MOODY'S
INVESTORS SERVICE

By Electronic Mail

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

> Re: Request for Comment to Assist in Study on Assigned Credit Rating – Release
>   No. 34-64456; File No. 4-629 (the "**RFC**")

Moody's Investors Service ("**MIS**") appreciates the opportunity to provide feedback to
the Securities and Exchange Commission ("**Commission**") on the RFC concerning Section 939F
of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**").
Specifically, that section requires the Commission to carry out a study ("**Study**") and submit a
report to Congress on, among other matters, the rating process for structured finance products
and the feasibility of establishing an alternative system of allocating credit rating assignments for
them. Once the Study is completed, and if the Commission concludes that it is necessary or
appropriate, it is to establish a system:

> *"in a manner that prevents the issuer, sponsor, or underwriter of the structured
> finance product from selecting the nationally recognized statistical rating
> organization that will determine the initial credit ratings and monitor such credit
> ratings".[1]*

Taking into account this statutory language, we understand that the ultimate objective of
the Study is to encourage high quality ratings for structured finance by evaluating potential
solutions to the problem of "rating shopping" in that market. The term "rating shopping" refers
to instances where an issuer selects the credit rating agency ("**CRA**") that provides the most
optimistic credit rating opinion. Some commentators have claimed that rating shopping is a
direct result of the issuer-pays business model, and that replacing the issuer-pays model with the
investor-pays or some other business model will remove potential conflicts of interest and
therefore ensure higher quality ratings.

These proposals ignore the fact that conflicts are inherent in every CRA business model,
and that the potential to exert influence on the rating process exists regardless of who pays for
the rating or selects the CRA. An investor-pays nationally recognized statistical rating
organization ("**NRSRO**") must adopt measures designed to prevent investors with large
positions on particular securities from influencing the NRSRO's ratings. An issuer-pays
NRSRO must adopt measures designed to prevent issuers from influencing its ratings. Finally, a
government-selected NRSRO, if that is ultimately the model that the Commission chooses to

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[1]   Dodd-Frank Act, Section 939F(d)(1).

adopt, must adopt measures designed to prevent the government from influencing the NRSRO's ratings. Consequently, when considering an alternative business model, we believe the Commission should assess whether the new system simply transfers the ability to rating shop from one set of interested parties to another.

It is possible for policymakers to effectively mitigate fee-based conflicts by establishing a blind fee distribution process, such as a lottery. This type of a model, however, might encourage other types of conflicts and also might reduce the incentives to strive to improve performance and quality. On balance, MIS recommends that rather than establishing a system that picks winners and losers, the Commission should encourage NRSROs, regardless of their business models, to compete against one another on the basis of the credibility, reliability and independence of their analysis and opinions.

We continue to believe that instead of debating "who should pay for the rating or select the CRA", the debate is better focused on "how can the system encourage high quality ratings?" In this respect, MIS agrees that rating shopping is a problem in the structured market, and we fully support the Commission's efforts to better dimension the drivers of the structured finance market and to put in place a solution that is both practical and long-lasting. It is important to note that rating shopping generally does not exist in the US corporate market. We believe that the corporate market can serve as an important point of reference and largely can be emulated in the structured finance market. In our view, the most direct and constructive approach to solving the problem of rating shopping has three components.

- **First, enhance disclosure in the structured finance market**

  The best way to discourage rating shopping is for the Commission to increase the direct flow of information from structured finance issuers to the broader market, and particularly investors, pursuant to Subtitle D of the Dodd-Frank Act. The Rule 17g-5 Program, as defined in the RFC, is a step in the right direction. We believe, however, that additional information should be made publicly available. When investors can more easily "look under the hood" of structured securities, they can form their own views of credit risk and knowledgably assess the credibility of CRAs, on a rating-by-rating basis.

- **Second, reduce regulatory use of and reliance on credit ratings[2]**

  Reducing regulatory reliance on ratings, which MIS has strongly urged[3] for some twenty years, is an important goal of the Dodd-Frank Act. The regulatory use of ratings can inadvertently create an incentive for issuers to seek ratings from CRAs that are officially recognized for regulatory purposes. Consequently, issuers may consider "shopping" for the officially recognized CRA that will assign the highest possible rating. This is particularly an issue in the structured finance market, where regulatory use is overwhelmingly skewed toward holding securities that have been rated Aaa by at least one NRSRO (but that need not hold a high rating from any other CRA). In our view,

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[2]   Please see our comments to the Commission on "References to Ratings of Nationally Recognized Statistical Rating Organizations – Files S7-17-08, S7-18-08 and S7-19-08", September 5, 2008 ("**2008 Comment Letter**"), available on moodys.com.

[3]   See generally "*Ratings in Regulation - A Petition to the Gorillas*," page 7, a speech by a former MIS Executive Vice President in April 1995 (Doc. # 02295), available on moodys.com.

limiting regulatory reliance on credit ratings would remove one of the important drivers behind rating shopping in the structured finance market.

- **Third, CRAs continuously must strive to improve their processes and methodologies**

  It is incumbent upon CRAs to strive to achieve high quality analysis supporting their credit ratings and to continually develop their processes and methodologies. We at MIS take this responsibility very seriously, and continue to look for ways to improve our practices in line with regulatory requirements and market demand.

In our comments, we discuss this three-part solution in greater detail. Taking into consideration the GAO Framework,[4] we then discuss potential, alternative business models. Finally, in the Annex we answer some of the technical questions raised by the Commission, including: possible metrics to evaluate ratings performance and data regarding our ratings performance under the issuer-pays model.

I. A Three Part Solution to Preventing Rating Shopping in the Structured Finance Market

> *The problems [with appropriating ratings for regulation] are most obvious in the newer areas of the financial markets, such as structured finance, where disclosure is weakest and investors have the least experience.*[5]

A. What Has Caused Rating Shopping in the Structured Market?

MIS recognizes that rating shopping in the structured finance market is a prevalent and harmful practice engaged in by some issuers, sponsors or underwriters, (collectively, "**Arrangers**") and that it can exacerbate the potential conflicts that CRAs face as a result of being paid to provide credit ratings. Some commentators have argued that rating shopping is a direct result of the issuer-pays business model. In fact, an issuer's ability to rating shop stems from its control over availability of relevant credit information, not payment of fees. (MIS's historical performance, operating first under an investor-pays and then an issuer-pays model, refutes the assertion that business model is the cause of rating shopping. Please see the Annex for a more detailed discussion.[6])

Absent changes in information availability, rating shopping will be a feature under any business model. For example, a CRA that operates under an investor-pays model can still be limited in its ability to publish an opinion if the issuer does not make credit relevant information public. In this respect, it is important to note that rating shopping is essentially nonexistent in the US corporate finance sector, even though as a general matter CRAs use the same business model in all sectors. The attribute that has been unique to the structured finance market, up until the passage of the Dodd-Frank Act, has been that unlike for corporate issuers, the securities laws

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4   As that concept is defined in the RFC.

5   See "*Ratings in Regulation - A Petition to the Gorillas*," page 7.

6   The data presented does not include ratings on structured securities because securitization did not exist during the 1920-1970 period, so the issuer-pays vs. investor-pays comparison can only reasonably be made for corporate ratings. Nonetheless, the absence of rating shopping in the corporate sector during the issuer-pays era leads naturally to the question of why has the securitization sector behaved differently and to the identification of differences in information availability between the two sectors.

have not required Arrangers to continuously and publicly provide all relevant, material information to the markets. Thus, a great deal of Arranger-generated information is not easily and immediately available to investors.

Issuers' ability to rating shop is further compounded by ratings requirements in regulation. Rather than seeking long-term credibility with investors, regulatory use has provided issuers with a different basis on which to choose a CRA.

B. What Is the Solution to Rating Shopping?

The threshold question before the Commission is "how to eliminate rating shopping in the structured finance market?" In our view, the most direct solution to rating shopping has three components. We take each component in turn below.

1. Enhance Disclosure in the Structured Finance Market

In the US corporate finance market, there is practically no rating shopping because investors and other market participants can develop their own opinions based on information that issuers, pursuant to securities laws, make publicly available. This practice also allows CRAs and other commentators (not just NRSROs) to form confirming or contradictory views. Importantly, this system also allows investors to make an informed assessment of the credibility of individual CRAs, which in turn enables them to ignore those CRAs that they believe have inflated ratings.

In contrast, rating shopping has been more prevalent in the structured finance market because, until recently, the disclosure requirements for structured finance products were insufficiently detailed. Under the limited information disclosure model in the securitization market, CRAs, for example, typically have asked for additional information to analyze and rate securities. Consequently, if an Arranger had not requested a particular NRSRO for a rating, that NRSRO (regardless of business model) would have found it difficult to publish a rating because it would not have had access to the underlying information necessary to form a credit opinion. Arrangers had been able to exert control over access to underlying information.

The adoption of the 17g-5 Program has been a step in the right direction toward improving transparency in the structured market.[7] It has the effect of requiring Arrangers to make all of the information they provide to the hired NRSRO available simultaneously to all other NRSROs. The 17g-5 Program, however, does not require Arrangers to make all the information available to, for example, non-NRSRO CRAs, other market commentators and most importantly, investors. Consequently, Arrangers have continued to retain a certain amount of control over access to underlying information.

Subtitle D of the Dodd-Frank Act requires issuers of asset-backed securities ("**ABS**"),[8] among other things, "at a minimum, to disclose asset-level or loan-level data, if such data are

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[7]   MIS remains concerned with this rule because we believe that rather than reducing reliance on NRSROs, the rule inappropriately creates an impression that the availability of NRSRO opinions can be a substitute for transparency in the structured finance market. Please see our comments to the Commission: Proposed Rules for Nationally Recognized Statistical Rating Organizations (Release No. 34-57967; File No. S7-13-08), July 28, 2008; and Re-proposed Rules for Nationally Recognized Statistical Rating Organizations, Release No. 34-59343; File No. S7-04-09, March 28, 2009 (both available on moodys.com).

[8]   As that term is defined in the Dodd-Frank Act.

necessary for investors to independently perform due diligence,"[9] "to perform a review of the assets underlying the asset-backed security," [10] and "to disclose the nature of the review".[11] We have supported the Dodd-Frank Act's enhanced disclosure requirements for ABS issuers.[12] The Commission's rigorous implementation of Subtitle D will make the transparency of the structured finance market more comparable to that of the corporate market and yield three beneficial results.

- *First*, giving investors increased access to better and more information will improve their ability to develop their own views about structured finance products. That, in turn, will enhance their ability to assess the work of CRAs and provide a market-based quality control mechanism. Rating shopping can be checked if investors can more easily "look under the hood" of structured finance products and independently determine whose credit opinion they find more credible and whose opinions they can ignore.

- *Second*, if sufficient information is made more readily available to investors, then it is necessarily also available to all other market participants. Providing sufficient information to everyone in the market increases the range of opinions, including unsolicited ratings and research from NRSROs and non-NRSRO CRAs. This, in turn, may increase the range of analysis and views, as well as act as a self-policing mechanism against ratings inflation within the industry.

- *Third*, embedding enhanced information requirements in prospectus disclosures intended for investors likely will improve the information quality about structures and assets. Issuer indifference to information quality is less likely to be a problem if the information is subject to federal securities law requirements for accuracy and completeness. The effect of alternative proposals to provide information only to CRAs is that structural conditions that induced rating shopping in the last credit cycle may induce "disclosure shopping" in the next.

2. Reduce Regulatory Use of and Reliance on Credit Ratings

An opaque disclosure regime in the structured finance market is the primary enabler for rating shopping in that market. However, by using credit ratings as a regulatory tool, policymakers can commoditize ratings and inadvertently further entrench the rating shopping problem.[13]

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[9]   Section 942.

[10]   Section 945.

[11]   Section 945.

[12]   For a more detailed analysis of our views, please refer to MIS's Comment Letter re Proposed Amendment to Regulation AB – File No. S7-08-10 (August 31, 2010), available on moodys.com.

[13]   For a more detailed analysis of our views on mechanical triggers in regulation and regulatory reliance on ratings, please see, *e.g.*,: MIS's Comment Letter re: Joint Advance Notice of Proposed Rulemaking on Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies, OCC (Docket ID: OCC-2010-0016); Board (Docket No. R-1391); FDIC (RIN 3064-AD62); OTS (Docket ID: OTS-2010-0027) (October 25, 2010); and the 2008 Comment Letter (all available on moodys.com). Importantly, as discussed in these documents, regulatory use of ratings can change the behavior of all market participants, as well as of regulators. In this letter, we limit our discussion to the

In, the US, CRAs have operated primarily under a "market use" model, which describes an environment where issuers seek ratings to increase their potential investor base and the marketability of their debt. Issuers naturally want to obtain the highest possible rating and exercise maximum control over the rating process. Because investors demand credible (*i.e.* objective, predictive and relatively stable) ratings, however, issuers are motivated to seek ratings from CRAs that have the best reputations among investors since such ratings facilitate better access to capital markets. Consequently, CRAs have competed to deliver credible ratings. This is because, under the market use model, the credibility that CRAs build with investors instills a natural defense against rating shopping.

However, by using credit ratings as a regulatory tool, policymakers can induce market participants to change their behavior. MIS believes that widespread incorporation of ratings into regulation can encourage regulated entities to treat ratings from recognized CRAs as interchangeable for regulatory purposes. Ratings, therefore, tend to become commoditized, which can affect the traditional incentives to differentiate among CRAs based on the ratings' credibility. In other words, the incentive for entities to conduct their own credit analysis and use ratings as just one of several inputs in their decision-making process is weakened if the regulatory framework permits them to use an officially recognized rating without ongoing consideration of whether the rating conveys the information they need and is of sufficient quality.

Officially recognizing CRAs and their ratings contributes to the misperception that ratings are interchangeable, and the incentives for issuers to choose among CRAs on the basis of ratings quality and performance may get diluted. This in turn introduces incentives for issuers to attain the greatest regulatory benefit by "shopping" among officially recognized CRAs. This has been particularly a problem in the structured finance market because of the regulatory over-reliance and heavy preference for securities rated Aaa.

MIS has continuously supported initiatives to encourage market participants and regulators to consider carefully whether and how ratings should be used. Most recently, MIS has supported section 939A of the Dodd-Frank Act, which asks regulatory authorities to review, assess and limit their use of ratings in regulation. We believe that by limiting the mechanistic use of ratings in regulation, authorities will discourage issuers from shopping among CRAs for greatest regulatory benefit and encourage CRAs to compete on the basis of quality.

3. CRAs Must Continuously Strive to Improve Their Processes and Methodologies

Over the course of its history, MIS – in an effort to enhance accountability – has reached out to market participants and policymakers globally for feedback regarding the utility of our ratings and ratings system. In the recent past, based on the feedback we have received and our own deliberations, MIS has adopted a wide range of measures to enhance how we manage potential conflicts of interest, improve the quality of our credit ratings, reinforce our independence and increase the transparency of our credit ratings.[14]

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connection between regulatory use and rating shopping, but it is essential to stress that regulatory use of ratings creates other problems as well.

[14] Please see "*Moody's Investors Service Looks Forward as Regulatory Landscape Evolves*," June 3, 2011, available on moodys.com.

One initiative that we believe is particularly important to the structured finance market is our introduction of additional measures to help market participants better understand the characteristics and performance attributes of securitized instruments. These added metrics, known as V Scores and Parameter Sensitivities, seek to address two distinct questions asked by investors: (i) what is the degree of uncertainty around the assumptions that underlie our structured ratings; and (ii) how sensitive are MIS's ratings to changes in our key assumptions? We believe that supplementing our traditional ratings with answers to these questions can improve market understanding of credit risk, which as we have explained is core to eliminating rating shopping. We will continue to enhance our policies and procedures.

II.   Alternative Business models

The Commission has asked for an evaluation of the 15E(w) System, as defined in the RFC, and the alternative business models under the GAO Framework. The GAO Framework asks for analysis of alternative business models taking into account the following factors: independence, accountability, competition, transparency, feasibility, market acceptance and choice, and oversight. We generally agree that these are the appropriate factors to consider in assessing business models. In particular, we believe that the "quality" component of the competition factor is critical. Considering this framework, we believe that the business models under discussion can be divided into two broad categories: those that maintain or transfer potential conflicts from one interested party to another; and those that eliminate conflicts, but in doing so also eliminate competition. In our view, there are pros and cons with every business model.

1. Two Broad Categories of Business Models

a. Models That Maintain or Transfer the Conflict from One Interested Party to Another

No CRA business model is "conflict-free". The only parties likely to pay for ratings or be in a position to select a CRA – whether issuers, investors or governments – are parties directly interested in the outcome of the rating. This results in tension between the desires on the one hand for healthy competition and on the other hand for avoiding conflicts of interest. That is to say, competition and conflicts are inextricably linked in that whoever either directly pays the CRA *or* selects the CRA can seek to exert influence on the CRA competing to provide rating services. For example:

- *Issuers*: issuers are motivated to obtain the highest rating and then sustain that rating.

- *Short Investors* (for example, hedge funds that take a significant short position on a particular company): they may be highly motivated to encourage a negative rating action – and the more negative and unexpected the action, the better.

- *Long Investors*: similar to their short-term counterparts, long investors are understandably interested in the outcome of rating actions. Before they purchase a security, they may prefer lower ratings to obtain higher yields; following a purchase (especially for those who trade actively), they are likely to want to have ratings maintained or raised rather than lowered.

- *Governments*: governments, often faced with competing financial market and social policy objectives, may seek to have ratings "protect" nationally or systemically important issuers such as large industrial employers or banks, or to protect ratings of government entities. This conflict can exist in any model if the government has significant involvement in the substance of the rating determination.

Further complicating the situation, there is often no clear distinction between investors and issuers. There are instances where the "investor", the "issuer" and the "government" are either the same entity or a group of tightly interconnected entities.

Consequently, changing "who pays" (or selects) CRAs will not eliminate the potential for conflicts: it will only shift the conflicts from one set of interested parties to another. Moreover, all of the interested parties have other means to try to influence ratings. For example, entities seeking to influence rating actions can and have attempted to do so by challenging CRAs through mechanisms unrelated to fees, such as litigation to coerce higher ratings. Put simply, numerous parties – including investors, issuers and governments – may want ratings assigned and maintained in a manner that is most beneficial to their particular interests, and those interests may often conflict with the CRA's goal to issue an objective rating.

Finally, it is worth noting that the issuer-pays model embeds a significant benefit: the release of ratings to the investing public occurs simultaneously and for free. Small and large investors alike, as well as other market commentators, have equal and contemporaneous access. In contrast, for example, subscriber-pays models by definition cannot offer this public good (otherwise, who would subscribe for something they can receive just as quickly for free?). Since different models reveal similar costs in the form of conflicts that must be properly managed, relevant differentiation comes from the benefits side of the equation.

b. Business Models That Eliminate Potential Conflicts of Interest Also Eliminate Competition

Just as competing for business creates the potential for conflicts, the lack of conflicts can eliminate healthy competition. To illustrate, under a blind system of fee distribution (for example, a lottery or automated rotation system), fee-based and selection-based conflicts would be eliminated because entities seeking to influence rating actions would not control the distribution of fees. (As noted above, they would continue to have other levers to exert influence, such as litigation.) Competition, however, also would be eliminated because CRAs would have incentives to simply wait their turn to be allocated a portion of the business. Incentives to produce the highest quality analysis and ratings would be weakened. When fees are guaranteed (or, conversely, not achievable) regardless of the quality of credit rating opinions, the incentive for CRAs to innovate, update and adapt methodologies to changing market conditions – *i.e.*, to enhance ratings performance – may be removed. Rather, such a system may create incentives to conduct the least amount of work and innovation possible to remain in the lottery or rotation system.

2. Logistical Factors for Consideration by the Commission

Many of the models – the 15E(w) System, the Stand-Alone Model and the Designation Model – would either empower a third party to select NRSROs for the initial rating or ask that the third party operate a blind selection process. If the third party is the ultimate selector, as

discussed above, the model simply might shift the conflicts, so that the qualified NRSROs would compete for business from this third party. Importantly, this third party would be able to exert greater influence over the rating process because as the sole selector of "initial ratings", it would concentrate any potential conflicts. If the Commission were to adopt a blind selection model, then, as discussed above, the incentives to compete would be reduced or eliminated.

Consequently, in our view, in order to implement any one of the alternative business models included in the RFC, we believe the Commission should consider and answer some important questions. How they are answered would shape whether the system merely transfers the ability to rating shop from one set of parties to another. Questions to ask include the following:

- Who would sit on the Board? How would Board members be selected? Given that many people with sufficient experience to do the job probably would have connections or interests in the securitization industry that would present conflicts, how would the Commission ensure that Board members have both sufficient expertise *and* are not conflicted?

- How involved would the Commission remain with the work of the Board?

- What substantive powers would the Board have? For example, could the Board or another other third party vote on whether and which methodologies they believed were most analytically robust? Favoring the most conservative methodologies would create incentives for CRAs to downgrade underlying credits in an effort to win favor with the Board. Favoring less conservative approaches would introduce incentives for CRAs to inflate underlying credits in an effort to win favor with the Board.

- What would be the Board's knock-on effect on the functioning of the structured finance market and the activities that are supported by the securitization process, such as the real estate, mortgage, auto and consumer products markets? For example, would the Board or another third party be required to assign the initial NRSRO within a reasonable time? And if so, how would that term be defined? If assignment of an NRSRO is not accomplished in a reasonable time, how would that affect the securitization process itself and the activities supported by a robust securitization market?

- If the Board was required to distribute fees, how would it determine what fees to collect and distribute?[15] From whom would the Board collect fees? What organization would have to be put in place for the collection and distribution of fees?

3. Other Potential and Unintended Negative Consequences for Consideration

The 15E(w) System, as well as additional alternatives included in the RFC, may have unintended consequences if adopted.

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[15] With respect to the 15E(w) System, Section 15E(w)(1)(C)(ii) provides: "Reasonable Fee.—The Board shall issue regulations to define the term 'reasonable fee'." Section 15E(w)(8)(A) provides that a qualified NRSRO "shall charge a reasonable fee, as determined by the Commission…." Section 15E(w)(8)(B) provides: "Fees may be determined by the qualified [NRSRO] unless the Board determines it is necessary to issue rules on fees."

First, greater government involvement in the CRA industry could create the perception that the ratings produced are "more than opinions", and are instead statements of fact or performance guarantees. As addressed above, a crucial goal of the Dodd-Frank Act is to decrease reliance on credit ratings. Many of the alternative models rely on involvement from a third party, *e.g.*, the 15E(w) System, the Stand-Alone Model and Designation Model. To the extent that the government directs these third parties, it can create an impression in the market that, for example, the rating chosen by the Board (or other third party) is the "right" or "government-sanctioned" rating and that investors are regulatorily excused from conducting their own analysis. In other words, the Board may be viewed as providing the "government's stamp of approval." In this sense, such a model could increase, rather than decrease, reliance on ratings, thereby undermining an important goal of the Dodd-Frank Act.[16]

Second, the 15E(w) System, or any of the alternatives that would rely heavily on government involvement, could undermine the credibility of NRSROs's ratings internationally. For example, mandating that at least one rating assigned to any security be chosen by the Board could create the impression internationally that NRSROs are beholden to the US government for their business. This perception could have a negative impact on NRSROs operating internationally by casting doubts on the independence, and therefore the reliability of, these NRSROs and their ratings. Importantly, the system also could be replicated abroad with the specific intention of affecting the objectivity of ratings.

Third, the 15E(w) System could discourage competition. Identifying only a handful of NRSROs as "qualified" to rate structured finance products may diminish competition in the industry. It will be difficult to become "qualified" to rate a structured finance product if the NRSRO does not have the opportunity to rate such structured finance products because it is not "qualified" to do so. This may recreate the "chicken and egg" problem of which the pre-2006[17] NRSRO designation process had been accused.

Sincerely,

Michel Madelain
President and Chief Operating Officer
Moody's Investors Service

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[16] Potentially more dangerous, investors may be lulled into assuming that ratings, for example, chosen by the Board can be used as proxies for risks not measured by credit ratings, and will treat them as recommendations to buy or sell securities.

[17] In 2006, the Credit Rating Agency Reform Act was passed, which considerably opened the Commission's designation process to new CRAs seeking NRSRO status.

ANNEX

The Annex addresses certain technical questions contained in the RFC.

Range of metrics that could be used to determine the accuracy of credit ratings.

The Dodd-Frank Act calls for the SEC to assess the range of metrics that could be used to determine the accuracy of credit ratings. MIS believes that the SEC's study also should incorporate an assessment of metrics to assess ratings stability to supplement its assessment of rating accuracy metrics. MIS has found that market participants value both of these rating attributes. We, therefore, aspire to accurate and stable credit ratings, and we measure the performance of our ratings against those two objectives. That is not to say there is no value in a ratings system that provides greater accuracy with more volatility. Rather, which system is more useful depends on the investor's needs. Comparing the performance of different rating systems, however, proves quite challenging.

Below, we discuss in more detail how we measure ratings performance in terms of ratings accuracy and stability.

A.   How MIS Measures Ratings Performance

Taking into account the views of users of our credit ratings and our own deliberations, MIS has identified two principal objectives for our credit ratings and, therefore, two principal types of performance metrics. Ratings should rank order relative credit risk (*i.e.*, they should be "accurate") while reflecting more permanent changes to credit risk (*i.e.*, they should be "stable").

For MIS, ratings accuracy encompasses not only the concept of ordinal power but also standards of absolute performance, namely that high-rated credits should default only infrequently and defaulting credits should be rated low, on average, well in advance of default. Our principal measure of ratings accuracy is the *Average Position* (AP) of defaulters. Bounded between 0 and 1, AP measures where in the distribution of ratings defaulters were located relative to non-defaulters. As such, AP summarizes only the ordinal power of the rating system. We augment this with cardinal or absolute measures of accuracy, notably the investment-grade default rate and the average rating of defaulters prior to default.[18]

Stability in ratings is a valued attribute by many users. Moreover, the desire for stable ratings reflects not just an aversion to volatility, but also a view that more stable ratings are more accurate ratings with respect to the relative fundamental credit risk of the borrower. All other things being equal, a rating system that makes less frequent rating changes is a preferable system. Of course "all other things being equal" is an important restriction: some volatility is necessary

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[18]   There are no natural "targets" for default or loss rates by rating category over different investment horizons. Therefore, it is not appropriate to say that one realization of default or loss rates by rating is superior or another (as long as the rates generally are increasing or decreasing monotonically with rating levels). For our fundamental credit ratings, we generally expect that over the long run, loss rates by rating category will be similar in the future to what they have been in the past, assuming that the macroeconomic environment turns out to be similar as well. Unusually adverse or positive macroeconomic developments would affect those expectations.

to maintain accuracy. Sometimes credit ratings must change to anticipate dynamic, fluid circumstances.

We assess stability by measuring ratings volatility (essentially notch-weighted upgrade and downgrade rates) as well as the frequency of rating reversals. MIS seeks to change ratings only when relative, fundamental creditworthiness changes (subject, again, to the absolute boundaries discussed above). Since relative, fundamental credit risk generally changes quite slowly, ratings should be stable, especially when compared with other market-based risk measures. Infrequent reversals, and stability more generally, facilitate the use of ratings in connection with investment eligibility guidelines and performance benchmarks.

B.   Comparing Performance

Separate from the question of "What is the best way to measure the performance of a credit rating system?" is the question, "How should two different rating systems be compared?" Can we, for example, use the Average Position metric to conclude that one rating system is more accurate than another?

Simple comparisons across rating systems are extremely difficult to make. First, rating systems must be evaluated against their objectives, and if two systems have different objectives, it is not clear what it would mean to "compare" them. How should we think about comparing an ordinal rating system against a cardinal rating system for example? We would expect that default rates by rating category will be more stable in the cardinal system; the ordinal system, by definition, does not speak solely to default rates.

Second, even if the two systems are broadly similar (*e.g.*, perhaps both purport to be "ordinal"), they may still speak to different attributes of credit risk, thereby making direct comparisons difficult. For example, one CRA's rating system might attempt to measure only relative default risk, while another CRA's rating system might attempt to measure relative credit loss (the combination of default risk and severity). If the first CRA has a large number of high-rated defaulters that subsequently meet their obligations in full, this might indicate relatively weak performance relative to the objective of ratings accuracy. That conclusion, however, wouldn't necessarily be appropriate for the second CRA, since its rating system is seeking to measure relative credit loss. At best, we could hope to measure how well the first system ordered credit loss and how well the second system ordered default risk, but there is no sense in which we can say that one system is more effective against its objective than the other is against its different objective.

Third, even if two systems share the same objectives, comparisons must be limited to those objectives. When evaluating two ordinal rating systems, comparing default rates by rating category, for example, is not a valid test of their relative performance. It might be "interesting," but it sheds no light on which of the two systems has greater ordinal power.

Fourth, different definitions of credit events, and different ways of measuring them, can further complicate comparisons. Perhaps two rating systems are designed to order relative default risk, but perhaps they define default differently. For example, the first system might define it narrowly to include only payment defaults and bankruptcy, while the second system defines it broadly to include distressed exchanges. If a company executes a distressed exchange, it may warrant a high rating from the first system but a low rating from the second. Again, we may be able to measure how well each system orders the type of default risk it considers, but

then to claim that one is generally more effective than the other may be a misleading assertion. Perhaps ordering payment defaults is "easy" and the second system does a better job of it than the first, but ordering distressed exchange risk is "hard" such that, on balance, the first rating system is able to report a better Average Position metric since it does not even attempt to address this more difficult problem. It would be a mistake to then conclude that it is a better or more accurate system.

Finally, if two ostensibly equivalent rating systems are being compared against their stated objectives measured with uniform standards, the comparison must be based on a common set of observations. Suppose the first rating system assigned a high rating to a company which then defaulted with significant loss. This would typically be reflected in a lower Average Position metric. But if the other system did not rate that company at all, then the fact that it reports a better metric does not really inform us of whether it is, in fact, a more accurate system. Only by calculating the appropriate performance metrics on a common sample of data with common definitions of credit risk can any conclusions be drawn on the relative effectiveness of different rating systems.

C. The Limitations of Performance Measurement

Metrics for accuracy and stability can answer the question, "How accurate and stable are ratings today, compared to previous years?" These measures, however, do not control for changes in the economic environment. They indicate whether ratings performance has changed but not why it has changed. Changes in ratings performance may be due to changes in the quality of the rating process, or they might simply reflect a change in the environment that makes defaults more or less difficult to predict or makes ratings stability harder or easier to maintain. To control for changes in the economic environment, MIS also compares the accuracy and stability of its ratings to the accuracy and stability of other credit risk measures, such as market-implied ratings inferred from observed credit spreads.

We also wish to emphasize that there is a trade-off between ratings accuracy and ratings stability. It might be possible to increase the short-term correlation between credit ratings and defaults by making credit ratings more responsive to new information, regardless of whether that information reflects a transitory development or a more fundamental change. Such an increase in the responsiveness of credit ratings to all types of new information, however, likely would result in a decrease in ratings stability.

Are there empirical data, studies, or other information that the issuer-pays conflict of interest or the subscriber-pays conflict of interest influenced credit ratings issued by NRSROs?

MIS has performed a study that shows that our ratings performance improved as we moved from the investor-pays model to the issuer-pays model.

By way of background, in the early 1970s, MIS shifted from an investor-pays model to an issuer-pays model. This change was the result of several market trends, including increasing interest by investors for more in-depth and timely analysis. This more rigorous and more costly analysis could not be sustained by the fees charged to subscribers. It was at this time that MIS made its ratings publicly available. We have analyzed whether, after the change in our business model, our ratings performance deteriorated and whether there was any statistical evidence to

suggest that MIS's analysts began to cater more directly to the interests of issuers at the expense of the investors. More to the point, we asked:

- Did the pace of rating downgrades decrease?
- Did the average rating assigned to corporate issuers drift upward?
- Did the typical financial metrics associated with issuers within a given rating category weaken?
- As a consequence, did the default rates associated with particular rating categories increase?
- As a further consequence, did the accuracy of ratings as rank-order predictors of relative default risk decrease?

a. Performance of Corporate Finance Ratings

With respect to ratings on companies, as is shown in the table below, MIS's research[19] demonstrates that the issuer-pays era is actually associated with higher accuracy ratios,[20] lower investment-grade loss rates, and higher downgrade rates.[21] Altogether, the data suggest that MIS's ratings have become more accurate and less "issuer-friendly" over time.[22] Moreover, these findings are consistent with academic studies and our own research, which have observed

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[19]   Please see, "Measuring the Performance of Corporate Bond Ratings," April 2003, available on moodys.com. Accuracy ratios measure the ability of ratings to differentiate between issuers that default and those that do not default. The accuracy ratio lies between minus one and positive one, similar to a correlation statistic, and can be converted to a percentage. If all defaulters were initially assigned the lowest rating category, the accuracy ratio would approach one. If all defaulters were distributed randomly throughout the population without regard to ratings, the accuracy ratio would be zero. And, if all defaulters were initially assigned the highest rating category, the accuracy ratio would approach minus one.

[20]   Ordinarily a discrete rating system, such as MIS credit ratings, cannot obtain accuracy ratios of exactly 1 or 0. Consequently, we often make an adjustment for the default rate. The resulting adjusted accuracy ratios can, theoretically, obtain a value of 1 or 0. We report both adjusted and unadjusted accuracy ratios for completeness.

[21]   *Ibid.*, discusses these benchmarks of ratings performance.

[22]   MIS has conducted similar research for structured finance dating from 1993 (as far back as we maintain default and loss data on securitizations), but with two important limitations. First, securitization did not exist during the 1920-1970 period, so the issuer-pays vs. investor-pays comparison available for corporate ratings is not available for structured finance. Second, the current measurement period for structured finance through mid-2011 does not capture the full impact of the recent downturn on expected losses for outstanding structured finance securities. Nonetheless, for completeness we include the following table:

Structured Finance Performance Statistics (1993 - 2011H1)		
	Simple averages across monthly cohorts	Weighted average, by number of issuers
1 - Year Accuracy Ratio (Unadjusted)	84%	75%
5 - Year Accuracy Ratio (Unadjusted)	81%	70%
1 - Year Accuracy Ratio (Adjusted)	86%	79%
5 - Year Accuracy Ratio (Adjusted)	83%	73%
1 - Year Investment Grade Loss Rate	1.2%	2.7%
5 - Year Investment Grade Loss Rate	1.7%	3.9%
Broad Rating Downgrade Rate (12 Month)	7.9%	16.7%

that our corporate rating criteria, as measured by standard credit-related accounting ratios, appear to have become more "conservative" over time.[23]

Comparing Corporate Performance Over Time			
	Investors-Pays Era 1920 - 1970	Issuer-Pays Era 1971 - June 2011	Difference
Simple averages across monthly cohorts			
1 - Year Accuracy Ratio (Unadjusted)	67%	83%	16%
5 - Year Accuracy Ratio (Unadjusted)	61%	68%	7%
1 - Year Accuracy Ratio (Adjusted)	67%	84%	17%
5 - Year Accuracy Ratio (Adjusted)	64%	72%	8%
1 - Year Investment Grade Loss Rate	0.1%	0.0%	-0.1%
5 - Year Investment Grade Loss Rate	1.2%	0.6%	-0.7%
Broad Rating Downgrade Rate (12 Month)	5.2%	7.4%	2.3%
Weighted average, by number of issuers			
1 - Year Accuracy Ratio (Unadjusted)	61%	83%	22%
5 - Year Accuracy Ratio (Unadjusted)	52%	69%	17%
1 - Year Accuracy Ratio (Adjusted)	62%	84%	22%
5 - Year Accuracy Ratio (Adjusted)	55%	74%	19%
1 - Year Investment Grade Loss Rate	0.2%	0.1%	-0.1%
5 - Year Investment Grade Loss Rate	1.9%	0.6%	-1.3%
Broad Rating Downgrade Rate (12 Month)	7.3%	8.2%	0.8%

While this "before and after" comparison is by no means a definitive test, it indicates that a move from an investor-pays model to an issuer-pays model does not necessarily lead to deterioration in credit standards and rating inflation as some have suggested. Indeed, it suggests that the issuer-pays model is coincident with, and may lead to higher overall ratings quality.

One reason that overall ratings quality may have improved is that the quality of the analysis, itself, may have improved. With the advent of the issuer-pays model, the number of credits followed by individual rating analysts declined, the frequency of informational meetings with issuers and investors increased, investments in better technological tools increased, and the frequency of rating changes all rose over time. A second reason behind the improvement in our ratings performance during this time period may be the considerable increase in both the quantity and quality of corporate issuer disclosure and reporting.

Our findings are consistent with a December 2003 paper entitled "Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate," by Daniel M. Covitz, Federal Reserve Board, and Paul Harrison, Federal Reserve Board. In studying whether issuer-pays conflicts influenced rating decisions, the authors used a data set of about 2,000 credit rating migrations, which included data from MIS. This study likewise found that reputation-related incentives and not issuer-pays conflicts influenced rating decisions. Specifically, the paper concluded: "we find no evidence consistent with rating agencies acting in the interests of issuers due to a conflict of interest. Instead, rating

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[23] See, for example, Blume, M.E., F. Lim & A.C. MacKinlay (1998), "The Declining Credit Quality of U.S. Corporate Debt: Myth or Reality?" *Journal of Finance* 53.4, and "Maintaining Consistent Corporate Ratings Over Time," *Moody's Special Comment*, August 2008.

agencies appear to be relatively responsive to reputation concerns and so protect the interests of investors."

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Describe the processes by which an NRSRO determines an initial credit rating for a structured finance product and, thereafter, monitors that credit rating.

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Please refer to Exhibit 2 of MIS's current Form NRSRO for a description of how MIS determines and monitors credit ratings, including for structured finance products.

It should be emphasized that MIS analysts communicate with a wide variety of market participants and observers. These discussions enhance analytical rigor and bolster independence in the rating process by exposing analysts to diverse perspectives on the information MIS receives as part of the rating process, our analytical approaches and our opinions. In rating any structured finance product (or, for that matter, any other obligation or issuer), we may have analytical communications with issuers or their advisors.

These communications serve the dual purposes of: (a) helping us better understand the particular facts of the transaction as proposed by the issuer; and (b) clarifying for the issuer the rating implications of our methodologies for that transaction. In circumstances where there is considerable performance history for the particular asset being securitized and where the structure has been used previously, our published methodologies may provide sufficient transparency on our analytical approach to obviate the need for detailed communications. In contrast, we have more general communications about the application of methodology with issuers who are securitizing new asset classes or utilizing novel structures that are different from those we have discussed in our published methodologies.

As part of this communication process, an investment bank underwriting a mortgage-backed security, for example, provides the composition of a pool of mortgages and the details of a particular structure and asks for the rating implications in light of our existing, published methodologies. What the investment bank does in response to our feedback – whether they decide to seek a rating of the structure presented, modify the structure as they see fit, or not seek a MIS rating at all – is determined entirely by the investment bank and the originator. We believe that these communications help enhance overall market transparency and stability in that both issuers and investors have a better understanding of our analytical thinking and our resulting ratings.

The communication process with issuers of structured finance instruments and their advisers is governed by MIS policies and procedures that have been adopted to implement SEC Rules 17g-5(a)(3) and (b)(9), as applicable.

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Provide data on the number of credit ratings for structured finance products initially determined by each NRSRO each year for the last ten years or identify sources of information where that data can be located.

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MIS discloses on its Form NRSRO the approximate number of credit ratings outstanding as of the most recent calendar year end for each class of credit ratings for which it is registered. As of year-end 2010, MIS had approximately 101,546 ratings of "asset-backed securities", (as that term is defined in 17 C.F.R. 229.1101(c)).

> ***Describe any actions that NRSROs have taken or internal controls that NRSROs have in place, or could take or put in place, to mitigate conflicts of interests in the issuer-pays model.***

All business models for CRAs (*e.g.*, issuer-pays, investor-pays and government-pays) have embedded potential conflicts of interest. Put simply, numerous parties, including investors and issuers, may want credit ratings assigned and maintained in a manner that is most beneficial to their interests, and those interests often may conflict with the goal of a CRA to issue an objective credit rating.

The issuer-pays model for the rating business serves the public policy objective of broad, contemporaneous dissemination of credit ratings to the public without charge. MIS recognizes, however, that this business model entails potential conflicts of interest, such as those that exist with financial news publications that receive advertising revenues from companies about which they report, that could have an impact on the independence and objectivity of its rating process.

Our policy is to identify and eliminate, or manage and disclose, as appropriate, actual or potential conflicts of interest. MIS and MCO have adopted codes of conduct, other policies, procedures and guidance to address the potential conflicts of interest that arise out of the issuer-pays model that we employ, as well as potential conflicts of interest from other sources. MIS supplements this framework with various mechanisms, including control functions such as the Credit Policy, Compliance and Internal Audit functions.

See Exhibit 7 of MIS's amended Form NRSRO, which lists and includes links to our policies to address and manage potential conflicts of interest.