthening the SEC's Vital Enforcement Responsibilities
May 13	Manufacturing and the Credit Crisis
May 13	Nominations of Peter M. Rogoff, Francisco J. Sanchez, Raphael W. Bostic, Sandra Henriquez, Mercedes Márquez, and Michael S. Barr
May 20	Oversight of the Troubled Assets Relief Program
June 3	A Fresh Start for New Starts
June 4	Nomination of Herbert M. Allison, Jr.
June 10	The State of the Domestic Automobile Industry: Impact of Federal Assistance
June 16	Greener Communities, Greater Opportunities: New Ideas for Sustainable Development and Economic Growth
June 18	The Administration's Proposal To Modernize the Financial Regulatory System
June 22	Over-the-Counter Derivatives: Modernizing Oversight To Increase Transparency and Reduce Risks
July 7	Public Transportation: A Core Climate Solution
July 8	The Effects of the Economic Crisis on Community Banks and Credit Unions in Rural Communities
July 14	Creating a Consumer Financial Protection Agency: A Cornerstone of America's New Economic Foundation
July 15	Regulating Hedge Funds and Other Private Investment Pools
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July 17	The U.S. as Global Competitor: What Are the Elements of a National Manufacturing Strategy?
July 22	Federal Reserve's Second Monetary Policy Report for 2009
July 22	Nomination of Deborah Matz
July 23	Establishing a Framework for Systemic Risk Regulation
July 28	Regulatory Modernization: Perspectives on Insurance
July 29	Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance
July 30	Minimizing Potential Threats From Iran: Assessing Economic Sanctions and Other U.S. Policy Options
August 4	Strengthening and Streamlining Prudential Bank Supervision—Part I
August 4	Rail Modernization: Getting Transit Funding Back on Track
August 5	Examining Proposals To Enhance the Regulation of Credit Rating Agencies

Written Testimony Concerning SEC Oversight of Credit Rating Agencies
Submitted by the United States Securities and Exchange Commission
Before the United States Senate Committee on Banking, Housing and Urban Affairs

August 5, 2009

Chairman Dodd, Ranking Member Shelby, and Members of the Committee: Thank you for the opportunity to submit for the record testimony concerning the Commission's oversight of credit rating agencies since the enactment of the Credit Rating Agency Reform Act of 2006 ("Rating Agency Act"). As you requested, this testimony describes the rules we have implemented to date as well as the Commission staff's July 2008 examination findings concerning certain credit rating agencies. It also provides a summary of ideas presented at our April 2009 Roundtable on credit rating agencies.

I. Introduction

In September 2006, Congress passed the Rating Agency Act with the stated goals of improving ratings quality and fostering accountability, transparency, and competition in the credit rating industry. Primarily, the Rating Agency Act:

- defined the term "nationally recognized statistical rating organization" ("NRSRO");
- provided exclusive authority to the Commission to implement registration, recordkeeping, financial reporting and oversight rules with respect to NRSROs; and
- provided the Commission with authority to examine and take enforcement actions against NRSROs.

In June 2007, the Commission approved rules implementing a registration and oversight program for NRSROs under the Rating Agency Act, with the rules becoming effective that same month. Over the next year, ten credit rating agencies registered with the Commission as NRSROs. Also, in response to credit market turmoil, beginning in August 2007 the Commission staff conducted an examination of the NRSROs most active in rating residential mortgage-backed securities backed by subprime mortgage loans and collateralized debt obligations linked to such loans. In February 2009, the Commission adopted a second round of rules to address issues raised by the role played by NRSROs in the credit market turmoil. As you requested, this testimony describes these actions in detail.

II. The Commission Oversight Program for NRSROs

The first round of post-Rating Agency Act rulemaking established the Commission's rating agency oversight program. Specifically, in June 2007 the Commission adopted six rules (Rules 17g-1, 17g-2, 17g-3, 17g-4, 17g-5 and 17g-6) and an application and ongoing disclosure form ("Form NRSRO").

Rule 17g-1, among other things, requires an NRSRO to disclose information about the: (1) firm's ratings performance statistics (e.g., default and transition statistics); (2) firm's methodologies for determining credit ratings; (3) firm's policies for preventing the misuse of material non-public information; (4) firm's organizational structure; (5) firm's code of ethics; (6) conflicts of interest inherent in the firm's activities; (7) firm's policies for managing conflicts of interest; (8) general qualifications of the firm's credit analysts; and (9) identification and qualifications of the firm's designated compliance officer.

Rule 17g-2, among other things, requires an NRSRO to make and retain certain financial records; document the identities of the credit analysts who determine a rating action and persons who approve the rating action; document the identities of issuers that have paid for ratings and the ratings determined for them; and document all ratings methodologies. NRSROs also are required to retain records such as compliance and internal audit reports, marketing materials, and communications (e.g., emails) relating to determining ratings actions.

Rule 17g-3, among other things, requires an NRSRO, on a confidential basis, to furnish the SEC with annual reports that include: (1) audited financial statements; (2) an unaudited report of revenues received from the different types of rating services offered by the NRSRO; (3) an unaudited report of the aggregate and median compensation of the NRSRO's credit analysts; and (4) an unaudited report of the 20 largest clients of the NRSRO as determined by revenues received.

Rule 17g-4, among other things, requires an NRSRO to establish, maintain and enforce procedures reasonably designed to prevent the inappropriate dissemination of material, non-public information received during the rating process; the trading of securities while in possession of material, non-public information; and the selective disclosure of a pending ratings decision.

Rule 17g-5, among other things, requires an NRSRO to disclose and manage each conflict of interest resulting from its business activities, including from the issuer-pay and the subscriber-pay models. It also prohibits an NRSRO from having the following conflicts: (1) receiving more than 10% of its annual revenues from a single client; (2) having an analyst rate or approve the rating for a security the analyst owns; (3) rating an affiliate; and (4) having an analyst rate or approve the rating for a security of a company where the analyst is a director or officer of the company.

Rule 17g-6, among other things, prohibits an NRSRO from engaging in certain practices that are unfair, coercive or abusive. Such practices include: (1) conditioning a rating on the rated person buying another service of the NRSRO; (2) deviating or threatening to deviate from established methodologies for determining credit ratings because an issuer did not agree to pay for the rating; (3) modifying or threatening to modify a rating because the issuer does not agree to continue to pay for the rating; and (4) employing a methodology for rating structured finance products that discounts or "notches," for anticompetitive purposes, the ratings of other NRSROs for assets underlying the structured finance product.

In response to the role played by NRSROs in the credit market turmoil and informed by the Commission staff's first round of NRSRO examinations (as discussed in Section III below), the Commission adopted a second round of rules in February 2009. Most of the new requirements specifically target the rating process for structured finance products. The new rules require the following, among other things:

- **Enhanced performance statistics**. The Commission amended Form NRSRO to require an NRSRO to provide greater specificity – to achieve better comparability – as to how performance statistics are generated. In particular, NRSROs are now required to provide default and transition statistics over 1, 3, and 10 year time periods (as opposed to the previously prescribed generic "short, medium, and long" time frames). Further, an NRSRO is required to generate these performance statistics for each class of credit ratings for which the NRSRO is registered.

- **Enhanced disclosure of ratings methodologies**. The Commission amended Form NRSRO to require more detailed disclosures concerning the procedures and methodologies an NRSRO uses to determine credit ratings. Specifically, the NRSRO must disclose (as applicable):

    - whether and, if so, how, information about verification performed on assets underlying or referenced by a structured finance product is relied on in determining the rating;
    - whether and, if so, how, assessments as to the quality of originators of assets underlying or referenced by a structured finance product factor into the determination of credit ratings; and
    - with respect to rating surveillance, how frequently credit ratings are reviewed, whether different models are used for surveillance, and whether changes to initial rating or surveillance models are applied retroactively to existing ratings.

- **Record of model deviation**. The Commission amended Rule 17g-2 to add a new recordkeeping requirement relating to the use of models in rating structured finance products. Specifically, if a quantitative model was a substantial component in the process of determining a credit rating for a structured finance product, the NRSRO is required to make a record of the rationale for any material difference between the credit rating implied by the model and the final credit rating issued.

- **Record of ratings history.** The Commission amended Rule 17g-2 to add a new recordkeeping requirement to allow examiners to track the history of all current ratings. Specifically, for each outstanding credit rating, an NRSRO is required to make a record showing all rating actions and the date of such actions from the initial credit rating to the current credit rating identified by the name of the rated security or obligor and, if applicable, the CUSIP of the rated security or the Central Index Key ("CIK") number of the rated obligor. In addition, NRSROs with 500 or more issuer-paid credit ratings in a credit rating class must publicly disclose on a six-month delayed basis the ratings histories for a random sample of 10% of the current credit ratings in that class.

- **Written complaints**. The Commission amended Rule 17g-2 to add a new recordkeeping requirement to allow examiners to review how an NRSRO handles complaints about credit analysts from, for example, issuers or underwriters of structured products. Specifically, an NRSRO is required to retain any written communications received from persons not associated with the NRSRO (e.g., individuals that are not employees) that contain complaints about the performance of a credit analyst in initiating, determining, maintaining, monitoring, changing, or withdrawing a credit rating.

- **Rating actions report**. The Commission amended Rule 17g-3 to add a new financial report that must be furnished to the SEC annually. The report is designed to alert the SEC about the number of rating actions (upgrades, downgrades, placements on watch or withdrawals) taken by an NRSRO during the fiscal year in each class of credit rating for which the NRSRO is registered.

- **Prohibited conflict – recommendations**. The Commission amended Rule 17g-5 to add a new conflict prohibition to prohibit an NRSRO from making recommendations to issuers and others about how to obtain desired ratings. Specifically, the rule prohibits an NRSRO from issuing or maintaining a credit rating where the NRSRO or an affiliate made recommendations to an issuer, obligor or arranger about how to structure the rated entity or security.

- **Prohibited conflict – fee discussions**. The Commission amended Rule 17g-5 to add a new conflict prohibition to prevent credit analysts and the persons who establish ratings methodologies from participating in fee discussions with issuers and others who pay for ratings. Specifically, the rule prohibits an NRSRO from issuing or maintaining a credit rating where the fee paid to the NRSRO to determine or maintain the credit rating was negotiated, discussed or arranged by a person within the NRSRO with responsibility for determining or approving the credit rating or for developing or approving procedures or methodologies used for determining credit ratings.

- **Prohibited conflict – gifts.** The Commission amended Rule 17g-5 to add a new conflict prohibition designed to prevent credit analysts from being influenced by gifts from issuers and others who pay for ratings. Specifically, the rule prohibits an NRSRO from determining or maintaining a credit rating where a credit analyst who determined the rating or approved the rating received a gift from the person paying for the rating.

III. 2008 Examination of S&P, Moody's and Fitch Subprime RMBS and CDO Rating Process

In August of 2007, the Commission's staff initiated examinations of three NRSROs – Fitch Ratings, Moody's Investor Services, and Standard & Poor's Ratings Services – to review their policies and practices related to rating subprime residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") linked to subprime RMBSs.

The examination review period generally covered January 2004 through July 2008. The firms under examination had become subject to regulation as NRSROs when they registered with the Commission in September 2007. All three NRSROs agreed to undertake remedial actions as a result of the examinations. The staff published a summary of the examination's findings and observations in July 2008.

A. Staff's Findings and Recommendations

1. Increased Deal Volume and Complexity

The staff found a substantial increase in the number and complexity of RMBS and CDO deals beginning in 2002, and also that some of the NRSROs appeared to struggle with the growth. Staffing increases with respect to CDOs at two NRSROs did not appear to match the increases in deal volume. Internal documents at two of the NRSROs appeared to reflect struggles to adapt to the increased deal volume and complexity. As a result of these findings, the staff recommended that the NRSROs evaluate whether they had sufficient staff and resources to manage their volume of business.

2. Disclosure of Ratings Process

The staff found that significant aspects of the ratings process were not always disclosed. For example, relevant ratings criteria were not fully disclosed. In addition, the NRSROs made "out of model adjustments" without documenting the rationale for such adjustments. Accordingly, the staff recommended that each NRSRO review whether it was fully disclosing its ratings methodologies with respect to RMBS and CDOs.

3. Documentation of Ratings Policies and Procedures

The staff found that the NRSROs' policies and procedures for rating RMBS and CDOs could be better documented. None of the NRSROs had consolidated and comprehensive written procedures for rating RMBS and CDOs. This lack of full documentation impaired the staff's ability to review deals and ratings criteria, and, the staff believed, could impair an internal auditor's ability to review the deals and ratings criteria. The staff also found that the NRSROs did not appear to have specific policies and procedures to identify or address errors in their models or methodologies. As a result of these findings, the staff recommended that each NRSRO review whether its written policies and procedures used to determine credit ratings for RMBS and CDOs were fully documented.

4. Documentation of the Ratings Process

The staff discovered that the NRSROs did not always document significant participants and steps in the ratings process. For example, RMBS and CDO deal records did not always document the rationale for deviations from the model or out of model adjustments. There was also a lack of documentation of committee actions and decisions and sometimes no documentation of committee attendees. As a result of these findings, the staff recommended that each NRSRO conduct a review of its current policies and practices for documenting the credit ratings process.

5. Surveillance Processes

The staff found that the NRSROs' surveillance processes appeared to be less robust than their initial ratings processes. Lack of resources appeared to impact the timeliness of the surveillance efforts. Moreover, there was poor documentation of the surveillance that was conducted. For example, one NRSRO could provide no documentation of the surveillance performed. The staff also found that two NRSROs did not have internal written procedures documenting the steps that their surveillance staff should undertake to monitor RMBS and CDOs. As a result of these findings, the staff recommended that each NRSRO conduct a review to determine if adequate resources were devoted to surveillance of outstanding RMBS and CDO ratings.

6. Management of Conflicts of Interest

Each of the examined NRSROs operates under the "issuer pays" model, in which the arranger or other entity that issues the security also is seeking the rating and pays the NRSRO for the rating. While each NRSRO had policies and procedures restricting analysts from participating in fee discussions with issuers, the policies at each of the firms still allowed key participants in the ratings process to participate in fee discussions. The staff observed that the analysts appeared to be aware, when rating an issuer, of the firm's business interest in securing the rating. In addition, the NRSROs did not appear to take steps to prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria. Accordingly, the staff recommended that each NRSRO consider and implement steps that would insulate or prevent the possibility that considerations of market share and other business interests could influence ratings or ratings criteria.

The staff also observed that each NRSRO had adopted policies prohibiting employees from owning any security that was subject to a credit rating by a team on which the employee was a member. However, the NRSROs varied in how rigorously they monitored or prevented prohibited transactions, including personal trading by their employees, from occurring. As a result of its findings, the staff recommended that each NRSRO conduct a review of its policies and procedures for managing the securities ownership conflict of interest to determine whether these policies are reasonably designed to ensure that employees' personal trading is appropriate and complies with the requirements of NRSRO regulations.

7. Internal Audits

The staff found that the internal audits of the ratings processes of two NRSROs appeared to be inadequate. At one NRSRO, the internal audits of its RMBS and CDO groups constituted a one-page checklist limited in scope to evaluate the completeness of deal files. That NRSRO provided only four examples where the reviewer forwarded findings to management and no examples of any management response. The examination of another NRSRO's internal audits of its RMBS and CDO groups uncovered numerous shortcomings, including the failure of management to formally review/validate derivative models prior to posting for general use. As a consequence of these findings, the staff recommended that two of the NRSROs review whether their internal audit functions are adequate and whether they provide for proper management follow-up.

8. Due Diligence Practices

The staff found that the NRSROs did not engage in any due diligence or otherwise seek to verify the accuracy or quality of the loan data underlying the RMBS pools they rated during the review period. The rating agencies each relied on the information provided to them by the sponsor of the RMBS.

During the examination period, NRSROs were not required to verify the information contained in RMBS loan portfolios presented to it for rating. Additionally, rating agencies were not required to insist that issuer perform due diligence, nor were the agencies required to obtain reports concerning the level of due diligence performed by issuers. Notwithstanding the lack of regulatory requirement to do so, all the NRSROs implemented, or announced that they would implement, measures designed to improve the integrity and accuracy of the loan data they receive on underlying RMBS pools.

B. Ongoing NRSRO Examination Program

Since issuing the July 2008 public report, the Commission staff has been monitoring the examined NRSROs as they continue to address the staff's examination findings. In addition, staff has initiated examinations of other NRSROs. Finally, the Commission recently allocated resources for a branch of examiners dedicated specifically to NRSRO oversight. Once fully staffed, this branch will conduct routine, special and cause examinations of the NRSROs to review their activities for compliance with the Rating Agency Reform Act and SEC rules.

IV. Roundtable on Credit Rating Agencies

On April 15, 2009, the Commission held a "Roundtable to Examine Oversight of Credit Rating Agencies" at its Washington, D.C. headquarters ("Roundtable").

Roundtable participants included individuals from investor organizations, financial services associations, government agencies, credit rating agencies, and academia. Discussion topics at the Roundtable included issues related to recent Commission rulemaking initiatives, such as conflicts of interest, competition, and transparency. The Commission received a number of proposals from participants with suggestions on how to improve the regulation of NRSROs. The Commission does not necessarily endorse any of the proposals received, each of which received varying levels of support at the Roundtable. Ideas and proposals by Roundtable participants, among others, included: establishing compensation models to replace the issuer pay model in order to address conflicts of interest;[1] transitioning away from reliance on credit ratings to market-based measures of credit risk, including credit spreads and credit default swap spreads;[2] increasing disclosure regarding the information underlying a particular credit rating to NRSROs not hired to issue a rating and to other market participants in order to enable the development or alternative ratings;[3] and removing the NRSROs' exemption from misstatements in registration statements in Section 11 of the Securities Act of 1933 and their exemption from liability as experts under Securities Act Rule 436, and also adopting legislation indicating that NRSROs are subject to private rights of action under specified statutory criteria.[4]

All of the written statements of the panel participants as well as the transcript of the Roundtable are available on the Commission's Web site.[5]

V. Looking Forward

As previously noted, in February 2009, the Commission adopted several measures to increase transparency and accountability at NRSROs to address concerns about the integrity of their credit rating procedures and methodologies. In conjunction with the adoption of these new measures, the Commission proposed an additional amendment which would require NRSROs to disclose on a 12-month delayed basis ratings history information for 100% of all issuer-paid credit ratings determined on or after June 26, 2007.[6] On the same date, the Commission re-proposed an amendment that would prohibit an NRSRO from issuing a rating for a structured finance product paid for by the product's issuer, sponsor, or underwriter unless the information about the product

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1 See letter from Joseph A. Grundfest and Eugenia Petrova, Stanford Law School and The Rock Center on Corporate Governance, (File No. 4-579), dated April 9, 2009; letter from Mayree Clark and Andrew Jones, (File No. 4-579), dated April 9, 2009; letter from Alex J. Pollock, Resident Fellow, American Enterprise Institute, (File No. 4-579), dated April 15, 2009.

2 See letter from Frank Partnoy, George E. Barrett Professor of Law and Finance, University of San Diego School of Law, San Diego, California, (File No. 4-579), dated April 15, 2009.

3 See letter from Ethan Berman, RiskMetrics Group, (File No. 4-579), dated April 15, 2009 ("Berman Letter"); letter from James H. Gellert, President and CEO, and Dr. Patrick James Caragata, Founder and Executive Vice Chairman, Rapid Ratings International, Inc., (File No. 4-579), dated April 15, 2009.

4 See letter from Gregory W. Smith, General Counsel, Colorado Public Employees' Retirement Association, (File No. 4-579), dated April 8, 2009.

5 See http://www.sec.gov/spotlight/cra-oversight-roundtable.htm.

6 See "Re-proposed Rules for Nationally Recognized Statistical Rating Organizations", February 2, 2009, http://www.sec.gov/rules/proposed/2009/34-59343.pdf, ("February 2, 2009 Re-proposing Release").

provided to the NRSRO is made available to other NRSROs.[7] The Commission also previously had proposed rules concerning use of different rating symbols[8] and removing references to NRSRO credit ratings from Commission rules and forms.[9] The Commission is assessing the comments received in response to all of these proposals and working towards taking appropriate action this summer.

In addition, at the direction of Chairman Schapiro, the Commission staff has been exploring possible new regulations in this area, such as proposals to require disclosure of rating shopping by issuers. One possible approach would be to require disclosure by issuers of all pre-ratings obtained from NRSROs prior to selecting a firm to conduct a rating, in conjunction with other disclosures. The Commission staff also has been exploring possible requirements that would result in enhanced NRSRO's internal controls and greater disclosure of the nature of their business activities.

Furthermore, the Commission has allocated resources to establish a branch of examiners dedicated specifically to conducting examination oversight of the NRSROs. This branch will conduct routine, special and cause examinations of the ratings agencies to review compliance with the Rating Agency Act and SEC rules. These actions in combination with the Commission's regulatory efforts should help to establish a stronger oversight regime for NRSROs.

The Chairman recently testified that the Commission is committed to working with Congress to ensure a strong and robust regulatory framework for credit rating agencies and noted her personal belief that legislation to require mandatory registration by credit rating agencies would be a significant step forward. The recent financial regulatory reform legislation submitted to Congress by the Administration includes such a proposal as well as other proposals for addressing the oversight of credit rating agencies. As this Committee considers this and other related proposals, the Commission stands ready to lend our expertise or provide other assistance as may be helpful. Thank you again for the opportunity to discuss these important issues.

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7 See February 2, 2009 Re-proposing Release.

8 See "Proposed Rules for Nationally Recognized Statistical Rating Organizations", June 16, 2008, http://www.sec.gov/rules/proposed/2008/34-57967.pdf, ("June 16, 2008 Proposing Release").

9 See "References to Ratings Of Nationally Recognized Statistical Rating Organizations", July 1, 2008, http://www.sec.gov/rules/proposed/2008/34-58070.pdf, ("July 1, 2008 Proposing Release, 34-58070"), "Security Ratings", July 1, 2008, http://www.sec.gov/rules/proposed/2008/33-8940.pdf, ("July 1, 2008 Proposing Release, 33-8940"), and "References to Ratings of Nationally Recognized Statistical Rating Organizations", July 1, 2008, http://www.sec.gov/rules/proposed/2008/ic-28327.pdf, ("July 1, 2008 Proposing Release, IC-28327").