United States Senate
WASHINGTON, DC 20510

September 14, 2011

Submitted via email
The Honorable Mary L. Schapiro
Chairman
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Comments on Assigned Credit Ratings; File Number 4-629.

Dear Chairman Schapiro:

We write today to convey our support for the implementation of the Franken-Wicker amendment on assigned credit ratings. While we recognize the SEC's efforts to improve the credit rating agency industry under its recent proposed rule,[1] the provisions in this proposed rule do not get at the industry's root problem—the conflict of interest inherent when an issuing institution directly negotiates to purchase a credit rating from a Nationally Recognized Statistical Rating Organization (NRSRO). Only the Franken-Wicker amendment, or a similar alternative, will restore integrity to the credit rating agencies and ensure that, going forward, the industry is driven by accuracy and competition.

I. Conflicts of Interest Fostered Inaccurate Ratings

Credit ratings are intended to serve as an indicator of a financial product's creditworthiness. Investors, such as pension fund or university endowment managers, use these credit ratings to make investment decisions, generally opting for "investment-grade" products—those rated AAA to BBB-. Products that carry a great deal of risk are labeled "below investment grade," or simply "junk." Products that receive an investment grade rating, predictably, have a much broader market in which to sell. Thus, issuers of securities are under pressure to secure the highest rating possible, regardless of the riskiness of their product. The current system necessitates that issuers directly purchase credit ratings from the rating agencies. Consequently, the issuers, with incentives to secure top ratings, have pressured the credit rating agencies to award them AAA ratings. The issuers hold a valuable bargaining chip—if a rating agency does not give them the rating they want, they can go to a competitor and give them their lucrative business instead. This is known as "ratings shopping." The credit rating agencies, of course, could have chosen to ignore their threats and issue ratings based on sound analysis. Instead, the credit raters put profits ahead of integrity and caved to the issuers.

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[1] Securities and Exchange Commission, Proposed Rules for Nationally Recognized Statistical Rating Organizations, Release No. 34-64514 (June 8, 2011), 76 Fed. Reg. 33420-01.

A report issued by the Senate Permanent Subcommittee on Investigations (PSI), released after a lengthy investigation, revealed a 2004 email from an S&P manager to a colleague that illustrates the ratings shopping problem:

> "We are meeting with your group this week to discuss adjusting criteria for rating CDOs of real estate assets this week because of the ongoing threat of losing deals."[2]

A 2006 email from an S&P employee who had become frustrated with the company's blind dependence on the issuers is also illustrative:

> "They've become so beholden to their top issuers for revenues they have all developed a kind of Stockholm syndrome which they mistakenly tag as Customer Value creation."[3]

This flawed system, in which issuers are pursuing the highest rating possible but are also the source of revenue for ratings agencies, created a market in which accuracy was discouraged and competition was stifled. It should come as no surprise that a market analogous to a student buying his grades has produced dismal results.

In an April 23, 2010 PSI hearing, credit rating agency executives admitted that ratings shopping occurred during the lead-up to the financial crisis, and that it persists.[4]

II. Flawed Ratings Played Central Role in the Great Recession

This flawed system is not problematic simply because it is unethical. More importantly, its role in the recent financial crisis had widespread, devastating consequences for the entire economy. Between 2004 and 2007, the two largest rating agencies gave top ratings to the vast majority of residential mortgage-backed securities (RMBS) and collateralized debt obligations (CDO) even though these instruments were based on sub-prime and risky mortgages. Investors took the ratings at face value, and purchased these risky products for pension funds and university endowments without conducting further due diligence. During this period, more and more of these risky loans began to go delinquent. Emails uncovered by the PSI revealed that executives and analysts at the credit rating agencies saw the trouble brewing in the mortgage markets, but continued to give top ratings to risky instruments.[5] The Financial Crisis Inquiry Committee concluded that "the failures of the credit rating agencies were essential cogs in the wheel of financial destruction. . . [and] were key enablers of the financial meltdown."[6]

If there is any doubt that inflated ratings ran rampant in the lead-up to the crisis, consider this: of the thousands of mortgage-related securities rated by Moody's in 2006, 83 percent of those rated AAA were ultimately downgraded. The impact of these inflated ratings, and their subsequent

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[2] U.S. SENATE, PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE 276, (2011) *citing* 8/17/2004 email from S&P manager, "RE: SF CIA: CDO methodology invokes reactions," Hearing Exhibit 4/23-3 [emphasis removed].

[3] *Id.* at 277.

[4] *Id.* at 287-288.

[5] *Id.* at 268-270.

[6] FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT, xxv(2011).

mass downgrades, was far-reaching. CalPERS, on which one and a half million Californians rely for their pension and health benefits, estimated it lost $1 billion.[7] It is estimated that pensioners in Ohio lost about half a billion dollars.[8] The direct effect of these mass credit downgrades on retirement savings nationwide is almost certainly in the tens of billions of dollars. As a result of the financial collapse more broadly, Americans' retirement savings saw losses of about $2 trillion.[9]

III. The Franken-Wicker Amendment

a. Credit Rating Agency Board

While Dodd-Frank and the Credit Rating Agency Reform Act both gave the SEC as yet under-utilized authority to address conflicts of interest, the Franken-Wicker amendment is the only proposal included in the Dodd-Frank Act that gets at the root of the problem—the inherent conflicts of interest in the issuer-pays system. The Franken-Wicker amendment would reduce the conflicts of interest, eliminate ratings shopping for initial ratings, encourage the market to reward accuracy, and promote competition. The Franken-Wicker amendment would fundamentally reform the industry and break up its oligopoly, but does not seek to eliminate the credit rating industry. Once the market is functioning properly, incentives will be aligned to promote quality ratings and increase competition. The credit rating industry could once again play a valuable role in our financial sector.

The Franken-Wicker amendment uses a simple solution: create an independent, self-regulatory board to administer a system in which issuers are assigned a credit rating agency to provide an initial rating. NRSROs could opt-in in to this system, and apply to become a qualified NRSRO (QNRSRO), which would allow them to participate in the assignment process. The process would not be "random." The board could consider things like institutional capacity, expertise, and track record in developing its assignment system. For example, the board could determine that a certain set of QNRSROs are qualified to rate a particular subset of securities, and another set of QNRSROs are qualified to rate a different subset. The board would not randomly assign a large, complex, sophisticated structured finance product to a newly registered QNRSRO with limited expertise for that type of product. The amendment also permits a selected NRSRO to refuse to rate a product. The Franken-Wicker amendment does not affirmatively prescribe the criteria that should be used in its assignment system, but does prohibit issuer preference as one of those criteria.

The majority of the board would be comprised of investors but also include representatives from the credit rating industry, the issuer industry, and at least one independent member. The initial members of the board would be selected by the SEC, but the board would develop a selection

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[7] Complaint at 21-23, Cal. Pub. Employees' Retirement Sys. v. Moody's Corp., Nos. C 09-03628 SI, C 09-03629 JCS, 2009 WL 3809816 (N.D. Calif. Nov. 10, 2009).

[8] Complaint at 65-70, Ohio Police & Fire Pension Fund v. Standard & Poor's Fin. Servs., (S.D. Ohio 2009).

[9] Statement of Peter R. Orszag, Director, Congressional Budget Office, before the House Committee on Education and Labor, *The Effects of Recent Turmoil in Financial Markets on Retirement Security* (October 7, 2008).

process for subsequent members. Because a majority of members would represent the investor community, which wants AAA bonds to perform as AAA bonds, the board would have an incentive to develop an assignment system that best promotes quality ratings. To promote transparency, the Franken-Wicker amendment requires that the board publish its assignment methodology.

The Franken-Wicker amendment applies only to initial ratings, and does not affect non-initial ratings or unsolicited ratings. Also, it applies only to structured finance products, which is the most problematic category of products handled by the rating agencies. The amendment would have no effect on the government or corporate bond market.

Finally, the Franken-Wicker amendment makes clear that a rating received through the assignment system has not been "evaluated, approved or certified by the Government of the United States or by a federal agency." Any undue consideration given to a rating received through the assignment system would be in direct contravention of the amendment's legislative language.

b. Eliminating Conflicts of Interest Will Increase Competition

The SEC recently estimated that, based on the credit rating agencies' filings, approximately 94 percent of the outstanding credit ratings for structured finance products were determined by the three largest NRSROs.[10] That means that the other seven NRSROs are battling for the remaining six percent of the market.

However, the current issuer-pays model and its inherent conflicts of interest make true competition in this industry nearly impossible. When asked about the Franken-Wicker amendment's effect on competition, researcher James Lardner said that it "lays the foundation for a ratings market in which competitive forces support diligence, accuracy, and a sense of duty to the purchasers (rather than just the issuers) of debt securities. The only kind of competition it would discourage is the kind we have seen too much of – in which the goal is to attract more business by giving out more generous ratings."[11]

The board is granted authority to adjust assignments based on proven track records of accuracy. When the market begins to reward quality ratings, the smaller rating agencies will have an opportunity to compete by producing a track record of quality ratings. Of course, these track records would take time to develop. But, over time, it would be possible to effectively judge NRSROs on track records of accuracy.

Finally, a little-noticed provision in the Franken-Wicker amendment instructs the board to issue a report to Congress, within five years of beginning to assign ratings, with its recommendations regarding the continuation of the board, and modifications to the procedures of the board or

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[10] Securities and Exchange Commission, Solicitation of Comment to Assist in Study on Assigned Credit Ratings, 76 Fed. Reg. 28265, 28267 (May 16, 2011).

[11] James Lardner, *The Ratings Agencies and The Franken Amendment*, DEMOS, June 1, 2010, http://www.demos.org/publication.cfm?currentpublicationID=F68A14B1-3FF4-6C82-51CF8955309A97FD.

provisions in the authorizing language. The Franken-Wicker amendment recognizes that the industry may shift in a way that necessitates fundamental changes in the board's operations, or the discontinuation of the board itself.

IV. Response to Specific Requests for Comment

a. Unique Character of Structured Finance Products

The SEC's solicitation for comment asked whether there were differences between structured finance products and other products, and whether those differences warranted a separate system for assignment of ratings. The Franken-Wicker amendment seeks to limit government involvement in any area beyond that which is necessary to protect the public from risky industry practices. Evidence suggests oversight is most needed in the structured finance sector, so the Franken-Wicker credit rating agency board's assignment process is mandatory only in the structured finance sector.

The problems that plagued the ratings of structured finance products were distinct from other sectors of the bond market. Alan Blinder theorizes that "part of the answer is that the securities, especially the now-notorious C.D.O.s, for collateralized debt obligations, were probably too complex for anyone's good."[12] That complexity made the ratings process more opaque to outside observers, and therefore less accountable. Illegitimate "adjustments" to ratings by the agencies could be more easily concealed.

Second, the problem of client concentration is more potent in the structured finance sector. While the top six underwriters of asset-backed securities controlled over 50 percent of the market, accounting for thousands of transactions, in the corporate bond sector, no single client accounted for more than 1 percent of a particular credit rating agency's business.[13]

Finally, there is evidence that ratings inflation is more pervasive in the structured finance sector than the corporate sector. At least one study points out that corporate bond downgrades during the 2000 to 2001 recession averaged a downgrade of -1.8 notches. This indicates that the ratings were "well-calibrated" to the bonds' underlying risk. Structured finance products in 2007 and the first part of 2008, however, averaged downgrades of -4.7 and -5.8 notches, respectively. The data suggest that "the initial distribution of structured finance credit ratings was inflated."[14]

Therefore, we maintain that the scope of the Franken-Wicker credit rating agency board remains limited to structured finance products.

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[12] Alan Blinder, *Six Fingers of Blame in the Mortgage Mess*, N.Y. TIMES, Sept. 30, 2007.

[13] Enhancing Investor Protection and the Regulation of Securities Markets: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 110th Cong. 28 (Mar. 10, 2009)(testimony of Professor John C. Coffee, Jr.).

[14] E. Benmelech & J. Dlugosz, *The Credit Rating Crisis*, *in* NBER MACROECONOMICS ANNUAL 2009, 169-76 (2010), *available at* http://www.economics.harvard.edu/faculty/benmelech/files/MacroAnnual.pdf.

b. Fees

i. Fees Paid by Issuers to QNRSROs

The SEC's solicitation of comment asked whether it would be necessary for the board to regulate fees charged to issuers, whether the closed market created by the board would invite inflated fees, and how fees should be collected. The Franken-Wicker amendment contemplates minimal involvement of the credit rating agency board in the setting or collection of fees.

The Franken-Wicker amendment assumes that there will be a significant amount of market activity within the assignment process system, but that a large majority of activity will occur outside of the assignment process system. For example, it assumes that Moody's would be giving up a vast majority of its businesses if its *only* business came through the assignment process system, and it ceased providing secondary or tertiary ratings for structured finance products, or rating corporate or municipal bonds. There is no reason, however, to expect that would be the case. Therefore, any behavior that having a semi-closed market might induce would be countered by the business outside of the assignment process system. Thus, in this hypothetical example, the board could easily gauge whether Moody's was taking advantage of the market created by the assignment system and jacking up its fees simply by comparing its fees for comparable products outside the assignment process. Under the Franken-Wicker amendment, the board would have the authority to intervene if credit rating agencies were charging unreasonably high fees for initial ratings compared with fees it charged for similar products outside the assignment process. The Franken-Wicker amendment anticipates that its grant of authority to the board to ensure reasonable fees will go largely unutilized, because of the market indicators readily available, and because of the increased competition that will result from the assignment process system.

Regarding the collection of fees and the systems for payment, the Franken-Wicker amendment does not prescribe a structure in which the board serves as an intermediary for the collection and distribution of fees. The board's assignment system is intended to eliminate direct conflicts of interest and ratings shopping, and it can accomplish this objective without becoming a fee intermediary.

ii. Fees to Fund the Board's Operation

The Franken-Wicker amendment calls for the levy of fees from QNRSROs to fund the operation of the board. While this option strikes us as the most straightforward, a fee-sharing scheme among the QNRSROs, the issuers, and investors might also be formulated in a way to fairly distribute costs.

c. Reliance on Credit Ratings

The SEC's solicitation for comment asked, in several sections, whether the implementation of the Franken-Wicker amendment would be contrary to efforts elsewhere in the Dodd-Frank Act intended to reduce reliance on ratings. The answer, in fact, is that these two efforts go hand in hand toward improving the credit rating industry.

First, there is a distinction between eliminating reliance on credit ratings altogether versus reducing *over*-reliance on credit ratings, and that distinction should be made clear. We think that the former is somewhat unlikely, given the complexity of structured finance products. Professor John Coffee agrees, noting that it is unrealistic to expect that investors will be able to assess the risk of "complex and opaque debt instruments such as CDOs."[15] Even the SEC seems to concur, allowing partial reliance on NRSRO ratings in its new proposed rule on establishing alternative measures of creditworthiness.

We applaud efforts to reduce over-reliance on credit ratings, but believe that the expectation that reliance can be entirely eliminated is simply unrealistic. First, while the language in Dodd-Frank eliminated many statutory references to required NRSRO ratings, the language does not extend beyond federal law. Every state and the District of Columbia incorporate NRSRO ratings into state law. In addition to direct incorporation, many state pension and other investment funds also incorporate NRSRO ratings in their investment policies, among them Alaska's Permanent Fund, the Ohio Public Employees Pension Fund, and Florida's Local Government Surplus Funds Trust Fund. Even Bill Gross, PIMCO manager who frequently criticizes the ratings agencies for their failures, admits, "To tell the truth, [the rating agencies] can't really die—they serve a necessary and even productive purpose when properly managed and more tightly regulated."[16]

Researcher Jim Lardner explains the relationship between these two parallel efforts:

> "The [Franken-Wicker] amendment is consistent with the goal of reduced reliance. The mission that the rating agencies so thoroughly betrayed is a vitally important one. It is easy for policymakers to tell investors to do their own due diligence; tracking highly structured, multi-tiered debt securities to their underlying assets, however, is necessarily a huge task - one far beyond the means of many insurance companies, pension plans, and other small institutional investors. Thus, credit ratings are likely to remain important even if they lose some of their standing in law.
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> The Franken amendment would insulate rating agencies from industry pressure to loosen standards, while laying the foundation for a new ratings market in which business forces support diligence, accuracy, and a sense of duty to the purchasers (not the issuers) of debt securities. That is an important and worthy aim, regardless of the degree to which some investors are able to wean themselves off of their current reliance on credit ratings."[17]

Therefore, we see nothing contradictory about seeking to reduce over-reliance on credit ratings and concurrent implementation of the Franken-Wicker amendment.

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[15] J.C. Coffee Jr., *Ratings Reform: The Good, The Bad, and The Ugly*, 1 HARV. BUS. L. REV. 231, 233 (2011).

[16] *See* W.H. Gross, "Lovin' Spoonful," PIMCO: INVESTMENT OUTLOOK, May 2010, http://www.pimco.com/EN/Insights/Pages/Lovin%20Spoonful%20-%20May%202010%20IO.aspx.

[17] Lardner, *supra* note 11.

d. Measuring Accuracy

The Franken-Wicker amendment requires that the credit rating board evaluate the performance of the credit rating agencies and reward good performance with additional assignments. The SEC's solicitation of comment asks what metrics could be used to measure accuracy.

Professor John Coffee has one proposal—to instruct the SEC to define "default" and "impaired," calculate the rates of default and impaired over five year periods for each credit rating agency, and to subsequently publish them.[18] Or the board could compile a total metric based on standards that Professor Lyn Bai has identified for gauging accuracy—the default ratio, "fallen angels" ratio, rating change ratio, and large rating change ratio.[19] While there is not a perfect metric for measuring accuracy, there are certainly factors that are indicative of a track record of quality ratings.

V. Other Alternatives and Conclusion

The SEC's solicitation for comment asks for feedback on five alternatives to the Franken-Wicker amendment. Four of these proposals have benefits and shortfalls that we would be happy to discuss with you in a meeting at your convenience. We see promising possibilities for implementing some combination of them in conjunction with the Franken-Wicker amendment. However, one proposal—reliance on the existing Equal Access Rule, which has had minimal effect—is an inadequate substitute for the Franken-Wicker amendment.

We would like to thank the SEC for soliciting comments on this important proposal, and anticipate that this comment period will yield helpful feedback from the relevant industries and from consumer representatives. We would like to emphasize that although we believe that the Franken-Wicker proposal is the most promising option for moving forward, we hold no pride in authorship and would applaud the implementation of any similar proposal or set of proposals that adequately tackles the conflict of interest and ratings shopping problems in a way that protects consumers and the American public from a future economic collapse.

Sincerely,

Al Franken
United States Senator

Roger F. Wicker
United States Senator

cc: Elizabeth M. Murphy, Secretary, Securities and Exchange Commission

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[18] Turmoil in U.S. Credit Markets: The Role of The Credit Rating Agencies: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 110th Cong. 5 (Apr. 22, 2008)(testimony of Professor John C. Coffee, Jr.).

[19] *See id.*