

STATEMENT
of
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before the

U.S. SECURITIES & EXCHANGE COMMISSION

CREDIT RATING AGENCIES ROUNDTABLE

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Washington, DC

I appreciate the invitation to the Ratings Agency Roundtable where the SEC has presented a number of topical questions such as “What Went Wrong” and “How to Improve Credit Rating Agency Oversight.” We are fortunate to have a host of industry representatives and numerous academic and other experts to provide affirmative replies. This morning, however, I want to begin by stressing some things that were not the case.

First, the much publicized failures of the industry’s largest companies to provide timely and accurate ratings are not a new development. Second, these problems are not limited to structured finance. Third, the industry’s problems are not the result of lack of competition.

A Pattern of Failures

Enron brought much attention to the rating industry when that company failed in 2002 despite the fact that S&P and Moody’s had its debt at investment grade as late as four days before the bankruptcy filing. The fact is, however, that the work product of the major ratings agencies was equally dismal in numerous other instances, including Orange County California, Pacific Gas & Electric, WorldCom, Delphi, General Motors and Ford. All of that was before the major credit rating agencies not only missed the subprime meltdown, but actively abetted it with inflated and grossly inaccurate ratings on billions of dollars of non-prime mortgage securitizations.¹

¹ See President’s Working Group On Financial Markets “Policy Statement on Financial Market Developments,” p. 8 (March, 2008).

Well before the current crisis, as noted, for example, by Professor Jonathan Macey of Yale Law School in Congressional testimony leading up to the enactment of the 2006 reform legislation, there was “a plethora of academic studies showing that credit rating changes lag the market.”² He further observed that “to the extent that it [their work product] is accurate, by the time it reaches investors it is so stale as to be useless to the investors...”

Failures Go Beyond Structured Finance

Second, the problems were not just in structured finance, but also the unsecured bonds and other “plain vanilla” debt offerings of many corporate entities, including Fannie Mae, Freddie Mac, Countrywide, New Century, IndyMac, Lehman, Bear Stearns, AIG, Washington Mutual, the Reserve Fund, etc. Delimiting this issue to structured finance would likewise ignore the more recent situation confronting the so-called “monoline” or bond insurers such as Ambac, MBIA, ACA, and FGIC, which carried AAA ratings up through and even during the time period when state insurance officials were actively pursuing multi-billion restructuring of these companies.

At a Congressional hearing in 2003, I stated that Fannie Mae and Freddie Mac did not merit the Triple-A rating which Moody’s, S&P, and Fitch accorded

² "Credit Rating Agency Duopoly Relief Act of 2005," House Committee on Financial Services, 109th Cong., 1st Sess. (Nov. 29, 2005).

them.³ At about the same time, we issued a rating call to the same effect with respect to MBIA, which our competitors were still rating AAA five years later.

How is it that the major rating agencies which have approximately 400 employees for every analyst at Egan-Jones have been consistently wrong across the broad spectrum of debt offerings over such an extended period of time? I would like to say that we have more sophisticated computer models or that our people are just more talented and I hope that some of that is true. However, the real answer is that Egan-Jones is paid by investors to be in the business of issuing timely and accurate credit ratings, whereas Moody's, S&P and Fitch have gravitated to the business of being paid by the issuers of securities to facilitate the sale of those securities.

Take, for example, this statement by Harold McGraw, Chairman & CEO of McGraw-Hill, on the mission of its wholly owned subsidiary, Standard & Poor's Ratings Services:

“What we do is provide access to the capital market. If the markets want those kinds of products and the institutional investors want those products, then we move with the market and we're going to rate whatever.” (Oct., 2007).

³ “GSE Oversight: The Need for Reform and Modernization,” House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, 108th Cong., 1st Sess. (June 25, 2003).

Investors want credible ratings. Issuers, on the other hand, want the highest rating possible since that reduces their funding costs. Under the issuer-paid business model, a rating agency which does not come in with the highest rating will, before long, be an unemployed ratings firm. It's that simple and all the explanations and excuses cannot refute the market evidence. The major rating agencies like to say that the need to preserve their reputation for honesty and independence overrides any inclination towards overly generous ratings, but the facts are that after the Enron debacle, revenues at Moody's and S&P only accelerated. Indeed, profits soared at these companies but quality and independence moved inversely.

As well summarized by the National Community Reinvestment Coalition (NCRC) in its Complaint filed with the SEC last year: "the rating agencies knowingly issued false and inflated ratings for securities backed by problematic high-cost loans that have created a financial nightmare for millions of families across the country whose homes have been lost to foreclosure or are now in jeopardy of foreclosure..." Because rating agencies are paid by the companies whose bonds they rate, the NCRC pointed out, the agencies suffer from "an inherent conflict that created one of the worst financial crisis this country has ever faced."⁴

⁴ Press Release of April 8, 2008: "Civil Penalties & Equitable Relief Sought For Consumers & Communities Injured By Rating Agencies Role In Foreclosure Epidemic; SEC Urged To Suspend Licenses Of Culpable Rating Agencies."

The SEC has instituted a number of regulatory changes aimed at “managing” this “inherent conflict” and additional actions have also been proposed, but these will not be sufficient. As Chairman Shapiro pointed out in a recent speech before the Council of Institutional Investors, “we all know that compensation drives behavior.”⁵ This is precisely the case, but much of the debate over credit rating agencies has ignored this compelling factor. Because “compensation drives behavior,” the ratings industry solution must be oriented to the compensation system which I will address after discussing the unique aspects of competition in the ratings industry.

Additional Issuer-Paid Competition Has Been Adverse to Improving Quality

It is instructive (albeit counterintuitive) to note that competition *per se* is not the answer. In fact, former Chairman Arthur Levitt was known to admonish that additional competitors could produce rating inflation, and, in fact, the growth of Fitch as a viable competitor to S&P and Moody's actually produced less rather than more accuracy in ratings. The logic is as follows: it was the emergence of Fitch and Duff & Phelps on the scene in the early 1990s that “gave issuers the opportunity to play S&P and Moody’s off against each other. They would shop each deal at both S&P and Moody’s, choose the agency that gave them the best execution (which almost always meant the lowest level of credit support), and then use either Fitch or Duff & Phelps as the swing rating since, generally, one of these would offer support levels below the major rating agencies.”⁶

⁵ Spring 2009 Meeting (April 6, 2009).

⁶ Paine Webber, “Mortgage Strategist,” p. 10 (June 3, 1997).

Recommendations for Reform

The Commission's announcement specifically asked about "corrective steps" being taken by the industry. As recently recited in testimony by S&P before the U.S. Senate, these have focused on procedural antidotes such as establishing an Office of the Ombudsman; implementing "look back" reviews when an analyst leaves to work for an issuer; instituting a rotation system for analysts; and, increasing analyst training programs.⁷ These actions are completely inadequate to address the inherent and truly unmanageable conflicts of interest lying at the core of the current multi-trillion dollar global financial crisis.

I agree with Chairman Shapiro that the compensation is the key to altering behavior, and, in the ratings industry, the best way to do this is to heighten the awareness levels of who is paying for what. We have a free market system and the government cannot and should not compel the use of one business model over another. However, it is the role of the SEC and other policy makers charged with the responsibility to protect investors to make sure that investors and other users of credit ratings know whether the seller or the buyer is paying for the work product.

A recent report by the Group of 30, led by Paul Volcker, has also recommended that regulators encourage the development of payment models that "improve the alignment of incentives" in the rating industry, by which is

⁷ "Enhancing Investor Protection and the Regulation of Securities Markets – Part II," Senate Committee on Banking, Housing & Urban Affairs, 111th Cong.; 1st Sess. (March 26, 2009).

meant, of course, the alignment of interests between the ratings firms and investors. Here are some specific disclosure requirements directed toward these goals.

1. [DISCLOSURE BY RATING AGENCY](#)

The publication of any debt rating, whether in written reports or on websites, should be accompanied by a prominent disclosure statement indicating how the entity which provided the rating was compensated. For example, if a rating agency is paid by the issuer of the securities, a securities dealer, a securities broker or any other party being compensated from the proceeds of the sale of the debt obligations being rated, this fact would be disclosed. For Illustration:

“IMPORTANT RATING AGENCY DISCLOSURE”

“This rating was arranged and paid for by the issuer, sponsor or underwriter of the debt obligation being rated.”

If the rating agency’s report is paid for by investors or any other party, it would likewise be required to disclose the generic source of its compensation.

2. [DISCLOSURE BY INSTITUTIONAL MONEY MANAGERS](#)

Fiduciaries such as mutual funds, pension funds and investment advisors currently disclose the general risk profile of a particular fund in their annual or more frequent investor reports. If the fiduciaries invest in rated debt instruments, they should also be required to disclose and describe the extent to which they rely on external ratings and whether or not those ratings were generated by

rating firms compensated directly or indirectly from the sales proceeds of the debt issuance.

3. [FINANCIAL REGULATORY REQUIREMENTS](#)

Bank capital requirements, particularly after the recent adoption of the so-called Basel II revisions, rely on NRSRO ratings for purposes of prescribing appropriate capital levels. Assets with high quality ratings are subject to lower capital requirements than lesser rated and non-investment grade bonds. Financial regulatory bodies in the U.S. and abroad are increasingly concerned about the impact which inflated ratings may have on the banking system.

Since banks using external ratings to compute their capital compliance, they should also be required to disclose in their SEC and other regulatory filings the extent to which they rely on NRSRO ratings to value their bond portfolios and the rationale for this reliance, including whether or not those external ratings were generated by rating firms compensated directly or indirectly from the sales proceeds of the debt issuance.

4. [RELEASE OF ISSUER INFORMATION TO ALL NRSROs](#)

The SEC currently has proposed that any issuer or other sponsor of a security seeking a credit rating from an NRSRO provide the same financial information given to a solicited NRSRO to all other NRSROs designated to offer ratings for that particular type of security. This would be true competition in that it

would allow unsolicited NRSROs to issue pre-sale and ongoing reports to the investment community.

CONCLUSION

The only real reform for the ratings industry is to return to the business of representing those who invest in securities, not those who issue them. This is how the industry was structured when John Moody founded his company in the early 1900s and the same was true for S&P and Fitch. This principle of putting investors first can be reclaimed through proper market disclosures and through a system that promotes actual competition through the flow of information used to rate securities.

Thank you for having this Roundtable and for inviting Egan-Jones to participate. I would be pleased to address any questions the Commission may have.