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February 7, 2011

Ms. Elizabeth Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: *Credit Rating Standardization Study,*
        Securities Exchange Act of 1934 Rel. No. 34-63573,
        File No. 4-622 (December 17, 2010)

Dear Ms. Murphy:

Standard & Poor's Ratings Services ("Standard & Poor's"), a nationally recognized statistical rating organization ("NRSRO") registered under Section 15E of the Securities Exchange Act of 1934 (as amended, the "Exchange Act"), welcomes the opportunity to provide the Commission with its views on matters addressed in the release referenced above (the "Comment Request").

In the Comment Request, the Commission seeks public input to help inform its study pursuant to Section 939(h) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") on the feasibility and desirability of: standardizing credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms; standardizing the market stress conditions under which ratings are evaluated; requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress; and standardizing credit ratings terminology across asset classes, so that named ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity.

A.   <u>Summary</u>

For reasons that are explained in more detail below, Standard & Poor's does not believe that the contemplated actions are wise or desirable, nor in some cases are they feasible. This is due to a number of reasons, some of which are based upon the nature of ratings as evaluative tools, and some of which are based on legal reasons.

Reasonable professionals who assess creditworthiness can and do differ in how to define, analyze and interpret credit factors. The market and investors benefit from having more than one approach. The key is that each credit rating agency should communicate clearly what its ratings mean and the methodology used to arrive at its ratings. Standard & Poor's believes that the investing public will be better served not by the use of one set of rating symbols, with one meaning, across all credit rating agencies, but by a clear

understanding of what the ratings of each credit rating agency signify, and how they are determined. Having multiple assessments based on different methodologies, conveyed in a transparent fashion, provides more information to investors and other market participants. Standardization would deprive investors and market participants of a diversity of approaches and information and in our view would hinder analytic advancement.

Mandating a uniform terminology or other standards for credit ratings would have the effect of stifling competition within the credit rating industry by restricting opportunities for innovative approaches that differ from the standard. This would frustrate a principal aim of the Credit Rating Agency Reform Act of 2006 and at least one goal of the Dodd-Frank Act, which is to encourage additional competition in the credit rating industry.

Standardization of credit ratings terminology and practices may have other unintended consequences as well. It would effectively "shoehorn" all credit rating agencies into taking the same approach to analyzing creditworthiness. As credit rating agencies adopt less diverse opinions, investors and the market would be left with one uniform view of credit risk for consideration in making investment decisions and other financial judgments. Paradoxically, with more homogenous credit ratings from the various credit rating agencies, users might place greater reliance upon them. That is, where there are numerous differing opinions, users of credit ratings can consider some or all of them, affording them differing weights. Where this diversity of opinion is diminished or eliminated, the weight accorded to the views that remain will in all likelihood be greater. We believe the Commission and others should also consider whether mandating standardized ratings methodologies or procedures could increase systemic risk should they prove in hindsight to have been flawed. The net effect of standardization appears to run counter to the mandate in Section 939A of the Dodd-Frank Act for government agencies to eliminate references to credit ratings from their regulations and in so doing, reduce reliance on them. Some users of credit ratings may well take any standards and processes mandated through regulation as evidence of government endorsement of them.

Standardizing credit ratings terminology and practices would inevitably require some level of regulation directing credit rating agencies as to the rating symbols and terms to use, and defining to some extent the parameters within which credit rating agencies must conduct their credit evaluations. It is difficult to see how the Commission could mandate this consistently with the requirement in Exchange Act Section 15E(c)(2) that the Commission may not "regulate the substance of credit ratings or the procedures and methodologies by which any [NRSRO] determines credit ratings."

Regulatory mandates concerning what ratings must mean and how credit rating agencies go about their work would also raise serious First Amendment concerns. Ratings are expressions of opinion and courts across the country have repeatedly recognized that credit rating agencies that publish those ratings are entitled to the full protections of the First Amendment.

The foregoing and other points are dealt with in more detail in the sections that follow.

B.   Standardizing Credit Ratings Terminology

The question of standardizing credit ratings terminology has two layers: (i) the nature of the opinions that credit rating agencies publish for their readers and (ii) the symbols that rating agencies use for publishing their rating opinions.

1.   *The Nature of Credit Rating Agency Opinions*

Rating agencies differ in how they define credit risk and in how they analyze it. Reasonable professionals can and do differ in how to define, analyze, and interpret credit factors. Some rating agencies, such as Standard & Poor's and Fitch, may focus more (although not exclusively) on likelihood of default – relative or absolute – while others, such as Moody's, may focus more on expected loss, which is the likelihood of default taking into account the anticipated severity if there is a default. The market and investors benefit from having more than one approach because users of rating opinions can receive informed analysis from multiple perspectives. The key is that each rating agency communicate clearly what its ratings mean and the methodology used to arrive at its ratings.[1]

Mandating standardized rating definitions would deprive an investor of the ability to select among different, competing methodologies from different rating agencies based on his or her view of which agency's methodology best matches his or her analytic views. It would also deprive a credit professional of the ability to compare the results of analysis under different methodologies. In short, mandating standardized rating definitions would encourage homogeneous analysis among rating agencies, thus depriving the market of the value of diverse approaches and opinions.

It is a misconception to believe that credit analysis is simply a mechanical, cookie-cutter exercise. It is not. It requires not only mastery of a substantial body of technical knowledge but also insight, a sound grounding in qualitative assessment, and experience. There is not a pure science or an orthodoxy for credit analysis or credit ratings.

Additionally, standardized rating definitions would chill competition among rating agencies. One way that rating agencies compete is by trying to make their ratings the most useful to investors. Being able to fashion distinctive definitions is one of the ways that rating agencies compete to better serve their customers. Innovation is important to the assessment of credit risk. There is no uniquely correct or best way to represent credit risk and there are many ways to express that risk in a measure that is useful to market participants. The greater the homogeneity in ratings definitions, the less incentive there will be for users of ratings to seek alternative views, effectively increasing the barriers to new entrants and to the advancement of new approaches to credit analysis. This would frustrate one of the principal aims of the Credit Rating Agency Reform Act of 2006 and the Dodd-Frank Act provisions on credit rating agencies, which is to encourage additional competition in the credit rating industry. We also believe the Commission should consider whether standardization could have the unintended consequence of increasing systemic risk: that is, if all rating agencies are required to follow uniform methodologies, could the impact of any flaw be magnified many times over versus the current system of diversified methodologies and views?

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[1] For example, see Adelson, M., R. Ravimohan, C. Griep, D. Jacob, P. Coughlin, N. Bukspan and D. Wyss, *Understanding Standard & Poor's Rating Definitions,* Standard & Poor's article (3 Jun 2009).

Accordingly, we believe the focus of any efforts in this area should be not on dictating a rigid one-size-fits-all approach, but on ensuring that rating agencies are transparent about their methodologies, their ratings, and what those ratings mean. This would contribute far more to investors and other users of credit ratings appreciating the meaning of those ratings than any efforts to standardize terminology.

> *a.   Diversity of Credit Rating Systems and Definitions*

There are many reasonable approaches for constructing a rating system and establishing rating definitions. By way of illustration, potential rating definitions can be divided into several groups. The first group is simple rating definitions, each of which is based on one primary attribute.

> *1)   "Simple" Rating Definition Systems*

As we explained in a recent research report,[2] there are at least four basic paradigms for creating simple rating definitions:

A. Fixed default/loss metric: One simple type of rating definition is based on fixed (absolute) default or loss metrics. An example of such a definition would be where each rating category corresponds to a specified default frequency (or to a specified level of expected loss). Such a definition is sometimes described as "probability of default" or "PD," although it does not necessarily depend on any assumption that defaults are produced by a probabilistic process.[3] A fixed default/loss metric definition essentially disregards the element of business cycles. Accordingly, it has the potential to make ratings over- or under-predict the measured factor as the economic climate fluctuates over time.

B. Cycle-adjusted default/loss metric: A second type of simple definition emphasizes rank ordering of risk instead of fixed default frequencies or loss rates. This type of definition would allow for the fluctuations of the business cycle. Under this type of definition, the observed default frequency (or expected loss) for each rating category would be expected to rise and fall with changes in the business and economic environment. This type of definition might or might not make reference to target long-term averages over multiple business cycles. In either case, under a cycle-adjusted default/loss metric definition, ratings would not give the appearance of weak performance when actual default frequencies or loss rates rise and fall over the economic cycle, provided that rank ordering is preserved.

C. Scenario-based: A third type of simple definition is based on scenarios or stress tests associated with each rating category. For example, the top rating category might be defined in terms of an historical example of severe or extreme stress that credits in the top category would be expected to survive without defaulting. A scenario-based definition acknowledges the

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[2] Adelson, M., F. Parisi, and C. Woodell, *The Time Dimension of Standard & Poor's Credit Ratings*, Standard & Poor's research report (22 Sep 2010).

[3] Credit professionals sometimes use the term "probability of default" in describing the default risk of a given obligation or cohort of obligations. Moreover, for some types of mathematical credit models, they actually use the mathematical concept of probability for expressing simplified abstractions of the real world in mathematical terms. However, the majority of credit professionals would most likely reject the notion that probability of some probabilistic system is the driver of credit defaults in the real world. On the contrary, most would agree that the true driver of credit defaults is the combination of idiosyncratic factors, like excessive leverage and weak cash flow, with systemic factors, like wars and business cycles.

fact of varying amplitude of the peaks and troughs of successive business cycles. Also by focusing on stress scenarios, a scenario-based definition addresses the notion that, during periods of stress, market participants may have the greatest desire for opinions about the creditworthiness of credits to which they have exposure. However, a scenario-based scheme of definitions may present difficult measurement problems because of the inherently limited precision of grading new episodes of stress against historical antecedents.

D. Distance/time-to-default: A fourth type of simple definition emphasizes the "warning" aspect of ratings. Under a distance/time-to-default definition, credits with higher ratings should be "farther away" from defaulting than credits with lower ratings. One way to implement a distance/time-to-default definition is to equate distance with time. Under such an approach, credits at higher rating levels should take longer to default than credits at lower ratings levels. Another way to implement a distance/time-to-default definition would be to frame it in terms of the standard indicia of credit quality: financial ratios, market position, and business prospects, among others.

Of the four basic paradigms, the fixed default (or loss) metric (type A) would be the toughest to implement but the simplest to measure. In fact, such a paradigm is impossible to implement over any but the shortest time horizons because of the inherent unpredictability of business cycles. That unpredictability makes it impossible to estimate unconditional default frequencies (or expected losses) with assurance. The business cycle is real, and it is a plain fact that defaults increase for all credit grades during the weak phase of the cycle and decrease during the strong phase of the cycle. Producing a useful estimate of the unconditional default frequency of a cohort of obligations (*i.e.*, obligations of roughly equivalent credit quality) would require the ability to make reliable predictions about the relative likelihood of different fluctuations of the business cycle. Historically, this has proven to be an elusive goal.

Moreover, even if it were possible to estimate unconditional default frequencies, there would be other difficult implementation challenges for a fixed default (or loss) metric-based system. One, for example, would be the need to adjust ratings over the course of a business cycle to achieve stable default rates for each rating category at differing points in the cycle. This would make ratings quite volatile and would likely undermine their practical usefulness. For example, ratings on financial institutions might rise and fall sharply through the phases of a business cycle. On the other hand, it would be easy to measure performance of a fixed default metric definition simply by observing whether default rates for each rating level diverge from the target rates. Professionals who use ratings as inputs to quantitative models sometimes might favor this paradigm because they use ratings to ascribe assumed default probabilities to credits in their models.

The other three simple definitions bear greater similarity to each other, although each one addresses the issue of business cycles in a different way. The cycle-adjusted default/loss metric (type B) recognizes that default/loss rates vary over the course of a cycle. This paradigm essentially emphasizes rank-ordering of risk. If a rating system based on this paradigm targets long-term average default (or loss) rates, then it necessarily embeds the assumption that successive business cycles are generally similar (*i.e.*, that the amplitude and duration of their

fluctuations do not vary from one cycle to the next). Significantly, there is overwhelming evidence to the contrary.[4]

A rating system based on the scenario approach (type C) emphasizes the potential variations in cycles but does not provide convenient numerical guideposts for measuring whether the system is over- or under-estimating risk.

Distance/time-to-default (type D) has a very different flavor but amounts to nearly the same thing as the scenario-based approach. While the distance/time-to-default paradigm may be easy to implement, it too is hard to measure. Also, from the perspective of providing warning, the distance/time-to-default paradigm works better on some types of credits than on others.

In our view, none of the simple paradigms is optimal to serve as the sole basis of a practical and useful scheme of ratings definitions. Each can be inflexible and taken alone may fail to optimally meet the expectations of users.

2)   Beyond Simple Rating Definitions

A "compound" rating definition system would be formed by combining simple definitions. For example, a rating agency might define its ratings as a combination of equal parts (i) cycle-adjusted default frequency, (ii) scenario definitions, and (iii) distance/time-to-default. Under such a scheme, each rating level would be defined by elements of all three of the simple component definitions. For example, a hypothetical compound definition might read as follows:

> ★★★★★ **(5 stars)**: An obligation rated '★★★★★' has the highest rating. This means that such obligations should display lower default frequencies than obligations rated in lower categories. Over the long term (multiple business cycles), obligations rated '★★★★★' should display average default frequencies of roughly ____ over ___ years. In addition, obligations rated '★★★★★' should be able to withstand periods of extreme stress (*i.e.*, equivalent to that of the Great Depression) without defaulting. Obligations rated '★★★★★' display extremely strong stability and should not become vulnerable to default within ___ years, under normal conditions.

The appeal of the compound definition is immediately apparent. It would offer users of ratings very specific benchmarks for understanding the nature of the rating opinion. However, such an approach cannot readily be implemented from a practical perspective. The shortcomings of each of the component simple paradigms combine rather than cancel each other out. The kind of analysis that rating agencies can do does not produce the kinds of specific estimates required for a compound definition of the type illustrated above. Credit analysis simply is not precise enough to do so. That is largely why the most widely used credit rating systems have evolved into systems of relative rankings.

b.   Real-world Rating Definition Systems: Relative Ranking

Each of three large .global credit rating agencies defines its rating system primarily as a system for *relative rankings* of creditworthiness. This reflects the practical balancing of what is most useful to investors and what credit rating agencies can reasonably deliver. Although each

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[4] In this regard, see Adelson, M., R. Ravimohan, C. Griep, D. Jacob, P. Coughlin, N. Bukspan, and D. Wyss, *Understanding Standard & Poor's Rating Definitions*, Standard & Poor's article (3 Jun 2009), Appendix V, Table 3.

of the three defines its ratings and its system somewhat differently, each focuses on relative rankings. For example, Standard & Poor's has stated:

Rank ordering of creditworthiness

Standard & Poor's credit ratings express forward-looking opinions about the creditworthiness of issuers and obligations… *More specifically, Standard & Poor's credit ratings express a relative ranking of creditworthiness.* Issuers and obligations with higher ratings are judged by us to be more creditworthy than issuers and obligations with lower credit ratings…

* * *

[W]hen we conduct studies to measure the performance of our ratings, we return to the touchstone of relative ranking of observed default frequency. We may measure and report on absolute default frequencies or on secondary factors, but our primary emphasis for performance measurement always remains the relative ranking of default frequency during any given study period.[5]

Likewise, Moody's rating definitions emphasize relative risk:

Moody's long-term ratings are opinions of the relative credit risk of financial obligations with an original maturity of one year or more. They address the possibility that a financial obligation will not be honored as promised. Such ratings use Moody's Global Scale and reflect both the likelihood of default and any financial loss suffered in the event of default.[6]

Other Moody's publications reinforce the point: "The purpose of Moody's ratings is to provide investors with a simple system of gradation by which *relative creditworthiness* of securities may be noted."[7] Moody's corporate default study addresses the matter in two ways. First, it emphasizes a performance measurement that focuses on the rank-ordering power of the rating system.[8] Second, it states directly that: "Moody's credit ratings are opinions of *relative* expected credit losses, which are a function of both the probability of default and severity of default (LGD)."[9]

Fitch also focuses on relative rankings. Its rating definitions state:

Fitch Rating Definitions
Understanding Credit Ratings — Limitations and Usage
* * *
Ratings are *relative measures of risk*; as a result, the assignment of ratings in the same category to entities and obligations may not fully reflect small differences in the degrees of risk. Credit ratings, as opinions on *relative ranking of vulnerability to default*, do not imply or convey a specific statistical probability of default, notwithstanding the agency's published default histories that may be measured against ratings at the time of default. Credit ratings are opinions on *relative credit quality* and not a predictive measure of specific default probability.

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[5] Adelson, M., R. Ravimohan, C. Griep, D. Jacob, P. Coughlin, N. Bukspan, and D. Wyss, *Understanding Standard & Poor's Rating Definitions*, Standard & Poor's article (3 Jun 2009).

[6] Moody's Investors Service, *Rating Symbols and Definitions* (Dec 2010) http://v3.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004 (accessed 31 Dec 2010).

[7] Moody's Investors Service, *About Moody's Ratings: Rating Definitions*, http://v3.moodys.com/ratings-process/Ratings-Definitions/002002, (accessed 31 Dec 2010) (emphasis added).

[8] Emery, K., S. Ou, and J. Tennant, *Corporate Default and Recovery Rates, 1920-2009*, Moody's special comment, at 10 (Feb 2010), http://v3.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_123042 (discussion of "rating accuracy metrics").

[9] Id. at 8 (emphasis added).

Credit Rating Scales

> Fitch Ratings' credit ratings provide an opinion on the *relative ability* of an entity to meet financial commitments, such as interest, preferred dividends, repayment of principal, insurance claims or counterparty obligations…

<p style="text-align:center">* * *</p>

> *Credit ratings express risk in relative rank order*, which is to say they are ordinal measures of credit risk and are not predictive of a specific frequency of default or loss.[10]

The common emphasis on rank ordering reveals the practical limitations of credit analysis. Credit analysis does not produce useful and reliable point estimates of "default probability" or "expected loss" in most cases. It produces something that is more coarse, yet still useful: rank ordering.

> c.   *Different Interpretations of Creditworthiness (Credit Quality)*

Although these three global credit rating agencies utilize rank ordering as the general theme for rating system design, they differ on what they rank. In other words, each defines creditworthiness or credit quality in its own way. For example, Standard & Poor's views "creditworthiness" as a multi-dimensional phenomenon:

> We view likelihood of default as the single most important dimension of creditworthiness. We place the greatest emphasis on rank ordering default likelihood in applying our rating definitions, in developing rating criteria, and in rating specific issuers and obligations.
>
> In addition, we place secondary emphasis on absolute likelihoods of default as part of how we strive for comparability of ratings. In an indirect way, our consideration of absolute default likelihood can be viewed as associating "stress tests" or "scenarios" of varying severity with the different rating categories. We do not expect to observe constant default frequencies over time; we expect observed default frequencies for all rating categories to rise and fall with changes in economic conditions.
>
> Beyond likelihood of default, we also consider secondary dimensions of creditworthiness: payment priority, recovery, and credit stability. Those can become critical elements of how we apply our rating definitions in developing criteria for particular situations.[11]

In contrast, as shown above, Moody's focuses on "relative expected credit losses." Meanwhile, Fitch's rating definitions refer to several elements, including "vulnerability to default" and "ability of an entity to meet financial commitments."

Other credit rating agencies also seem to embrace differing views of what constitutes creditworthiness. Kroll's rating definitions refer to an institution's "financial condition."[12] Realpoint's rating definitions state that they address "the ability of the collateral to support timely

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[10] Fitch Rating Definitions, http://www.fitchratings.com/creditdesk/public/ratings_defintions/index.cfm (emphasis added).

[11] Adelson, M., R. Ravimohan, C. Griep, D. Jacob, P. Coughlin, N. Bukspan, and D. Wyss, *Understanding Standard & Poor's Rating Definitions*, Standard & Poor's article (3 Jun 2009).

[12] Kroll Bond Ratings, *KBRASRS Rating Process*, at 6 (5 Nov 2010) ("KBRA Subscription Rating Service's Rating Symbols and Definitions," version November 1, 2010), http://lace.krollbondratings.com/Out/downloads/Exhibit-2.pdf. Recent articles in the press suggest that Kroll will take a take a somewhat different tack in its analysis than has been traditional. "Kroll Ratings Takes Aim at S&P, Fitch and Moody's," *The Wall Street Journal,* January 20, 2011; "Kroll on Fast Track to Ratings," *The Bond Buyer,* January 24, 2011. It would be incongruous, at the very time that evidence of the possibility for increased competition and fresh analytical approaches is emerging, to potentially squelch it by mandating a more standardized and systematized approach.

interest payments and to repay principal by the rated final distribution date according to the terms of the transaction and subject to the various qualifications, caveats and considerations enumerated in the respective ratings letters, pre-sale report, deal report and/or Realpoint's website at www.realpoint.com, including the 'Realpoint Analysis and Considerations' link on [the company's] website."[13]

Numerous publications inform market participants of the differing approaches of the rating agencies. For example, a 2000 working paper from the Basel Committee compiles the practices of roughly two dozen rating agencies from around the world, including, for each one, whether its approach leans more toward default frequency or expected loss.[14] Likewise, a 2003 report from Lehman Brothers states directly that "[u]nlike Moody's, which rates on the basis of expected loss, S&P rates on the basis of the probability of incurring a loss."[15] Later publications from the Bank for International Settlements (BIS) also highlight the point:

> Amongst credit market participants, it is well known that Moody's ratings are based on the concept of expected loss, while S&P and Fitch base their ratings on probabilities of default. Accordingly, the relevant result of an agency's credit risk analysis for a given tranche is ultimately mapped into an alphanumeric scale based on historical (EL or PD) data. As a result, PD and EL ratings provide investors with somewhat different information and should thus be expected to differ for some, if not many, products with multiple ratings. *The rating agencies, in turn, have always been careful to communicate to investors both the meaning of their ratings (i.e., whether the rating basis is EL or PD) and the methodologies used to assign them*.[16]
> [emphasis added]

More recently, an IMF publication highlighted the same point:

> S&P measures default risk in terms of default probability whereas Moody's ratings measure expected loss. Fitch rates issuers on a default probability basis and instruments on an expected loss basis. Hence, in theory, Moody's ratings should diverge from Fitch's and S&P on the same issuer according to variations in loss severity, as the expected loss can be approximated by the product of the default probability and expected loss severity.[17]

Even retail-oriented websites today describe the differing approaches of the larger global credit rating agencies in defining creditworthiness: "Standard & Poor's focus is on attachment probability, Moody's focus is on the expected loss and Fitch's focus combines both the attachment probability and the expected loss."[18]

The bottom line is: many investors both understand and also value the fact that the ratings from, for example, two different rating agencies do not represent two opinions about the same thing but rather two opinions about two different things. They benefit from receiving analysis that embodies more than one perspective or point of view. Having multiple ratings that

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[13] Realpoint, LLC, From NRSRO, Exhibit 2.A (3 Nov 2010) https://www.realpoint.com/PublicDocs/NRSRO%20Application.pdf.

[14] Estrella, A. et al., *Credit Ratings and Complementary Sources of Credit Quality Information*, Basel Committee on Banking Supervision Working Papers No. 3 at 15-16, 23-34 (Aug 2000), http://www.bis.org/publ/bcbs_wp3.pdf.

[15] O'Kane, D., et al., *The Lehman Brothers Guide to Exotic Credit Derivates*, Lehman Brothers research report, at 43 (2003), http://www.investinginbonds.com/assets/files/LehmanExoticCredDerivs.pdf.

[16] Fender, I. and J. Kiff, *CDO Rating Methodology: Some Thoughts on Model Risk and Its Implications*, Bank for International Settlements, BIS Working Papers No. 163, at 10-11 (Nov 2004) http://www.bis.org/publ/work163.pdf .

[17] International Monetary Fund, *Global Financial Stability Report – Sovereigns, Funding, and Systemic Liquidity*, at 88, n.2, (Oct 2010) http://www.imf.org/external/pubs/ft/gfsr/2010/02/pdf/text.pdf.

[18] *Credit Ratings–Investment Risk*, http://www.high-interest-deposits.com/credit-ratings.html (accessed 1 Jan 2011).

address different interpretations of creditworthiness allows market participants to have the benefits of more insights when they make important investment decisions. Rather than standardizing credit ratings terminology and practices, investors would be better served by requiring each credit rating agency to communicate clearly what its ratings mean and the methodology used to arrive at its ratings.

d.   Standardization of Rating Symbols

Because the nature of ratings agencies' opinions varies, as discussed above, the symbols should not be standardized. On the contrary, because the nature of their opinions varies, rating agencies should be encouraged to adopt distinctive symbols. As a practical matter, existing rating agencies may be loath to change their symbology, which may over time have come to be uniquely associated with a particular rating agency or group of rating agencies, and in which they may have certain intellectual property rights. However, new rating agencies should be encouraged to be distinctive in their choice of symbols.[19]

C.   Standardizing the Market Stress Conditions Under Which Credit Ratings Are Evaluated

Standard & Poor's uses a common set of general macro-economic stress scenarios as part of calibrating its criteria across different sectors. Standard & Poor's defines the scenarios broadly – by reference to GDP, unemployment, and equity markets.[20] Standard & Poor's does not use those stress scenarios as part of its analysis of individual issuers and obligations.

Standard & Poor's' analysis in certain sectors uses projections or forecasts of sector-specific economic factors, such as oil prices or population growth. For example, projected oil prices may be important for an energy producer or an airline, while population growth may be important for a school district. Given their diverse nature and the different factors that may be important from one situation to another, it would not be feasible or useful to develop standardized scenarios for the thousands of issuers and issues that we rate.

Additionally, different rating agencies may reasonably differ in how they associate industry- or sector-specific stress factors with macro-level stresses. Those differences reflect the fact that there can be more than one view as to what is likely to happen in the future and different professionals can form different analytical opinions as to which factors will play which role. As noted, this diversity of approach and opinion is an important market benefit. Indeed, were this diversity to be appreciably lessened through mandated standardization, it is possible that market participants would place greater reliance on credit ratings of any one credit rating agency than they do now, perceiving less opportunity for the ratings of different agencies to reflect differing analytical approaches. In effect, where diversity of opinion is diminished or eliminated, the weight accorded to those views that remain will, in all likelihood, be greater. It is even possible that some participants will equate standardization mandated by regulation as representing government endorsement of the standardized process. This result would seem at odds with the

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[19] Trademark and similar intellectual property rights exist in certain existing symbology under the laws of the United States and other jurisdictions. In standardizing any symbology, the Commission would need to take care to develop a program that does not violate those legal rights.

[20] Adelson, M., R. Ravimohan, C. Griep, D. Jacob, P. Coughlin, N. Bukspan, and D. Wyss, *Understanding Standard & Poor's Rating Definitions*, Standard & Poor's article (3 Jun 2009) (Appendix IV).

purpose underlying the requirement in Section 939A of the Dodd-Frank Act for government agencies to remove references to credit ratings from their regulations.

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D.   <u>Requiring a Quantitative Correspondence Between Credit Ratings and a Range of Default Probabilities and Loss Expectations Under Standardized Conditions of Economic Stress</u>

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As detailed above, the larger global credit rating agencies use relative ranking systems because it is impractical to adopt a quantitative correspondence between credit ratings and default probabilities or expected losses. As shown in a 2000 Basel Committee working paper, only a tiny minority of rating agencies around the globe at that time even attempted to achieve such a quantitative correspondence. The study names two that did so: LACE Financial in the U.S. and Upplysningscentralen AB (UC AB) in Scandinavia (LACE Financial has since been acquired by Kroll).[21]

Given the nature of ratings there are substantial pitfalls in trying to establish a forward-looking, quantitative correspondence between ratings and default probabilities. Model-based approaches may estimate probability of default, but we believe that in addition to quantitative factors, qualitative factors may need to be considered as well. Quantitative modeling can indeed be a useful tool in credit analysis, but there are inherent limitations to the use of formulaic approaches in an environment that is not ruled solely by those formulas.

Meaningful analysis must recognize the dependence on the macro environment, which means that any notion of absolute (*i.e.*, unconditional) default probability cannot be achieved. However, as noted above, even assessing default probabilities conditional on specific scenarios is unrealistic in that it both (i) connotes a false precision and (ii) marginalizes other dimensions of credit quality. Other factors, such as payment priority, recovery and credit stability, can significantly influence creditworthiness, and our ratings and research reports emphasize the importance of considering those factors when assessing creditworthiness.

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E.   <u>Standardizing Credit Ratings Terminology Across Asset Classes, so That Named Ratings Correspond to a Standard Range of Default Probabilities and Expected Losses Independent of Asset Class and Issuing Entity</u>

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Standard & Poor's strives to make its rating symbols reflect a broadly comparable view of creditworthiness wherever they appear. Standard & Poor's believes that maximizing comparability makes Standard & Poor's' ratings more useful to investors. Thus, when Standard & Poor's assigns a given rating symbol to multiple issuers, it intends to connote roughly the same opinion of creditworthiness, irrespective of whether the issuers are a Canadian mining company, a Japanese financial institution, an Illinois school district, a British mortgage-backed security, or a sovereign nation.[22]

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[21] Estrella, A. et al., *Credit Ratings and Complementary Sources of Credit Quality Information*, Basel Committee on Banking Supervision Working Papers No. 3 at 23-34 (Aug 2000), http://www.bis.org/publ/bcbs_wp3.pdf.

[22] Adelson, M., R. Ravimohan, C. Griep, D. Jacob, P. Coughlin, N. Bukspan, and D. Wyss, *Understanding Standard & Poor's Rating Definitions*, Standard & Poor's article (3 Jun 2009).

While each credit rating agency should pursue such comparability in our view, we do not believe that mandating standardized ratings terminology across rating agencies furthers this goal. Rather, for reasons stated above, such standardization is not desirable and ultimately would reduce the usefulness of credit information provided to the market by rating agencies.

F.   <u>Standardizing Rating Symbology, Rating Definitions,</u>
           <u>or Analytic Practices Such as Stress Testing Would</u>
           <u>Be Contrary to the Intent of Section 15E(c)(2) of the Exchange Act</u>

It would also be difficult, if not impossible, to reconcile standardized ratings symbology, ratings definitions, or analytical practices such as stress testing with existing law. Specifically, Section 15E(c)(2) of the Exchange Act provides that:

> The rules and regulations that the Commission may prescribe pursuant to this chapter, as they apply to nationally recognized statistical rating organizations, shall be narrowly tailored to meet the requirements of this chapter applicable to nationally recognized statistical rating organizations. Notwithstanding any other provision of this section, or 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 nationally recognized statistical rating organization determines credit ratings.* [emphasis added]

This provision recognizes not only that different rating agencies may employ different methodologies, but also that this diversity of approaches is important to the market and must be preserved. This principle is sometimes referred to as "analytical independence" and it is fundamental to the value ratings bring to the market. Ratings analysts must be free to make their own judgments about items such as, for example, the appropriate level of stress testing to apply. Regulations that call for "identical" ratings definitions and analytical assumptions would, by definition, undermine that independence and the diversity of views the Credit Rating Agency Reform Act of 2006 sought to ensure and could very well run afoul of the statutory prohibition against such regulation.

Attempts to compromise analytical independence in the U.S. could also conflict with requirements elsewhere—the European Union, for example—to protect analytical independence by avoiding substantive regulation of methodologies and ratings.

G.   <u>Standardizing Rating Symbology, Rating Definitions,</u>
           <u>or Analytic Practices Such as Stress Testing Would Be</u>
           <u>Inconsistent with the First Amendment and the Protections</u>
           <u>Afforded Ratings Agencies Under It</u>

Regulatory mandates concerning what ratings must mean and how credit rating agencies must go about their work would also raise serious First Amendment concerns.

Ratings are expressions of opinion and courts across the country have repeatedly recognized that rating agencies that publish those ratings are entitled to the full protections of the First Amendment.

These judicial holdings make sense. There is no doubt that commentary about the issuers of publicly traded securities speaks to matters of public concern. For example, there is no doubt that if *The New York Times* offers an editorial opinion about the financial condition of

Greece or the State of California, that opinion is protected by the First Amendment. Just as surely, a rating agency's opinion to the same effect is entitled to the same protection. Nor are these protections limited to the realm of public finance issuers. Courts have similarly applied First Amendment protections to ratings on corporate issuers and structured finance ratings.

Any other result could dramatically "chill" the free exchange of views in the market and provide incentives for rating agencies to substitute their best opinions for ratings less likely to provoke litigation and/or regulatory censure.

Regulations that mandate how rating agencies should "define" their ratings and go about generating them would likely run afoul of these principles. The very essence of the First Amendment is that the speaker, not the government, should determine the content of the speech. In this context, that means that rating agencies should be the ones determining what their own ratings mean, how they go about developing them, and what they publish concerning them.

H.   Measures Required by Other Provisions of the
Dodd-Frank Act Will Effectively Address the
Concerns Sought to Be Addressed by Standardization

Underlying Congress's intention in having the Commission perform the study that is the subject of this Comment Request is the desire to make it easier for the users of credit ratings to understand their meaning and the manner in which they are derived. In large part, this goal can be met through regulations that other provisions of the Dodd-Frank Act require the Commission to adopt.

Perhaps most significant in this regard is the provision in Section 938(a) that the Commission adopt regulations to require each NRSRO to establish, maintain and enforce policies and procedures to clearly define and disclose the meaning of any ratings symbol and apply the symbol consistently for all instruments for which the symbol is used. As noted earlier, we believe that investors and market participants generally will be better served not by the use of one set of rating symbols by all NRSROs, but by a clear understanding of what the ratings of each credit rating agency signify and the manner in which they were determined. In this latter regard, Section 932(a)(8) requires the Commission to prescribe rules that require each NRSRO to ensure that ratings are determined using procedures and methodologies that are approved by the NRSRO's board of directors in accordance with the policies and procedures for the adoption of such procedures and methodologies. Further, when material changes to rating procedures and methodologies occur, they must be applied consistently to all ratings to which they apply, and the reason for the change must be publicly disclosed.

Further measures within Section 932(a)(8) will require enhanced disclosure of ratings performance and methodologies. Among other things, to allow assessment of accuracy and establish comparability across NRSROs, the Commission must issue rules to require each NRSRO to publicly disclose performance information on initial credit ratings and any subsequent changes. In addition, to enhance the transparency of rating methodologies, the Commission is directed to issue rules requiring each NRSRO to prescribe a form to accompany the publication of each rating disclosing specified information, including assumptions underlying procedures and methodologies, data relied upon to determine the rating, and, if applicable, how servicer or other reports were used in the rating process. The form must be easy to use and directly comparable across types of securities.

These provisions are all intended to result in increased transparency of the rating process and improve investor understanding of how credit ratings are determined and what they mean. To the extent the regulations that are proposed and ultimately adopted achieve their goals, they would obviate the need for standardization, with its inherent shortcomings.

I.   Conclusion

For the reasons set forth above, Standard & Poor's believes that it is neither wise nor desirable to (A) standardize credit ratings terminology, so that all credit rating agencies issue credit ratings using identical terms; (B) standardize the market stress conditions under which ratings are evaluated; (C) require a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations under standardized conditions of economic stress; or (D) standardize credit ratings terminology across asset classes, so that named ratings correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity. In addition, any decision to do so would be contrary to both Section 15E(c)(2) of the Exchange Act and the First Amendment.

If you have any questions or need additional information, please contact me or Rita Bolger, Senior Vice President and Associate General Counsel, Global Regulatory Affairs, at (212) 438-6602.

Sincerely yours,
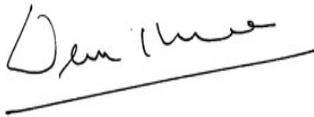
Deven Sharma
President
Standard & Poor's

cc: Hon. Mary L. Schapiro, Chairman
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