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By Electronic Mail

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

Re: Credit Rating Standardization Study – Release No. 34-63573; File No. 4-622 (the "Request for Comment")

I. Introduction

Moody's Investors Service ("**MIS**") appreciates the opportunity to provide comments to the Securities and Exchange Commission ("**SEC**") in response to its Request for Comment. We understand that section 939(h) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") requires the SEC to conduct a study (the "**Study**") of the feasibility and desirability of:

- Standardizing credit ratings terminology, so that all credit rating agencies ("**CRAs**") 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.

MIS's preeminent objective is to provide high quality, forward-looking credit opinions that users of our ratings find credible and useful. We frequently solicit feedback from those who use our ratings, including market participants and regulators, and we welcome the healthy dialogue about the role and use of ratings that the SEC is facilitating through the Study. In this comment letter, we believe that the most useful contribution we can make to that dialogue now is to describe our approach to credit ratings, identify what we consider to be the key attributes of ratings that users value, and then suggest several, over-arching factors for the SEC to consider in conducting the Study. In summary, we suggest that, in addition to assessing the feasibility of standardizing aspects of ratings, the SEC consider the following factors:

- Would standardization pose a threat to financial stability?
- Would standardization promote ratings quality for the protection of investors and in the public interest?
- Would standardization encourage over-reliance on ratings?

- Would standardization requirements directly or indirectly interfere with CRAs' independence?
- Could some or all of the perceived benefits of standardization be achieved through other means?

II. MIS Credit Ratings and the Value of Ratings in the Financial System

To meet market needs over time, credit ratings have developed important attributes including insightful, robust and independent analysis, symbols that succinctly communicate opinions, and broad coverage across markets, industries and asset classes. These attributes have enabled credit ratings to serve as a point of reference and common language of credit that is used by financial market professionals worldwide to compare credit risk across jurisdictions, industries and asset classes, thereby facilitating the efficient flow of capital worldwide.

MIS's credit ratings are forward-looking opinions about credit risk. They address the probability that a financial obligation will not be honored as promised (*i.e.*, probability of default, or "**PD**"), and any financial loss suffered in the event of default. Our analysis of these two factors together forms the basis of MIS's expected loss ("**EL**") approach to credit risk. Obligations rated on MIS's global rating scale measure long-term credit risk, and our analytical focus is on the key factors that drive each issuer's ability over the long term to meet its obligations as they come due.

Generally, our rating system is a relative (or ordinal), rather than an absolute (or cardinal) ranking system. In other words, rather than assigning a specific EL (or EL range) to an obligation, we are communicating through our ratings that we believe an MIS-rated Aaa obligation likely has a lower EL than one rated Aa1, which we believe has a lower EL than one rated Aa2, and so on down the rating scale.

Some people may believe that MIS ratings are the product of a quantitative model. This is absolutely and categorically wrong. While we use quantitative models to assist our analysis and enhance consistency in our decision-making, our ratings take into account qualitative as well as quantitative factors and are intended to reflect the exercise of judgment about the expected creditworthiness of an obligation or entity. Our ratings cannot be reduced to an output from a formulaic methodology or model. They are determined by committees, with each member being expected to apply his or her judgment to the decision-making process. Ultimately, ratings are subjective opinions that reflect the majority view of the committee's members.

MIS also supplements its long-term ratings with additional credit signals that provide information on our developing views on credit risk, either for a specific issuer/obligation or a sector. For example, MIS may assign an Outlook (Positive, Stable or Negative) to a rated obligation to indicate our view of opinion regarding the likely direction of an issuer's rating over the medium term. A rating will be placed on the Watchlist to indicate that the rating is on review in the short term for upgrade, downgrade or occasionally with "direction uncertain". These signals reflect our opinions about credit. They are not statements of fact that are suitable for standardization across the CRA industry.

Other CRAs may take a different overall approach to determining credit ratings. For example, some CRAs' principal rating systems focus only on PD. CRAs also may differ with respect to how much they emphasize predictiveness in their ratings over the shorter term versus the longer term. These differences may reflect preferences expressed by users of their ratings regarding the importance of ratings "accuracy" (*i.e.*, responsiveness to new information about creditworthiness, even if that new information does not reflect enduring change) and "stability". These and other variations in approach reflect the

reality that users of credit ratings are not homogenous and may have different views as to which rating approach is most useful to them.

Moreover, we believe that many users of ratings value diverse perspectives, which collectively can provide more comprehensive and deeper insight into questions about credit. Similarly, both Congress and the SEC have taken steps to promote competition in the CRA industry as a means to increase dissemination of diverse opinions in order to enhance ratings quality. As a consequence of both market demands and these regulatory expectations, CRAs compete with each other to provide the most predictive, high quality and useful credit opinions to the market.

To compete in financial markets, MIS's rating systems and methodologies have evolved over time in response to the increasing depth and breadth of the global capital markets and interests of users of our ratings. For example, in the area of structured finance, we have introduced two new risk measures for structured finance instruments: V Scores and Parameter Sensitivities. V Scores address the degree of uncertainty around the assumptions that underlie our structured ratings. Although MIS's credit ratings already emphasized expected lifetime credit loss rates, V Scores are designed to signal to users of our credit ratings which types of structured finance securities have greater exposure to data limitations and modeling assumptions. Parameter Sensitivities address the sensitivity of MIS's Credit Ratings to changes in our key assumptions, and are designed to measure how the initial rating of a security might have differed if key rating input parameters were varied. For our Parameter Sensitivity analyses, MIS analysts identify the key rating input parameters that are relevant for a particular asset class or sub-class in light of MIS's applicable methodology or methodologies. The factors that we stress in our analysis are, therefore, derived from our rating methodologies. Other CRAs may have different views on what constitute the key rating drivers for a particular asset class.

For our fundamental, long-term credit ratings, MIS incorporates into our credit rating opinions an assessment of the key rating drivers and our opinion about what could cause the rating to move up or down. As in the area of structured finance, the identification of key rating drivers is tied to our methodologies. For both our structured and fundamental credit ratings, MIS's credit opinions take into account a common, central macro-economic scenario and alternative risk scenarios that are developed by MIS's Macro-Economic Board on a semi-annual basis.

In the interests of transparency, MIS makes publicly available for free detailed descriptions of our various rating symbols, our rating methodologies, and a wide range of rating performance studies. These publications equip market professionals, the intended users of our ratings, with the relevant information to understand our ratings approach and compare our approach and the performance of our ratings with those of other CRAs.[1] Consistent with the SEC's rules, we also make rating history data available in XBRL format so that users can use the raw data to conduct their own analyses of our ratings' performance.

III. Suggested Factors for Consideration in the Study

As the SEC proceeds with the Study, we suggest that it consider the following factors in its analysis of whether it is desirable to standardize certain aspects of credit ratings.

[1] See, *e.g.*, *Moody's Guide to Default Research: January 2011 Update* (Doc. 129977).

Would standardization pose a threat to financial stability?

This Study is mandated by the Dodd-Frank Act, whose core purpose is the promotion of financial stability. MIS believes, therefore, that the most important factor to be considered in the Study is whether standardization would adversely affect financial stability.

In our view, mechanistic reliance on any measure of credit risk so that a near-automatic response is triggered among market participants when there is a change in the risk measure increases the potential for negative market dynamics and system-wide disruption. This can happen, for example, where ratings-based requirements in regulation require or motivate regulated market participants to dispose of particular investments when the ratings on those investments are downgraded.

This type of reaction could be exacerbated if CRAs are required or motivated to homogenize their rating approaches. In our view, rules requiring standardization along the lines outlined in the Request for Comment would reduce diversity of rating opinions across CRAs. This is because standardization of terminology, of stress conditions under which ratings are evaluated, or of PD or EL ranges associated with specific ratings, likely would motivate CRAs to reach the same or similar opinions. For example, if the SEC prescribes standard market stress conditions under which ratings are to be assessed, CRAs might be less inclined to invest resources in developing their own stress scenarios.

We believe that homogenization of rating opinions will significantly increase the risk of system-wide disruption, since there will be a greater likelihood that different CRAs' ratings will move in lockstep. In response, market participants that use different CRAs' ratings, either for regulatory purposes or in portfolio or investment guidelines, could be motivated to respond in a similar fashion as the different CRAs' ratings move at the same time in the same direction.

In times of crisis, the phenomena of market movements driven by "herd instinct" and "group thinking" are often prevalent. At times like these, it is particularly important for diverse opinions to be disseminated in the market to counteract these tendencies. Any regulatory measures that directly or indirectly reduce diversity of opinions could lead to credit ratings that exacerbate, rather than serve as a counterweight against, these destabilizing market movements.

Would standardization promote ratings quality for the protection of investors and in the public interest?

Under the Credit Rating Agency Reform Act of 2006 ("**2006 Act**"), the SEC is authorized to adopt and enforce rules for the regulation of Nationally Recognized Statistical Rating Organizations ("**NRSROs**") "To improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency and competition" in the CRA industry. Under the 2006 Act, the ultimate goal is ratings quality, the beneficiaries of that goal are investors and the public interest, and the means to achieve the goal are accountability, transparency and competition. Those means, however, should not become ends in themselves. In other words, if measures would, for example, enhance competition based on factors other than ratings quality, we believe this would not be consistent with the 2006 Act.

We believe that rules requiring standardization along the lines outlined in the Request for Comment could adversely affect ratings quality to the detriment of investors and the public interest in various ways. First, as we discussed above, we believe that these types of standardization would reduce

diversity in the *substance* of CRAs' rating opinions. To the extent regulation requires or encourages CRAs to share the same opinions, users of ratings will be less inclined to dispute or disagree with that common opinion. If no one challenges CRAs with respect to their opinions, the incentives for CRAs to compete with each other based on the quality of their analysis would be weakened.

Second, reducing the diversity of rating opinions could adversely affect market discipline and efficiency. MIS believes that the expression of different opinions by CRAs and other commentators on credit risk stimulates dialogue and debate. This marketplace of competing ideas enhances the ability of market participants to comprehensively identify and evaluate for themselves all of the relevant factors affecting credit risk. This in turn leads to better informed judgments by these market participants, thereby contributing to market discipline and the efficient allocation of capital. To the extent regulatory measures directly or indirectly reduce the diversity of rating opinions, we believe that investors will be adversely affected by the reduction in market discipline and efficiency.

Third, requiring CRAs to standardize aspects of their rating systems and analysis could discourage CRAs from developing approaches that they believe serve different parts of the investor universe. For example, some investors might want a "through the cycle" credit rating, while others might want a "point in time" rating. Some investors might want credit ratings based on PD, while others might want ratings based on EL, and some investors might want to use both types of ratings. Some might want rating systems that minimize rating reversals, while others might not care. A government-prescribed "one-size-fits-all" approach certainly will fail to meet some investors' needs.

Fourth, any prescribed, quantitative correspondence between credit ratings and a range of default probabilities or expected losses would produce a simplistic measure. This is because establishing a single quantitative interpretation is difficult. The only way to do so would be to choose something very simple, such as a five year expected loss rate. Such a definition would miss a myriad of considerations that arise naturally in the rating process, such as the goal of balancing default and loss risk at multiple horizons. Moreover, a single-dimensioned definition likely would underemphasize ratings stability, which many investors value. Greater ratings volatility also could adversely affect the stability of the financial system.

Fifth, government-mandated standardization could limit CRAs' ability to respond to new developments in the market. This is because regulation will always lag the market to some extent.

Finally, to the extent differences remain with respect to CRAs' overall rating approaches or specific rating methodologies, standardization of terminology could inadvertently create the impression for investors that CRAs share the same opinion or approach. We believe that this result would not be consistent with the SEC's overall mandate of investor protection.

Would standardization encourage over-reliance on ratings?

In requiring federal agencies to study how ratings are used in their regulations and rules and consider whether alternatives to ratings-based measures should be adopted, Congress has taken steps to discourage over-reliance on ratings. MIS has long supported initiatives to reduce the risk of over-reliance on ratings and encouraged users of our ratings to treat use them as just one of various inputs in their decision-making process.[2]

[2] See, e.g., *MIS Comment Letter on the Office of Thrift Supervision's Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of External Credit Ratings* (Nov. 15, 2010); *MIS Comment Letter on the*

We believe, therefore, that one of the key considerations in the Study is whether standardization would be more or less likely to motivate users of ratings to over-emphasize ratings or use them for purposes for which they are not intended (*e.g.*, as a gauge of risks other than credit risks). In our view, a regulatory framework that standardizes key components of ratings could inadvertently encourage market participants to see different CRAs' ratings as a government-sanctioned, homogeneous product. If market participants perceive ratings as a government-sanctioned tool, they are more likely to use credit ratings as a substitute for their own credit risk assessment. If market participants perceive ratings as interchangeable, they are less likely to consider carefully whether or not the rating system serves their purposes, which could lead to the use of ratings for purposes for which they are not intended. This potential outcome seems contrary to current efforts to reduce over-reliance on ratings.

Would standardization requirements directly or indirectly affect CRAs' independence?

MIS believes that market participants and policymakers want credit ratings to reflect CRAs' independent opinions about credit risk. A CRA's credibility depends on the quality *and* the independence of its opinions and rating process. We believe that markets benefit when we arrive at our opinions through a rigorous and objective review of the information we consider to be relevant to our assessment of credit risk. The 2006 Act highlights the importance of CRA independence in the rating process by, among other things, prohibiting the SEC from regulating the substance of credit ratings or the procedures and methodologies by which NRSROs determine credit ratings.

MIS believes that rules requiring standardization along the lines described in the Request for Comment likely would interfere with the independence of the rating process by regulating the substance of rating opinions and methodologies. For example, if CRAs are required to use the same market stress scenarios, this could require them to based their ratings on factors that they do not consider most relevant to the rating in question. Likewise, if CRAs are required to use the same symbol system for different types of obligations, this could interfere with their view that credit ratings for these different types of obligations mean different things and therefore should be rated using different systems of symbols. Similarly, if all CRAs are required to adopt a common definition of credit risk (*e.g.*, to have their ratings express an opinion about probability of default, rather than an opinion about expected loss), this could interfere with the choice CRAs make about which type of credit risk measure is most relevant for their users.

We acknowledge that it would be possible for Congress to modify the applicable legislation to authorize the SEC to regulate NRSROs in this way. We believe, however, that it would be inconsistent with the overall purpose of the 2006 Act and erode a core attribute of ratings valued by the market and regulators.

Could the potential benefits of standardization be achieved through other means?

The Request for Comment does not state explicitly what the underlying regulatory purpose of standardizing credit ratings would be. It can be inferred from a number of the specific questions in the

Banking Regulators' Request for Comment re Alternatives to the Use of External Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies (Oct. 25, 2010); *MIS Comment letter re SEC's Proposed Amendments to Certain Rules and Forms Governing Money Market Funds* (Sept. 8, 2009); *MIS Comment Letter on SEC's Proposals Regarding References to Ratings of NRSROs* (Sept. 5, 2008).

Request for Comment, however, that some people may believe that it is difficult for market participants to compare the opinions and rating systems of different CRAs, and this may be perceived as affecting the usability of ratings or users' ability to evaluate the performance of different CRAs. MIS believes that the Study, which will collect information from users of ratings and market commentators on this point, will be very helpful as MIS continually seeks to improve the quality and relevance of its rating systems and ratings.

MIS suggests that the SEC may also wish to consider whether there are existing or potential alternatives to standardization that could enhance users' ability to evaluate the performance of CRAs' ratings and their ability to use ratings as one of several tools in their decision-making processes. For example, various transparency measures can facilitate the evaluation of CRAs' rating performance and improve users' ability to determine whether a particular rating system or opinion is useful to their credit analysis. On our own initiative and in response to the evolving expectations with market participants and policymakers, we have significantly increased the amount of information we make available about specific ratings, the meaning of our rating systems, our rating methodologies, and the aggregate performance of our ratings. Much of this information is available to the public for free. We believe that this information enables professional market participants to develop a thorough understanding of our approach to credit ratings, the rating rationale for specific rating actions, and how our ratings perform in the aggregate. This information also can help users of our ratings compare our approach to ratings and specific rating opinions with other CRAs' approaches and opinions. Transparency measures like these, therefore, help to foster competition based on quality in the CRA industry without intruding upon the independence of CRA decisions.

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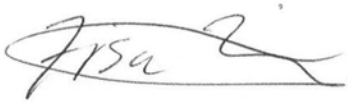
As stated earlier, we support the SEC's efforts, through the Study, to promote dialogue and debate among market participants, CRAs, market commentators and others about the potential benefits and disadvantages of standardization of ratings. We appreciate the opportunity to comment on the Study. We would be pleased to discuss our comments further with the SEC or their staff.

Sincerely,



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