In the past decade, credit rating agencies have grown tremendously in size and scope as they have consolidated into three major firms. While these agencies have often provided valuable services for the financial markets and for the public, they have also created much financial turmoil along the way. During the last nine months, we have seen mounting evidence that credit rating agencies played a destabilizing role in the recent market troubles. As a country, we need to take a holistic look at how we regulate these important agencies. In my view and in the views of many economists, asset pricing in the financial markets would be better served by more competition among a greater number of rating agencies. As regulators, the SEC would be in a stronger position if they were less dependent on three views for price discovery. When I co-sponsored the Credit Rating Agency Duopoly Relief Act in 2006, Congressional intent was to foster more competition within a framework of smarter market oversight. Given the current state of affairs, market realities have yet to catch up with our intent.

Earlier this year, Comptroller of the Currency John Dugan testified before the Senate Banking Committee that “it is fair to say that bank management, the most sophisticated people among the banks structurers and the bank regulators were lulled into a sense of complacency by these very high ratings.” In retrospect, we have seen how the rating agencies lacked a complete understanding of the assets they were rating. Without the pressure of serious competition, the three rating
agencies were not digging for better information on mortgage backed securities and they issued stale and inaccurate ratings.

Our financial markets need accurate ratings to function in a free and transparent way. Throwing more regulation at the problem for the sake of doing something will only make matters worse. The government is in no better position to facilitate accurate price discovery than the existing three firms. While the SEC needs more tools to regulate this marketplace, we need to be smart about which tools we give them. Again, I believe that smarter regulation coupled with greater competition is the best way forward.

These problems did not come as a surprise to many of us in Congress. As I already mentioned, I co-sponsored Credit Rating Agency Duopoly Relief Act of 2006. In this bill, we set clear rules for registering and certifying “nationally recognized statistical rating organizations” (NRSROs) with the SEC. By requiring NRSROs to register with the SEC, the Commission was given two important new tools to regulate the process of assigning credit ratings. First, the SEC could now take action against any NRSRO that issues credit ratings in contravention of the methodologies that it included in its registration application with the Commission. And second, the SEC now has the authority to censure, restrict or suspend the license of a rating agency for violations of established rating policies.

To prevent conflicts of interest, NRSROs were required to develop internal controls that guard against conflicts of interest. The SEC also has greater authority to adopt rules or regulations to prohibit, or require disclosure of, any conflict of interest relating to a credit rating. To ensure compliance with these and other SEC
rules and regulations, NRSROs must appoint internal compliance officers to ensure compliance with all SEC rules and regulations.

Even though these provisions became law as part of the Credit Rating Agency Reform Act of 2006, we find ourselves grappling with the many of the same questions two years later. Which factors led to the consolidation of credit rating agencies? What has the resulting impact been on securities markets? What are the problems, if any, resulting from limited competition among credit rating agencies? Do state or federal regulators impede such competition?

In spite of new rules and regulations, the competitive landscape in the credit rating industry has been very slow to change. As we have seen in the past year, the continued dominance of just three firms contributed to turmoil in the structured finance market when changes in the assumptions underlying their rating models led to dramatic ratings downgrades over an unusually short period of time. Concentrating ratings opinions in so few hands destabilized markets and weakened the American economy.

As we see some signs of stability returning to global financial markets, we have a window to ensure that the spirit of the Credit Rating Agency Reform Act is enforced in the marketplace. Government, especially the SEC, should be a catalyst for breaking down some of the unfair barriers to entry in credit rating agency market. A greater diversity of views and genuine competition will yield better credit ratings and more stable financial markets.

In recent weeks, government has acted to build higher walls around the credit rating agency market that undermine the Congressional intent of the Credit
Rating Agency Reform Act. When the Federal Reserve created the Term Asset-Backed Securities Loan Facility, or “TALF,” it announced that asset-backed securities must receive a AAA rating from a “major” NRSRO in order to be eligible for TALF. It defines major NSRSO as Standard and Poor’s, Moody’s and Fitch. No one at the Fed has offered an explanation for this decision to create a de-facto sub-category of NRSROs. Since TALF may well be the entire securitization market for the foreseeable future in the United States, the effects of this new policy are significant for excluded NRSROs.

Another problem that has arisen in the last year is a lack of uniform regulation by the SEC. The Credit Rating Agency Reform Act stipulates that the SEC should move towards a single regulatory regime applicable to all NRSROs. Under a new rule adopted by the SEC, issuer-pay NRSROs must publish ratings history information on a delayed basis in a user-friendly format on their public websites. Subscriber-pay NRSROs are not bound by the same rule because they protested that even a delayed public disclosure of their ratings would be antithetical to their business model. If we want to seriously evaluate whether subscriber-pay or issuer-pay business models provides more reliable ratings, investors and other market participants need public information from both types of firms to verify their ratings accuracy claims.

If further obligations continue to pile up on “non-major” NRSROs under the Credit Rating Agency Reform Act, the Congressional intent of the Act will be undermined and the regulatory regime will become skewed in favor of the three biggest firms. The Commission should seriously consider ways to enhance
competition with rules that would give all NRSROs access to the information underlying credit ratings. This would make the market fairer by reducing the competitive disadvantage that comes from a lack of access to information on the assets underlying a structured credit product. While this would be a step in the right direction, there are still more ways to open up this market and give investors a reliable alternative to the current “big three” NRSROs.

Restoring investor and consumer confidence is crucial to shoring up our wounded financial markets. American investors deserve a better credit and bond rating system than what we currently have. This is not a discussion about esoteric rule changes; we are talking about protecting the savings of all Americans for things like retirement, education and home ownership. Our citizens and our businesses depend on access to capital so they can recover and once again prosper. A more competitive credit rating agency market with more players will go a long way towards serving this objective.

Finally, I want to briefly mention the importance of credit default swaps for price discovery in this market. Credit default swaps have come under a lot of scrutiny during the past several months. While we need to take a closer look at how much more transparency is needed in this market, I believe that the CDS market has become an effective measurement of risk and a strong market pricing mechanism. To many observers, the spreads established in this analytical market are powerful indicators of the potential financial risks of the identified entity. In fact, many view this process as a more accurate indicator than the existing rating agency process.
Before the regulators rush to pull the rug out from under this market, we need to make sure we understand the benefits it brings to the market.

I appreciate having the opportunity to speak at the roundtable today and I look forward to answering any questions you may have.