Consumer Federation of America

March 3, 2014

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

Re: File Number S7-18-11
Request for Re-Proposal Relating to Nationally Recognized Statistical Rating Organizations

Dear Secretary Murphy,

We are writing on behalf of the Consumer Federation of America (CFA)[1] to urge the Commission to re-propose and extensively revise rule changes relating to credit rating agencies registered with the Commission as Nationally Recognized Statistical Rating Organizations (NRSROs). We previously expressed our concerns[2] with the Commission's proposed rule when it was first published and made available for public comment in 2011. We reiterate here the points we made in our previous comment, as the proposed regulations did not match the scale of the problem they were intended to address, nor did they deliver the full scope of the credit rating agency reforms that Congress intended when it adopted the Dodd-Frank Act.

The fundamental problems underlying NRSROs' business models and practices, which drove NRSROs' shoddy rating activities, and which in turn helped to trigger the financial crisis, have been well-documented.[3] Almost three years after the Commission proposed its rules relating to

[1] CFA is a non-profit association of nearly 300 national, state, and local pro-consumer organizations. It was formed in 1967 to represent the consumer interest through research, advocacy and education.

[2] *See* CFA-AFR comment regarding proposed ruled changes relating to credit rating agencies registered with the Commission as Nationally Recognized Statistical Rating Organizations (NRSROs), Filed August 8, 2011, http://www.sec.gov/comments/s7-18-11/s71811-49.pdf.

[3] *See Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, By the Staff of the Office of Compliance Inspections and Examinations Division of Trading and Markets and Office of Economic Analysis, United States Securities and Exchange Commissions, July 2008, http://www.sec.gov/news/studies/2008/craexamination070808.pdf; *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Majority and Minority Staff Report, Permanent Subcommittee on Investigations, United States Senate, April 13, 2011, https://www.levin.senate.gov/imo/media/doc/supporting/2011/PSI_WallStreetCrisis_041311.pdf; *The Financial Crisis Inquiry Report*, Final Report of the National Commission on the Causes of the Financial and Economic

NRSROs, the public has gained an even better appreciation for those business models and practices—past and present. The Commission's own inspection reports, the Department of Justice's (DOJ's) lawsuit against Standard & Poor's (S&P), and new information relating to historical and recent credit rating performance across asset classes provide strong evidence that NRSROs still suffer from severe deficiencies with regard to their internal controls, conflicts of interest, and standardization of ratings across asset classes. Those deficiencies would not likely be cured under a final rule that is the logical outgrowth of the proposed rule for three reasons:

A. First, the Commission's proposed rule governing NRSROs' internal controls is deeply flawed and misguided because it fails to set any standards governing internal controls, inappropriately delegating that responsibility to the NRSROs, which proved incapable of self-monitoring and enforcing prior to the crisis, and which continue to demonstrate weaknesses in internal controls structures;

B. Second, the Commission's proposed rule governing NRSROs' conflicts of interest is unacceptably narrow in that it only addresses the involvement of marketing personnel in ratings decisions, and thus ignores the myriad and more fundamental ways in which conflicts of interest can arise; and

C. Third, the Commission's proposed rule governing NRSROs' universal ratings improperly defers to NRSROs to standardize rating symbols of different products with different risks, providing no clear guidance about what levels of variation in ratings performance across assets are acceptable or what the repercussions will be if an NRSRO falls outside those parameters.

The remainder of this letter will discuss each issue in greater detail, and why the Commission should re-propose and extensively revise its rule changes relating to NRSROs.

Crisis in the United States, Submitted by the Financial Crisis Inquiry Commission, Pursuant to Public Law 111-21, January 2011, http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf

A. The Commission's proposed rule governing NRSROs' internal controls is deeply flawed and misguided because it fails to set any standards governing internal controls, inappropriately delegating that responsibility to the NRSROs, which proved incapable of self-monitoring and enforcing prior to the crisis, and which continue to demonstrate weaknesses in internal controls structures. The Commission should therefore prescribe standards for internal controls by which NRSROs can be held accountable.

One of the clear causes of the ratings failures that led to the financial crisis was the willingness of rating agencies to ignore or override their own policies and procedures in order to arrive at a more favorable rating if doing so translated to higher profits and increased market share. This was well documented by the Commission's own staff[4] as well as by the Senate Permanent Subcommittee on Investigations,[5] the Financial Crisis Inquiry Commission,[6] and press accounts at the time. That is why Congress mandated that credit rating agencies have effective internal control systems to ensure compliance with their ratings methodologies and procedures.

Specifically, section 932(a)(2)(B) of the Dodd-Frank Act requires NRSROs to "establish, maintain, enforce, and document an effective internal control structure governing the implementation of and adherence to policies, procedures, and methodologies for determining credit ratings, taking into consideration such factors as the Commission may prescribe, by rule." While the statute does not mandate the Commission to prescribe factors that rating agencies would have to consider in establishing and maintaining their internal control structures, it does authorize the Commission to do so.

1. When the Commission proposed its rule in 2011, it took a wait-and-see approach, justifying its decision to defer to NRSROs by saying it lacked evidence to act and it would use its annual examination process to understand and review NRSROs' internal controls. We rejected that approach as unnecessary and imprudent, and offered suggestions on what an internal control system should look like.

At the time the Commission proposed its rule, it elected to defer prescribing factors that an NRSRO must take into consideration with respect to its internal control structure. The Commission's stated rationale for deferring action was that doing so would give the Commission the time and opportunity to undertake annual examinations of NRSROs and review how the NRSROs have complied with their own internal controls structures. We strongly disagreed with the Commission's approach then for three reasons. First, deferring generally to financial market participants to self-regulate their activities proved ineffective prior to the 2008 financial crisis, and it is unreasonable to believe a similar hands-off approach will prove effective going forward. Second, and more specifically, deferring to NRSROs to self-regulate failed miserably prior to the 2008 financial crisis, including with regard to the adoption and implementation of credible and effective control systems. It would be entirely inappropriate and unjustified to once again delegate such critical standard-setting authority to the same companies that contributed so greatly

[4] *See supra, Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies.*
[5] *See supra, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*.
[6] *See supra, The Financial Crisis Inquiry Report.*

to the crisis, and that have not given us any credible reason to believe that they are prepared to take on those critical responsibilities by themselves. Finally, we rejected the Commission's wait-and-see approach as unnecessary and imprudent, given that the Commission already had extensive expertise that it could draw on to help NRSROs develop effective internal control systems.

In our 2011 comment letter, we suggested an internal control framework that the Commission could adopt to set minimum, enforceable standards by which NRSROs could be held accountable. As we discussed, in developing the basic components of internal controls, the Commission can look to the Committee of Sponsoring Organization (COSO) framework for internal controls over financial reporting as a guide.[7] In addition, we argued that strict documentation, retention, and reporting requirements should be prescribed and that there should be a requirement that independent personnel within the rating agency, whose compensation is in no way tied to the company's profitability, review the control systems and expose material weaknesses. As we noted in our previous letter, it is crucial not to rely exclusively on executives to monitor compliance, as their incentives may be tarnished by financial or reputational concerns.

2. After three years of examinations of NRSROs' internal control systems by the Commission's staff, the Commission now has the evidence it said it lacked in 2011 to develop specific standards for internal controls.

While we do not have a clear idea, based on available evidence, what NRSROs' control systems currently look like, after three years of inspections, the Commission's staff should. If the NRSROs have developed and implemented effective internal controls that meet the framework that we have suggested, then the NRSROs and the Commission should have no qualms with codifying those controls. Codifying the requirements would help to ensure that NRSROs maintain those standards and it would better enable the Commission to enforce them. Moreover, if NRSROs' control systems are already operating effectively, codifying those controls would result in no additional burdens for the NRSROs, as they would continue to effectuate standards that are already in place. However, if the NRSROs have not developed and implemented internal controls that meet the framework that we have suggested, then the Commission must adopt such a framework, so that NRSROs are provided direction on just what is required of them.

While we commend the Commission's efforts to use the inspection process to bring these persisting issues to light and to improve NRSROs' control processes, those efforts appear to fall far short of what is necessary and appropriate to remedy underlying failures in NRSROs' control structures. Given the evidence of very rudimentary control violations from the Commission's examinations, we are highly skeptical that effective internal control systems are in place. After three years of examinations, NRSROs are still engaging in basic failures, which likely represent deeper flaws in their systems. In the most recent examination, which again, was the NRSROs'

[7] *See* Internal Control – Integrated Framework, Committee of Sponsoring Organizations of the Treadway Commission, September 1992, http://www.coso.org/documents/Internal%20Control-Integrated%20Framework.pdf

third opportunity to cure internal control defects, there were still basic failures that would adversely affect ratings accuracy, objectivity, and reliability.[8]

These failures include: not having in place certain internal control procedures and controls, not maintaining documents, not following the policies and procedures that they do have in place specifically with regard to ratings procedures, not communicating their policies and procedures to staff, not undertaking appropriate internal audits, not maintaining a strict separation between marketing and ratings personnel, allowing ratings personnel to have inappropriate contacts with the issuers who pay them, and changing ratings at issuers' behest.

More specifically detailed in the report, the Commission's staff found that NRSROs failed to adopt adequate internal supervisory controls:

- Two larger NRSROs showed weaknesses in some of the procedures and supervisory controls governing their rating process. One of those NRSROs did not maintain written procedures governing ratings placed under review and did not have adequate controls for timely updating certain ratings after an initial surveillance review. At this NRSRO, a rating was identified as requiring revision, but no rating action was taken for three months. When this rating was ultimately revised, a rating committee downgraded the rating five notches, from investment grade to below investment grade.
- One larger and two smaller NRSROs were in need of better documentation of changes to their rating processes, in need of better communication of those changes to employees, and in need of a review of the effectiveness of the rating committee process.
- One larger and five smaller NRSROs showed deficiencies in their internal audit or testing programs. In certain instances, the audit department and compliance department were not adequately monitoring rating criteria to ensure their independence from business and market share considerations.

In addition, the Commission's staff found not just that the control systems themselves had failed but also that, as result of that control failure, NRSROs failed to conduct business in accordance with their policies, procedures, and rating methodologies:

- At one larger and five smaller NRSROs, there were instances in which rating procedures and methodologies were not followed. At the larger NRSRO, the NRSRO even incorporated changes to ratings that were suggested by an issuer without obtaining the requisite managerial approval.
- One larger NRSRO did not consistently follow its rating criteria development policies and procedures, including when it revised significant structured finance criteria.
- All three of the larger NRSROs and six of the seven smaller NRSROs had certain weaknesses in following their procedures for maintaining records related to rating actions.

The Commission's staff also found that NRSROs failed to appropriately manage conflicts of interest:

[8] 2013 Summary Report of Commission Staff's Examination of Each National Recognized Statistical Rating Organization, As Required by Section 15E(p)(3)(C) of the Securities Exchange Act of 1934, December 2013, https://www.sec.gov/news/studies/2013/nrsro-summary-report-2013.pdf

- One larger NRSRO and five smaller NRSROs had weaknesses in procedures and controls governing conflicts of interest, including employee securities ownership. At the larger NRSRO, there were no formal written procedures requiring pre-clearance of certain securities trading, three analysts were not in compliance with the NRSRO's securities trading policy, and two employees submitted inaccurate certifications of securities holdings.
- Four smaller NRSROs did not have sufficient procedures and controls for separating business and analytical functions or for preventing rating analysts from being involved in the fee discussions and from having access to rating fee information. At one smaller NRSRO, two analysts had preliminary fee discussions with underwriters.

These are exactly the types of fundamental control violations that allowed credit rating agencies to manipulate their ratings to achieve their desired results in the years leading up to the financial crisis, and that Congress was clearly trying to eradicate with section 932(a)(2)(B). They are also the types of basic control violations that our suggested internal control framework is designed to prevent.

In addition to the Commission's staff examination results, the Department of Justice's (DOJ's) complaint[9] against Standard and Poor's (S&P) for fraud details how basic weaknesses in an NRSRO's control systems can impact ratings decisions. According to the DOJ's allegations, S&P had policies and procedures in place to ensure that the company engaged in ratings that were high-quality, objective, independent, and free from influence by any conflicts of interest.[10] However, according to the DOJ allegations, executives and ratings analysts continually flouted the company's policies and procedures when they conflicted with the company's profit and market share interests. Specifically, according to the DOJ, S&P delayed implementation of models that would better gauge market risk, fiddled with models when they did not result in the ratings they sought, and overrode ratings altogether, sometimes on-the-fly, when they did not suit their economic interests.[11] In addition, S&P's surveillance of ratings was often purposefully ignored, DOJ alleges, which resulted in sudden and severe mass downgrades when the market and the public realized S&P's ratings were not in accordance with the company's stated policies and procedures.[12]

Regardless of whether the Commission finds that NRSROs have adopted and implemented successful control systems, the Commission's almost three-year delay in finalizing rules relating to internal controls has eliminated whatever claim the Commission may originally have had that it needed more evidence to guide a standard-setting process. Indeed, the Commission is now in a strong position to adopt standards that build on the best aspects of what the NRSROs are already doing and fill in gaps where NRSROs' systems are lacking. As such, the Commission should re-propose the rules, setting forth a concrete framework that would allow the Commission to hold all NRSROs to the same clear standards of accountability, provide the companies' management

[9] *Compl*., United States of America v. McGraw-Hill Companies, Inc., and Standard and Poor's Financial Services LLC, No. CV-13-00779, C.D. Cal, February 4, 2013, http://www.justice.gov/iso/opa/resources/849201325104924250796.PDF
[10] *Id*. at 28, 31.
[11] *Id*. at 39-59.
[12] *Id*. at 59-105.

the ability to effectively administer their internal compliance measures, and instill confidence in their investors and the public that the companies in fact are achieving the objectives of their internal control rules and, in so doing, promoting ratings that are high-quality, objective, independent, reliable, and free from influence by any conflicts of interest.

B. The Commission's proposed rule governing NRSROs' conflicts of interest is unacceptably narrow in that it only addresses the involvement of marketing personnel in ratings decisions, and thus ignores the myriad and more fundamental ways in which conflicts of interest can arise. The Commission should therefore broaden the scope of the proposed language to prohibit sales and marketing considerations from influencing, in any form, the production of ratings.

The Credit Rating Agency Reform Act of 2006 gave the Commission broad authority "to prohibit, or require the management and disclosure of, any conflicts of interest relating to the issuance of credit ratings by a nationally recognized statistical rating organization."[13] In the Dodd-Frank Act, Congress added section 932(a)(4), which requires the Commission to "issue rules to prevent the sales and marketing considerations of an [NRSRO] from influencing the production of ratings by the [NRSRO]."[14] The statutory language is expansive, requiring the Commission to prevent an NRSRO's sales and marketing considerations from creating conflicts of interest in any number of forms. In a sign of just how seriously Congress viewed such conflicts, it provided for the suspension or revocation of an NRSRO's registration if an NRSRO commits a violation of the rule and the violation affects a rating.

The proposed rule, however, only limits the involvement of sales personnel in the ratings process, an extremely narrow restriction that fails to encompass the breadth and depth of how business interests can pervade the ratings process. The proposed rule would still allow sales considerations to influence ratings production in a number of ways. For example, management could still exert influence on ratings, either overtly or covertly. Management, which would not likely fall under the Commission's definition of "participants" in either sales or ratings activities, could directly alter ratings results, indirectly alter ratings by manipulating default criteria and models to attain desired ratings results, or foster a culture in which the quest for revenue and market share trumps the quest for accuracy and independence.

In our 2011 comment letter, we advocated for a rule governing conflicts of interest that prohibits the influence, in any form, of sales considerations on ratings production. Such a principles-based rule would cover instances in which the management of an NRSRO uses sales and marketing considerations to influence ratings, or condones (explicitly or implicitly) such activity at any level of the NRSRO. Additionally, an appropriate rule governing conflicts of interest must prohibit an NRSRO's compensation and promotion of personnel involved in the ratings process from being based on sales revenues or market share.

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[13] *See* Credit Rating Agency Reform Act of 2006, Public Law 109–291, http://www.sec.gov/divisions/marketreg/ratingagency/cra-reform-act-2006.pdf

[14] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law 111-203, http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm

1. **The facts alleged in the Department of Justice's (DOJ's) complaint[15] against S&P for civil fraud, filed in 2013, provide vivid illustration of the many ways in which sales and marketing considerations can influence the ratings process.**

The Commission's rule narrowly applies to instances in which an NRSRO's marketing personnel are involved in ratings decisions, but as the DOJ's allegations make clear, sales and marketing considerations can influence the production of ratings in a variety of ways. While the following discussion is based on the DOJ complaint against S&P, there is reason to believe that similar problems existed to a greater or lesser extent at other rating agencies.

a) As supported by the DOJ's allegations against S&P, top-down policies and practices that emphasize profitability and the drive for market share can influence an NRSRO's ratings decisions.

First and foremost, the DOJ's complaint describes a business environment at S&P in which the profitability of S&P's Residential Mortgage Backed Securities (RMBS) and Collateralized Debt Obligation (CDO) ratings business was central to S&P's ratings decisions, and competition for market share among the different credit rating agencies affected S&P's ratings decisions. According to the complaint, typically an issuer/arranger made the decision to retain S&P to provide ratings. As a result, S&P executives and staff viewed issuers as S&P's primary customers and as the source of S&P's rating business.[16] For example, in its January 5, 2006 CDO Strategic Plan (as cited in the DOJ complaint), S&P explained: "The primary customers of the CDO group today are the **deal arrangers** (banks/intermediaries). This customer group continues to be responsible for the vast majority of revenue, including all initial deal rating fees paid to S&P."[17] (Emphasis in original). Also in that Strategic Plan, marked "Private and Confidential," S&P rationalized that, "arrangers will go with the agencies that are able to (1) meet their transaction schedule, and (2) use criteria that provide them favorable economics for the transaction."[18] The evidence overwhelmingly suggests that these factors were causing S&P in specific and credit rating agencies in general to compromise their independence and integrity, leading them to require issuers to provide less credit support than was prudent in order to make the deals more profitable for the issuer and spur more ratings business for the ratings agency.[19] Internal discussions about maintaining market share confirmed that S&P's focus was on "ensuring that S&P continues its high ratings penetration and leading position in the ratings business."[20]

As described in the DOJ complaint, that drive for increased revenue and market share appears to have led to policies and practices that shaped ratings results. According to the complaint, ratings requests were occasionally withdrawn during the ratings process. This was usually because

[15] We recognize that facts alleged in a complaint are not "evidence" in the legal sense, and to date, nothing has been proved in court. We merely offer the allegations, which are consistent with contemporary news accounts and the findings of the Senate Permanent Subcommittee on Investigations, as well as the Commission's own study of rating agencies' practices during the period leading up to the financial crisis, as an illustration of the myriad ways in which marketing and sales considerations can influence the ratings process.
[16] *See supra*, *Compl*., at 16.
[17] *Id*.
[18] *Id*. at 42.
[19] *Id*. at 13.
[20] *Id*. at 11.

another credit rating agency permitted lower credit support levels, which generally made RMBS riskier to investors but more profitable for the RMBS issuer. Any time that a rating request was withdrawn, the rating analyst on the deal was required to submit to the head of Global ABS a "lost deal" memo that explained why S&P had lost the rating business.[21] In one such memo, an S&P analyst allegedly advised the Executive Managing Director in charge of the Structured Finance department and, the Managing Director of the Global CDO group, a department within Structured Finance that issued initial ratings for CDOs, that S&P was losing a deal because S&P was more conservative than other rating agencies and that the analyst believed that S&P would need to change its stance on future deals. According to the DOJ complaint, the analyst said: "What we found from the arranger was that our support level was at least 10% higher than Moody's…Losing one or even several deals due to criteria issues, but this is so significant that it could have an impact on future deals."[22] (Quote in original)

According to the DOJ's allegations, in 2004, S&P adopted a new process for implementing changes to S&P's rating criteria. The new process required consideration of "market insight," "rating implications," the polling of "3 to 5 investors in the product" and "an appropriate number of issuers and investment bankers for a full 360-market perspective."[23] As a result of S&P's new ratings process, the company's RMBS and CDO ratings business experienced surges in revenues. In its 2005 annual report, McGraw-Hill, S&P's parent company reported a 40.3% growth in revenue within the structured finance division; in its 2006 annual report, McGraw-Hill reported a 55.4% growth in revenue within structured finance.[24]

The Commission's proposed rule on conflicts of interest would not prohibit the perpetuation by an NRSRO's management of top-down policies and procedures that emphasize profitability and increased market share at the expense of accuracy and reliability, despite the fact that doing so would be clear instances in which sales and marketing considerations influence the production of ratings. Accordingly, the proposed rule is completely inadequate to address conflicts of interest of this scope and magnitude.

b) As supported by the DOJ's allegations against S&P, profitability and market share interests can influence an NRSRO's rating criteria and analytical models.

If the allegations in the DOJ's complaint are accurate, S&P limited and delayed updates to its rating criteria and analytical models not for increased accuracy and reliability, but instead for increased revenues and market share. It also manipulated and ignored ratings models when those ratings models did not lead to the ratings that they desired.

The DOJ's complaint first cites S&P's resistance to updating its RMBS LEVELS (Loan Evaluation & Estimate of Loss System) model, a program that generated summary information for RMBS pools as well as subordination levels for each rating category.[25] According to the DOJ's complaint, S&P's executives knew that an updated LEVELS model, which incorporated a

[21] *Id*. at 19-20.
[22] *Id*. at 44.
[23] *Id*. at 40.
[24] *Id*. at 18.
[25] *Id*. at 19.

larger, more current set of loan data, was more accurate than the existing LEVELS model in assessing the credit risks posed by certain RMBS. But they still refused to implement the update because it would have required issuers to provide more credit protection to obtain S&P's investment grade ratings and would therefore have been less profitable for issuers.[26]

In one instance, when one S&P executive objected to the delay in adopting the new model, the response he received was that, if the new LEVELS model was not going to result in S&P increasing its market share or gaining more revenue, there was no reason to spend money putting it in place.[27] A senior analyst responded, copying the Managing Director in charge of the U.S. RMBS group, saying, according to the DOJ complaint:

> "When we first reviewed [proposed LEVELS] Version 6.0 results **a year ago** we saw the sub-prime and Alt-A numbers going up and that was a major point of contention which led to all the model tweaking we'd done since. Version 6.0 could've been released months ago and resources assigned elsewhere if we didn't have to manage the sub-prime and Alt-A numbers to preserve market share."[28]

As the DOJ's allegations detail, when S&P did update its LEVELS model to a "new" version 6.0, it updated it so that the results were more favorable to issuers than the proposed LEVELS 6.0 that was previously under consideration. Additionally, according to the DOJ, S&P executives continued to poll issuers to make sure they were comfortable with the update, and gave them a choice about which model to use—the old version or the revised "6.0" version—whichever was more favorable to them.[29]

The DOJ complaint also cites S&P's resistance to updating its CDO Evaluator, which determined whether the pool of assets could support a deal's proposed structure. In about 2003, S&P began updating its CDO Evaluator model because its quantitative analysts recognized that the key assumptions underlying CDO Evaluator, including the default assumptions, were inaccurate and not consistent with historical data.[30] At the time, S&P enjoyed dominant market share in the non-investment grade cash CDO market, but had a smaller market share in the investment-grade synthetic CDO market. According to the complaint, a core goal of the CDO Evaluator update was to revise the underlying assumptions, while (a) preserving S&P's market share in the highly lucrative non-investment grade cash CDO business by not negatively affecting the current model's ratings of these CDOs; and (b) improving S&P's market share in the investment-grade synthetic CDO business by making the model's ratings of these CDOs more competitive with other rating agencies.[31]

To achieve this goal, S&P executives allegedly directed its quantitative rating analysts to update CDO Evaluator in a way that minimized the impact to ratings on non-investment grade deals and made it more competitive with respect to ratings on investment grade deals.[32] When the analysts

[26] *Id*. at 44.
[27] *Id*. at 45.
[28] *Id*. at 46.
[29] *Id*. at 47-48.
[30] *Id*. at 48.
[31] *Id*. at 48-49.
[32] *Id*. at 49.

were unable to meet the executives' demands, one senior executive allegedly took matters into his own hands by developing his own default matrix, which S&P's quantitative analysts viewed as indefensible because it was cobbled together based on considerations of market share and profits, not analytics.[33] Ultimately, S&P executives decided not to use the senior executive's default matrix, according to the DOJ complaint, not only because it was analytically indefensible, but because testing revealed that it did not achieve the company's stated market share goals.[34]

The DOJ complaint alleges that S&P continued to poll CDO issuers to determine their tolerance levels with respect to proposed updates to CDO Evaluator, and test proposed changes to CDO Evaluator against existing ratings to make sure the proposed changes would not negatively affect market share.[35] In February 2005, Andrea Bryan, the Managing Director in charge of the Synthetic CDO group allegedly sent an email, stating: "[W]e may have to put this beta model in the hands of a few trusted souls and let them help us understand their risk tolerance level."[36] In June 2005, an S&P analyst stated that new CDO criteria would "be meaningless unless we can compare them to either where the clients [CDO issuers] would expect the numbers to be or where our competitors were."[37]

S&P scheduled the new version of Evaluator (labeled E3) to be released in July 2005. However, prior to its release, S&P received feedback from issuers, including Bear Stearns, a major synthetics dealer, indicating that the new E3 rating model would hurt S&P's market share, because "Moody's and Fitch can do better than E3 already."[38] After receiving this feedback, S&P decided to delay the release of CDO E3.[39]

According to the DOJ's complaint, S&P subsequently developed an alternative version of E3, called "E3 Low," which had less demanding assumptions than E3, thereby making it easier for a CDO issuer to achieve higher CDO ratings.[40] But E3 Low was not based on historical or analytical research; rather, its purpose was to preserve S&P's market share.[41] S&P instructed its analysts to use the following procedure for rating synthetic CDOs: "If the transaction passes E3.0, GREAT! The deal is modeled, rated and surveilled with E3.0…If the transaction fails E3, then use E3Low."[42]

When the market was deteriorating, in order to allay any fears that S&P was not being responsive to certain credit risks, S&P publicly announced that it would "notch" its own ratings (that is, consider them to have lower ratings for purposes of rating CDOs with exposure to them) on certain tranches of non-prime RMBS.[43] However, according to the DOJ complaint, S&P did

[33] *Id*. at 50.
[34] *Id*.
[35] *Id*.
[36] *Id*. at 51.
[37] *Id*.
[38] *Id*. at 53.
[39] *Id*.
[40] *Id*. at 54.
[41] *Id*.
[42] *Id*. at 55.
[43] *Id*. at 104.

not apply its notching policy consistently to all deals. Instead, it worked with issuers to use a deal-by-deal analysis that it never revealed to the public. When this analysis showed that application of the publicly-announced notching policy would interfere with S&P's ability to rate a CDO, S&P allegedly used various methods to get around the publicly-announced policy and issue a rating for the CDO.[44]

In one particularly egregious example cited in the DOJ complaint, on the same day that S&P announced its new policy, it was preparing a closing date rating for Delphinus CDO, which contained a large number of subprime RMBS tranches. When S&P analysts ran the Delphinus portfolio through CDO Evaluator with full notching at around 5:00 p.m. that night, they discovered that four CDO tranches failed the Q-Ramp test,[45] which determined if a CDO had sufficient cash flow to meet the obligations of the CDO tranches being rated. The analysts then progressively scaled back the notching on subprime RMBS assets until, just after midnight, only one CDO tranche was failing. Despite the directive not to allow a CDO to be rated if one or more tranches should fail the Q-Ramp test, S&P rated Delphinus.[46]

The Commission's proposed rule regarding conflicts of interest would not quell any of the aforementioned delays or adjustments to an NRSRO's basic rating criteria or analytical models. Nor would it stop an NRSRO from manipulating or ignoring ratings models when those ratings models do not produce the results an NRSRO desires. Those are obvious instances in which sales and marketing considerations would influence the production of ratings and are precisely the types of abuses Congress sought to address by including this rule-making mandate in Dodd-Frank. Accordingly, the proposed rule is completely inadequate to address conflicts of interest of this scope and magnitude and must be revised.

c) As supported by the DOJ's allegations against S&P, profitability and market share concerns overrode any concerns that employees expressed about ratings decisions, and this infected S&P's corporate culture.

If the allegations in the DOJ's complaint are accurate, S&P ignored protestations from staff about the deteriorating market and created a culture in which employees understood that their priorities were to issue and/or confirm ratings to further S&P's profit and market share goals.

For example, at one alleged meeting, attended by several executives, S&P analysts determined that they would develop new criteria by testing multiple assumptions, then picking the assumptions that led to the results they wanted—that is, fewer and less severe downgrades. At the meeting, a member of RMBS Surveillance allegedly protested this results-oriented approach, telling the group that they were using the ends to justify the means. The RMBS Surveillance member who raised these objections, however, after attending one further such meeting, was no longer invited to the meetings, according to the DOJ complaint.[47]

In another situation, an executive who was in charge of RMBS Surveillance regularly expressed frustration to her colleagues that, notwithstanding the dire performance of subprime RMBS, she

[44] *Id*.
[45] *Id*. at 21.
[46] *Id*.
[47] *Id*. at 58-59.

was prevented by other S&P executives from downgrading the ratings of subprime RMBS because of concerns that S&P's ratings business would be affected if there were severe downgrades.[48]

Lower-level analysts also came to understand that S&P's business model focused on profits and not accuracy or reliability, according to the DOJ complaint. For example, a senior analyst allegedly sent an email to a colleague, saying: "Remember the dream of being able to defend the model with sound empirical research? The sort of activity a true quant CoD [senior analyst's job title] should be doing perhaps? If we are just going to make it up in order to rate deals, then quants are of precious little value."[49]

In another now infamous interaction between two analysts, they reportedly expressed exasperation about the deals they were rating, and just how severely S&P's rating models were underestimating credit risk:

> A1: "btw that deal is ridiculous"
> A2: "I know right…model def[initely] does not capture half of the…risk"
> A1: "We should not be rating it"
> A2: "we rate every deal…it could be structured by cows and we would rate it"[50]

According to another incident recounted in the DOJ complaint, one analyst who had recently been hired sent an email to an investment banker client, recounting internal conflict regarding rating decisions and management's response, saying, "The fact is, there was a lot of internal pressure in S&P to downgrade lots of deals earlier on before this thing started blowing up. But the leadership was concerned of p*ssing off too many clients and jumping the gun ahead of Fitch and Moody's."[51]

The proposed rule would not quell any of the aforementioned instances in which an NRSRO creates a corporate culture in which employees are held back from raising concerns, and a sense is instilled among staff that their priorities should be profits over ratings accuracy. Those are obvious instances in which sales and marketing considerations would influence the production of ratings and are precisely the types of abuses Congress sought to address by including this rule-making mandate in Dodd-Frank. Accordingly, the proposed rule is completely inadequate to address conflicts of interest of this scope and magnitude and must be revised.

2. The Commission should re-propose the rules prohibiting the influence of sales and marketing considerations, in any form, on ratings production.

As the DOJ's allegations make clear, sales and marketing considerations can influence the production of ratings in a variety of ways. Motivations by management to increase profits and market share can lead to top-down policies and practices that emphasize higher ratings over improved accuracy and reliability. Those same motivations can cause an NRSRO to limit, delay, manipulate, or ignore updates to its rating criteria and analytical models. Motivations to increase

[48] *Id*. at 60-61.
[49] *Id*. at 51.
[50] *Id*. at 80.
[51] *Id*. at 99.

profits and market share can also infect the corporate culture, instilling a sense among staff about what their priorities should be. Employees understand the environments in which they work, and if they reasonably believe that there will be positive "career consequences," such as being promoted or invited to important meetings, as well as negative consequences, for their activities, most will naturally fall in line and fulfill the company's interests.

If the Commission were to allow any of these activities to persist, as it seems to have done in the proposed rule, it would contravene what Congress intended when it passed the Credit Rating Agency Reform and Dodd-Frank Acts. As such, the Commission should re-propose the rules to fulfill congressional intent by broadening the scope of the proposed language to prohibit sales and marketing considerations, in any form, from influencing the production of ratings.

D. **The Commission's proposed rule governing NRSROs' universal ratings improperly defers to NRSROs to standardize rating symbols of different products with different risks, providing no clear guidance about what levels of variation in ratings performance across assets are acceptable or what the repercussions will be if an NRSRO falls outside those parameters. The Commission should therefore require that credit ratings correspond to a range of default probabilities and corresponding loss expectations, and those statistics should be published in a format that is easily understandable and allows for comparability across asset classes. Furthermore, the Commission should hold NRSROs accountable if they fail to achieve a high degree of ratings comparability between asset classes.**

It has been well-documented by the Senate Permanent Subcommittee on Investigations,[52] the Senate Banking Committee,[53] the House Financial Services Committee,[54] the Financial Crisis Inquiry Commission,[55] as well as in the academic literature,[56] that NRSROs have issued similar ratings of different assets with very different risks, which have, as a result, experienced widely divergent downgrade and default rates. That is why Congress required the standardization of ratings across asset classes. As the Report of the Committee on Banking, Housing and Urban Affairs explained, "an NRSRO's credit rating symbol should have the same meaning about creditworthiness when it is applied to any issuer – the same symbol should not have different meaning depending on the issuer."[57]

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[52] *See supra, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*.
[53] *See* Committee Report, U.S. Senate Committee on Banking, Housing and Urban Affairs, Report No. 111-187, The Restoring American Financial Stability Act of 2010, April 30, 2010, http://www.banking.senate.gov/public/_files/RAFSAPostedCommitteeReport.pdf
[54] *See* Hearing Before the Committee on Financial Services, U.S. House of Representatives, ''Municipal Bond Turmoil: Impact on Cities, Towns and States," 110th Cong, 2d Session, March 12, 2008, http://www.gpo.gov/fdsys/pkg/CRPT-110hrpt835/pdf/CRPT-110hrpt835.pdf
[55] *See supra*, The Financial Crisis Inquiry Report.
[56] *See, e.g.*, Richard E. Mendales, *Collateralized Explosive devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix it*, PENN STATE LEGAL STUDIES RESEARCH PAPER NO. 09-2009, March 5, 2009, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1354062; Richard Cantor and Frank Packer, *The Credit Rating Industry*, FEDERAL RESERVE BANK OF NEW YORK QUARTERLY REVIEW (Summer 1994), 1-26, http://www.newyorkfed.org/research/quarterly_review/1994v19/v19n2article1.html; Charles W. Calomiris, *The Debasement of Ratings: What's Wrong and How We Can Fix It*, Working Paper, Columbia Business School, October 2009, *http://www0.gsb.columbia.edu/faculty/ccalomiris/RatingAgenciesE21.pdf*.
[57] *See supra*, Committee Report.

Specifically, section 938(a) of the Dodd-Frank Act requires the Commission to issue rules that require NRSROs to establish, maintain, and enforce written policies and procedures that: 1) assess the probability that the issuer of a security or money market instrument will default, fail to make timely payments, or otherwise not make payments to investors in accordance with the terms of the security or money market instrument; 2) clearly define and disclose the meaning of any symbol used by the NRSRO to denote a credit rating; and 3) apply any such symbol in a manner that is consistent for all types of securities and money market instruments for which the symbol is used.[58]

1. **The Commission's 2011 proposed rule inappropriately deferred to NRSROs to apply rating symbols in a consistent manner and failed to explain how to fulfill that mandate. We rejected that approach as vague and asked the Commission to provide additional guidance on universal ratings before finalizing the rule to ensure that the rule has the effect that Congress intended.**

The Commission's proposed rule mirrors the statute and adds a requirement for NRSROs to "document" their policies and procedures reasonably designed to achieve the objectives identified in 938(a). While this added documentation requirement is necessary to ensure the Commission is able to examine for compliance, as well as for NRSROs' own internal controls and compliance effectiveness, it is not sufficient to cure the fundamental problem in section 938, namely, that it provides no meaningful guidance about how the Commission will implement and enforce the statute to achieve the mandate to standardize ratings across assets, as Congress intended.

2. **Since the Commission proposed its rule in 2011, new information has been revealed, showing that credit ratings across asset classes historically have been applied in a wildly inconsistent manner.**

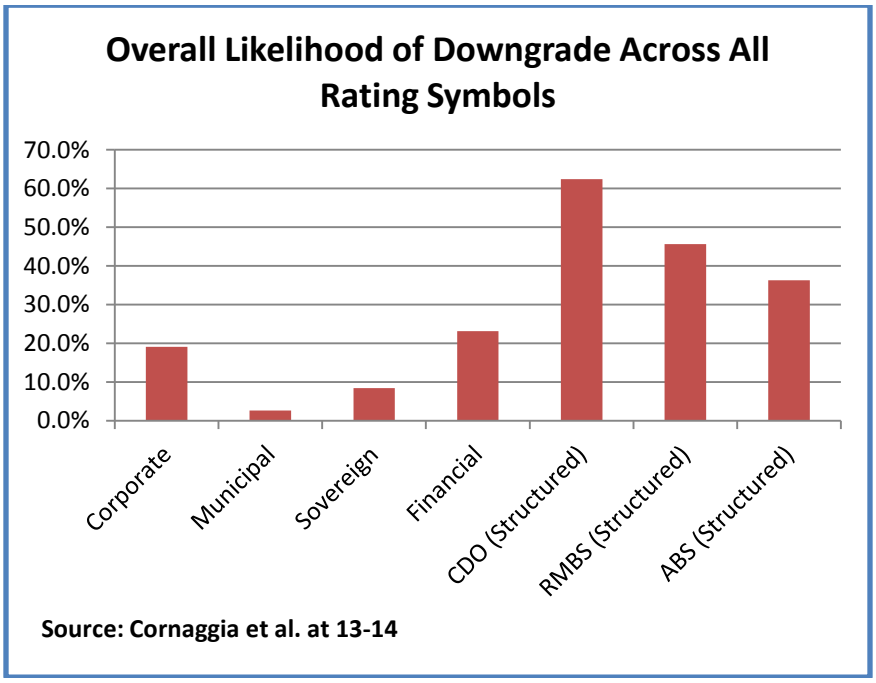
In September 2012, the Commission's own staff issued a report to Congress on Credit Rating Standardization.[59] The report found that credit ratings historically have not been comparable across asset classes.

One study cited in the report, by Jess and Kimberly J. Cornaggia and John E. Hund (hereinafter Cornaggia et al.),[60] provided a comprehensive examination of credit ratings performance between 1980 and 2010 across broad asset classes. These included corporate bonds, sovereign bonds, municipal bonds, bonds issued by financial institutions, and structured products, which in turn included Collateralized Debt Obligations (CDOs), Residential Mortgage Backed Securities (RMBS), Commercial Mortgage Backed Securities (CMBS), Asset Backed Securities (ABS), and Public Finance (PF) tranches. The authors found significant differences by rating in default

[58] *See supra*, Dodd-Frank Act.
[59] Report to Congress Credit Rating Standardization Study, As Required by Section 939(h) of the Dodd-Frank Wall Street Reform and Consumer Protection Act
http://www.sec.gov/news/studies/2012/939h_credit_rating_standardization.pdf
[60] Jess Cornaggia, Kimberly J. Cornaggia, and John E. Hund, *Credit Ratings Across Asset Classes*, August 21, 2013, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1909091

rates, transition statistics, instantaneous upgrade and downgrade intensities, and accuracy ratios among the different asset classes.[61] For example:

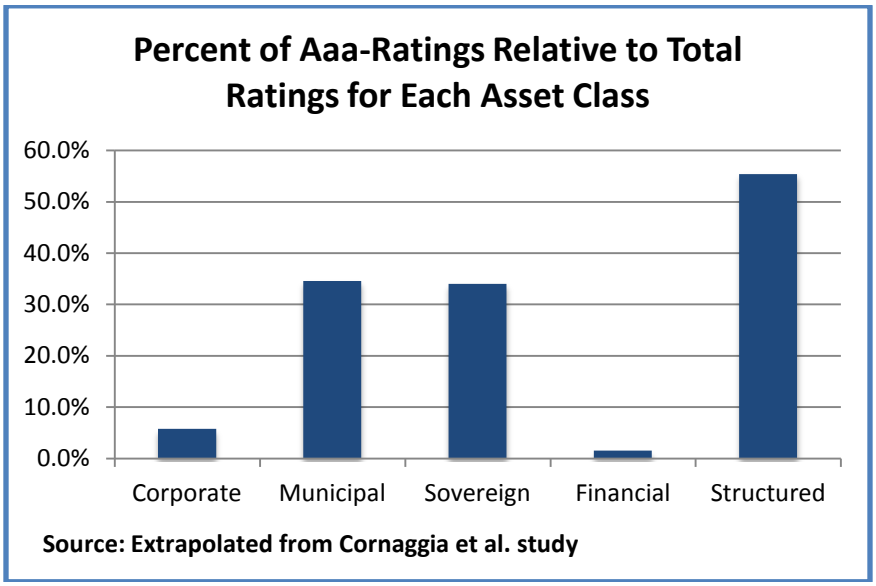
- The authors found that across all rating symbols, certain assets were more likely to experience a downgrade. Specifically, 2.64% of municipals, 8.40% of sovereigns, 19.06% of corporations, and 23.11% of financials experienced a downgrade. Structured finance experienced even higher levels of downgrades, suggesting pronounced initial ratings inflation.[62]
- Within the structured finance category, CDOs were most likely to be downgraded, with 62.39% experiencing a downgrade. They were followed by RMBS, with 45.61% experiencing a downgrade, and ABS, with 36.30% experiencing a downgrade.[63]



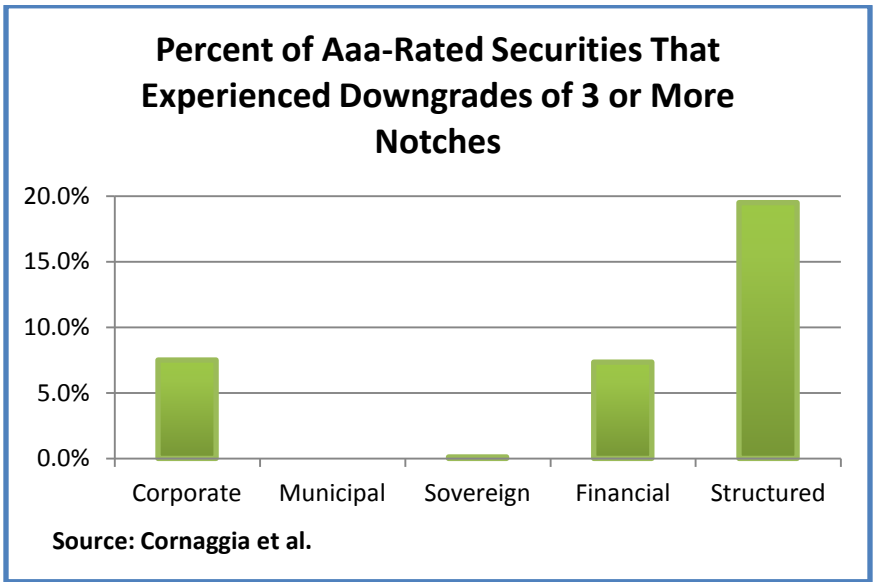
Almost as striking is the percentage of structured finance transactions that received initial ratings of AAA, compared with the percentage of other asset classes that received initial ratings of AAA.

- 55.4% of structured finance transactions received initial ratings of AAA, whereas only 34.04% of sovereigns received initial ratings of AAA.[64]
- However, 30.96% of those AAA-rated structured finance products were downgraded over a 5-year span, whereas only 8.3% of sovereigns were downgraded.[65]

[61] The authors limited their sample to Moody's rated assets because of resource constraints, but intuited that, because ratings by the Big 3 are highly correlated, results for S&P or Fitch would likely be similar to those reported in their study. *Id*. at 9.
[62] *Id*. at 13-14
[63] *Id*.
[64] Data extrapolated from Cornaggia et al.'s figures at 41 [Table 2]. See Appendix A.
[65] *Id*. at 42-43 [Table 3]. *See* Appendix A.

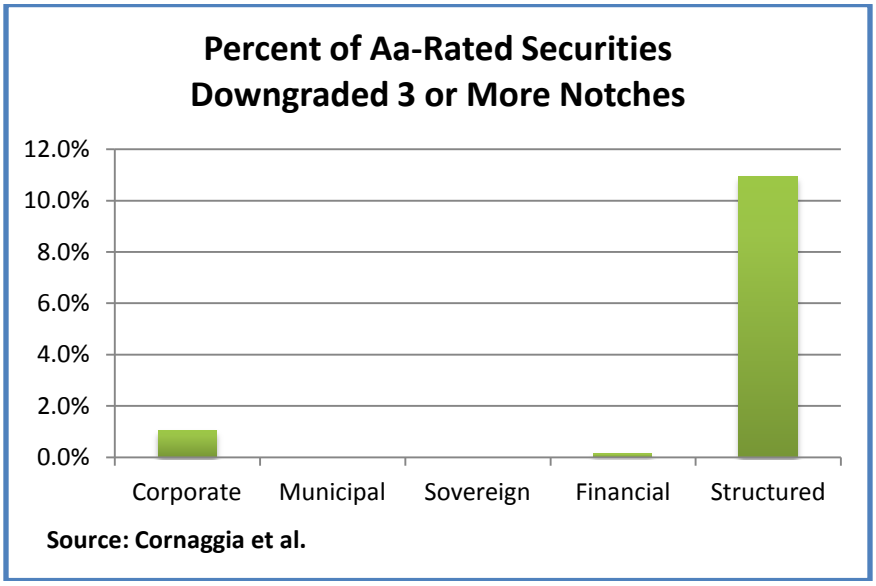


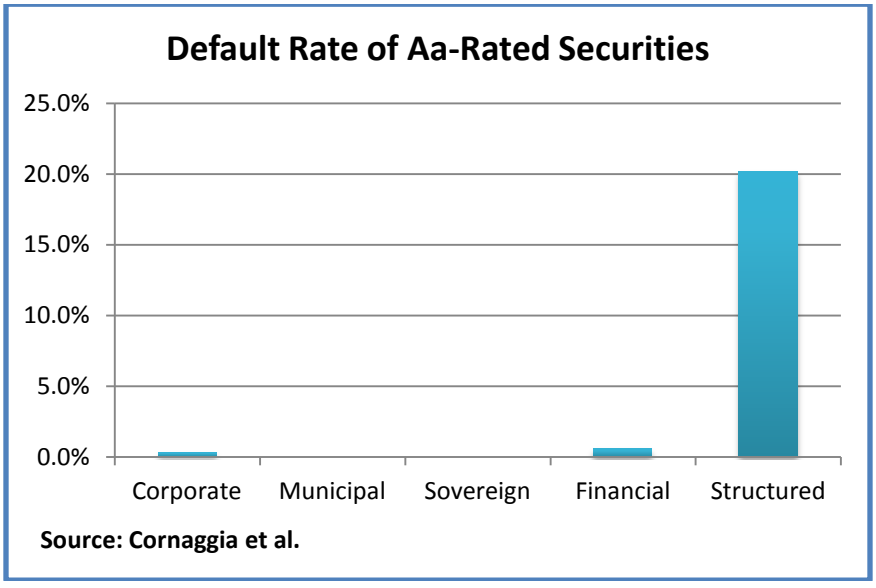
This suggests that the initial AAA ratings of the structured finance products were faulty. If one looks further into the authors' findings, one finds that 19.5% of AAA-rated structured products suffered a downgrade of three or more notches. Only 0.11% of AAA-rated sovereigns experienced a 3-notch downgrade, and municipals never experienced such a drastic downgrade. This suggests that not only were structured finance products' initial ratings faulty, they were wildly out of line with similar ratings for different asset classes.



As one continues to examine Cornaggia et al.'s findings, Aa-rated assets also exhibited extremely divergent ratings results. For example, in that rating category, structured products

experienced a default rate of 20.21%, with 42.62% experiencing a downgrade over a 5-year window, and 10.95% of them experiencing a downgrade of three or more notches. In contrast, Aa-rated municipals, which never defaulted, were downgraded only 1.32% of the time, and were never downgraded three or more notches; and sovereigns, which also never defaulted, were downgraded 7.29% of the time, and also were never downgraded three or more notches.[66]

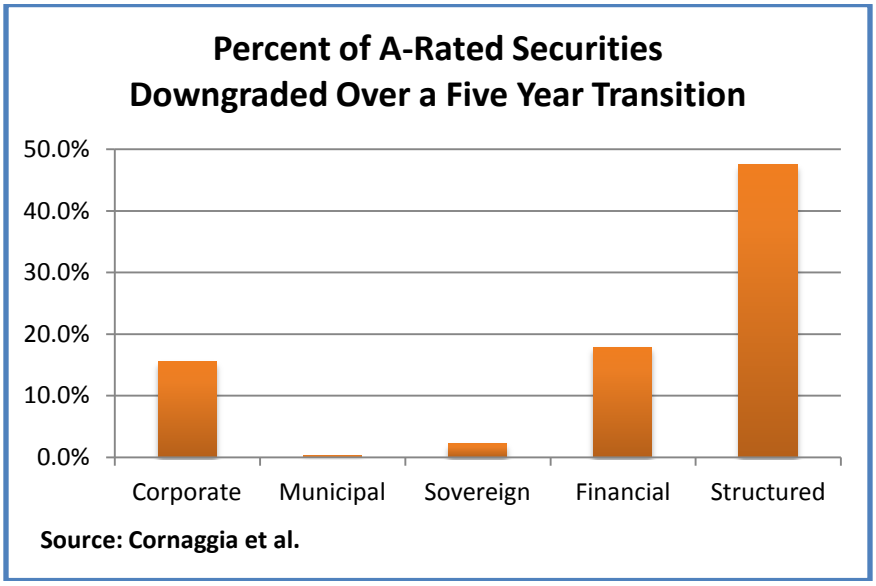


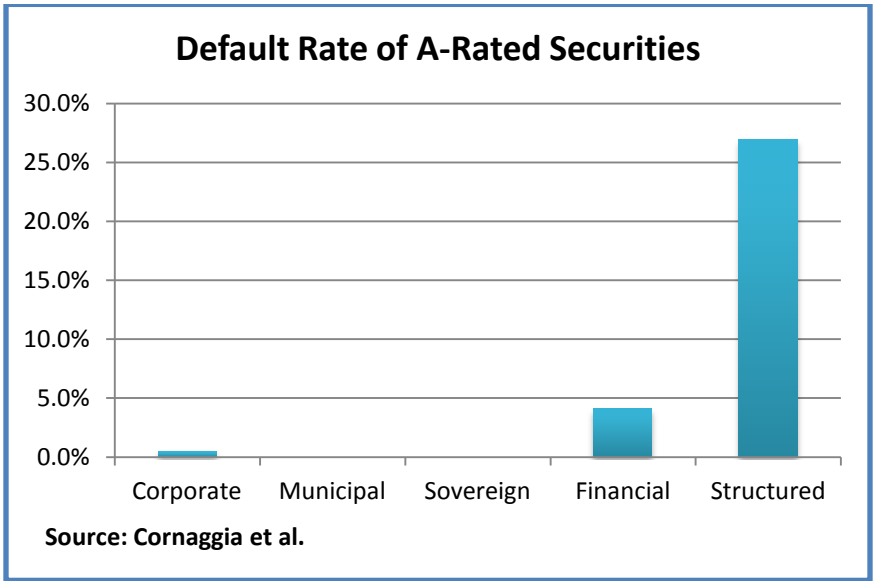


Next, if one examines A-rated assets, the widely divergent ratings results continue. For example, in that rating category, structured products were downgraded 47.49% of the time and suffered a

[66] *Id*. at 41-43. *See* Appendix A.

downgrade of three notches of more 10.57% of the time. In contrast, municipals were downgraded just 0.28% of the time, and were never downgraded three or more notches; and sovereigns were downgraded 2.19% of the time, and also were never downgraded three or more notches.[67] Structured Products experienced a default rate of 26.97%, whereas municipals and sovereigns never defaulted and corporates defaulted only 0.51% of the time.





The disparities in ratings performance continue throughout the ratings system, and we've provided supporting evidence from Tables 2 and 3 in Cornaggia's paper, as well as our analysis of Cornaggia et al.'s findings, in Appendix A.

[67] *Id*. at 41-43. *See* Appendix A.

3. **Our own analysis of the big three NRSROs' ratings performance corroborates the Commission staff's and Cornaggia et al.'s findings that performance across assets has not been comparable. Further, there is reason to be skeptical that NRSROs have learned the lessons of the financial crisis, and that without a vigorous regulatory response, NRSROs will improve their rating practices in any meaningful way in the long term.**

In addition to the Cornaggia paper's findings, we have done our own analysis of the big three NRSROs' ratings performance, which can be found in their Form NRSRO Exhibit 1 disclosures.[68] First, we compared the NRSROs' historical average performance across assets (typically over a span of between 12 and 32 years, depending on the company and asset class), based on one-, three-, and ten-year time-frames. This included an analysis of the average percentage of different assets that were downgraded three or more notches and the average percentage of default within each asset class. We also compared the NRSROs' performance across assets through the most recent calendar year.[69]

If one examines S&P's historical average performance across AAA-rated assets (typically from the early 1980s through 2012), one finds that structured products were approximately five times more likely to be downgraded three or more notches than corporates and municipals, within a one-year average transition period. In addition, AAA-rated structured products were downgraded three or more notches more than 10% of the time within a three-year average transition period. In contrast, AAA-rated municipals were downgraded three or more notches less than 0.5% of the time and foreign sovereigns were downgraded three or more notches less than 2% of the time over a three-year average transition period.[70]

Similarly, if one examines Fitch's historical average performance across AAA-rated assets (typically from 1990 through 2012), one finds that structured products were approximately ten times more likely to be downgraded three or more notches than any other asset class, within a one-year average transition period. In addition, structured products were downgraded three or

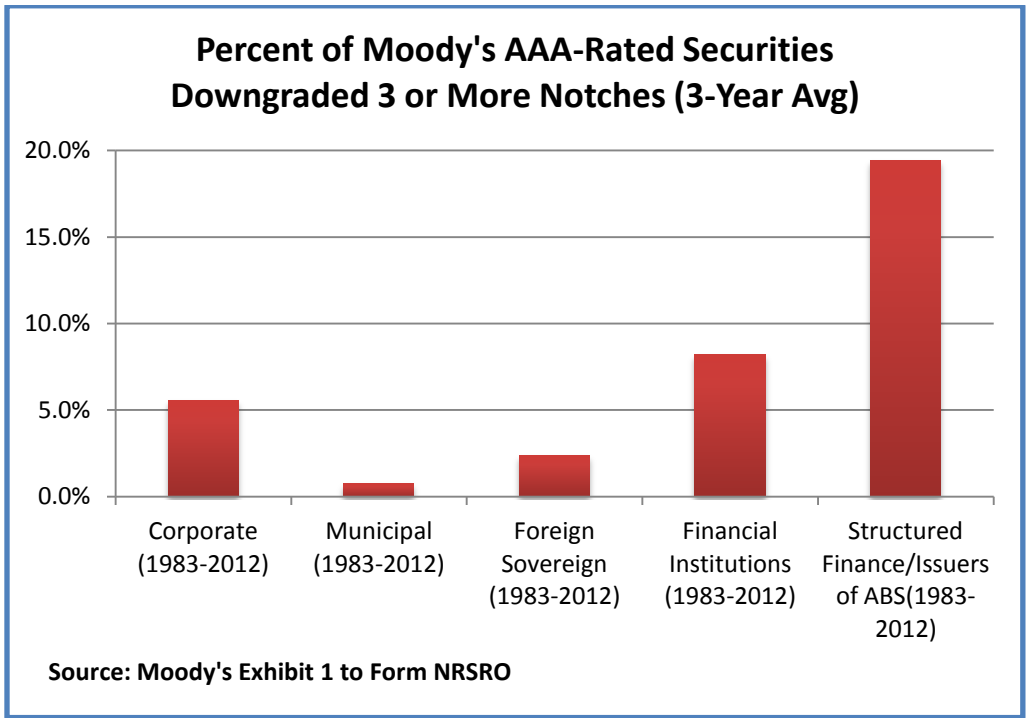
[68] Form NRSRO, Application for Registration as a Nationally Recognized Statistical Rating Organization (NRSRO), https://www.sec.gov/about/forms/formnrsro.pdf ; Standard and Poor's Ratings Performance for Exhibit 1 Form NRSRO, March 27, 2013, http://www.standardandpoors.com/servlet/BlobServer?blobheadername3=MDT-Type&blobcol=urldata&blobtable=MungoBlobs&blobheadervalue2=inline%3B+filename%3DEx+1-1.March2013.pdf&blobheadername2=Content-Disposition&blobheadervalue1=application%2Fpdf&blobkey=id&blobheadername1=content-type&blobwhere=1244255376298&blobheadervalue3=UTF-8; Fitch Ratings, Inc., 2013 Form NRSRO Annual Certification, Exhibit 1. Credit Ratings Performance Statistics, March 15, 2013, https://www.fitchratings.com/web_content/nrsro/nav/NRSRO_Exhibit-1.pdf; Moody's Investors Service, Inc., Annual Certification of Form NRSRO 2012, Exhibit 1., March 22, 2013, https://www.moodys.com/sites/products/ProductAttachments/NRSRO%202013.pdf

[69] Because Form NRSRO Exhibit 1s are currently organized according to each asset class (for example, all ratings of structured finance over a one-year transition period are in a single chart), instead of in a way that allows for comparing ratings across asset classes (for example, AAA-rated structured products vs. AAA-rated municipals), it was extremely difficult and labor intensive to provide a comprehensive analysis of performance across assets. Accordingly, we have limited our analysis to AAA-rated and BBB+/Baa1-rated assets.

[70] *See* Appendix B.

more notches more than three times as often as corporates and more than 17 times as often as municipals within a three-year average transition period.

Moody's historical average performance across AAA-rated assets (typically from 1983 through 2012) follows a similar track as S&P's and Fitch's. For example, issuers of asset backed securities[71] were almost thirty times more likely to be downgraded three or more notches than municipals within a one-year average transition period. Over a three-year period, issuers of asset backed securities suffered downgrades of three or more notches approximately 20% of the time, whereas foreign sovereigns were downgraded three or more notches less than 3% of the time and municipals were downgraded three or more notches less than 1% of the time.



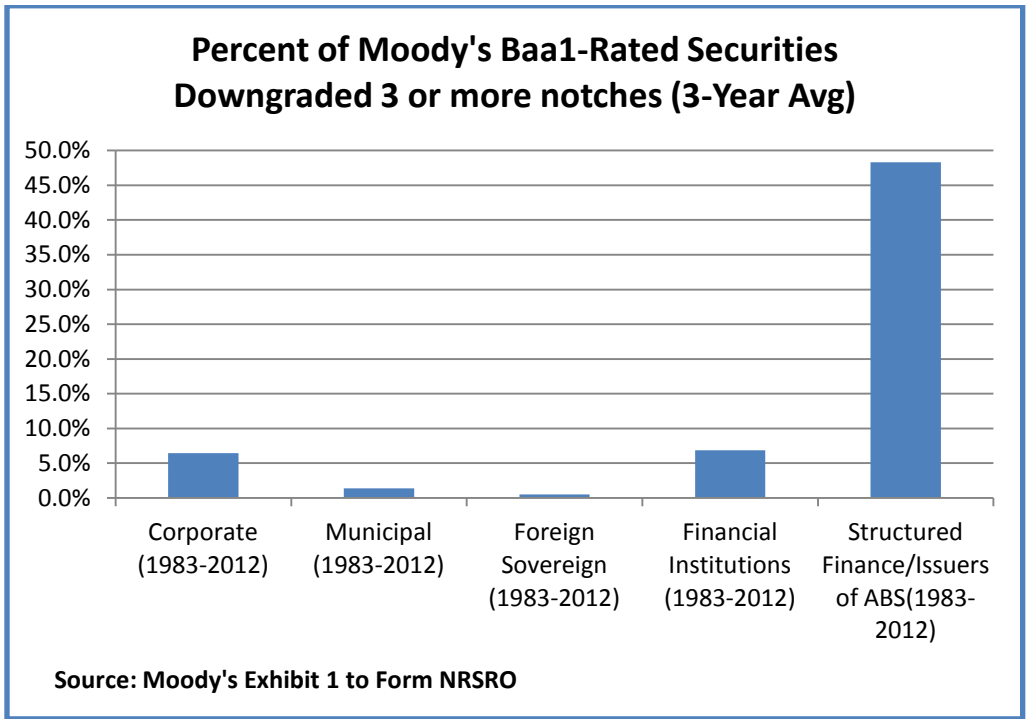
Moody's also exhibited stark default statistics between asset classes. Over a ten year average transition period, issuers of asset backed securities that originally were rated AAA defaulted 21.15% of the time, compared to all other asset classes, which never defaulted within the same time frame.[72]

Trends showing inconsistencies based on historical average performance can also be seen in lower-rated securities. For example, if one examines S&P's historical average performance across BBB+-rated assets, one finds that over a one-year period, structured products were downgraded 3 or more notches more than 20% of the time. In contrast, corporates and foreign sovereigns faced similar downgrades less than 2% of the time, and municipals faced similar downgrades less than 0.5% of the time. Over a three-year period, S&P's structured securities

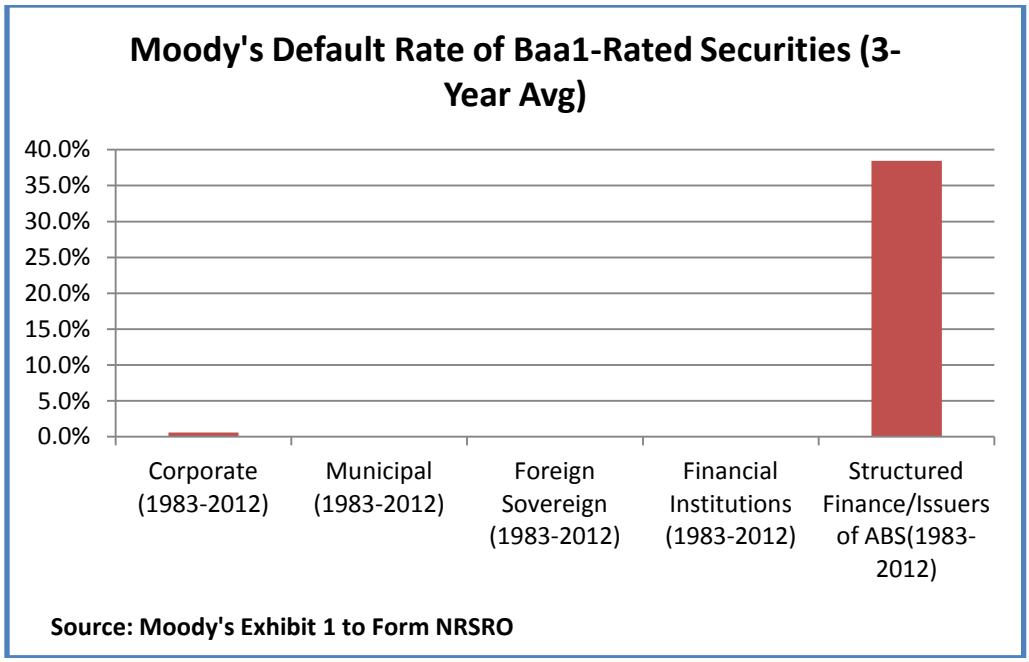
[71] Moody's refers to "issuers to asset backed securities" instead of "Structured Finance" or "Structured Products."
[72] *See* Appendix B.

were downgraded three or more notches approximately 30% of the time, compared with foreign sovereigns and municipals, which had similar downgrades less than 2% of the time. S&P also showed vast differences in default statistics. For example, over a three-year period, structured products defaulted more than 18% of the time, whereas corporates defaulted less than 1% of the time, foreign sovereigns defaulted less than 2% of the time, financial institutions defaulted approximately 1% of the time, and municipals defaulted just 0.02% of the time.

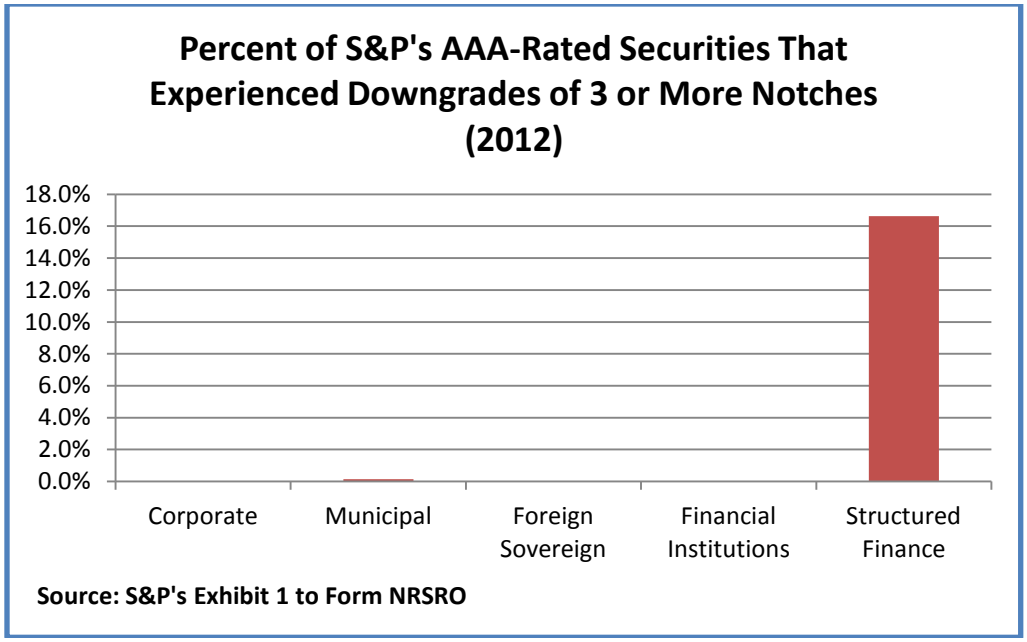
Moody's historical average performance across Baa1-rated assets follows a similar trend. Over a one-year transition period, issuers of asset backed securities were downgraded 3 or more notches more than 27 % of the time. In contrast, all other assets experienced similar downgrades less than 2% of the time. Over a three-year period, issuers of asset backed securities were downgraded 3 or more notches more than 48% of the time, compared with corporates and financial institutions, which experienced similar downgrades less than 7% of the time, municipals, which experienced similar downgrades less than 2% of the time, and foreign sovereigns, which experienced similar downgrades less than 1% of the time.



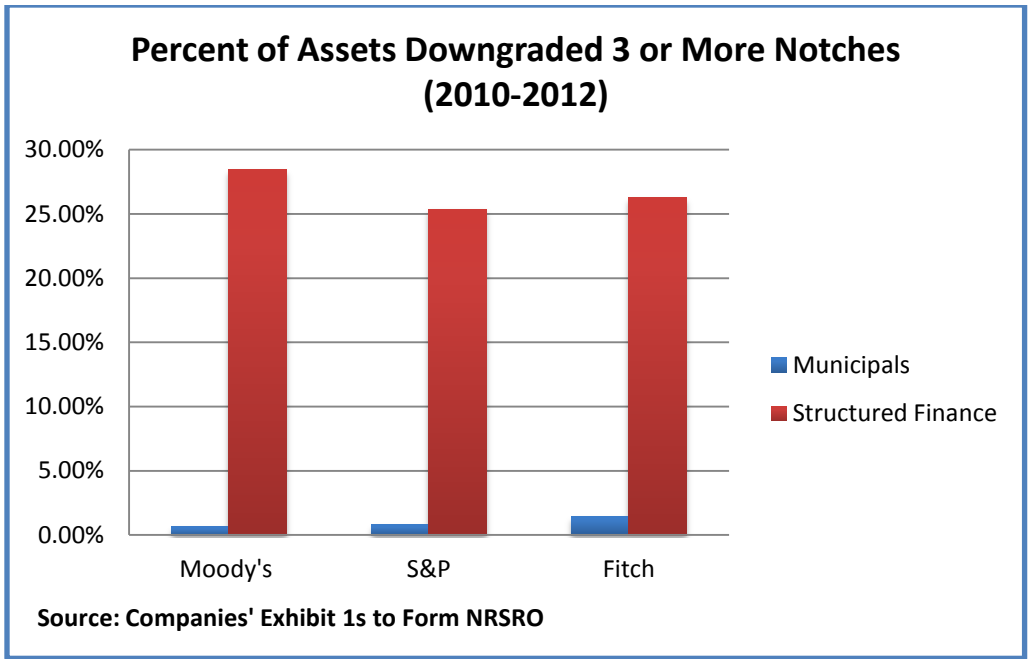
Moody's historical average default statistics are also inconsistent between asset classes, further underscoring a lack of rating standardization. For example, over a three-year period, issuers of asset backed securities defaulted more than 38% of the time, compared with corporates, which defaulted less than 1% of the time, and municipals, foreign sovereigns, and financial institutions, which never defaulted during the same transition period. Over a ten-year period, issuers of asset backed securities defaulted approximately 80% of the time, compared with financial institutions, which defaulted less than 6% of the time, corporates, which defaulted less than 4% of the time, municipals, which defaulted 0.2% of the time, and foreign sovereigns which never defaulted.



NRSROs' most recent ratings performance still shows signs of inconsistency across asset classes. If one examines S&P's performance across assets through the most recent calendar year, for example, one finds that in 2012, AAA-rated structured products suffered downgrades of three or more notches more than 16% of the time. In contrast, corporates, foreign sovereigns, and financials experienced no downgrades, and municipals were only downgraded 0.15% of the time.[73] This trend continues across the most recent three-year window, from 2010 to 2012. Fitch's and Moody's data show similar results.



[73] *See* Appendix B.



We are mindful that some of the recent downgrades may be due to the fact that certain structured securities hold vintages that were originated and structured before the crisis. Until those pre-crisis securities are no longer outstanding, we will not have a complete understanding of the NRSROs' most recent rating practices and performance.

Still, there are reasons to be skeptical that NRSROs have learned the lessons of the financial crisis, as recent ratings activities have been of dubious quality. First, if the securities being downgraded do contain pre-crisis vintages, the delay in downgrades, followed by mass sudden and severe downgrades —more than three years after, and in some cases five years after the risks originally surfaced— does not speak well to the credit rating agencies' surveillance activities, and suggests that they failed to monitor, assess, and appropriately respond to known risks in a timely manner. Second, even after the crisis, NRSROs rated certain very complex and opaque securities very highly, only to downgrade them a short time later. For example, S&P gave certain re-securitizations, or re-remics (real estate mortgage investment conduits) that were structured by three prominent issuers and likely repeat customers, Credit Suisse, Jeffries, and Royal Bank of Scotland, AAA-ratings in 2009. In 2010, S&P issued sudden mass-downgrades for these securities, cutting them to junk status.[74] Fitch, which has also rated re-securitizations, recently affirmed or upgraded 825 classes of securities, while downgrading only 12, despite the fact that most of the residential mortgage backed securities underlying the re-securitizations are from vintage transactions that continue to experience high delinquencies, extended liquidation timelines, and negative equity.[75]

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[74] Jody Shenn, *S&P Cuts to Junk Mortgage Bonds It Rated AAA in 2009*, BLOOMBERG, May 14, 2010, http://www.bloomberg.com/news/2010-05-14/s-p-cuts-to-junk-home-mortgage-bonds-that-it-rated-aaa-quality-last-year.html

[75] Press Release, "Fitch Takes Various Actions on U.S. Prime RMBS Re-REMICs," BUSINESS WIRE, (February 21, 2014), http://finance.yahoo.com/news/fitch-takes-various-actions-u-211000793.html

There are also reasons to be skeptical that without a vigorous regulatory response, NRSROs will improve their rating practices in any meaningful way in the long term. During the financial crisis, there was a precipitous decline in the issuance of structured products.[76] But as the economy has rebounded, so has the structured products market.[77] It is reasonable to believe that market will continue to follow a path similar to that of the economic cycle. Such a scenario would result in substantial revenue potential for NRSROs and could lead to a situation in which ratings inflation in the structured finance market proliferates.

There is a clear nexus between revenue potential and ratings inflation, which is a function of the issuer-pays business model leading to conflicts of interest within credit rating agencies. Ratings agencies are likely to grant more favorable ratings to issuers who are likely to seek significant current and future business. This phenomenon is likely reinforced when there are few issuers in a certain asset class, which is common in the structured finance arena, because those issuers will choose whichever NRSRO rates their securities most favorably, and because NRSROs won't risk losing any business from an issuer with such market power. Jie He, Jun Qian, and Philip E. Strahan's recent finding that there is significant ratings inflation among credit rating agencies' largest clients substantiates this point,[78] and the DOJ's complaint provides an illustration. As the DOJ alleges and as discussed above, in one instance an S&P ratings analyst informed his superiors in a lost deal memo that they had just lost a huge deal from Mizuho, a significant issuer of RMBS. The analyst cautioned them that losing even one significant deal could have a lasting impact on future deals.[79]

Consistent with He et al.'s findings, Cornaggia et al. have found that ratings inflation increases with revenues by asset class. According to their research, revenues generated from structured products are significantly higher than those generated from corporate issuers, which are in turn higher than those generated from sovereign and municipal issuers.[80]

Without strong regulation to curb the interplay of these forces that cause ratings inflation, there is a serious risk of returning to an environment similar to the one that helped to incubate the recent financial crisis. Clearly, decisive action will be needed to reform these dynamics and deliver the universal ratings intended by Congress.

4. Although the Commission's staff found that credit ratings historically have not been comparable, the staff recommended to the Commission that it take no further action to address this problem. Failure to act would ignore the congressional mandate set forth in Dodd-Frank to require "consistent application of ratings symbols and definitions."

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[76] *See* Research Statistics, US ABS Issuance and Outstanding, US Mortgage-Related Issuance and Outstanding, Global CDO Issuance and Outstanding, SIFMA, https://www.sifma.org/research/statistics.aspx

[77] *Id*.

[78] Jie He, Jun Qian, and Philip E. Strahan, *Are All Ratings Created Equal? The Impact of Issuer Size on the Pricing of Mortgage-Backed Securities*, January 20, 2012, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1512732

[79] *Compl*., United States of America v. McGraw-Hill Companies, Inc., and Standard and Poor's Financial Services LLC, at 44, No. CV-13-00779, C.D. Cal, February 4, 2013, http://www.justice.gov/iso/opa/resources/849201325104924250796.PDF

[80] Cornaggia et al., *Credit Ratings Across Asset Classes* at 4.

Despite the Commission staff's finding that credit ratings have not historically been comparable across asset classes, the staff recommended that the Commission not take any further action at the time with respect to standardizing credit rating terminology across asset classes so that named ratings would correspond to a standard range of default probabilities and expected losses independent of asset class and issuing entity.[81] The staff justified this laissez-faire approach on the grounds that it may not be feasible to attain comparability across asset classes. In reaching this conclusion, the report cited industry comments, relying on the same companies that have proven themselves incapable of issuing accurate and reliable ratings. Without explanation, the Commission's staff seemed to take the NRSROs at their word when they said they "strive" to make their rating symbols reflect a "broadly comparable" view of creditworthiness, and that when they assign a given rating symbol to multiple issuers, they "intend[] to connote roughly the same opinion of creditworthiness."[82] The Commission's staff did not raise a red flag at this carefully worded language, which rings reminiscent of when NRSROs claimed that their ratings were only opinions and not actual assertions based on fact. Instead, the Commission's staff deferred to the industry's judgment when they said that, although each credit rating agency should pursue comparability across asset classes, they did not believe that mandating standardized ratings was the answer.

Regardless of NRSROs' intent, the fact remains that they have failed to actually achieve comparability. The kind of wildly divergent results that we've seen can logically be explained in only one of two ways: either ratings agencies have intentionally inflated certain products' ratings or they have been so grossly incompetent that have been incapable of producing comparable results. Either explanation demands a more forceful response from the Commission and its staff. The first explanation could be addressed through a strong policy on universal ratings. The second explanation raises questions about whether ratings agencies should lose their right to rate certain products if they cannot issue ratings that more accurately reflect the credit risks.

The Commission staff's conclusion was unfounded and contravenes the plain language of the law, in addition to Congress' intent when it passed section 938(a) of Dodd-Frank.

5. In addition to the fact that Congress mandated that the Commission standardize credit ratings, the Commission should also recognize the fact that the non-standardization of credit ratings imposes real costs to the market and to society.

Credit ratings play an essential role in the U.S. economy. Ratings dictate how much creditors will be paid to lend and how much issuers, including corporations and municipalities, will pay to borrow. They also provide information to a host of market participants. Specifically, in the structured finance arena where complexity is seemingly ubiquitous, investors may rely on ratings more heavily than they would for other types of securities.[83] When it is virtually impossible to accurately gauge credit risk based on ratings, ratings become meaningless and credit rating agencies no longer serve their intended purpose.

[81] *See supra, Report to Congress Credit Rating Standardization Study.*
[82] *Id*. at 34-38.
[83] *See supra*, *The Financial Crisis Inquiry Report* at 148.

While the Dodd-Frank Act required the removal of ratings references in all federal regulations, state (i.e. insurance) and international (i.e. Basel) regulations are not subject to Dodd-Frank mandates. As a result, state and international regulatory costs can be imposed on financial institutions based on their exposure to different rated assets.[84] Additionally, credit ratings can affect institutional investors' decisions based on their incentives to reach for yield while still holding highly-rated debt.[85] And even where references to ratings have been or will be removed from the statute and related rules, it is not clear that industry will be any less reliant on ratings in practice. Thus, the public continues to have a strong interest in the effective regulation of NRSROs. Dodd-Frank recognized that continuing interest when it both removed the ratings agencies' statutorily mandated role and greatly expanded regulatory requirements.

With regard to municipalities, credit ratings have a direct impact on the costs to taxpayers. Because ratings dictate the amount American taxpayers spend to borrow, and because municipal debt is often held to more stringent ratings criteria than other assets (as the previous analysis has shown), municipalities appear to be paying inflated costs to borrow. It has been well-documented by the Senate PSI[86] and House Financial Services Committee[87] that, although state and local government bonds are much less likely than other securities to incur defaults, they have faced discriminatory ratings and, as a result, increased borrowing costs, relative to other securities. In 2008, then-Attorney General of the State of Connecticut and current Senator Richard Blumenthal (D-CT) sued Moody's, Fitch, and McGraw-Hill (parent company of S&P), claiming that they rated municipal bonds on a stricter scale than other asset classes, which resulted in higher interest costs imposed on taxpayers. Blumenthal alleged that, as a result of these rating practices, Connecticut cities, towns, school districts, and sewer and water districts were forced either to spend millions of taxpayer dollars to purchase bond insurance to improve their credit rating or pay higher interest costs on their lower-rated bonds.[88] In 2010, S&P and Fitch said that they would recalibrate their municipal bond ratings so that they are on the same scale as other securities and in 2011, all three companies, settled with the State of Connecticut, agreeing to credit the state about $900,000, to offset the expense of obtaining future ratings on the sales of state bonds.[89]

In addition, Jess Cornaggia, Kimberly J. Cornaggia, and Ryan Israelsen recently released a paper[90] documenting just how economically significantly increased borrowing costs based on lower credit ratings can impact municipalities. Cornaggia found that Moody's recalibration of its municipal rating system resulted in more than $642 billion in municipal debt across the country being upgraded, which lowered the average annual yield by 19 basis points. The product of a 19-

[84] *See* Cornaggia et al., *Credit Ratings Across Asset Classes* at 5-6.
[85] *Id.*; *See* Calomiris, *The Debasement of Ratings.*
[86] *See supra, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*.
[87] *See supra,* Hearing Before the Committee on Financial Services, ''Municipal Bond Turmoil: Impact on Cities, Towns and States."
[88] Press Release, Connecticut Attorney General's Office, "Attorney General Sues Credit Rating Agencies For Illegally Giving Municipalities Lower Ratings, Costing Taxpayers Millions," (July 30, 2008), http://www.ct.gov/ag/cwp/view.asp?a=2795&q=420390
[89] David McLaughlin and Zeke Faux, *Moody's, S&P, Fitch Settle Connecticut Lawsuit Over Public Bond Ratings,* BLOOMBERG, October 14, 2011, http://www.bloomberg.com/news/2011-10-14/moody-s-s-p-fitch-settle-connecticut-lawsuit-over-public-bond-ratings.html
[90] Jess Cornaggia, Kimberly J. Cornaggia, and Ryan Israelsen, *Do Credit Ratings Still Matter? Evidence from the Municipal Bond Market*, December 15, 2013, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2304373

basis point discount on $642 billion is more than $1.2 billion, which represents the annual value lost by U.S. taxpayers because of Moody's dual-class rating system. However, even after this recalibration, it is unclear whether any disparities in ratings performance between municipals and other assets persist. If they do persist, municipalities, and therefore U.S. taxpayers, are continuing to pay premiums on their borrowings, which would translate to increased costs to build schools, bridges, roads, sewer systems, hospitals, and other vital infrastructure.

6. **The Commission should re-propose its rule requiring universal rating symbols so that NRSROs' public disclosures are easily understandable and comparable, and so that NRSROs are held accountable if they fail to achieve a high degree of comparability.**

As we've already discussed, Congress required that NRSROs apply ratings symbols and definitions consistently; it is not optional. And it is the Commission's duty to make sure that the statute is implemented and enforced, as Congress intended. To fulfill its obligation, the Commission will need to take forceful action. The do-nothing approach suggested by the staff is not acceptable.

The Commission has clear authority to hold NRSROs accountable for producing comparable ratings across asset classes. As a first step, it should require NRSROs to specify an acceptable range of default probabilities and corresponding loss expectations for each asset class and rating symbol. Where ratings of certain asset classes diverge significantly from the expected norms, the Commission should require the NRSRO to identify the source of the error that led to the divergence and what it is doing to remedy the problem. While external factors could explain a divergence in a given year or two-year period, where the divergence in ratings performance across asset classes persists, the Commission should require the NRSRO to adjust its methodology—which in turn could affect its outstanding and prospective ratings—to correct the problem. That approach would create a strong incentive for NRSROs to get it right on the front end by issuing accurate and comparable ratings.

One likely result of this proposed framework is that rating agencies will cease to use similar ratings across asset classes. This is a perfectly acceptable outcome, as long as the symbols are truly different and the rating agencies provide a clear explanation of the expected performance of each rating symbol. Clear disclosure of different assets' expected risk characteristics and recent performance outcomes is necessary to ensure that ratings are not being degraded to a degree that makes them non-meaningful and that they are in fact performing comparably, based on objective criteria. Again, we strongly disagree with the Commission's staff's recommendation not to take any further action with respect to requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations, as that approach would allow rating agencies to continue to issue non-meaningful ratings. Additionally, merely allowing NRSROs to engage in gimmicks like adding subscripts to ratings (for example, AAAm, AAAc, or AAAsf) is not an acceptable outcome. During the run-up to the crisis, had structured finance products been rated under either a comparability requirement, or even under a different system of symbols, they might not have been able to so pervade and ultimately disrupt the financial system.

Next, the Commission should invoke its Section 15E(p)(4) authority to seek fines and the disgorgement of profits when an NRSRO persistently issues non-standardized ratings. The use of this authority to penalize and deter NRSROs from failing to achieve comparable ratings between asset classes will create further incentive for them to get it right on the front end.

The Commission should also make clear that if an NRSRO fails repeatedly to produce accurate ratings or achieve comparability across asset classes, the Commission will use its section 932 authority to suspend or revoke the NRSRO's status for the affected asset class. NRSRO status is a privilege that comes with certain obligations, chief among them to be accurate and reliable and to consistently produce credit ratings with integrity. If an NRSRO ceases to operate according to those obligations, it should lose the pleasure of doing business until it demonstrates that it is able and willing to operate according to them.

Relying on disclosure alone is not sufficient, but the disclosures themselves are also inadequate. At a bare minimum, the Commission should amend Instruction H to Form NRSRO (the instructions for Exhibit 1 performance measurement statistics) and Rule 17g-1 to require that the information presented in Exhibit 1 disclosures is publicly understandable and comparable across assets. Form NRSRO Exhibit 1s are currently organized according to each asset class, which makes it extremely difficult and labor intensive to compare ratings performance. To cure these deficiencies, the Commission should require NRSROs to present their performance statistics in a way that allows the public to compare and cross-reference different assets with the same credit ratings, as we have done manually for AAA-rated and BBB+/Baa1-rated assets.

Moreover, the Commission should consider requiring NRSROs to submit the data that is presented in Exhibit 1 disclosures in "tagged" format. As the SEC Investor Advisory Committee has observed, tagging data through formats like XML and XBRL would allow all of the information in those disclosures to become fully searchable, sortable, and downloadable. Doing so will enable investors, regulators, and other capital market participants to retrieve and closely analyze the information, then react accordingly.[91]

While it may not be easy to achieve comparability of credit ratings across asset classes, it is incumbent on the Commission to continue to seek ways to ensure either that ratings do become comparable or that different ratings systems are adopted where comparability cannot be achieved. Because the Commission's proposed rule neither encourages accurate, reliable, consistent, and standardized ratings, nor discourages inaccurate, unreliable, inconsistent, and non-standardized ratings, the Commission should re-propose its rule in such a way that those goals are achieved.

Conclusion

As we stated in our 2011 comment, the Commission has the opportunity with these rules to significantly improve both the transparency and operations of credit rating agencies and deliver on Dodd Frank's promise of bringing accuracy, integrity, and reliability to the ratings process.

[91] Recommendations of the Investor Advisory Committee Regarding the SEC and the Need for the Cost Effective Retrieval of Information by Investors (Adopted July 25, 2013), https://www.sec.gov/spotlight/investor-advisory-committee-2012/data-tagging-resolution-72513.pdf

But it cannot make good on that promise unless important changes are made to the proposed rule. Accordingly, we urge the Commission to re-propose and extensively revise rule changes relating to credit rating agencies registered with the Commission as Nationally Recognized Statistical Rating Organizations (NRSROs) so that they match the scale of the problem they were intended to address and deliver the full scope of the credit rating agency reforms that Congress intended when it adopted the Dodd-Frank Act.

Respectfully submitted,

Micah Hauptman
Financial Services Counsel

Barbara Roper
Director of Investor Protection

cc: The Honorable Mary Jo White, Chair
The Honorable Luis Aguilar, Commissioner
The Honorable Daniel Gallagher, Commissioner
The Honorable Michael Piwowar, Commissioner
The Honorable Kara Stein, Commissioner

Appendix A. Cornaggia et al.'s findings [Tables 2 and 3 in *Credit Ratings Across Asset Classes*]

Moody's Aaa

Major Asset Classes	# Aaa ratings	Total # ratings	% Downgraded 3 or more notches	% of Aaa ratings relative to total ratings in that asset class	Default rate	% Downgraded 5 yr transition	% Downgraded 3 or more notches
Corporate	1,867	32,355	7.50%	5.77%	0.16%	37.76%	7.50%
Municipal	1,862	5,388	0.00%	34.56%	0.05%	4.35%	0.00%
Sovereign	3,541	10,402	0.11%	34.04%	0.00%	8.30%	0.11%
Financial	395	26,142	7.34%	1.51%	0.25%	23.29%	7.34%
Structured	102,680	185,340	19.50%	55.40%	3.64%	30.96%	19.50%

Moody's Aa

Major Asset Classes	# Aa ratings	Total # ratings	% Downgraded 3 or more notches	% of Aa ratings relative to total ratings in that asset class	Default rate	% Downgraded 5 yr transition	% Downgraded 3 or more notches
Corporate	3,480	32,355	1.06%	10.76%	0.34%	26.35%	1.06%
Municipal	2,811	5,388	0.00%	52.17%	0.00%	1.32%	0.00%
Sovereign	2,251	10,402	0.00%	21.64%	0.00%	7.29%	0.00%
Financial	11,113	26,142	0.16%	42.51%	0.56%	28.38%	0.16%
Structured	30,063	185,340	10.95%	16.22%	20.21%	42.62%	10.95%

Moody's A

Major Asset Classes	# A ratings	Total # ratings	% Downgraded 3 or more notches	% of A ratings relative to total ratings in that asset class	Default rate	% Downgraded 5 yr transition	% Downgraded 3 or more notches
Corporate	13,635	32,355	0.84%	42.14%	0.51%	15.50%	0.84%
Municipal	715	5,388	0.00%	13.27%	0.00%	0.28%	0.00%
Sovereign	1,965	10,402	0.00%	18.89%	0.00%	2.19%	0.00%
Financial	12,750	26,142	0.91%	48.77%	4.13%	17.88%	0.91%
Structured	21,682	185,340	10.57%	11.70%	26.97%	47.49%	10.57%

Moody's Baa

Major Asset Classes	# Baa ratings	Total # ratings	% Downgraded 3 or more notches	% of Baa ratings relative to total ratings in that asset class	Default rate	% Downgraded 5 yr transition	% Downgraded 3 or more notches
Corporate	6,875	32,355	0.92%	21.25%	1.69%	12.35%	0.92%
Municipal	0	5,388	0.00%	0.00%	0.00%	0.00%	0.00%
Sovereign	1,092	10,402	0.00%	10.50%	2.29%	17.22%	0.00%
Financial	1,562	26,142	13.38%	5.98%	2.18%	26.70%	13.38%
Structured	19,578	185,340	11.25%	10.56%	39.52%	58.35%	11.25%

Moody's Ba

Major Asset Classes	# Ba ratings	Total # ratings	% Downgraded 3 or more notches	% of Ba ratings relative to total ratings in that asset class	Default rate	% Downgraded 5 yr transition	% Downgraded 3 or more notches
Corporate	2,140	32,355	1.72%	6.61%	7.52%	20.98%	1.72%
Municipal	0	5,388	9.09%	0.00%	0.00%	36.36%	9.09%
Sovereign	941	10,402	2.76%	9.05%	5.74%	13.07%	2.76%
Financial	322	26,142	8.07%	1.23%	5.59%	34.47%	8.07%
Structured	7,013	185,340	10.35%	3.78%	40.98%	61.61	10.35%

Moody's B

Major Asset Classes	# B ratings	Total # ratings	% Downgraded 3 or more notches	% of B ratings relative to total ratings in that asset class	Default rate	% Downgraded 5 yr transition	% Downgraded 3 or more notches
Corporate	3,798	32,355	0.29%	11.74%	21.30%	25.78%	0.29%
Municipal	0	5,388	0.00%	0.00%	0.00%	42.86%	0.00%
Sovereign	612	10,402	0.00%	5.88%	10.95%	10.46%	0.00%
Financial	0	26,142	0.00%	0.00%	0.00%	11.11%	0.00%
Structured	2,629	185,340	11.91%	1.42%	38.00%	53.44	11.91%

Appendix B. [Our analysis of S&P's, Fitch's and Moody's Exhibit 1 Form NRSRO Disclosures]

S&P HISTORICAL AVERAGE PERFORMANCE		
S&P AAA 1 Year avg performance	**Downgraded 3 or more notches**	**Default**
Corporate (1981-2012)	1.61%	0.00%
Municipal (1986-2012)	0.11%	0.00%
Foreign Sovereign (1975-2012)	0.00%	0.00%
Financial Institutions (1981-2012)	1.10%	0.00%
Structured Finance (1983-2012)	5.02%	0.11%
S&P AAA 3 Year avg performance	**Downgraded 3 or more notches**	**Default**
Corporate (1981-2012)	6.69%	0.00%
Municipal (1986-2012)	0.44%	0.00%
Foreign Sovereign (1975-2012)	1.98%	0.00%
Financial Institutions (1981-2012)	4.28%	0.00%
Structured Finance (1983-2012)	10.83%	1.21%
S&P AAA 10 Year avg performance	**Downgraded 3 or more notches**	**Default**
Corporate (1981-2012)	22.83%	0.25%
Municipal (1986-2012)	0.92%	0.00%
Foreign Sovereign (1975-2012)	5.26%	0.00%
Financial Institutions (1981-2012)	14.33%	0.00%
Structured Finance (1983-2012)	2.27%	0.33%

S&P RECENT PERFORMANCE		
S&P AAA 1 Year performance 2012-2012	**Downgraded 3 or more notches**	**Default**
Corporate	0.00%	0.00%
Municipal	0.15%	0.00%
Foreign Sovereign	0.00%	0.00%
Financial Institutions	0.00%	0.00%
Structured Finance	16.64%	0.00%
S&P AAA 3 Year performance 2010-2012	**Downgraded 3 or more notches**	**Default**
Corporate	0.00%	0.00%
Municipal	0.80%	0.00%
Foreign Sovereign	0.00%	0.00%
Financial Institutions	7.40%	0.00%
Structured Finance	25.38%	0.80%
S&P AAA 10 Year performance 2003-2012	**Downgraded 3 or more notches**	**Default**
Corporate	27.59%	0.00%
Municipal	1.77%	0.00%
Foreign Sovereign	6.25%	0.00%
Financial Institutions	8.58%	0.00%
Structured Finance	5.03%	0.86%

FITCH HISTORICAL AVG PERFORMANCE

Fitch AAA 1 Year avg performance	**Downgraded 3 or more notches**	**Default***
Corporate (1990-2012)	0.51%	0.00%
Municipal (1999-2012)	0.23%	0.00%
Foreign Sovereign (1995-2012)	0.43%	0.00%
Financial Institutions (1990-2012)	0.35%	0.00%
Structured Finance (1990-2012)	4.50%	0.97%

Fitch AAA 3 Year avg performance	**Downgraded 3 or more notches**	**Default***
Corporate (1990-2012)	4.12%	0.00%
Municipal (1999-2012)	0.73%	0.00%
Foreign Sovereign (1995-2012)	2.47%	0.00%
Financial Institutions (1990-2012)	Not Listed	Not Listed
Structured Finance (1990-2012)	7.48%	5.58%

Fitch AAA 10 Year avg performance	**Downgraded 3 or more notches**	**Default***
Corporate (1990-2012)	39.22%	0.00%
Municipal (1999-2012)	1.35%	0.00%
Foreign Sovereign (1995-2012)	4.25%	0.00%
Financial Institutions (1990-2012)	Not Listed	Not Listed
Structured Finance (1990-2012)	0.71%	0.29%

* Fitch calculates its Structured Finance performance not based on default but on impairment rates, which includes defaults and "near defaults," which include bonds rated CCsf or below.

FITCH RECENT PERFORMANCE

Fitch AAA 1 Year performance 2012-2012	**Downgraded 3 or more notches**	**Default***
Corporate (Global Industrial)	0.00%	0.00%
Municipal	0.23%	0.00%
Foreign Sovereign	0.00%	0.00%
Financial Institutions	0.00%	0.00%
Structured Finance	17.12%	0.00%

Fitch AAA 3 Year performance 2010-2012	**Downgraded 3 or more notches**	**Default***
Corporate (Global Industrial)	0.00%	0.00%
Municipal	1.44%	0.00%
Foreign Sovereign	6.67%	0.00%
Financial Institutions	9.09%	0.00%
Structured Finance	26.27%	0.49%

Fitch AAA 10 Year performance 2003-2012	**Downgraded 3 or more notches**	**Default***
Corporate (Global Industrial)	50.00%	0.00%
Municipal	1.41%	0.00%
Foreign Sovereign	9.09%	0.00%
Financial Institutions	16.67%	0.00%
Structured Finance	1.71%	0.47%

* Fitch calculates its Structured Finance performance not based on default but on impairment rates, which includes defaults and "near defaults," which include bonds rated CCsf or below.

MOODY'S HISTORICAL AVG PERFORMANCE		
Moody's AAA 1 Year avg performance	**Downgraded 3 or more notches**	**Default**
Corporate (1983-2012)	1.58%	0.00%
Municipal (1983-2012)	0.27%	0.00%
Foreign Sovereign (1983-2012)	0.15%	0.00%
Financial Institutions (1983-2012)	0.92%	0.00%
Structured Finance/Issuers of ABS(1983-2012)	7.98%	0.38%
Moody's AAA 3 Year avg performance	**Downgraded 3 or more notches**	**Default**
Corporate (1983-2012)	5.53%	0.00%
Municipal (1983-2012)	0.74%	0.00%
Foreign Sovereign (1983-2012)	2.37%	0.00%
Financial Institutions (1983-2012)	8.23%	0.00%
Structured Finance/Issuers of ABS(1983-2012)	19.44%	5.20%
Moody's AAA 10 Year avg performance	**Downgraded 3 or more notches**	**Default**
Corporate (1983-2012)	18.14%	0.00%
Municipal (1983-2012)	2.02%	0.00%
Foreign Sovereign (1983-2012)	8.67%	0.00%
Financial Institutions (1983-2012)	26.98%	0.00%
Structured Finance/Issuers of ABS (1983-2012)	2.20%	21.15%

MOODY'S RECENT PERFORMANCE		
Moody's AAA 1 Year performance 2012-2012	**Downgraded 3 or more notches**	**Default**
Corporate	5.26%	0.00%
Municipal	0.31%	0.00%
Foreign Sovereign	0.00%	0.00%
Financial Institutions	0.00%	0.00%
Structured Finance/Issuers of ABS	12.62%	0.07%
Moody's AAA 3 Year performance 2010-2012	**Downgraded 3 or more notches**	**Default**
Corporate	8.00%	0.00%
Municipal	0.64%	0.00%
Foreign Sovereign	5.56%	0.00%
Financial Institutions	8.57%	0.00%
Structured Finance/Issuers of ABS	28.43%	0.43%
Moody's AAA 10 Year performance 2003-2012	**Downgraded 3 or more notches**	**Default**
Corporate	15.79%	0.00%
Municipal	1.06%	0.00%
Foreign Sovereign	15.79%	0.00%
Financial Institutions	12.50%	0.00%
Structured Finance/Issuers of ABS	6.43%	3.80%

S&P HISTORICAL AVERAGE PERFORMANCE		
S&P BBB+ 1 Year avg performance	**Downgraded 3 or more notches**	**Default**
Corporate (1981-2012)	1.54%	0.13%
Municipal (1986-2012)	0.34%	0.01%
Foreign Sovereign (1975-2012)	1.59%	0.00%
Financial Institutions (1981-2012)	1.69%	0.28%
Structured Finance (1983-2012)	20.66%	1.34%
S&P BBB+ 3 Year avg performance	**Downgraded 3 or more notches**	**Default**
Corporate (1981-2012)	5.23%	0.64%
Municipal (1986-2012)	0.76%	0.02%
Foreign Sovereign (1975-2012)	1.79%	1.79%
Financial Institutions (1981-2012)	2.84%	1.08%
Structured Finance (1983-2012)	29.71%	18.60%
S&P BBB+ 10 Year avg performance	**Downgraded 3 or more notches**	**Default**
Corporate (1981-2012)	9.39%	3.74%
Municipal (1986-2012)	1.23%	0.21%
Foreign Sovereign (1975-2012)	0.00%	0.00%
Financial Institutions (1981-2012)	4.17%	3.26%
Structured Finance (1983-2012)	7.89%	14.14%

S&P RECENT PERFORMANCE		
S&P BBB+ 1 Year performance 2012-2012	**Downgraded 3 or more notches**	**Default**
Corporate	0.00%	0.00%
Municipal	1.59%	0.16%
Foreign Sovereign	0.00%	0.00%
Financial Institutions	7.83%	0.00%
Structured Finance	18.65%	0.17%
S&P BBB+ 3 Year performance 2010-2012	**Downgraded 3 or more notches**	**Default**
Corporate	1.08%	0.00%
Municipal	0.51%	0.00%
Foreign Sovereign	0.00%	25.00%
Financial Institutions	3.84%	0.00%
Structured Finance	34.41%	7.43%
S&P BBB+ 10 Year performance 2003-2012	**Downgraded 3 or more notches**	**Default**
Corporate	6.27%	0.99%
Municipal	1.26%	0.00%
Foreign Sovereign	0.00%	0.00%
Financial Institutions	10.24%	1.14%
Structured Finance	4.85%	8.50%

MOODY'S HISTORICAL AVG PERFORMANCE		
Moody's Baa1 1 Year avg performance	**Downgraded 3 or more notches**	**Default**
Corporate (1983-2012)	1.88%	0.00%
Municipal (1983-2012)	0.19%	0.00%
Foreign Sovereign (1983-2012)	1.42%	0.00%
Financial Institutions (1983-2012)	4.35%	0.00%
Structured Finance/Issuers of ABS(1983-2012)	27.07%	3.90%
Moody's Baa1 3 Year avg performance	**Downgraded 3 or more notches**	**Default**
Corporate (1983-2012)	6.43%	0.59%
Municipal (1983-2012)	1.37%	0.00%
Foreign Sovereign (1983-2012)	0.50%	0.00%
Financial Institutions (1983-2012)	6.88%	0.00%
Structured Finance/Issuers of ABS(1983-2012)	48.30%	38.44%
Moody's Baa1 10 Year avg performance	**Downgraded 3 or more notches**	**Default**
Corporate (1983-2012)	8.13%	3.33%
Municipal (1983-2012)	0.96%	0.21%
Foreign Sovereign (1983-2012)	0.78%	0.00%
Financial Institutions (1983-2012)	1.12%	5.72%
Structured Finance/Issuers of ABS (1983-2012)	21.41%	79.70%

MOODY'S RECENT PERFORMANCE		
Moody's Baa1 1 Year performance 2012-2012	**Downgraded 3 or more notches**	**Default**
Corporate	0.00%	0.00%
Municipal	2.48%	0.00%
Foreign Sovereign	0.00%	0.00%
Financial Institutions	9.86%	1.49%
Structured Finance/Issuers of ABS	15.28%	0.00%
Moody's Baa1 3 Year performance 2010-2012	**Downgraded 3 or more notches**	**Default**
Corporate	0.73%	0.00%
Municipal	3.61%	0.00%
Foreign Sovereign	14.29%	0.00%
Financial Institutions	22.96%	2.08%
Structured Finance/Issuers of ABS	58.01%	15.69%
Moody's Baa1 10 Year performance 2003-2012	**Downgraded 3 or more notches**	**Default**
Corporate	6.23%	1.21%
Municipal	2.24%	0.22%
Foreign Sovereign	0.00%	0.00%
Financial Institutions	0.00%	0.00%
Structured Finance/Issuers of ABS	9.58%	18.95%