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Via Email

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street N.E.  
Washington, D.C. 20549

Re: Roundtable on Oversight of Credit Rating Agencies (File No. 4-579)

Dear Ms. Murphy:

I have been involved with two of the three major rating agencies from 1968 to 1998, first as outside counsel and then as Vice Chairman and General Counsel. I am currently on the board of Assured Guaranty Ltd., a bond insurance company that has survived the current crisis. I am submitting this comment in connection with the Roundtable on Oversight of Credit Rating Agencies to suggest that the Commission facilitate the formation of and private investment in new rating agencies which I believe would constitute a private sector solution to the deficiencies found by the Commission within the existing rating agencies.

During my involvement with the rating agencies, their culture emphasized and analysts appreciated the very broad impact that ratings have on our financial system and our economy (it is no exaggeration to say that, although the rating agencies did not single-handedly cause the current financial crisis, they could have single-handedly prevented or at least minimized it). Analysts also appreciated the attendant responsibility to issue accurate ratings and they prioritized accuracy over revenue production. Moreover, management made it clear to analysts that issuers will pay for ratings only so long as investors had enough confidence in the ratings to accept comparatively lower yields and therefore provide issuers with a lower cost of financing, i.e., accurate ratings and helpful research were consistent with profitability.

The findings of the Commission and subprime crisis demonstrate that somewhere in the last five years this priority shifted from accuracy to revenue production. In my view, this shift was the result of three factors. The first was the failure of management to appreciate and/or make clear to analysts the connection between rating accuracy and transparency with profitability. If just one of the agencies refused to rate, and actually criticized,

subprime ratings, lower yields would now attend their ratings and issuers would favor that agency.

The second was a compensation structure within the agencies that rewarded revenue production over accuracy and didn't adequately compensate analysts for challenging rating methodology. The third was a culture that didn't adequately encourage analysts to challenge rating methodology where it threatened a major revenue stream such as the revenues generated by subprime ratings. Compensation structures need to be changed to align compensation more with accuracy and transparency of research that provides investors with the ability to second guess the ratings.

But compensation and culture are set by senior executives and overseen by directors. Therein lies the problem. Executives have an obligation to maximize profits for shareholders and, perhaps more compelling, compensation is most often correlated with short term profits. Directors have an obligation to maximize profits to shareholders and, in the case of the rating agencies, apparently did not ask the right questions regarding their agencies ratings of mortgage-backed securities (MBS), including CDOs of ABS and CDOs squared.

Clearly, regulation could, and should, require rating agencies to adopt and disclose compensation structures and internal cultures and that would satisfy the above concerns. Such disclosure would likely impose liability for failure to employ these structures and cultures and, as a result, provide incentive to employ and maintain them. But as long as management and the board are obligated to maximize profits for shareholders, there will be forces that pull in the opposite direction of accuracy and transparency.

The better approach is to have a board that is motivated almost entirely by rating accuracy and transparency. More specifically, the Commission should encourage the formation of new rating agencies (the "New Agencies") with a majority of their boards consisting of the largest fixed income investors (FIIs) that use ratings and whose economic interests in the New Agencies' profits would be minimal. The extent of the FIIs economic interest in the New Agencies would be a function of the type of shares they own. Moreover, the priorities of accuracy and transparency would be provided for in the New Agencies' charters, bylaws and shareholder agreements.

The FIIs would ask issuers to obtain a rating from the New Agencies. They, as a group, would have enough buying power to make the New Agencies' ratings almost essential. As a result, the ability of an issuer to "ratings shop" – a major cause of the subprime crisis – would be minimized and, at the same time, the issuer-pay model which is necessary to the funding of a rating agency's operations would be preserved. Importantly, the New Agencies would constitute a private sector solution that would not require the Commission to mandate that issuers obtain the ratings of any rating agency. Nor would the Commission need to qualify the FIIs or dictate any elements of governance. All these issues would quite naturally be addressed by a board that is predominantly motivated by accuracy and research that is transparent enough to allow investors to disagree with the New Agencies' ratings.

For example, the compensation committee of the New Agencies' boards would adopt a compensation structure in which bonuses and equity awards were based on accuracy and transparency. Moreover, bonuses might be paid over several years, and if the rating proved wrong as a result of poor analysis, the unpaid balance would be forfeited. The board would also require that analysts responsible for challenging rating methodologies be paid as much as those who assign ratings, and that their compensation be based on their record of discovering and correcting mistakes in rating methodologies that would result or have resulted in inaccurate ratings.

Had rating agency boards' priorities been accuracy and transparency, and had they compensated analysts for achievement of these goals, perhaps the agencies might have been more scrutinizing of the credit underwriting standards of mortgage originators that securitized — sold off — substantially all their risk. Agencies might not have relied as much on FICO scores, given their poor performance as default predictors. Rapidly rising home values might have signaled inflated appraisals and loan to value ratios. Loans that started with low monthly payments but spiked later and the failure to verify borrowers' income might have raised affordability issues. And maybe the agencies would have adapted their models to better reflect the absence of any performance history for these new types of loans.

In addition, transparency of methodology is likely to be high where it is a board priority. The New Agencies would reinvest in expanded research instead of limiting costs to maximize profits. For example, the vulnerability of financial institutions to downgrades, which contributed significantly to the financial crisis, might have been factored into financial institution ratings and reflected in the accompanying research. Clearly, downgrades have contributed to the deterioration of financial institutions. For example, the downgrades of MBS, among other things, resulted in capital depletion and lower insurance company ratings that limited or precluded their ability to do business. Downgrades also triggered termination payments and collateral posting requirements in credit default swaps and accelerated obligations such as guaranteed investment contracts.

As previously stated, it is important to challenge rating agency methodology and that those charged with that responsibility be compensated based on their success in doing so. I suggest that this responsibility would best function outside the rating agencies and be resident in an oversight board (the "Oversight Board") with fulltime employees whose sole responsibility is to challenge rating methodology (I don't suggest that it would have authority to require changes in methodology). The Oversight Board would identify deficiencies that might lead the agencies to improve their methodologies, form its own opinions and critiques of rating methodology, and publish them in order to facilitate investors understanding and evaluation of those methodologies. To avoid conflicts, Oversight Board members would not be allowed to have interests in any rated bonds. The Oversight Board would be not-for-profit and, at the Commission's urging, funded by fixed income investors that would nominate its members. Although this oversight

approach would apply to all rating agencies, oversight and scrutiny of rating methodologies would occur quite naturally where the agency's profit motive is *de minimis* and expressly subordinated to the priority of accuracy and transparency.

The Credit Rating Agency Reform Act of 2006 is based, in part, upon the notion that if more rating agencies were recognized, they would compete by providing more accurate ratings and more transparent research. In my view, this would be true only where the board is motivated predominantly by accuracy and transparency. Let's look at history. When Moody's and Standard & Poor's had no competition, rating criteria for residential and commercial mortgage and asset backed securities were more conservative, i.e. credit enhancement -- or subordination levels -- were higher. After Fitch became a serious competitor, as found by the Commission in its investigation, rating agencies scurried for

market share and its attendant revenues by lowering enhancement levels that provided issuers with lower cost financing in order to attract their business. It bears emphasizing that the battle for market share was a battle for revenues and the resultant profitability.

While it is true that rating agencies that were paid by investors would compete by providing accurate ratings and transparent research, it is doubtful that such an agency could generate enough revenues to operate effectively. Therefore, it is important to preserve the issuer-pay model as would be the case with the New Agencies.

It is important to point out that the New Agencies would have their own type of conflicts. FIIs with rating-dependent capital requirements benefit from higher ratings. Other FIIs may want lower ratings for higher yields. Some FIIs may want higher ratings to sell bonds at better prices. These conflicts can be addressed by prohibiting FII board members from participating in the actual ratings of any securities and by selecting board members that have no responsibility or obligation to their FII employer to participate in investment decisions. These conflicts and their solutions would of course be disclosed.

Although the Credit Rating Agency Reform Act of 2006 does not allow a rating agency to qualify as a Nationally Recognized Statistical Rating Organization (NRSRO) unless, among other things, it has been in the business of issuing ratings for at least three years, the ratings of a New Agency could be recognized more quickly under state laws and regulation for investment eligibility purposes for public retirement plans, by the National Association of Insurance Commissioners to determine capital requirements for insurance companies, by banking regulators to determine bank capital levels, and mutual funds for investment eligibility purposes.

Various capital structures are possible. The FIIs could provide all the capital, own class A stock that controls the board but has limited economic interest in the New Agencies' profits, and class B stock would be awarded to employees based on their records in achieving rating accuracy and research transparency. Alternatively, seed capital investors might contribute capital in exchange for common stock and the FIIs would receive either another class of common, or non-cumulative, non-convertible, non-redeemable 5% preferred shares, both of which would entitle them to control of the board but give them

minimal interest in the New Agencies' profits. Even if the FIIs provided all the capital and received all the stock except for stock awarded to employees, the returns to the FIIs would be insignificant compared to the size of the FIIs' portfolios. In all cases, the New Agencies' charter, bylaws and shareholder agreements would state that the New Agencies' first priorities are accuracy of ratings and transparency of research.

For the reasons stated above, I would urge the Commission to facilitate the formation of New Agencies by encouraging FIIs to invest and become directors.

Very Truly Yours,

S/Neil Baron  
Neil Baron