AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

S. Hrg. 107–471

RATING THE RATERS: ENRON AND THE CREDIT RATING AGENCIES

HEARING

BEFORE THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

MARCH 20, 2002

Printed for the use of the Committee on Governmental Affairs

U.S. GOVERNMENT PRINTING OFFICE

79–888 PDF WASHINGTON : 2002

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON GOVERNMENTAL AFFAIRS

JOSEPH I. LIEBERMAN, Connecticut, *Chairman*

CARL LEVIN, Michigan
DANIEL K. AKAKA, Hawaii
RICHARD J. DURBIN, Illinois
ROBERT G. TORRICELLI, New Jersey
MAX CLELAND, Georgia
THOMAS R. CARPER, Delaware
JEAN CARNAHAN, Missouri
MARK DAYTON, Minnesota

FRED THOMPSON, Tennessee
TED STEVENS, Alaska
SUSAN M. COLLINS, Maine
GEORGE V. VOINOVICH, Ohio
PETE V. DOMENICI, New Mexico
THAD COCHRAN, Mississippi
ROBERT F. BENNETT, Utah
JIM BUNNING, Kentucky

JOYCE A. RECHTSCHAFFEN, *Staff Director and Counsel*
CYNTHIA GOOEN LESSER, *Counsel*
BETH M. GROSSMAN, *Counsel*
THOMAS J. HOLLOMAN III, *Legislative Fellow*
RICHARD A. HERLTING, *Minority Staff Director*
WILLIAM M. OUTHIER, *Minority Chief Counsel*
JANA A. SINCLAIR, *Minority Counsel*
DARLA D. CASSELL, *Chief Clerk*

CONTENTS

	Page
Opening statements:	
Senator Lieberman	1
Senator Thompson	4
Senator Levin	5
Senator Bunning	6

WITNESSES

WEDNESDAY, MARCH 20, 2002

Ronald M. Barone, Managing Director, Corporate and Government Ratings Group, Standard & Poor's	6
John C. Diaz, Managing Director, Moody's Investors Service	8
Ralph G. Pellecchia, Senior Director, Global Power Group, Fitch Ratings	9
Hon. Isaac C. Hunt, Jr., Commissioner, U.S. Securities and Exchange Commission	40
Jonathan R. Macey, J. DuPratt White Professor of Law, Cornell Law School	43
Glenn L. Reynolds, Chief Executive Officer, CreditSights, Inc.	45
Steven L. Schwarcz, Professor of Law, Duke University School of Law	46

ALPHABETICAL LIST OF WITNESSES

Barone, Ronald M.:	
Testimony	6
Prepared statement with attachments	55
Diaz, John C.:	
Testimony	8
Prepared statement	116
Hunt, Hon. Isaac C., Jr.:	
Testimony	40
Prepared statement	131
Macey, Jonathan R.:	
Testimony	43
Prepared statement	138
Pellecchia, Ralph G.:	
Testimony	9
Prepared statement	129
Reynolds, Glenn:	
Testimony	45
Prepared statement	148
Schwarcz, Steven L.:	
Testimony	46
Prepared statement with an attachment	168

APPENDIX

Article entitled "Private Ordering of Public Markets: The Rating Agency Paradox," submitted by Mr. Schwarcz	175
Chart entitled "Project Margaux: Whitewing Associates, L.P. Financing Transaction, September 24, 1999" (submitted by Senator Levin)	207
Responses to Questions posed by Senator Levin during hearing from:	
Ralph G. Pellacchia	208
Questions for the Record and responses from:	
Hon. Hunt	211
Mr. Macey	212
Mr. Reynolds	213
Mr. Schwarcz	215

RATING THE RATERS: ENRON AND THE CREDIT RATING AGENCIES

WEDNESDAY, MARCH 20, 2002

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The Committee met, pursuant to notice, at 9:35 a.m., in room SD–342, Dirksen Senate Office Building, Hon. Joseph I. Lieberman, Chairman of the Committee, presiding.

Present: Senators Lieberman, Levin, Thompson, Bennett, and Bunning.

OPENING STATEMENT OF CHAIRMAN LIEBERMAN

Chairman LIEBERMAN. Good morning, and welcome to this fourth in a series of Governmental Affairs Committee hearings on the collapse of Enron and the implications for Enron employees, investors, and the American economy as a whole.

We are engaged in an ongoing investigation here into whether the private and public watchdogs did all they could have done to prevent or at least anticipate and warn the rest of us of Enron's collapse.

Today, we are going to look at the private sector credit rating agencies that wield immense power—to me, quasi-governmental power—to determine which companies within the corporate world are creditworthy and which are not. In pursuit of our purpose here, which is to learn the lessons of Enron and craft solutions to avoid future corporate calamities of this sort, we will ask why the credit raters continued to rate Enron as a good credit risk right up until 4 days before it declared bankruptcy.

In this particular part of our investigation, I must say I have learned a lot that I didn't know before about credit rating agencies. A credit rating, I suppose self-evidently, is an assessment of a company's creditworthiness or its likelihood of repaying its debt. The entire corporate credit rating industry consists of just three entities, three agencies—Moody's Investors Service, Standard & Poor's, and Fitch Ratings—three agencies that exercise significant power over corporate America, the markets, and, therefore, our entire economy. These are private companies, but the enormous scope of their influence comes largely as a result of their government-conferred power.

John Moody, the founder of what is now Moody's Investors Service, is recognized, I have learned, for devising credit ratings in 1908, and he did so for public debt issues, mostly railroad bonds at that time. Moody's credit ratings, first published in 1909, met

a need for accurate, impartial, and independent information on these bonds.

Now, almost a century later, an investment grade credit rating has become an absolute necessity for any company that wants to tap the resources of the capital markets. The credit raters really do hold the key to capital and liquidity, which, after all, are the lifeblood of corporate America and of our capitalist economy. The ratings they give affect a company's ability to borrow money. It affects whether a pension fund, for instance, or a money market fund can invest in a company's bonds, and it affects stock price. So the difference between a good rating and a poor rating can be the difference literally between success and failure, or more intensively stated, prosperity and poverty.

The government, through hundreds of laws and regulations, requires ratings. Corporate bonds, for instance, must be rated if they are to be considered appropriate investments for institutional investors. Most of the laws that require credit ratings involve banks and securities, but their reach, actually quite interestingly, also extends into education where schools must be rated in order to participate in certain financial assistance programs, and even into transportation where highway projects must receive a rating to qualify for Federal funding, and into telecommunications where companies must be rated in order to receive Federal loan guarantees. These rating requirements, quite understandably, have been placed by lawmakers in a whole series of economic activities as a way to give some independent assessment of the strength of the company.

Along with this power that the credit rating agencies have, comes special access and special protections. The credit raters, for example, I learned, are allowed to look at a company's inside information when making assessments, and they are exempted from liability when they participate in securities offerings, which are two benefits that give them more information than other analysts have who work within our system.

Someone once said that raters hold "almost Biblical authority." On a "NewsHour with Jim Lehrer" program in 1996, *New York Times* columnist Tom Friedman went so far as to say, "There are two superpowers in the world today: The United States and Moody's bond rating service. And, believe me, it's not clear," Friedman said, "sometimes who is more powerful."

With so much power, access, and protection, it's not surprising that profitability also follows close behind. Not all the agencies' books are open because some of them are subsidiaries of larger corporations, but Moody's was spun off into a separate company a few years ago, and by one calculation my staff came across, it is worth $6.2 billion. So nothing wrong with that, except it just indicates the scope of the enterprise.

It seems reasonable that a power of this magnitude should go hand in hand with some accountability, and yet once the SEC anoints or accepts the status of a credit rating agency which is now enjoyed by the three, the agencies are essentially left alone. So I think it is appropriate, as we try to learn the lessons of Enron, to ask whether these agencies should have some more ongoing sense of accountability, some oversight from the SEC, for instance, as we

ask whether they are adequately and as fully as possible performing a function as watchdogs or gatekeepers.

In the Enron case, it seems to me that the credit raters were no more knowledgeable about the company's problems than anyone else who was following its fortunes, including those who were following it in the newspapers. I just want to briefly go over some of the events leading to the raters' decisions to withdraw their assessment of Enron as a good credit risk.

Remember after a summer of last year during which Enron stock steadily declined, it was reported in the third week in October that the SEC had asked the company to disclose its ties to outside investment partnerships set up by the company's chief financial officer. Enron stock dropped 20 percent that day, October 22, to a closing price of $20.65 per share. On October 24, CFO Andrew Fastow resigned, and the stock went down another $5 to $16.41. Five days later, on October 29, S&P's credit rating analyst appeared on *CNN*. By this time, the agencies had put Enron on a credit watch, but the company was still literally investment rated as a good risk. The S&P's analyst predicted that, "Enron's ability to retain something like the rating that they're at today is excellent in the long term." When asked about the off-balance sheet partnerships which had become public, as I mentioned, the analyst assured investors that there would be no long-term implications. "That's something that's really in the past," he said.

Now, I want to go back to the last hearing we held in this series when a Wall Street analyst said to this Committee that his "buy" recommendation was supported by the confidence expressed by the credit rating agencies, which he specifically pointed out had access to inside information about Enron's liabilities that he didn't have. So S&P's confidence had an effect on others, and I want to ask the witnesses about that today.

We know that as time went on, the market was not convinced. The stock price continued its descent, dropping to $8.41 on November 8, when Enron disclosed it had overstated earnings by over half a billion dollars since 1997. But, still, the rating agencies kept Enron at investment grade. By November 28, the day Moody's and Standard & Poor's downgraded Enron to junk bond status, effectively, the company's stock was trading at just over $1, and 4 days later, of course, it went into bankruptcy.

In other words, the credit raters, despite their unique ability to obtain information unavailable to other analysts, were no more astute and no quicker than the others to act in warning and responding, and I want to ask about that today. The agencies, I understand, defend their ratings as opinions protected by the First Amendment. They refer to their assessments as the world's shortest editorials. But the fact is that their endorsement, if I can use the metaphor of the editorials, is required by law unlike, fortunately, other endorsements that newspapers give or don't give, which are not required by law.

So the point here is that almost all the watchdogs who should have barked before a lot of good people were hurt by Enron's collapse didn't. Among them were the credit rating agencies who had more access to Enron's books than most of the other watchdogs, and the fundamental question we want to ask today is: Why did

that happen? And what can we do together, hopefully, to make sure that the authority that credit rating agencies have is used as actively as possible to protect and defend the integrity of our capital markets, let alone the confidence of the millions of average investors and not-so-average investors who are institutional investors. So I look forward to the hearing today, and I thank the witnesses who are here for being here.

Senator Thompson.

OPENING STATEMENT OF SENATOR THOMPSON

Senator THOMPSON. Thank you, Mr. Chairman. I think you have framed the issues very well, and I will just simply ask that my full statement be made a part of the record.

I was given a summary here that I think accurately summarizes the issues, and it says basically that these rating organizations are delegated responsibility by the government for certifying certain debt. They have the opportunity to access information that other professionals and the public cannot due to their exemption from Regulation FD. They are protected from competition by the SEC as a result of their status. They have the ability to effectively collect a tax from companies issuing debt, and they operate virtually free from liability. And yet some think that there is very little accountability, so the issue here is whether or not that is a good situation, and if not, what, if anything, should be done about it.

I think there are First Amendment implications. I think it is clear that people need to understand these organizations do not recommend buy or sell. They deal in broad categories, and perhaps, if nothing more, we can illuminate exactly what they do and what they do not do for the benefits of investors and the extent to which investors should or should not rely upon what they are looking at.

So I think that very well frames the issues, and I look forward to our witnesses today.

Chairman LIEBERMAN. Thanks, Senator Thompson. Your full statement, of course, will be printed in the record.

[The prepared statement of Senator Thompson follows:]

PREPARED STATEMENT OF SENATOR THOMPSON

Mr. Chairman, thank you for holding this hearing today. I appreciate the way this series of hearings has focused on the gatekeepers. Obviously, there is not much congress can do about individuals who choose to skirt or violate the law. However, I think it is appropriate for us to review the actions of regulatory agencies or, as we are looking at today, private entities with special dispensations from the government. That is the way I believe we can affect some positive change.

During our first hearing which covered a number of topics, Professor Frank Partnoy testified about problems he saw in the structure of the credit rating agencies. Since that time, we have had an opportunity to delve deeper into that topic.

The issues raised about credit rating agencies are not unlike those raised during our hearing on Wall Street analysts. For example, the Wall Street analysts maintained "buy" and "strong buy" ratings until very late in the year last year. Similarly, each of the three credit rating agencies on our first panel maintained investment grade ratings until just four days before Enron declared bankruptcy. Like the Wall Street analysts, some of the reasons given for the positive ratings on Enron are that the credit rating agencies were misled, they are not auditors and had to rely on Enron's financial statements and the work of Arthur Andersen, and because of the anticipated merger with Dynegy which never occurred.

The difference with the Wall Street analysts is that the credit rating agencies do not have similar conflict of interest concerns because they do not have the same investment banking relationships. However, questions about conflicts and incentives

to dig deep have been raised as a result of the unique regulatory setup involved here.

My understanding of that setup is that three specific credit rating agencies currently have Nationally Recognized Statistical Rating Organization, or NRSRO, status. Several regulations and statutes require issuers or debt holders to rely on NRSRO ratings. As a result, issuers have little choice but to pay for ratings. Credit rating agencies, by virtue of their exemption from Regulation FD, have the opportunity to obtain information that others cannot. And they are basically free from liability.

However, despite this special status, there appears to be little accountability. Some writers have noted that the requirements for NRSRO status appear to be "inputs"—their reputation, access and organization—but does not include "outputs." that is, for example, some method of following the agencies to see how timely and accurate their ratings are.

A number of proposals have been floated from adding more NRSROs, to eliminating the NRSRO status altogether, to maintaining the status quo and providing more oversight. I look forward to hearing from the three credit rating agencies today to hear their explanation for their decisions. I would note that during the hearing on Wall Street analysts, we had to pick and choose among a number of firms, but because of the oligopoly associated with the NRSROs, we have all three of those firms here today. I am also pleased that in these hearings on government oversight we finally have a government official here today and I look forward to the testimony of Commissioner Hunt. I also look forward to hearing the experts discuss the current regulatory framework and what, perhaps, should be done to provide stronger incentives and to engender greater confidence.

Chairman LIEBERMAN. Senator Levin.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Thank you, Mr. Chairman, for your continuing determination to get to the bottom not just of the Enron disaster, but also as to whether or not the problems disclosed are more endemic, more generic, and, therefore, require us to take some very determined and specific actions to try to restore confidence in our markets and in financial statements.

As the many failures of various players come to light and as we dig deeper and deeper, the credit rating agencies clearly have a role here that we have to investigate and, if necessary, take action to see if we can't improve this situation so that their ratings can be more reliable.

As our Chairman pointed out, one of the big questions that we are looking at is why were the rating agencies so slow to downgrade after the deceptions and the decline of Enron became public. Even before the deceptions and decline became public, the agencies were given access to information long before. Why didn't they see early signs, for instance, of the extreme use of structured finance deals, the use of undisclosed guarantees not made public but which apparently were made available to the rating agencies, which clearly affected the financial circumstance and situation of Enron? Not just the undisclosed guarantees here, which were not made public apparently, but also items which were left off these financial statements—liabilities which were omitted, which it would seem to me, with an inside view that the credit rating agencies have, would have shown that liabilities of Enron were omitted from the financial statements, which should have been disclosed.

So there is a whole host of questions here. I am glad that the agencies are represented this morning, all of them, and that you, Mr. Chairman, are pursuing this investigation because there are many, many layers that need yet to be uncovered, to be disclosed, to be analyzed, and for corrective action to be taken.

Thank you.

Chairman LIEBERMAN. Thanks very much, Senator Levin.

Now we will go to the first panel: Ronald Barone, John——

Senator BUNNING. Mr. Chairman.

Chairman LIEBERMAN. Oh, I am sorry. How could I forget the big man.

OPENING STATEMENT OF SENATOR BUNNING

Senator BUNNING. That is all right, Mr. Chairman. I understand you want to get to the witnesses, but I do have some background that I would like to——

Chairman LIEBERMAN. I apologize. Please.

Senator BUNNING. Back in March 2001, *Fortune Magazine* published an article by Bethany McLean titled, "Is Enron Overpriced?" Now, this is March 5, 2001. In that article, she asked several individuals to explain how Enron made its money. The responses were not encouraging, according to the article. An analyst from Standard & Poor's said, "If you figure it out, let me know." An analyst from Fitch, who I believe is also testifying on our first panel today, said, "Do you have a year?"

While these may have been off-the-cuff statements, they are very disturbing. Many of the people the public and the investors depend on to give them independent, unbiased, and accurate information dropped the ball. There is certainly enough blame to go around from the accountants to the analysts. Of course, most of the blame rests solely on the shoulders of those Enron executives who apparently were not truthful to their employees, investors, or analysts. But that doesn't let the rest of you off the hook.

Last month, this Committee held a hearing on why Wall Street analysts continued to recommend Enron stock even as the company was collapsing. Those analysts told us that Enron withheld information and that the company's financial documents were not properly audited. This may be true. However, the one independent financial analyst on the panel, Howard Schilit, from the Center for Financial Research and Analysis, said that there were clear warnings in Enron's public filings and that just by reading over the statements the night before the hearing, he was able to pick out multiple problems. He said, "For any analyst to say there were no warning signs in the public filings, they could not read the same public filings that I did."

The question that must be asked and answered is: How did Enron get away with the questionable business practices for so long? And what changes need to be made to ensure other companies cannot follow in Enron's footsteps?

I appreciate the time the panelists testifying today have set aside to be here, and I look forward to gaining their perspective on this important issue.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thank you, Senator Bunning.

Now we will go to the first panel: Ronald Barone, John C. Diaz, and Ralph Pellecchia. Gentlemen, as is the custom of the Committee, I would ask you all to stand at the table and raise your right hands so I can administer the oath. Do you solemnly swear that the testimony that you will give this Committee today is the

truth, the whole truth, and nothing but the truth, so help you, God?

Mr. BARONE. I do.

Mr. DIAZ. I do.

Mr. PELLECCHIA. I do.

Chairman LIEBERMAN. Thank you very much. Please be seated, and let the record show that the witnesses have answered the question in the affirmative.

Mr. Barone, Managing Director of Standard & Poor's, we thank you for being here, and we look forward to your testimony now.

TESTIMONY OF RONALD M. BARONE,[1] MANAGING DIRECTOR, CORPORATE AND GOVERNMENT RATINGS GROUP, STANDARD & POOR'S

Mr. BARONE. Good morning, Mr. Chairman and Members of the Committee. I am Ronald M. Barone, a Managing Director in the Corporate and Government Ratings Group of Standard & Poor's. From 1994 until Enron's bankruptcy in December 2001, one of my roles was to serve as an analyst and then a manager with respect to our ratings work for Enron. On behalf of Standard & Poor's, I welcome this opportunity to appear at this hearing. As a member of the financial community that relied on Enron for complete, timely, and reliable information, and instead received incomplete, deceptive, and, it now appears, fraudulent representations, Standard & Poor's supports the Committee's urgent sense of the need to investigate the circumstances relating to Enron's collapse.

Standard & Poor's credit ratings have gained respect because they are based on objective and credible analyses. Our reputation ultimately depends on the credibility of our opinions. In order to ensure maximum objectivity and in-depth analysis, ratings are assigned by a Committee, not by an individual, and no portion of an analyst's compensation is dependent on the performance of the companies the analyst rates. The record bears out our method, as there is a longstanding and strong correlation between the ratings we initially assign and the eventual default record.

At their core, our ratings opinions are based on the issuer's public information, including audited financial statements. We also may have access to certain confidential information—we did with Enron—but only to the extent the company is willing to provide such information. We expressly rely on the companies we rate not only for current and timely information at the time of the initial rating but for material updates to that information.

From December 1995 until November 1, 2001, Standard & Poor's rating of Enron was BBB-plus, which we define as adequate ability to repay debt but subject to worsening economic conditions. This placed Enron at the lower levels of investment grade ratings, well below what Enron repeatedly, and unsuccessfully, sought.

Standard & Poor's made continuous efforts to monitor Enron's credit quality closely. When Enron's troubles began to surface late last year, we changed Enron's outlook to negative on October 25. Over roughly the next month, we downgraded Enron three times,

[1] The prepared statement of Mr. Barone with attachments appears in the Appendix on page 55.

despite Enron's announced acquisition by financially stronger Dynegy. Indeed, we stated publicly that without the proposed merger, Enron's credit rating would likely fall below investment grade.

On November 28, the day we determined that the merger was unlikely to occur, yet still before Dynegy publicly called it off, Standard & Poor's lowered Enron's rating to B-minus, a non-investment grade rating.

We now know things we did not know when we were rating Enron. Despite our repeated requests for all information material to our analysis, Enron appears to have intentionally concealed the true nature of its debt obligations by treating almost $4 billion worth of in-substance loans as financial hedges. Moreover, as documented in the report of Enron's special committee, the company also failed to adequately disclose its material dealings with the Chewco, LJM1, LJM2, and Raptor partnerships.

In fact, beginning in October 1999, and prompted by Standard & Poor's express request for full information regarding Enron's off-balance sheet partnerships, Enron made a series of formal presentations to us which they labeled as "a kitchen sink analysis" of all the non-recourse debt for its off-balance sheet affiliates. But in the presentations, two of which I have included with my testimony, there is no mention of any of these partnerships.

Had Enron told Standard & Poor's the truth about its financial condition during the ratings process, as it was required to do, the impact on Enron's rating would necessarily have been significant. In addition to having a financial impact, Enron's disclosure failures related directly to Enron's honesty and, thus, to the validity of all its numbers. Enron's deceptions about its true debt burdens and off-balance sheet dealings not only hid many of its debt obligations from view, but were done, the Powers Report concluded, to accomplish favorable financial statement results, not to achieve bona fide economic objectives.

Enron hid its true financial picture and, more specifically, its true creditworthiness from Standard & Poor's. Standard & Poor's publishes thousands of ratings that are subject to market scrutiny every day. We welcome that scrutiny, and I welcome the opportunity to testify here today.

Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thanks, Mr. Barone.

Now we are going to hear from John C. Diaz, who is the Managing Director of Moody's Investors Service. Thanks, Mr. Diaz. Please go forward with your testimony now.

TESTIMONY OF JOHN C. DIAZ,[1] MANAGING DIRECTOR, MOODY'S INVESTORS SERVICE

Mr. DIAZ. Good morning, Mr. Chairman, Senator Thompson, and Members of the Committee. My name is John Diaz, and I am a Managing Director of Moody's Investors Service. I am pleased to have the opportunity to appear before you today to discuss Moody's, the role that rating agencies play in the markets, and Moody's actions in rating the Enron Corporation and its debt instruments.

[1] The prepared statement of Mr. Diaz appears in the Appendix on page 116.

Moody's Investors Service is owned by Moody's Corporation, a New York Stock Exchange-traded company. Moody's is the oldest credit rating agency in the world. Our roots trace back to 1900, when John Moody & Company first published Moody's Manual of Industrial and Miscellaneous Securities. From its beginning, Moody's Investors Service has focused on rating debt instruments, and as early as 1924, Moody's was rating nearly every bond in the U.S. bond market.

Moody's and other rating agencies occupy a niche in the investment information market. Ratings express relative creditworthiness. The heart of our service lies in ratings on long-term fixed-income debt instruments. We also provide, for instance, short-term ratings, deposit ratings for banks, and various rating services in foreign countries. Moody's has nine primary long-term debt rating categories. Investment grade ratings range from AAA at the high end down to a low of Baa. Ratings below Baa are considered to be speculative grade, or junk. Moody's supplies this long-term scale to ratings on other types of financial obligations and to companies. We also assign short-term ratings—mainly to issuers of commercial paper—on an independent scale that ranks obligations Prime–1, Prime–2, Prime–3, or Not Prime. In all, Moody's ratings are designed to provide a relative measure of risk, with the probability of default increasing with lower ratings.

As part of Moody's commitment to predictive ratings, we review the relationship between defaults and our ratings. We publish an annual study, which we call our default study, which consistently shows that higher-rated bonds default less frequently than lower-rated bonds, although the rates of default may vary over time. Our default studies show the predictive nature of our ratings. Put simply, as a forward-looking opinion, ratings effectively distinguished bonds with higher credit risk from bonds with lower credit risk.

Our strong record is due in large part to the availability of reliable information. The combination of the financial disclosure regime in the United States, audited accounts, information that is provided directly to Moody's, and issuers' good-faith dealings have normally been sufficient. Enron was an anomaly, partly in the nature of its activities, and certainly in the disclosure of its activities. As we have come to learn, Enron's public disclosures and its responses to our specific requests for information were misleading and incomplete. Although we do not have investigative authority, our analysts are encouraged to exercise skepticism with respect to an issuer's claims and promises. That skepticism led us to assign Enron a long-term rating that, at all times, was no better than low investment grade and contained speculative elements.

Throughout Moody's rating history with Enron, we followed processes and practices that conformed to our established methods of credit analysis—methods that have been proven to predict relative creditworthiness. In the case of Enron, however, that methodology was undermined by the missing information upon which our ratings should have been based and the misleading information on which the ratings were, in fact, based.

Having said that, my colleagues at Moody's and I wish we had discovered the information that would have allowed us to serve the market more effectively in this instance. We acknowledge that the

public bond markets look to us for our opinion forecasts of long-term creditworthiness, and we recognize that the market does not expect a very large issuer of bonds, which we have rated investment grade, to default very shortly after holding such a rating.

The integrity and reliability of our ratings and rating processes are the essence of our business. We are constantly striving to enhance rating processes and quality, and we have examined the circumstances around the Enron bankruptcy to see what lessons can be learned. For example, we are looking more comprehensively at the role of so-called rating triggers, which can cause payment obligations to accelerate or require the posting of collateral based upon a rating downgrade. We have enhanced our analysis of short-term corporate financial capacity, that is to say, liquidity, and we are reviewing more thoroughly the sufficiency and certainty of an issuer's near-term sources of cash and credit under conditions of stress. We have also contacted the large asset management firms in a coordinated review of their use of ratings in the marketplace. Finally, we commend this Committee, along with Congress in general, for your efforts to ensure the continued health of our financial markets.

I thank you for your time, and I look forward to your questions.

Chairman LIEBERMAN. Thanks, Mr. Diaz.

Finally, we are going to hear from Ralph Pellecchia, Senior Director of the Global Power Group of Fitch Ratings. Good morning.

TESTIMONY OF RALPH G. PELLECCHIA,[1] SENIOR DIRECTOR, GLOBAL POWER GROUP, FITCH RATINGS

Mr. PELLECCHIA. Thank you, Mr. Chairman and Members of the Committee. My name is Ralph Pellecchia, and I am a Senior Director in the Global Power Group of Fitch Ratings. I joined Fitch in July 1989 as an analyst in the natural gas and power sector. I have been the lead analyst following Enron at Fitch since May 1997. At Fitch, I am the primary analyst for 14 companies in the Global Power Group and one of 15 Fitch analysts covering the North American Global Power sector.

Fitch is in the business of publishing independent ratings and credit analysis of companies around the world. I am responsible for coordinating this activity for the companies assigned to me. My work includes regularly visiting companies I cover, maintaining contacts with members of the finance staff and other important personnel at those companies and staying current on events affecting the companies and the industry that I follow. I also conduct much of the quantitative and qualitative analysis that Fitch uses to assess credit of the companies we rate in my area.

Finally, my role as the primary analyst is to synthesize the quantitative and qualitative analysis and to propose a rating, with the final rating outcome to be determined by a credit committee. The credit committee is comprised of a minimum of five voting members typically specialists from the industry/sector, but frequently includes members from other groups within Fitch.

In my role as primary analyst, I am guided by procedures and practices followed at Fitch. The ratings process related to Enron was in all respects consistent with those procedures and practices.

[1] The prepared statement of Mr. Pellecchia appears in the Appendix on page 129.

The assessment process itself is a blend of quantitative and qualitative factors. The quantitative factors that are parts of the rating process include an evaluation of published financial information, supplemental financial information, and peer financial performance. Qualitative factors include business fundamentals, competitive position, growth opportunities, the regulatory environment, and our view as to the abilities of management.

Our analysis of Enron followed the rating process described above. Over the past several years, because of a significant shift in its business mix and a rapid revenue growth, Enron's reported financial profile, in size alone, as presented in its income statement and balance sheet, changed significantly. Yet although the market capitalization of Enron increased dramatically over the past several years, the various credit ratios and other factors used by Fitch supported a constant BBB-plus rating during the period from 1993 until the fourth quarter of 2001. It should also be noted that of the more than 300 entities rated by our Global Power Group, the senior debt rating of more than 60 percent of the companies in the sector is above BBB-plus. BBB-plus is in the lowest investment grade category.

In mid-October 2001, Enron released third quarter results that reflected a $618 million third quarter loss and a $1.2 billion reduction in shareholder equity. Shortly thereafter, adverse press reports appeared, an informal SEC investigation was announced, and the CFO was replaced. Following these events, on October 25, Fitch placed Enron's rating on Rating Watch Negative warning that "the loss of investor and counterparty confidence, if it continues, would impair Enron's financial flexibility and access to capital markets, therefore, impacting its ability to conduct its business." Eleven days later, on November 5, Enron's senior debt rating was downgraded to BBB-minus, the lowest possible investment grade rating, and left on Rating Watch Negative, an indication of the possibility of future downgrades.

On November 8, Enron restated its earnings for a 5-year period, and on November 9, 2001, Enron announced its merger agreement with Dynegy. This announcement caused Fitch to revise the rating watch status to "evolving." It was Fitch's opinion that Dynegy was a financially viable and knowledgeable purchaser with a sound financial and business profile on a stand-alone basis supplemented by a strong financial backer and investor through its affiliation with Chevron-Texaco. The merger agreement with Dynegy provided Enron with $1.5 billion in cash, which supplied needed liquidity. We also held the opinion that Dynegy, as a direct competitor, was quite familiar with Enron's operations. The evolving status, however, reflected a high level of execution risk compared with other acquisitions by entities rated higher than the target company. In those cases, Fitch would typically place the target's ratings on Rating Watch Positive. Fitch warned in its commentary accompanying the ratings action of November 9 that, "If the merger were to terminate, Fitch believes Enron's ability to manage its business would be severely impaired and would expect to downgrade its securities to highly speculative grade. Termination provisions to the merger agreement add an element of uncertainty to completing the merger."

In the 3-week period following the merger agreement, Enron disclosed additional liabilities and incurred substantial cash outflows that compromised its financial condition. Fitch commented on these developments on November 21, stating that in the absence of a merger agreement with Dynegy, Enron's financial condition was "untenable." At the time we published that comment, based upon discussions with Enron and Dynegy management, it was our understanding that the parties were committed to the merger, but at revised terms that reduced the value received by Enron shareholders. Based upon the inability to execute a revised merger agreement, as well as obtain additional secured bank financing, Enron's ratings were lowered to CC on November 28, indicating probable default.

Thank you.

Chairman LIEBERMAN. Thank you, Mr. Pellecchia. Interesting opening statements by the three of you. We will do 7-minute rounds of questions on the Committee.

As I listened to your statements and familiarize myself with this whole Enron saga, one thing that struck me is, although you have reported the different levels of concern that each of you had about Enron as last year went on, the market in some way was better reflecting increasing concerns about Enron than the credit rating agencies were, because in some sense the market during the year was going like that, whereas the agencies were maybe going like that, [gesturing] and notwithstanding the additional access that we know that you had to information.

Let me go to some of the remarks, Mr. Barone, that I quoted from you and Mr. Shipman—Mr. Shipman's were the quotes from *CNN* in October, and then I didn't quote this in my opening statement, on November 2 at S&P's public conference call according to a transcript that was provided to my staff. You said, "We have a great deal of confidence that there are no more surprises to come. We're confident we capture or are privy to the obligations that Enron has. I think it's going to take a little more time before everybody can get fully comfortable so that there's not something else lurking out there, but at this point we feel very confident that that's unlikely."

So my question, obviously, is: What was the basis for your confidence then that the off-balance sheet problems, which were known, were in Enron's past or that nothing else would come out soon?

Mr. BARONE. Thank you, Senator. The confidence we had was gained from discussions with Enron's management at that time, the new president, Greg Whalley, and CFO Jeff McMahon. They explained to us that, as much as they knew, from their investigation, there were no further partnerships that had debt obligations that they were unaware of. But that, indeed, and as my comments stated, they had not fully completed all that the investigation was to provide. The Powers Report was not yet completed at that time. But for all that they saw, what they knew, that was their assessment. And we gained confidence from that discussion.

Chairman LIEBERMAN. Let me ask the other two witnesses, because my concern is that with your remarks, notwithstanding the slight downgrade, although you still kept them at investment grade

at that point, in early November, a month before Enron goes bankrupt, because of the way in which information was conveyed through *CNN* and other newspapers, etc., that you were still sending a message to the market that everything would be OK at Enron.

Now, I understand what you have said about why. I want to engage the other two of you in this conversation, which is—how does the communication typically go between the rating agencies and a company like Enron, particularly at moments like this where there is alarm? Are you calling them or—and we know from other indications all over the history of this company, they were very aggressive—were they calling you to make the case don't worry? Mr. Diaz.

Mr. DIAZ. Mr. Chairman, thank you. Maybe I can go back a little bit to the beginning of the crisis at Enron. On October 16, the company announced their earnings restatements and their equity charges. On that day, we placed the company on review for possible downgrade on our fundamental concerns about their accounting and about a potential crisis of confidence.

Chairman LIEBERMAN. You do that just based on the public announcement of what has happened?

Mr. DIAZ. No. We had talked to Enron a few days before that and they had given us a heads-up on the writedowns that were to come and began to explain to us the equity charge. And we were very surprised at not only the asset writedowns they were taking but also at the nature of the equity charge. And we were questioning and scratching our heads about the type of accounting that they were using for that charge and how did that $1.2 billion of equity actually come about.

They made a rough attempt to explain to us the complexity of the hedges, but we were not satisfied with their explanations. So we told them that we would likely put them on review for downgrade and then take a harder look at the situation.

So throughout that crisis stage, we had become increasingly concerned. At that time, Andrew Fastow was no longer involved in the discussions, so we were talking primarily to Tim Despain and then Jeff McMahon, who had joined as the new CFO.

Our discussions during that time were concentrated on understanding the liquidity position of the company and how that was impacting the trading business. When we became further concerned on, I think, October 24—my recollection is not exact—we had asked them about their availability of commercial paper, and they told us they were still able to place commercial paper, but that the price was getting much higher for them. So as we got ready to go to committee to act on the rating, they announced that they had drawn down their credit lines.

So the bottom line at that point was that we were increasingly concerned about the liquidity, and we downgraded them on October 29, and then kept the rating on review for further downgrade. We also put the commercial paper rating review for downgrade.

Chairman LIEBERMAN. Mr. Barone, I quoted you on the November 2 conversation, so I should give you an opportunity to say a little bit more about what Enron may have told you before that.

Mr. BARONE. Yes, generally going back to your question, Senator, we were calling Enron, and——

Chairman LIEBERMAN. They were not initiating calls with you by and large?

Mr. BARONE. There was an active dialogue back and forth, Senator, as we do with many issuers. If they have news to tell us, they would be active and do that, or respond to questions. They would research our questions and they'd call us back with answers.

Chairman LIEBERMAN. Were they more active than most companies, even at this point, in trying to convince you that everything was OK?

Mr. BARONE. Not unusually so. They've had a campaign for years to try to be higher rated, as many firms try who have a different opinion than we do.

Chairman LIEBERMAN. How do you carry out such a campaign?

Mr. BARONE. They try to show us, whether it be a financial or qualitative assessment, that we take one view of the information and they take a different view of it. They try to get at the heart of our review, and we try to get at the heart of their review. And often we have to agree to disagree.

Chairman LIEBERMAN. Am I right that in conversations with our staff leading up to the hearing, Mr. Barone, you told them that Enron officials told you that they didn't know what else was out there?

Mr. BARONE. That is correct.

Chairman LIEBERMAN. This was at the end of October, and that they had a special committee investigating?

Mr. BARONE. That's correct.

Chairman LIEBERMAN. But, still, you felt confident enough to make the statement you did on November 2?

Mr. BARONE. That is correct. They explained to us that in the investigation: (1) they found, I believe, the LJM1, LJM2, Chewco, and Raptors; (2) they had started to scrub down everything they could get their hands on; and (3) they would be surprised if they would find anything further. And while they said clearly that they did not have the full report, they believed they had uncovered the majority of what there was to uncover, and that this was what they expected.

Chairman LIEBERMAN. I am over my time. Mr. Pellecchia, I will come back to you in the next round. Senator Thompson.

Senator THOMPSON. Thank you very much.

In listening, it is surprising to me the extent to which you seemingly rely on the management leadership for your information. You know, Mom and Pop can read these public documents, and it seems that what we are learning from all of this is that there is really not much value-added for the average investor in looking at either the—what the analysts are saying or what the raters are doing; that when you have a complex set of documents, that you don't really go behind the documents, even though you have a right to; that when the company officials refused to divulge certain information, they can get away with that; and that you rely an awful lot—when things pop up that seem troublesome, you rely an awful lot, if not exclusively in some cases, on what the corporate management tells you.

Is that an unfair assessment or is that about the way it is?

Mr. BARONE. Senator, we do rely on what senior management tells us. It is in their best interest to tell us and be forthright and not convey a different message, because if we convey a message to the market that is different than what the market perceives over the long term, then the credibility of Standard & Poor's and then ultimately the credibility of the company is at risk. And you saw what happened with Enron as to what happened when the market loses confidence in their credibility. And so it is in their best interest to tell us the truth, and we rely on that.

Senator THOMPSON. That is kind of a chicken-and-egg deal. Are you saying you don't think it is ever in—strictly from a self-interested standpoint, it is never in the interest of a corporate executive to minimize bad news and stretch the truth? Clearly it is sometimes in their interest to play the short-term game and hope things turn out better, right?

Mr. BARONE. Yes. Many of the firms put forth their best foot, but they don't put forth fraudulent information.

Senator THOMPSON. What is it exactly that Enron put out that was most deceptive in retrospect, do you think? Did it have to do with these related-party transactions?

Mr. BARONE. I would say it had to do with the total amount of their obligations, whether it be these related-party transactions or other partnerships——

Senator THOMPSON. Mr. Diaz, briefly, could you pinpoint anything?

Mr. DIAZ. Senator, it's less what they put out. It's more what they didn't put out. It's the fact that the off-balance sheet partnerships were never disclosed anywhere. We've come to learn about names like Braveheart, Raptor——

Senator THOMPSON. Is that what we now know was apparently being referred to in footnote 16, related-party transactions?

Mr. DIAZ. I believe that was related to LJM2, one of the Fastow partnerships. There are a lot of other partnerships, Senator, partnerships like Braveheart, Raptor, Southampton, and Rawhide. The names just seem to be coming out.

Senator THOMPSON. In retrospect, is not footnote 16 also referring to them? I mean, it is in the plural here.

Mr. DIAZ. I believe that, having looked at it in some detail and tying it back to the Powers Report, I believe that it's talking about the LJM2 transactions, the Chewco transactions, and the Raptors, which I think are embedded in their LJM2. It's still difficult to understand exactly what they were doing.

Senator THOMPSON. I think that makes the point, that we are still here today trying to figure out what they are talking about in footnote 16.

Mr. DIAZ. That's right. It's a very obtuse footnote. You know, there is some disclosure there, but it's extremely difficult to understand what is going on.

Senator THOMPSON. The question becomes: What should the rating agencies' obligations be? You can't audit every firm that you deal with. On the other hand, some are bigger than others. Some are more obtuse than others, I guess, in their public documents. What should the rating—if you are just going to look at this and

say this is very confusing and obtuse and call up the corporate executive and say is everything all right, and he says everything is all right, if that is it, you can see——

Mr. DIAZ. I understand the point, Senator. I think in looking at a footnote like 16, clearly what needs to be done in those situations is try to get behind it and try to understand a lot more of what's there.

Looking in hindsight at how that impacted the ultimate confidence in the company, it's pretty clear that there were—and from my point of view, we certainly look at it as a situation where we could have dug more into and tried to get behind that.

Senator THOMPSON. It would be fair to say that if you ran across this same situation again, you would delve into it deeper?

Mr. DIAZ. Yes, sir.

Senator THOMPSON. I noticed here that on November 8, after reviewing a copy of the merger terms, the merger with Dynegy, you were concerned there were too many conditions that would allow parties to walk away from the merger, and Moody's informed Enron that it might drop its rating to below investment grade. Subsequently, Moody's received a number of telephone calls from interested parties, including Richard Grasso, CEO of the New York Stock Exchange, Robert Rubin of Citibank, Michael Carpenter of Salomon Smith Barney, and William Harrison of J.P. Morgan Chase. The banks assured Moody's that they were not planning on getting out of the merger. Again, the next day, Moody's downgraded Enron, but not below investment grade.

Clearly, Enron had called all these investment bankers up to get them to call you, right?

Mr. DIAZ. Senator——

Senator THOMPSON. And I am asking whether or not that is correct. And, second, what are we to make of this? Here clearly are interested parties trying to presumably have some impact on what your rating was going to be. Is this normal in the business?

Mr. DIAZ. Senator, what I'd like to say is, first of all, we were ready to downgrade Enron that morning. The first bit of information was that there was a significant change in the transaction. There was going to be up to $1 billion of new equity put in, and they were going to be changing the terms of the agreement. That was what we were led to understand—so that we held off on the press release.

Throughout the course of the day, we had calls from bankers, and we also had a meeting with bankers—and I can't recall if Dynegy was actually in the room. But the bottom line there was that the agreement was changed. There were substantial changes made that made it more difficult for Dynegy to walk away. They eliminated a material adverse change clause. They eliminated rating triggers that were in the financing agreement. And, also, they agreed to collapse the structure of the combined entity so that the bonds of Enron and the bonds of Dynegy were pari passu.

From our point of view, we were looking at the combined entity as having an investment grade rating of Baa, at the low end, so we gauged the probability that the deal would go through to be high. We gauged the probability that Enron's liquidity would be shored up enough for Enron to survive——

Senator THOMPSON. I understand what you are saying, but without getting into the merits of the deal and the reason, I understand you were concerned there were too many ways to walk away and then they began to close that door somewhat.

Mr. DIAZ. Right.

Senator THOMPSON. But in the meantime, these bankers were calling you to tell you, I suppose, that they, according to what I have got here, were not planning on getting out of the merger. Of course, that is like a politician saying they are not planning on running for office, I suppose. They are not presently planning.

Senator BUNNING. Except in your case. [Laughter.]

Senator THOMPSON. Of course, they did walk away from the merger, what, 20 days later, I think, after I guess S&P's downgraded them. I am just asking for information. Is this a normal kind of interplay? I mean, do you get calls like this telling you we know you are concerned about this deal that would affect the welfare of the company, I am in on this deal, and I want you to know here is our present intention?

Mr. DIAZ. In general, we do get calls from banks and companies when the company's rating is under pressure. That is not an anomaly. Certainly, the intensity of that day was pretty high given the situation of Enron, but that did not—was not an influencing factor on our decision. The influencing factor on the decision was the change in the merger—in the terms of the merger agreement.

Senator THOMPSON. Well, I am not suggesting it was. All I am suggesting is clearly they were—from their standpoint they were making the call for some purpose. And if it wasn't to influence your decision, I am not sure what it was.

Mr. DIAZ. It was to get us to wait— that is to say—listen to the new terms of the deal, is really what they were trying to do. They weren't saying please don't do this because Enron's going to go bankrupt. They were saying we have a new deal on the table.

Senator THOMPSON. Thank you, Mr. Chairman.

Chairman LIEBERMAN. Thanks, Senator Thompson.

If I may, just following on the line of a question Senator Thompson raised, I assume you allow for the, if I can call it this, self-interest of the people calling and having Enron's rating remain high.

Mr. DIAZ. Sure, right.

Chairman LIEBERMAN. In other words, various of people, of the institutions that Senator Thompson has cited, we know from public sources were either heavily—were creditors of Enron or perhaps had fees which would be gained by the completion of the Dynegy-Enron proposed merger. But I presume you allow for that as you consider what they are saying.

Mr. DIAZ. That's right. There were a lot of self-interested parties in that situation. We certainly understand that. But, we're still looking at whether or not the deal was going to go through and what the impact on the combined companies was. That was the bottom line for us.

Chairman LIEBERMAN. OK. Senator Levin.

Senator LEVIN. Thank you, Mr. Chairman.

I want to pursue the line of Senator Thompson's questions as to what was not disclosed to you that you now know should have been disclosed to you, and what was deceptive and fraudulent. Mr.

Barone, you used the word "fraudulent," which means there was a representation of something which wasn't true. Can you give us some examples of what was represented to you that was not true?

Mr. BARONE. Yes, Senator Levin. Enron had presented to us something called its "kitchen sink analysis," which purported to show the full extent of all its obligations with partnerships, third parties, related parties, and the like. And we have come to learn that this representation of the kitchen sink—and I think they wrote the words "100 percent disclosure"—did not include all of the so-called third-party related transactions.

Senator LEVIN. Would you supply that document to the Committee?

Mr. BARONE. I believe, Senator, it's included with my full testimony.

Senator LEVIN. That is fine. Thank you.

Can anyone else give examples of what was not disclosed to you or what was disclosed to you and misrepresented in the disclosure? Mr. Diaz.

Mr. DIAZ. Yes, Senator. We also received the "kitchen sink analysis."

Senator LEVIN. Is that the same analysis?

Mr. DIAZ. I can't say it was exactly the same analysis, but it was supposed to represent the complete picture of the company's total obligations, and it clearly did not. As I've said earlier, there have been quite a few names of partnerships that have come out in the press and all the reports that we had no knowledge of and were not included in that.

Senator LEVIN. Mr. Pellecchia.

Mr. PELLECCHIA. Well, I would add, in addition to the fact that the company restated its financial statements back to 1997, the types of information they would supply us—and we also got a "kitchen sink analysis"—as far as the company's off-balance sheet debt and guarantees was consistent with what was provided the general public. So there wasn't any real additional information that we had. And I would say to the question of whether these presentations were fraudulent, what we read in the Powers Report certainly seems to say that they entered into transactions for a very different purpose than what was represented to us, particularly with what was called these LJM transactions, which were presented to us as a technique to transfer risk to sophisticated investors.

Mr. BARONE. Senator, may I——

Senator LEVIN. Please.

Mr. BARONE. I want to add, too—and I noted this in my opening remarks—that what was also hidden from us, not disclosed fully—or at all, I should say, are those almost $4 billion of in-substance loans that Enron made with financial institutions that were originally reported as financial hedges. And that was not disclosed as well.

Senator LEVIN. Was it falsely disclosed or not disclosed?

Mr. BARONE. I believe it was not disclosed as a loan, as it worked.

Senator LEVIN. Was it disclosed as a hedge?

Mr. BARONE. I don't know for sure, sir.

Senator LEVIN. What is the understanding that you have with your clients as to what is disclosed? Do you have a written agreement with them, a contract as to the amount of disclosure and what your access will be, inside access that is not publicly disclosed? Is that all set forth in a contract, Mr. Barone?

Mr. BARONE. We have an agreement—I don't know if it's contractual or not, but it's an agreement that is included in our rating letter, that they provide us full, timely, and accurate disclosure of all material information relating to their rating. I don't know the exact words, sir, but it is quite broad and comprehensive.

Senator LEVIN. And they sign that, they agree to that?

Mr. BARONE. Yes.

Senator LEVIN. Is that true with the other companies, too?

Mr. PELLECCHIA. We have a similar representation, but it's not a signed agreement.

Mr. BARONE. Senator, I don't know—excuse me, I apologize. I'm not exactly sure they're signed or not. I don't want to represent——

Senator LEVIN. All right. Mr. Diaz.

Mr. DIAZ. We have applications for ratings in which the maintenance of the rating is based on our satisfaction with the information that's being provided, but there's no specific agreement about the kind of or the type of information that has to be given to us.

Senator LEVIN. All right. Let me go through one of the transactions with you. Enron North America was trying to show strong cash flow on its 1999 end-of-year statement. According to the Powers Report, what Enron North America did or ENA did was pool a group of loans that it held into a trust. The trust then sold about $324 million of those notes and provided the purchasers with certain rights to cash flow from repayments of the loans. So these were collateralized loan obligations.

When they sold the loans, ENA was able to report an increase in cash flow, and since the risk of default on the loans was transferred to the trust, ENA didn't report or account for the possibility of a default. They left that out from their own reports.

Now, the trust that purchased those loans then sold interests in those loans to investors, but the sales did not go well. According to the Powers Report, the lowest-rated notes, those with the last claim on repayments of the loans, were extremely difficult to sell and no outside buyer could be found. At the end of 1999, LJM2 purchased about $20 million of those lowest-rated notes.

So LJM bought the notes that nobody else would buy, but some credit rating agency would have had to have rated those notes. And I think it was your agency, Mr. Pellecchia.

Mr. PELLECCHIA. We did.

Senator LEVIN. Is that correct?

Mr. PELLECCHIA. Yes.

Senator LEVIN. Now, how can your credit rating agency give an investment grade to those notes when nobody else would buy them? How does that work?

Mr. PELLECCHIA. Well, I'm a corporate analyst. This transaction was one that was structured in a way that the credit quality of the pool of loans—and I would say these loans were on a stand-alone basis very weak companies, loans to very weak companies—was structured in such a way so that there were different tranches of

ratings that apply to different groups of securities that were sold, and they were able to attain high ratings through this enhancement that is much higher than you could individually for each of those individual loans.

Senator LEVIN. So even though nobody else would buy them, they were given investment grade rating because of the guarantee?

Mr. PELLECCHIA. Well, I believe that this particular transaction—again, I'm not a structured analyst—was one that met all the qualifications that you would need for separateness and other qualifications for doing a structured transaction, and it was marketed and it was sold.

Senator LEVIN. Could you try to answer that, or get the answer for the record on that question for us?

Mr. PELLECCHIA. As to——

Senator LEVIN. How is it possible that those specific notes can be listed as investment grade if, in fact, nobody would buy them? Can you talk to the person who did the analysis on that—you said it wasn't you—and give us the answer?

Mr. PELLECCHIA. My answer was also I think they were sold, and——

Senator LEVIN. They were sold to LJM. They were sold right back to Enron.

Mr. PELLECCHIA. That might have been in the secondary market, but I will provide that information.

Senator LEVIN. All right. Now, according to an Enron employee who worked on the transaction, the head of ENA finance, told one of the investors that if the note defaulted, Enron would make the investors whole. Enron had agreed, in other words, to repurchase the notes at face value, which guaranteed the investment. Now my question to you is: Was it publicly known that that guarantee existed?

Mr. PELLECCHIA. I do not know the answer to that. I would say as far as a rating agency's obligation, we would have rated the securities based upon the risk to the investors, and——

Senator LEVIN. Would the guarantee affect that risk? Wouldn't it be less risky to buy it if there was an Enron guarantee?

Mr. PELLECCHIA. It certainly would, yes.

Senator LEVIN. OK. Was it publicly known that there was an Enron guarantee?

Mr. PELLECCHIA. I do not know if it was publicly known, and I'm not sure there was an Enron guarantee.

Senator LEVIN. So you don't know yourself whether there was an Enron guarantee?

Mr. PELLECCHIA. Apparently, LJM, as you explained—and I didn't know the facts on that—stepped up and bought securities which probably in effect would have done the same thing as providing a guarantee.

Senator LEVIN. So my specific question is: Was it known to your agency that there was such a purchase guarantee?

Mr. PELLECCHIA. I know that we had discussions with Enron personnel as to the situation with the loans, and I'm not sure exactly what agreements were struck, if anything, or what we learned from that.

Senator LEVIN. Well, wouldn't that affect the creditworthiness of the notes?

Mr. PELLECCHIA. It would have, certainly.

Senator LEVIN. And your rating?

Mr. PELLECCHIA. Yes.

Senator LEVIN. But you are not sure because of memory, or you are not——

Mr. PELLECCHIA. Well, I'm not sure about exactly what was——

Senator LEVIN. Your ratings are affected by whether there is a guarantee, but you are telling us you don't know whether there was a guarantee.

Mr. PELLECCHIA. I do not know if there was a guarantee.

Senator LEVIN. But whether or not there was a guarantee would have affected your rating?

Mr. PELLECCHIA. I would assume it would be considered, yes.

Senator LEVIN. OK. Can you find out for us whether anyone in your company knew whether or not there was a guarantee?

Mr. PELLECCHIA. Yes.

Senator LEVIN. And can you also then answer this question: If there had been a guarantee, assuming it went back to Enron, would that have affected the value of Enron's stock?

Mr. PELLECCHIA. I would answer from the credit rating standpoint. What we try to assess is the types of guarantees and the amount of guarantees Enron has. So the fact that if Enron had a guarantee, that would be a consideration in the credit rating.

Senator LEVIN. OK. But also not on the credit rating——

Mr. PELLECCHIA. Of Enron Corp.

Senator LEVIN. Of the Enron Corporation, so that would affect their stock.

Mr. PELLECCHIA. It would be considered in the credit rating. They had approximately $2 billion of guarantees outstanding to affiliated companies. Some of those guarantees were supported by collateral, some weren't. So you would make judgments, basically, upon what the effect of a guarantee would have on Enron Corp.

Senator LEVIN. Would you say this: To the extent that those guarantees were not known to the public, that they were, therefore, telling the public that their company was in a lot better shape than it really was, because guarantees which were outstanding wouldn't have been disclosed? Is that a fair statement?

Mr. PELLECCHIA. If Enron had a guarantee——

Senator LEVIN. If Enron had guarantees outstanding which were not disclosed publicly, that, therefore, they would have been—their financial statements would have looked better than, in fact, they should have because it wouldn't have disclosed outstanding potential obligations. Is that a fair statement?

Mr. PELLECCHIA. Yes, I do not believe Enron—and I'm not aware that Enron guaranteed that debt.

Senator LEVIN. I am not talking about that debt. I am talking about in general.

Mr. PELLECCHIA. In general, we would recognize guarantees in the context of all its obligations, yes. That would be a consideration.

Senator LEVIN. My question is: If the guarantees were not disclosed publicly, would that——

Mr. PELLECCHIA. That—we should be aware—they should be disclosed publicly, and as far as I know, every guarantee that Enron had was—that we were aware of was consistent with the guarantees that they published in their information, the public information. As far as I know.

Senator LEVIN. I see my time is up, but the bottom line is that you are not answering my question about failure to disclose guarantees publicly. But what you are saying to us is this: That you believe that every single guarantee that you were aware of was disclosed publicly?

Mr. PELLECCHIA. Yes.

Senator LEVIN. Thank you.

Chairman LIEBERMAN. Thanks, Senator Levin. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Just a little background for the average American and average person who looks at credit ratings as a means of investing. The SEC grants credit rating companies NRSRO status, and currently only your three companies—S&P's, Moody's, and Fitch—are those companies. You have special access to the companies that you deal with. In that, you can have private conversations with companies' management that analysts cannot have. You can see financial information about companies that is not public, and you are shielded from fraud under the security laws. All that true?

Mr. BARONE. That's true.

Senator BUNNING. Well, you realize in 1997 the SEC looked at this and said maybe there is a monopoly here, maybe you three shouldn't be the only ones doing this because the only three people that you could go to for a credit rating was Standard & Poor's, Moody's, and Fitch. Is that correct? And they tried to change the rules, and you fought them tooth and nail. The Justice Department fought them tooth and nail also. They criticized the new rules that pertained perpetuating the anticompetitive environment of credit agencies. The Justice Department was for changing the rules. The rule was never acted upon.

Now, I think you have a major obligation to look beyond what is given to you by any corporation. If the people rely on your ratings, investment grade or non-investment grade, particularly institutional investors, particularly anyone whose stock is on a roller coaster in a down spiral, and your three companies are still rating that as investment grade material.

Now, I don't even want to get to November. But I want to get to March and the document that *Fortune Magazine* put out. Someone said how can you rate these companies—how can you rate Enron specifically investment grade, and people from your companies made light of it. S&P's said, "If you figure it out, you let me know." Is that a quip or is that a serious statement by S&P's? This is quoted in *Fortune.*

You, Mr. Pellecchia, said, "Do you have a year?"

Mr. PELLECCHIA. Here's what I—could I answer that?

Senator BUNNING. I mean, is that a correct quote or not?

Mr. PELLECCHIA. I believe what I was asked was exactly how does Enron make its money, and my response was, "Do you have a year?" That was——

Senator BUNNING. In other words——

Mr. PELLECCHIA. That was a glib answer. But the spirit——

Senator BUNNING. OK. I know it is a glib answer, but you are responsible for the ability to grade that either investment grade security or non-investment grade security.

Mr. PELLECCHIA. Yes.

Senator BUNNING. And you are making light of the fact that you are not sure how they are making their money?

Mr. PELLECCHIA. Well, I think the spirit of the answer was Enron's a big company, it's a complex company——

Senator BUNNING. Your duty was to get beyond the bigness and just the words coming out of the corporate mouths. Is it true or is it not true that the CFO and the chairman of the board made calls to Mr. Diaz and Mr. Barone that they were aggressively trying to get a higher grade credit rating for their company? Is that true or false?

Mr. BARONE. That's false. Mr. Lay did not call aggressively seeking a higher rating for the company. Mr. Lay called to——

Senator BUNNING. He didn't call you personally?

Mr. BARONE. He called me personally, but not for that reason, sir. He called me to let me know that he was committed to the current credit quality of the company, that they would take steps necessary to preserve what he thought was a very important credit rating, and the similar steps to those that he had taken in the past by issuing equity or selling assets——

Senator BUNNING. Was there any pressure exerted by Enron to get a similar upgrade or remain the same kind of credit rating from your company?

Mr. BARONE. During this period of time, sir, no.

Senator BUNNING. Is it normal for the president and CEO of a company to call you?

Mr. BARONE. There are some that do, sir, and some that don't. It depends. This was the first time I had heard from Mr. Lay, but there are other firms that we follow under my purview, and some of them call and some of them don't.

Senator BUNNING. Don't you think there should be a separation, a separation between the analyst making a credit rating and the company executives? I mean, if somebody can testify before this Committee, it was right in the filings before the SEC that I could pick up that there were problems in the company. You as experts in credit ratings couldn't see that?

Mr. DIAZ. Senator, I spoke with Mr. Lay one time only, and that was just before putting them on review for downgrade, and what he was trying to do is keep us from putting him on review for downgrade.

Senator BUNNING. Thank you.

Mr. DIAZ. And we did not——

Senator BUNNING. That doesn't answer my question.

Mr. BARONE. Sir, we often speak with the senior management of the firm——

Senator BUNNING. I understand that——

Mr. BARONE [continuing]. Because strategy is a very key element to rating.

Senator BUNNING. What about the filings that they filed with the SEC as of all during this time that you were in charge of their

credit ratings? You couldn't pick anything out to give you a heads-up or a red flag——

Mr. BARONE. No, from the——

Senator BUNNING [continuing]. And some other analyst could? Why were you not able to pick up the red flags?

Mr. DIAZ. Maybe I can address that. Senator, I mean, hindsight is a great thing and——

Senator BUNNING. We all know that.

Mr. DIAZ [continuing]. People looking at this situation now can go back and sort of look for flags and situations where——

Senator BUNNING. It is your job.

Mr. DIAZ. But what I'm trying to say, Senator, is fundamentally we were looking at a company that on its face looked like it had a very strong franchise in wholesale trading. It looked like it was showing earnings, increasing earnings, because of the mark-to-market accounting.

Senator BUNNING. Then why was the stock plummeting? If all of those things be true, why was the stock going straight down?

Mr. DIAZ. The stock started to plummet in—I believe in the spring of——

Senator BUNNING. Inside traders were selling the devil out of it.

Mr. DIAZ. We're not equity analysts, so we don't focus necessarily on stock.

Senator BUNNING. I understand that, but there is a reason for a stock to react.

Mr. DIAZ. Sometimes, Senator, there are many reasons why stocks go down. I mean, bear markets cause stocks to go down. Enron stock had been hyped by the broadband euphoria, and it had gone from the mid-40s to 90, and we didn't upgrade the company then because we thought Enron is doing great. We kept the same low investment grade rating that we had because of the fundamental issues that we always looked for at the company.

Senator BUNNING. But somehow, sir—and I beg to differ with you—you have to be more responsible to the many people who rely on your ratings. And if you are not more responsible, then we have got to get more people rating.

Mr. DIAZ. Senator, I guess——

Senator BUNNING. My time has expired.

Chairman LIEBERMAN. Go ahead.

Senator BUNNING. Go ahead, Mr. Diaz.

Mr. DIAZ. Could I answer? Thank you. Senator, we stand on our record. We have a 100-year record that we publish every year——

Senator BUNNING. It just takes one.

Mr. DIAZ. One company that misleads.

Senator BUNNING. Billions and billions, and millions of employees lost every penny they ever had.

Mr. DIAZ. I understand that, Senator. But the reason was because the company misled. Their executives have——

Senator BUNNING. You have never had a company mislead you?

Mr. DIAZ. Not to the extent of Enron. Not a company that, in effect, has their executives refuse to testify, that have had their accountants indicted for shredding documents. You know, we're in a situation—we believe that Enron is an anomaly, that Powers Re-

port, a board-commissioned report, that points out to the dealings of the CFO. In my experience——

Senator BUNNING. I don't doubt that they are an anomaly, but, in fact, Global Crossing could be another Enron.

Mr. DIAZ. I'm not aware of—I don't rate Global Crossing, so I don't know the details——

Senator BUNNING. Well, OK. You don't grade it, but it is in the same situation.

Mr. BARONE. Senator, this was not a ratings problem. This was a fraud problem.

Senator BUNNING. It was also a rating problem. Your reaction was way too late and too little.

Mr. BARONE. The market expects us, with all due respect, Senator, to take a tempered, deliberate approach. And as my colleague——

Senator BUNNING. No. The market expects you to anticipate what happens and also warn people if something is red-flagging you. You didn't——

Mr. BARONE. And that's exactly what——

Senator BUNNING [continuing]. Do it until after the fact. Thank you.

Chairman LIEBERMAN. Thank you, Senator Bunning. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman, and I apologize for having to slip out, but I appreciate the fact that the panel is still here for my questions.

Now, follow me through this and see if I have it right, and if I don't, set me right.

We, of course, start from the fact that is pretty well established that the Enron management was engaged in fraud. They were hiding things. They were lying. So you weren't used to that. You weren't expecting that. And you were caught by surprise by that.

However, would it be accurate to say that their accounting gimmicks, the things they did to perpetuate that fraud, relied heavily on the credit ratings? Whenever Enron credit ratings dropped below investment grade levels or triggers, the special purpose entities required that the Enron parent guarantee the value of the SPE. That trigger was written into the deal, as I understand it. So as long as the credit ratings were high, the SPE does not demand the collateral, and Enron does not have to pledge its stock. Is that an accurate description of the way this was constructed?

Mr. BARONE. In general, yes, sir.

Mr. PELLECCHIA. Yes.

Senator BENNETT. OK. Now——

Mr. DIAZ. Senator, that's an accurate description of two SPEs that we rated. There are apparently many others out there that we didn't know about.

Senator BENNETT. OK. But as long as the credit rating is above the trigger, the stock does not have to be pledged, does not have to be delivered, and, therefore, Enron can say to the analysts and everybody else, well, it is unencumbered because this is a contingent liability, but it is a contingent that is not going to come to pass because the credit rating is sufficiently high.

So when the credit rating triggers the trigger, that is when things begin to be really, really difficult. So the credit rating does play a critical role in how this whole structure operates. Am I all right so far?

Mr. BARONE. In general, yes, sir.

Senator BENNETT. OK. So when the credit rating hit the trigger, and that is when former Secretary Rubin called the Treasury, as I understand it, because he could clearly see that this is where everything was going to go, the question is: Did the credit rating firms understand how crucial the triggers were as you were drawing up your credit rating? Did that enter into your decision making? I am not just issuing a garden variety rating here that some investor will say, ah, I don't think I want to take a chance on this stock or, what the heck, I made a lot of money in junk bonds, and if they are going to say this is junk, why, I will jump in, I prospered during the Michael Milken era, whatever.

It is not just that with an individual investor making that kind of analysis and that kind of a decision. It is a trigger that could bring the whole thing down. Were you aware of the significance of the trigger? And did that enter into your analysis as to where you were going to place it?

Mr. BARONE. Yes, sir. We were well aware of the triggers' existence in some of the partnerships that we knew about, specifically Marlin, Osprey–1, Osprey–2. And we do take into account the existence of those triggers in affecting Enron's credit rating. And, indeed, the assets that are in those entities as they began to lose value, we would then, because of the likelihood of Enron having to pony up, as it were, this contingent obligation, we put back to Enron some amount of that obligation and utilized that information in determining its credit rating.

On the sum, over the years we have placed roughly—and not just for these two or three partnerships, but for the ones that we did know—all the ones we knew about, placed roughly $2 to $4 billion of additional liabilities back to Enron for these contingent-like or related-party obligations, guarantees, leases, and other things that appear off-balance sheet. So, yes, Senator, we do take them into account.

But the other—going to your point, there's—as you get closer to it, clearly there's a heightened awareness of the impact that this could have. Again, Enron's stock trigger—there was a stock trigger. There was a credit trigger. It was an "and" situation. So when they blew through the stock trigger, we were still at BBB-plus. I believe the other agencies, because it was either of the agencies, if they lowered it below investment grade, here still at BBB-plus level, felt comfortable at that range that there was no—you know, no reason for alarm, so to speak.

Mr. DIAZ. Senator, can I follow up on that?

Senator BENNETT. Sure.

Mr. DIAZ. Certainly we were aware of the triggers. I'd just like to point out one thing. When we held our rating committee—I think it was November 7; it's in the record if I'm incorrect—that evening, we concluded that we would downgrade Enron to Ba2, non-investment grade, and we were ready to put that press release

out the next day. We were aware of the consequences to Enron, yet we made that decision.

The reason that we ultimately did not bring it down to non-investment grade had to do with the changes they made in the merger agreement and the additional equity they were willing to put in. And that's why we ended up with a Baa3 rating as opposed to Ba2. But we were aware of the circumstances, and that would not have stopped us from downgrading to below investment grade because we felt that fundamentally the company no longer merited that rating.

Senator BENNETT. So the thing that saved your rating and gave them a temporary reprieve from the harshest of all triggers was your conviction that the merger was going to give them sufficient capital to survive?

Mr. DIAZ. Three things: That the merger would give them the capital to survive; the probability that the merger would go through based on the changes they had made; and that the combined entity would be investment grade because of the structural changes they made to the deal.

Senator BENNETT. Well, those are all three if's. In order for the thing to make it, all three have to fall in place. If any one of them falls out of place, the whole thing collapses.

Now, we are here with the brilliance of hindsight, and I recognize that and don't want to put myself in your position when you are trying to look at it in foresight. But it does seem to me, to just summarize it, in order for Enron to avoid the disaster of the non-investment grade rating, three things have to happen. There is no absolute assurance—of course, I guess in this world there is no absolute assurance of anything. It was your judgment that it was likely that all three would happen.

Mr. DIAZ. Right. Yes, Senator. We based a lot of that judgment on probabilities. So we felt there was a high probability that because of the equity infusion that was coming into Enron, Enron would have sufficient capital to get through the period and so forth.

Senator BENNETT. Yes.

Mr. DIAZ. And we felt that the outs in the agreement were taken care of, and it had Chevron-Texaco behind it and motivated banks to make the deal happen.

Senator BENNETT. OK. Well, I have gone over my time, Mr. Chairman, and we are mixing this panel with the previous hearing. But the question obviously arises why an analyst faced with this kind of circumstance—and you are not analysts like the stock pickers that we had—wouldn't say, OK, they are on the brink of disaster, and the only thing that can save them is if the three following things all come to place simultaneously, and life being what it is, if one of the three falls out, it ain't going to work. And as an investor, I would really love to have had that understanding of just how tenuous it was before I make a decision. That is assuming I had any money to invest.

Thank you. This has been helpful.

Chairman LIEBERMAN. Thanks, Senator Bennett. A very interesting line of questions. You can feel the frustration, I think, of the Members of the Committee as we look back, and this is the basic question about whether you could have done more. I don't think

anybody is accusing you—I am certainly not—of sort of malfeasance here. Nobody is accusing you of conflicts of interest, which were rife in some of the other cases that we have held investigations on. The question here is whether you were aggressive enough and used the power that you have. And these rating triggers, your ratings had enormous impact on the companies.

Let me go back to this critical—and ask a few questions about it—moment when the merger was being discussed, and you had a decision to make as to whether to downgrade. You put Enron on a credit watch, but you didn't lower them below investment grade rating. Obviously this is a significant decision. You have conversations. You receive a call, I believe at that time, from Ken Lay, or certainly people from Enron. You receive calls from people that Senator Thompson mentioned, from the New York Stock Exchange, from various investment banks involved, etc.

I have got to ask: Did you receive calls from anybody else? For instance, did you receive calls from any government officials which were aimed at urging you to not downgrade Enron's rating?

Mr. BARONE. Through the whole process, sir, the only folks we were in conversation with were Enron and Dynegy about the merger prospects. We were never called by the banks, investment bankers, any government officials, or anyone else.

Chairman LIEBERMAN. Mr. Diaz.

Mr. DIAZ. No, we never received any calls from government officials.

Chairman LIEBERMAN. And as far as you know, no one else at the company?

Mr. DIAZ. As far as I know, no one else at the company.

Chairman LIEBERMAN. Mr. Pellecchia.

Mr. PELLECCHIA. We received no calls from anyone either in government, investment bankers, in any way to try to persuade us to do anything with the rating. However, in the course of our analysis and what we do as analysts is to get and receive and respond to calls from all types of people who work for financial institutions. So probably every major investment bank and commercial bank called me one time or another between October and December relative to Enron. But none of those calls were in any way indicative of any pressure to do anything with the rating.

Chairman LIEBERMAN. And not at the level presumably that Senator Thompson indicated. Did you agree that you had heard from Mr. Grasso and Mr. Rubin?

Mr. DIAZ. I believe we did get calls. I was not in those calls, but I don't believe that any material discussions ensued from those calls.

Chairman LIEBERMAN. OK. But, in any case, none of you heard from government officials.

Here is what is obviously agitating all of us, which is that this—credit rating agencies have grown up in some ways like Topsy, with an enormous power, with this sort of semi-sanction of the SEC NRSRO designation, but not that much that goes into them approving you for it. Then hundreds of statutes come along, Federal, State, and local, I presume, that say you have got to get the approval of these credit agencies to be out in the markets. And yet you are exercising real quasi-governmental authority, power, and

yet there is—and I must say in fairness that, by and large, your record is a very good one, I mean, judged in the most objective way that the number of defaults of companies that you have rated as investment grade is quite low. I think on AAA it is at 1 percent, and maybe on the others it is at 6 percent. Is that about right?

Mr. BARONE. Less than 1 percent on AAA.

Chairman LIEBERMAN. But this is our frustration. You have got a big actor—Enron—comes along and its downfall has disastrous consequences for its employees, for average—for their retirement security, for investors, for the economy, in fact. And we look and say, now, OK, you are the one that had—you had more access to them, and yet I think our—if I can summarize, I will say it for myself, I feel as if you weren't as aggressive as you should have been in asking for more information with the authority that you had.

Even some of the—I know it was a glib answer, but I know that even some of the questions that have been—that your answers have raised in my mind about the concern about their accounting practices, about the partnerships—and let me ask the baseline question. I assume each of you is saying that if you knew then what you know now about Enron, you would have downgraded Enron below investment grade. Is that correct?

Mr. BARONE. Senator, if we knew then what we know now, we would have withdrawn Enron's rating for failure to disclose proper information.

Chairman LIEBERMAN. Which would have had the effect of basically putting them out of business, probably.

Mr. BARONE. I don't want to speak for what the market's reaction would be.

Mr. DIAZ. We would have had a lower rating on Enron for—probably for a few years before.

Chairman LIEBERMAN. For a few years before.

Mr. DIAZ. Yes, I mean, it looks like their partnerships began to be put together back in at least 1999.

Chairman LIEBERMAN. But you didn't know about them. Mr. Pellecchia.

Mr. PELLECCHIA. I would say the same answer. We would have had a lower rating well before 2001.

Chairman LIEBERMAN. So looking back now at the confusion of their accounting practices, which you, I think, knew about, you had some sense that something—it was hard to understand everything there. Don't you feel that you should have asked more of them as you look back? Mr. Barone.

Mr. BARONE. Senator, we rely on the audited financial statements, and insofar as we read and understood fairly well where they were making their money based on the representation of those audited financial statements, we would ask questions, and we would receive answers and use that information in our ratings analysis.

Chairman LIEBERMAN. But you are expert——

Mr. BARONE. We are not forensic accountants, if that is the question, and we don't have subpoena power, and so there's a lot that——

Chairman LIEBERMAN. You know, maybe—in some ways I have been thinking, What is the analogy? You have authority here over

the markets and companies that is somewhat comparable—the first thing that comes to mind is the FDA, Food and Drug Administration. They don't let a drug go out on the market—this is a controversy in itself—until they have gone over all sorts of investigations to guarantee that it is safe, and then doctors prescribe the drug, people use it in reliance on that.

To some extent, we have asked you to play—to a real extent, we have asked you to play a similar role with regard to corporations, and yet—and you do have power, but the power is the threat that you will lower their rating or remove it. You can put people out of business. And it just looks—again, I want to be fair to you. Most of the cases people are leveling with you, and your record is pretty good, a low percentage of defaults. But here was one that as we look back, understanding hindsight is always clearer, you want to say to yourself: Why didn't you press harder for more information on accounting? Why didn't you press harder on partnerships? Even in that "kitchen sink" disclosure that they made, it just doesn't—it seems like it left a lot of questions in your mind.

Actually, Mr. Diaz, let me ask you this question. I appreciate the end of your opening statement because you said Moody's has gone around and talked to a lot of people, held interviews, and—let me read it—you are going to do some things differently. "Going forward, we are enhancing the ratings process by putting increased focus in several areas. We have substantially intensified our assessment of liquidity risk for issuers with both investment grade and speculative grade ratings." And Enron had a speculative grade rating, correct?

Mr. DIAZ. They had a low investment grade rating at the lowest level for pretty much their whole history, and then became speculative grade at the end.

Chairman LIEBERMAN. Right. "We're also focusing"—it is interesting to me—"on corporate governance and how aggressive or conservative are accounting practices."

Now, I am encouraged by that, but isn't that a way of saying that you wish you had done that earlier as well?

Mr. DIAZ. Senator, again I would hark back to our fundamentally good record. But we didn't sit on it. We look all the time at ways that we can improve. We've, over the years, constantly put out comments on the rating process, on securitization, on other issues. So certainly the Enron debacle focuses our attention on certain areas that we would like to get better understanding of, including rating triggers. But it is our ongoing—that's not something that we just started because of Enron. It's something we've had ongoing for a while, and certain areas are going to be a focus of more intense activity going forward.

Chairman LIEBERMAN. OK. My time is up. I appreciate it. Obviously in the next panel we are going to hear from some people who have ideas about how to alter the status quo to give you the authority or give you some sense of accountability for the enormous authority that you do have that really matters in a case like this. Senator Thompson and I were just talking about it. He said to me, you know, the bridge only collapses very rarely, but when it does, we wonder why the inspectors hadn't noted the crack that led to the bridge falling and a lot of people getting hurt. And that is es-

sentially the tough, but I think reasonable, question that we are asking of all of you today.

Senator Thompson.

Senator THOMPSON. Yes, just one or two points, Mr. Chairman. Studies indicate that for the most part credit rating agencies do get it right, and companies rated in the AAA range rarely default, companies rated in the BBB range default only at slightly higher percentage. And I think it is important for us to keep in mind that these companies do not recommend buy or sell, that basically what they are dealing with is a broad, general category with regard to the ability of a company to fulfill its financial commitments; and that while there is a relevance between the stock price and the rating, it is certainly not directly tied. A company could see its stock go down for any number of reasons, and it still may be practically unaffected in terms of its ability to fulfill its financial commitments. Is that correct?

Mr. BARONE. Or vice versa.

Senator THOMPSON. Or vice versa. So I think we need to understand that.

One of the things that interests me in looking at some of this history here is the statements that representatives of your companies make with regard to these stocks. I am wondering—of course, we are in the age of constant television coverage and cable and all of that, and some of the analysts have become superstars, and maybe the raters are going in that direction, and I guess it is strange for a politician to be commenting on that. But it looks to me like you have got your ratings, but then you have got your statements. And October 25, S&P's changed Enron's rating to a negative, but retained its BBB bond rating. Fitch also placed Enron on the watch for a downgrade on October 29. Moody's downgraded Enron one notch to B2A2, and kept it on review for another downgrade.

The same day S&P's primary Enron analyst Todd Shipman went on *CNN*, even though S&P's had placed Enron on credit watch negative, Shipman said, "Enron's ability to retain something like the rating they are at today, investment grade, is excellent in the long term."

When asked about the off-balance sheet partnerships, Shipman remarked that S&P's was "confident that there is not any long-term implications to that situation, that that's something that's really in the past."

Then S&P's met with Enron on October 31 and was told that Enron would sell off assets to shore up its access to capital. The next day, November 1, S&P's downgraded Enron to BBB and placed it on a negative credit watch.

Still, in its press release announcing the downgrade, S&P's said it "continues to believe that Enron's liquidity position is adequate to see the company through the current period of uncertainty."

It looks to me like that you are making your ratings, which are clearly broad category ratings—you are right, you are not making recommendations of buy and sell, but then either through your analysis on *CNN* or your press release you get into the stuff that the analysts get into, and you really are getting into painting a picture of long-term viability of the company. I guess the question—I don't know how long your ratings are supposed to apply. I mean,

suppose you have questions long term, but the current situation looks OK, that sort of thing. I mean, should you really be getting into all of that? Is this a recent phenomenon? Your ratings are one thing, but any analyst that comes out of there under questioning and he doesn't know what the questions are going to be, he clearly doesn't want to say anything that is going to cause a lot of problems for the company, then go back to headquarters and get this handed to him. So he is put in a really awkward position, it looks to me like, the same position that an analyst is in, really, to be positive, and it looks like touting the stock, in effect.

Is this what you consider to be part of your obligation? Is this a phenomenon that hasn't been around that long? Or have you always had your people out there commenting on their opinions as to various aspects of the company and not being content simply on putting out the ratings?

Mr. BARONE. I think it all depends on each market, sir, and the energy market has had a lot of attention, say, the last 3 or so years. I think there has been a stepped-up media interest, investor interest in the market. And so when we are called upon to provide an opinion beyond what we have written, whether it be in a news broadcast or an interview with a publication of sorts, we comply when and where we can.

Senator THOMPSON. So you have an analyst function. You see yourself as providing an analyst function as well as a rating function.

Mr. BARONE. Well, again, what we're providing, sir, is just our opinion. It goes back to the credit analyses that we have performed. Obviously we cannot convey anything greater in terms of confidentiality or anything like that than what we may have received. We just try to put forth what we may have written already in various articles or rationales on the company's credit. We are not recommending—we are not there recommending. We are not there supporting. We are not a company's advocate. We're not their dis-advocate. We really don't care. We're there just to call it as we see it, as a third-party, objective, credible opinion, as our default studies have proven.

Senator THOMPSON. What do you see your appropriate role as in this?

Mr. DIAZ. Our role is simply to gauge the company's creditworthiness. It's an opinion of the company's ability to repay its debt. And we do talk to the press and to other interested investors and lay out the weaknesses and strengths of a company. But it's not our role to recommend or to tout any company, simply to lay out what goes into our analysis.

Senator THOMPSON. Here, Mr. Barone, the S&P's Enron analyst says, after making your rating, your representative comments on Enron's ability to retain that rating in the long run. It says not only are we giving this rating today, but we are telling you that it's our opinion that you're going to—they're going to have this rating for a long time.

Mr. BARONE. Ratings generally go from an intermediate to long-term purview, the long-term rating.

Senator THOMPSON. Well, then does that really add anything to the rating itself in this comment?

Mr. BARONE. I am not sure I follow your question.

Senator THOMPSON. I get the impression you are saying that he is saying nothing more than what the rating itself says.

Mr. BARONE. Right, and I don't believe he was asked anything further than that. Our view at that time was, given the information we had to our avail, that there was a strong—that we had an opinion——

Senator THOMPSON. Mr. Pellecchia, do you have any comment on that?

Mr. PELLECCHIA. I think our commentary is particularly important, specifically the commentary that is written that goes along with the rating, for instance, the warnings that you can give investors, such as what we said during the Dynegy-Enron merger period, and we said if the merger goes away, Enron's ratings will drop several notches to speculative grade. So I think that that gives a warning to investors that this is——

Senator THOMPSON. You give a balanced treatment background as to how you came to that rating.

Mr. PELLECCHIA. Yes.

Senator THOMPSON. I venture to say that is something you would never be able to do on *CNN* or any of the other cable shows.

Mr. PELLECCHIA. To be honest, some of these conversations that we have talked about involve an hour conversation with a reporter.

Senator THOMPSON. Complicated situation.

Mr. PELLECCHIA. That picks up the most provocative——

Senator THOMPSON. And investors watching the show want to know——

Mr. PELLECCHIA. But I think that's an important——

Senator THOMPSON [continuing]. If you guys say a stock is going to be—this company is going to be in good shape.

Thank you, Mr. Chairman.

Senator LEVIN. Thank you. Let me just follow up with a few questions. We have talked about a couple of trusts and about some triggers. The trust names were referred to as Osprey and Marlin, and you were aware that there were triggers that would guarantee that investments in those trusts would, in fact, be repaid, I believe, Mr. Barone, right? You knew about the triggers. In fact, I think you testified that was relevant to your assessment of Enron's credit rating because they ultimately were the guarantor of that investment in those trusts. Is that a fair——

Mr. BARONE. That's correct, sir.

Senator LEVIN. Now, I just want to go through the timetable on this and discuss what these triggers were and when the gun went off. My understanding is that the stock price of Enron fell below a certain level on May 5, so that was one of the triggers at that point. Enron then was on the verge of having to pay $2.4 billion back to investors in that Osprey trust.

What were the other criteria? Do you remember offhand?

Mr. BARONE. That the ratings fall below investment grade from either of the agencies.

Senator LEVIN. Now, when that happened, you were aware of the trigger on the stock price.

Mr. BARONE. Yes.

Senator LEVIN. And you also were aware that the other criteria depended on your own rating, so that if you responded to the gun going off on that date by changing your rating, that would have certain massive consequences for Enron.

Did you on that day when that happened consider lowering your rating?

Mr. BARONE. No, sir, not at all.

Senator LEVIN. Did you know about it?

Mr. BARONE. Yes.

Senator LEVIN. All right. If, in fact, that trigger was relevant to the rating, why would the fact that the gun went off not be relevant to a changed rating?

Mr. BARONE. Again, the stock price dropping could be tied to multiple reasons. Whereas, the credit rating, the thing that I knew and knew best about, tied to the creditworthiness, is something that we can manage and we can monitor. The stock price dropped for many reasons. There was a general market decline. Most stocks had dropped from the last 2 years from general economic conditions. So it didn't cause us any alarm because we were looking at the fundamentals of the company, its business models, financial profile as we believed it to be, and its qualitative assessment, and we were still at BBB-plus. We had three notches to go before this trigger, the second part of that, the "and" clause would have been tripped.

Senator LEVIN. You were the tripper?

Mr. BARONE. We could have been, sure.

Senator LEVIN. It was in your hands as to whether it was tripped or not.

Mr. BARONE. Sure. Absolutely.

Senator LEVIN. But the first criteria had been met.

Mr. BARONE. Right.

Senator LEVIN. Was that public?

Mr. BARONE. Which part, sir?

Senator LEVIN. The triggers.

Mr. BARONE. I think these were private—I believe these partnerships were set up privately under 144(a) rules, so I do not know whether they were disclosed, whether the general market knew about them. Clearly, the investors who invested in them knew, and many of those who decided not to invest in them would have known because it was marketed to quite a few people on Wall Street.

Senator LEVIN. But the people who invested in Enron would not have known?

Mr. BARONE. The common equity shareholders? I can't say, but probably not, sir.

Senator LEVIN. It seems to me that this permeates this problem, the fact that there were hidden guarantees here that affected Enron's stock. This is a guarantee that could trigger a $2.4 billion repayment from Enron or Enron stock, not known to the public but known to you.

Mr. BARONE. I would say, sir, the Mom and Pop investors were not likely to know about it, but the institutional holders of the common shares were probably aware of it. It's just speculation on my part. I don't have firsthand knowledge.

Senator LEVIN. Well, this is one of the reasons that Mom and Pop got the shaft. There were guarantees here that were not disclosed to that average investor that you folks knew about. You folks knew about those guarantees, right?

Mr. BARONE. Right. Yes, sir.

Senator LEVIN. There is something wrong here. Something very wrong, because we have advisers who know parts of the investment banking—part of what an investment bank knows, you folks know.

Mr. BARONE. Right. This was a private deal, sir.

Senator LEVIN. I understand, and you are aware——

Mr. BARONE. We would have breached confidentiality if we had disclosed this.

Senator LEVIN. You are aware of it, though, and you are rating Enron's credit. So you know something. You don't act on it here even though you are aware of it. That bothers me, by the way. It seems to me that it was relevant to your rating; therefore, when it was triggered, it should be relevant to a re-rating. I will state it that simply. OK? If it is relevant to begin with, then the change in it makes it relevant to the re-rating.

Mr. BARONE. Are you asking a question——

Senator LEVIN. No, I will just make a statement on that. Since you are the one who said that it was relevant to your determination as to how to rate their debt, the fact that there were these triggers, that was relevant; the fact that the trigger went off, it seems to me would be relevant as well to your rating of debt. I will make that as my statement.

Mr. BARONE. It was specifically written, sir, with an "and" clause so that it wouldn't be subject to general market condition, as I understand it. They purposely put both triggers in, the slide of the common equity price as well as a decline in credit, knowing fully if both occurred that that would clearly indicate a significant impairment of their financial profile.

Senator LEVIN. I will just repeat: The second part is in your hands. That is the rating issue that is in your hands. So it is not some outside objective factor. It is whether you rate them below market grade.

Mr. BARONE. Or my colleagues.

Senator LEVIN. Of course, your colleagues. I am looking at you, but it is all three of you.

One other question here. I want to show you a typical structured financing deal. Hundreds of these structured finance deals were rated by you folks, or at least were entered into by Enron. If you look hard enough, you will find Enron on that chart. It is up somewhere in the top left bowl of the spaghetti. There is a little piece of spaghetti way up there.

This is a diagram of the Whitewing part of the financing of Project Margaux,[1] which is a European energy deal. This is a document which was produced from one of subpoenas issued by the Permanent Subcommittee on Investigations.

Now, wouldn't something as incomprehensible as this raise some questions to you about the purpose and the viability of this project? Because you are going to give a rating now to the instruments

[1] Chart entitled "Project Margaux" appears in the Appendix on page 207.

which result from that project. When you look at this and you realize there are hundreds of these things that Enron is getting into, Enron had more structured financing deals, I think, than any typical company, $15 to $20 billion a year in structured financing deals from 1997 to 2001. Here is one of them.

Two questions. Were your companies aware of the huge amount of structured financing deals at Enron? Second, shouldn't this have triggered some questions in your mind, this kind of a haystack where you are supposed to find the needle of debt? Shouldn't that have raised some questions in your mind as to the purpose and viability of the project? Let me start with you, Mr. Barone.

Mr. BARONE. We were aware of many of their structured finance deals, and Enron's aggressive use, if you will, of structured finance deals was one of the many reasons we only rated it BBB-plus, sir. If you looked at Enron's financial profile on its face, you would have come to a conclusion that this could have been a company with a much higher credit rating, and yet we take into account the aggressive use of financial structures and such.

Senator LEVIN. Would you agree this is a relatively incomprehensible structure?

Mr. BARONE. Not necessarily. I'm not a structured finance analyst, but we have structured finance analysts at Standard & Poor's, very capable ones, who make it their livelihood to understand structures like——

Senator LEVIN. We would appreciate if one of them would take a look at this and tell us whether that is a typical structured deal and whether it is comprehensible. Let the Committee know for the record, would you?

Do you have any comment, Mr. Diaz.

Mr. DIAZ. I would, to a great extent, echo Mr. Barone's comments. We were aware of a lot of their structured transactions. We rated a couple of them. But we were not aware, obviously, of a lot of the off-balance sheet partnerships. And, also, I also am not a structured finance analyst, but this kind of structure doesn't look dramatically different, all the wiggly lines and all that, than a lot of the ones that are done by our structured people.

Senator LEVIN. That looks to you like a typical structured finance deal?

Mr. DIAZ. It looks like the kinds of deals that I have seen other companies put together, and again I wouldn't rate them myself. I don't have the expertise to do structured financing. But it's not, on the face of it, out of the ordinary.

Senator LEVIN. OK. Perhaps you could ask one of your structured finance folks to tell us if that is typical, too, as well.

Mr. Pellecchia.

Mr. PELLECCHIA. Well, my response would be certainly that the complexity of the company and the types of transactions that it entered into was a factor in keeping Enron's rating in the BBB category. I don't think there's any question about that.

Senator LEVIN. Thank you. Thank you, Mr. Chairman.

Chairman LIEBERMAN. Senator Bunning.

Senator BUNNING. Yes, sir. Thank you, Mr. Chairman.

Can I go back to March 2000? Both S&P's and Fitch rated Enron as BBB-plus and Moody's rated Enron as Baaa–1, which is in the

slightly higher than ordinary but not at the top like a AAA rating. It is somewhere between BBB-plus and——

Mr. DIAZ. The Baa category is at the low end of the investment grade spectrum. It has——

Senator BUNNING. Baaa.

Mr. DIAZ. Baa, we call it, B-a-a. So a Baa–1 rating would be at the top of the low investment grade rating category.

Senator BUNNING. But it is still an investment grade rating?

Mr. DIAZ. It is an investment grade rating, yes, sir.

Senator BUNNING. OK. However, even as Enron's stock, common stock, crumbled through most of 2001, the credit rating agencies—that is you three—didn't downgrade Enron from investment grade status until 4 days before it declared bankruptcy—4 days.

Now, I know you are not security analysts as far as having the ability to understand why a stock would be going down so fast. But insider trading is published constantly on the Internet. As Senator Levin said, you were part of a two-pronged deal that said Enron was going to have to cough up $2.4 billion, their stock had hit $20 a share on the down side, but as long as they held their investment grade rating, they didn't have to do any of the $2.4 billion. The insider selling in that stock was unbelievable. Everybody that knew anything about the company was bailing out as fast as they could get their market shares to the market.

Now we also have a lockdown on their 401(k) plan, so the ordinary people in the company can't sell their stock.

Now, doesn't that ring a bell with you and say why in the world are all these people bailing out if this is such a sound corporation? And why in the world would I sell a share at $20 that was just $90 a few months prior if, in fact, I believed it was going to turn around and go back up? That makes no sense to me at all. And it should have triggered your investigation because you were part of that two-pronged deal. As long as they held an investment grade status, they didn't have to ante up the $2.4 billion.

Didn't that set off any alarms in your financial rating of those companies?

Mr. BARONE. No, sir. We see insider trading from firms quite frequently, and determining why a director or an officer of the company is selling its shares of stock——

Senator BUNNING. This was massive. This wasn't just one or two or three people. This was anybody who knew anything about the company. They were bailing. They had bad feelings about the company. And all you had to do was trigger the other half of that and make them come up with $2.4 billion if their stock is under $20, and that would have done it completely in, the $2.4 billion, because you know darn well they couldn't pay it off. They had no means of paying $2.4 billion off.

I would like to know why you held that rating to 4 days before they filed bankruptcy.

Mr. BARONE. For us, Senator, we were aware of the Dynegy merger on——

Senator BUNNING. Well, the Dynegy merger is an if. If they are successful in merging with Dynegy, then maybe they would be able to survive.

Mr. BARONE. It is our practice and the practice that the market has come to recognize, when mergers occur, to take into account the probability of the merger. We deal in probabilities, as my colleagues said. And our assessment was that there was a strong probability at the time that it would succeed. And when we lost confidence in that probability, that's when we decided to act prior to the merger being dis-consummated, so to speak.

Senator BUNNING. That is a pile-on, as far as I am concerned. That is after the fact. You are depending on something that the potential of it happening is not going to be 50/50 maybe.

Now, you are supposed to have inside information that we don't have, that the average investor doesn't have, and yet you didn't flag it.

Mr. BARONE. I'd say, sir, our assessment was that there was a greater, much greater, chance than 50/50 at the time when we made that assessment on November 1 or 2, that the merger would go through. Indeed, if we thought it was just 50/50, we would have lowered the rating to properly reflect that.

Senator BUNNING. We need more people doing the ratings then, because obviously you three all agreed.

Mr. DIAZ. Senator, I think I've testified before that we also believed that the probability of the merger going through was high. We had a rating committee that included our senior management, and we came to the conclusion, given the changes in that agreement, there was a very high probability the merger would go through. So that's the key for holding the rating during that period.

Just as another point, one of the comments that I've made is that we've been trying to figure out how can we improve the process, and one thing that we've done is talk to the major asset management firms to try to understand how they use ratings and how they would like us to, in effect, do the ratings.

One of the things that they've said to us is that they like the stability of ratings, but the other point is that when things are going—when a company is under certain amount of distress, they would like for us to give the company the ability, if there's a probability of correcting the problem, to give them the opportunity to do so.

Senator BUNNING. Do you all realize that once you take a corporate bond and make it a junk bond, the potential of bankruptcy in that company is really high?

Mr. DIAZ. Senator, I think when we take—a company that wouldn't be an Enron——

Senator BUNNING. Any other company that might be listed, or not even listed, just private——

Mr. DIAZ. A Ba category, which is not investment grade, is still a viable category. A company can live as a Ba company for many years.

Senator BUNNING. How long?

Mr. DIAZ. The probability of default is in our studies, but I think the probability of default over a 10-year period for a Ba—and I may be wrong and would have to double-check, but it is in the neighborhood of 16 to 20 percent, which means that 80 percent, roughly—and, again, don't hold me to the numbers, but it's a fairly high number—would actually survive for 10 years. So it's not a situation

where it's Ba and death. In Enron's case it was because of the triggers, and it was because everybody was running away from it. But it's a different situation.

Senator BUNNING. They were running long before you ever downgraded.

Mr. DIAZ. No, because the——

Senator BUNNING. They were.

Mr. DIAZ. Well, the——

Senator BUNNING. The general public, the management of the company, and all others were running from that stock, and because you failed to act in downgrading it below investment grade, it held on a heck of a lot longer than it would have.

Mr. DIAZ. But we had good reasons for doing so. We were looking at a good probability of a merger with a bona fide partner, with Chevron-Texaco behind it, and with bank funding that would have made it work—if Enron itself—the real problem was that Enron itself was rotting from inside. The fact is that Dynegy—I don't think Dynegy knew, I don't think the banks knew how bad the situation was.

Senator BUNNING. And all the poor people that worked for it were the ones that took the big hit.

Mr. DIAZ. That's right, Senator, and that's a real tragedy.

Senator BUNNING. Yes, it is a tragedy. Thank you.

Chairman LIEBERMAN. Thanks, Senator Bunning, for some excellent questions.

Thank you, gentlemen. Your testimony has been very important to this Committee as we try to learn the lessons of Enron as we follow the trail down to places that we didn't expect we would go. And I want to ask you to go back—maybe you are doing this already—and speak with the executives at your companies about how you can use, better use the real life-and-death power you have over corporations to protect us investors, individual and institutional, from the next Enron. We know it is the exception, but a lot of people, as you all just said, were hurt by it. And we think you are in a position to do more than was done in this case to try to protect the economy and a lot of people from the pain and suffering that they endured as a result of what happened. But for now, I thank you for your testimony this morning.

Mr. DIAZ. Thank you, Mr. Chairman.

Mr. BARONE. Thank you.

Mr. PELLECCHIA. Thank you.

Chairman LIEBERMAN. We are now going to call panel two: The Hon. Isaac Hunt, Jonathan Macey, Glenn Reynolds, and Steven Schwarcz. And as you come to the table, I will just ask you to remain standing so I can administer the oath before you begin your testimony.

I would ask the four witnesses to please raise your right hands, if you would. And do you solemnly swear that the testimony you are about to give this Committee today is the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. HUNT. I do.

Mr. MACEY. I do.

Mr. REYNOLDS. I do.

Mr. SCHWARCZ. I do.

Chairman LIEBERMAN. Thank you. Please be seated, and let the record show that each of the witnesses has answered the question in the affirmative.

Thanks very much for being here. Some of you have come quite a distance, but thanks particularly for your patience as we heard the testimony of the first panel, and we now look forward to your helping us answer some of the questions that were both asked and we are left with by the first panel. First we are going to call on the Hon. Isaac C. Hunt, Jr., Commissioner of the U.S. Securities and Exchange Commission.

TESTIMONY OF HON. ISAAC C. HUNT, JR.,[1] COMMISSIONER, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. HUNT. Good morning, Chairman Lieberman, Senator Thompson, and other Members of the Committee.

Thank you for the opportunity to testify before you today on behalf of the SEC regarding credit rating agencies and the Commission's experience with the credit rating industry.

The recent collapse of Enron has renewed questions as to whether rating agencies should be subject to increased regulation, particularly because all three nationally recognized statistical rating agencies rated Enron and/or its credit obligations as investment grade less than 1 week before Enron filed its bankruptcy petition.

As you know, for almost a century, credit rating agencies have been providing opinions on the creditworthiness of issuers of securities and other financial obligations. During this time, the importance of these opinions to investors and other market participants and the influence of these opinions on the securities markets has increased significantly, particularly with the increase in the number of issuers and the advent of new and complex financial products, such as asset-backed securities and credit derivatives. The globalization of the financial markets also has served to expand the role of credit ratings to jurisdictions other than the United States. Today, credit ratings affect securities markets in a number of important ways, including an issuer's access to and cost of capital, the structure of financial transactions, and the ability of fiduciaries and others to invest in particular investments.

During the past 30 years, regulators such as the Commission have increasingly used credit ratings as a surrogate for the measurement of risk in assessing investments held by regulated entities. Specifically, since 1975, the Commission has referenced the ratings of specified rating agencies in certain of its regulations, referring to these rating agencies as "Nationally Recognized Statistical Rating Organizations." The term "NRSRO" was originally adopted by the Commission solely for the purpose of the Commission's net capital rule. Subsequently, the Commission used the ratings of NRSROs to distinguish "investment grade" securities from those that are "non-investment grade," in regulations under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. Congress itself employed the term "NRSRO" when it defined the term "mortgage-related security" in Section 3(a)(41) of the Securities Exchange Act of 1934. Other Fed-

[1] The prepared statement of Mr. Hunt appears in the Appendix on page 131.

eral and State regulators also incorporated the NRSRO concept into their rules.

Currently, to determine whether a rating organization is an NRSRO, the Commission staff reviews the rating organization's operations, position in the marketplace, and other criteria (which are elaborated on in my written testimony). If the Commission staff determines that the NRSRO designation is appropriate, the staff sends a no-action letter to the rating organization stating that the staff will not recommend enforcement action to the Commission against broker-dealers that are using ratings issued by the rating agency for purposes of the net capital rule.

Chairman LIEBERMAN. Sir, excuse me. Am I right that this only happens once in the life of a credit rating agency that it gets this no-action letter?

Mr. HUNT. Yes, Senator, that's true, although we try to put the rating agencies on the same schedule for inspection as we do other investment advisers that are registered with us as investment advisers. Whether that is right or wrong is open to debate, but they are. And that is about every 5 years.

Chairman LIEBERMAN. That is interesting. So in that capacity—though presumably these no-action letters in some of the cases of these three agencies go back decades, correct?

Mr. HUNT. Yes, sir. There were four others that we gave no-action letters to, but they were all subsequently merged into the existing three. So at one time there were seven.

Chairman LIEBERMAN. So that every 5 years, because they also have the status of investment advisers, you do go back——

Mr. HUNT. Yes, sir.

Chairman LIEBERMAN [continuing]. And do an inspection. And what is that about? What does it constitute? What do you look at?

Mr. HUNT. Well, we look at the books and records. We look at their operations. We look at their capacity. We do a much broader inspection when we give them the no-action letter. But when we go back and look at them every 5 years as investment advisers, we look at their books and records and their operations. I would not say it's as extensive as the first look we do when we give them the original no-action letter.

Chairman LIEBERMAN. OK. Understood. Thank you.

Mr. HUNT. Over the course of its history, the Commission has considered a number of issues regarding credit rating agencies. Not surprisingly, many of the instances in which either the Commission or Congress reflected on the need for regulation coincided with a large-scale credit default such as the Orange County default and the default of the Washington Public Power Supply System bonds or, for example, Penn Central. Ten years ago the Commission seriously considered the need for oversight authority of credit rating agencies, given their increasing role in the financial and regulatory systems. The Commission at that time did not reach a consensus on the need for regulation.

In 1994, the Commission did, however, issue a concept release soliciting public comment on the appropriate role of ratings in the Federal securities laws, and the need to establish formal procedures for designating and monitoring the activities of NRSROs. In 1997, the Commission published a rule proposal that would have

adopted a definition of the term "NRSRO" that set forth the criteria a rating organization would have to satisfy to be acknowledged as an NRSRO. Generally, under the proposed amendments, the Commission would consider the same criteria currently used in the no-action letter process. To a large extent, the proposal was designed to bring greater transparency to the existing process and to provide for a formal appeal process to the Commission and, if necessary, to the Federal courts.

Observers have criticized the national recognition requirement as creating a barrier to entry for new credit rating agencies. However, the Commission historically has not found that the requirement creates a substantial barrier to entry into the credit rating business. At this time, the Commission plans to examine the competitive impact of the NRSRO designation and will consider suggestions concerning other market-based alternatives that might address the competitive concerns association with the NRSRO framework. The Commission's examination, which may include hearings, will ascertain facts, conditions, practices, and other matters relating to the role of rating agencies in the U.S. securities market. We believe it is an appropriate time and in the public interest to reexamine the role of rating agencies in the U.S. securities markets.

Thank you. I will be happy to try to answer your questions.

Chairman LIEBERMAN. Thanks, Commissioner Hunt, for that testimony and for what you indicated at the end. I gather you are going to commence your own inquiry here as a Commission.

Mr. HUNT. Yes, sir.

Chairman LIEBERMAN. Motivated in part by the Enron episode?

Mr. HUNT. Motivated in part by the Enron episode. Motivated in part by our concern that how people get this rating is not transparent to most of the investing public.

Chairman LIEBERMAN. Right.

Mr. HUNT. Motivated in part because, as more and more entities use credit rating agencies, there may be more need for more than three, as there is now a need for more than four accounting firms. So for all those reasons, we think we are going to take a thorough look at what they do and whether we should have more authority over them and whether indeed we should even come to you and ask for more authority over them.

Chairman LIEBERMAN. Yes. Is it your judgment—well, maybe this is a preliminary question, but I will ask you: Is it your judgment now that if you chose to exercise more authority over the credit rating agencies, you would need legislative authorization or that it is within your legislative mandate now?

Mr. HUNT. We could do a lot of it through rulemaking. Our hearings might show whether and to what extent we need more legislation.

Chairman LIEBERMAN. OK. I am greatly encouraged by that decision that the Commission has made. I appreciate it. And as I understand it, it goes not only to the question of whether there is sufficient competition within the credit rating agency sector, but also to the larger question of whether there is a public interest in having the SEC specifically do more oversight of the agencies.

Mr. HUNT. They perform an ever more important role in our securities markets, as you understand.

Chairman LIEBERMAN. Yes.

Mr. HUNT. They are involved in hundreds of millions, if not billions of dollars in our market, and so we thought it was time to take a look to see where we are and where we ought to go.

Chairman LIEBERMAN. Yes, excellent. Thank you.

Next we are going to hear from Jonathan Macey, J. DuPratt White Professor of Law, John M. Olin Program in Law and Economics, Cornell Law School. Pretty extensive title there, Professor Macey. Thanks for being here.

TESTIMONY OF JONATHAN R. MACEY,[1] J. DUPRATT WHITE PROFESSOR OF LAW, CORNELL LAW SCHOOL

Mr. MACEY. It's nice to be here. I am going to talk a little bit about the role of credit rating agencies in the economy.

The purpose of credit rating agencies is to inform investors of the credit quality of securities and warn investors when credit quality of securities deteriorates. Rating agencies are paid large fees by corporate clients in order to maintain ratings for the debt. For example, Enron paid Moody's between $1.5 and $2 million annually to maintain its ratings on its various public and private debt.

Being a credit rating agency is a great business to be in. The industry is dominated by the two leading firms, Moody's and Standard & Poor's. Analysts have estimated that the profits of the big credit rating agencies have grown at the phenomenal compound annual rate of 15 percent for the past 20 years.

Customer demand is strong because a host of regulations exists that forbid investors from purchasing securities that aren't rated. For example, money market mutual funds cannot hold securities unless they have one of the two highest ratings from rating agencies. Bank regulators long have required banks to write down bonds they hold in their portfolios unless they attain a certain rating. And they can't even own securities that aren't rated investment grade by one of the major rating agencies.

These sorts of regulations have extended to securities firms where ratings are used to determine how much capital broker-dealer firms need to hold against the securities in their portfolios under the so-called net capital rules. There are quotas on the quantity of lower-graded bonds that pension funds and insurance companies can have in their portfolios. The higher the credit ratings assigned by the rating agencies, the greater the percentage of the securities value you can count towards meeting a firm's net capital requirements.

Rating agencies have enormous power because government regulation creates an artificial demand for their services. Regulators have bestowed upon the big rating agencies the legal designation "Nationally Recognized Statistical Rating Organization"—NRSRO—and have shielded rating agencies from competition, creating a comfortable oligopolistic environment. I would just add that this is the same problem, in my view, that plagues the accounting industry in this country as well.

Of course, it's not just government regulation that gives rating agencies such immense power. They also get power from the exten-

[1] The prepared statement of Mr. Macey appears in the Appendix on page 138.

sive use of debt covenants and other financial instruments to create conditions of default. The downgrading of a rating by an NRSRO can throw a company into default under the terms of its debt covenants. But the artificial demand for the services of rating agencies that has been created by regulation should not be ignored.

These massive regulatory subsidies, in my view, have given rating agencies a lack of accountability by removing market incentives from the work they perform. Rating agencies have few incentives in the current environment to do good work. Their incentives in today's regulatory environment are to reduce costs as much as possible, knowing that regulation guarantees a fixed stable demand for their services. This, in my view, may account for the agencies' lack of vigorous pursuit of the situation involving the Enron special purpose entities.

The regulatory subsidies given to credit rating agencies would not be particularly troubling were it not for the fact that credit ratings, in my view, may not provide useful or timely information about the creditworthiness of companies in today's markets if the information is marginal because the information contained in credit ratings already has been incorporated into securities prices by the time a rating agency gets around to acting. For example, in Enron, the company's $250 million in senior secured debt retained its investment grade rating until November 28, 4 days before the energy firm filed for bankruptcy. But with respect to the market, in the 2 weeks before the bonds lost their investment grade status, their price had plummeted from $85 to $35.

Clearly, the financial markets were not waiting around for the credit rating agencies in the case of Enron, which is a good thing since the ratings providing by the rating agencies lagged the information contained in securities prices by a full year.

We have heard and the rating agencies have responded to these sorts of criticism by point to the fact that very few companies with investment grade ratings default over a 5-year period. The rating agencies also can show that companies that have been rated AAA are less likely to default than companies with lower ratings, and bonds with high ratings are stable over time.

Of course, this sort of track record isn't a big comfort to investors and companies like Enron when the rating agencies pull their investment grade ratings on the eve of default. The problem, in my view, is that there is little follow-through. The rating agencies rely too much on their corporate clients for information and don't ask tough questions of management that would permit them to deter future Enrons from occurring.

For example, in the case of Enron, the rating agencies have excused their tardiness by saying that they kept their ratings high only because the rating was dependent on the merger with Dynegy. But nobody needed the rating agencies to tell them what would happen if the merger went through. They needed to know what would happen if the merger didn't go through.

Poor credit ratings threaten to distort the process by which capital is allocated among businesses because in today's regulatory environment rating downgrades are self-fulfilling prophecies, triggering repayment of debt and bond covenants and causing those se-

curities by virtue of the regulations to be worth less than identical securities that haven't been downgraded.

In my view, I would make a few substantive recommendations with respect to the interactions between Commissioner Hunt's agency and the rating agencies. I think that the SEC should consider whether the rating agency should be obliged by regulation to disclose the public documents on which they relied as the basis for their rating determinations, and also to disclose whether the information contained in their ratings is based on anything other than publicly available documents like non-public interactions with the issuer or other entities.

I also think it would be useful to have disclosure about whether ratings are being issued despite the fact that the rating agencies lack the information that a reasonable investor would consider relevant to the formulation of a rating and to disclose the extent to which the ratings that are being issued were based on credit spreads rather than financial reporting.

Thank you very much.

Chairman LIEBERMAN. Thanks. Very constructive and helpful testimony.

Next we are going to hear from Glenn L. Reynolds, chief executive officer of CreditSights, Inc. Thanks for being here.

TESTIMONY OF GLENN L. REYNOLDS,[1] CHIEF EXECUTIVE OFFICER, CREDITSIGHTS, INC.

Mr. REYNOLDS. Thank you, Mr. Chairman. It is my pleasure to get an opportunity to testify on a subject that I know is of grave concern to many of the institutional debt and equity investors that we deal with on a regular basis. The difficulties in navigating a very complex market are challenging enough without the added pressures of questioning the integrity of reported numbers, the adequacy of disclosure, or the ability of the rating agencies to get sufficient information to do their job effectively.

In the aftermath of Enron, there have also been some questions about the steps the rating agencies took in bringing many of these issues to a head and the depth and vigor of their due diligence. The response to date, which has been to speed up the pace of downgrades but not necessarily shed more light on the expectations built into a given rating, have not been satisfactory and will not allow us to deal with future Enron-type situations.

Disclosure guidelines and accounting rules may be the responsibility of the SEC and the FASB, but the rating agencies can play a vital role in zeroing in on material risks and major shortcomings in the disclosure of those risks.

Chairman LIEBERMAN. Mr. Reynolds, would you excuse me a second? Under the arcane procedures and life that we lead here in the Senate, I have just been notified that a member of the Senate has lodged an objection to three committees proceeding with their business after noon, which is the right of the members, 2 hours after the Senate convenes. This Committee is one of those. This has nothing to do, as far as anybody would understand, with the subject of our inquiry. It probably has to do with something unrelated

[1] The prepared statement of Mr. Reynolds appears in the Appendix on page 148.

that the given Senator is trying to get attention for. One can only speculate that it might have something to do with the course of judicial nominations. I don't know.

You have all come from some distance, and we are not transacting business as it were here, so I hope this is not considered an act of civil disobedience. I am going to say that the official hearing is over, though I would like to ask the record to continue to be kept, and that we are going to just continue this discussion, because you have come a long way, you have got something to offer, and I would hate not to hear it.

So, with that caveat, please proceed.

Mr. REYNOLDS. I can just defer to my written testimony, and we can go right to questions and answers.

INFORMAL DISCUSSION

[12:04 p.m.]

Chairman LIEBERMAN. Well, go ahead and finish. But this is now not a formal hearing of the Governmental Affairs Committee. This is a discussion among a group of people interested in the credit rating agencies and what we have learned about them from the Enron episode.

Mr. REYNOLDS. Let me cut to the chase. If a company fails to answer critical questions that are crucial to an assessment of the risks, it should either prompt a withdrawal of the rating or even potentially a downgrading in certain circumstances. The recurring refrain from the rating agencies that the issuer will not tell them just does not hold. It rings hollow when one considers that a rating has a requirement for access and that any conflicts with the rating agencies will be an incentive for the market and the SEC, to be somewhat unforgiving and, in particular, as we saw in the case of Enron, the market.

With that I will just end my comments.

Chairman LIEBERMAN. Thanks.

Professor Steven Schwarcz is a professor of law of Duke University, a shorter title than Professor Macey has, but we are, nonetheless, pleased that you are here.

TESTIMONY OF STEVEN L. SCHWARCZ,[1] PROFESSOR OF LAW, DUKE UNIVERSITY SCHOOL OF LAW

Mr. SCHWARCZ. Thank you. Anticipating this would be an informal hearing, I did not wear a suit today.

Chairman LIEBERMAN. Well done. [Laughter.]

Mr. SCHWARCZ. One of the things I should say is I will be speaking about the rating agencies, but I am an expert on structured finance. I actually would have answers to many of Senator Levin's questions, and the third edition of my treatise on structured finance came out in January, and I would be happy to answer any questions afterwards.

Chairman LIEBERMAN. Let me urge you to, if you haven't already, be in touch with Senator Levin after the hearing because

[1] The prepared statement of Mr. Schwarcz with an attachment appears in the Appendix on page 168.

this is a particular interest of his, and he has done a lot of—we have sent out a number of subpoenas through his Subcommittee, and one of the topics they are interested in is structured financial deals here. So you could be helpful to him.

Mr. SCHWARCZ. I will do so. Thank you.

Rating agencies are not substantively regulated by the United States. or any other major financial-center nation. Financial-center nations, nonetheless, impose a minimal form of governmental control by giving official recognition to rating agencies that meet certain criteria. This is exemplified in the United States by the NRSRO designation.

Now, as you know, if a rating agency is designated a NRSRO, its ratings can be used to satisfy rating requirements established by governmental agencies like the SEC in certain Federal regulatory schemes.

Today's hearing is being held because of a failure of the NRSRO-designated rating agencies to predict the Enron meltdown. In this context, I should note that rating agencies have always made their rating determinations based primarily on information provided by the issuer of securities. Thus, a rating is no more reliable than that information.

Furthermore, ratings do not cover the risk of fraud. To the extent Enron provided the rating agencies with insufficient or fraudulent information, that would explain their failure to predict Enron's demise.

I'll now turn to an analysis of the need for regulation, and I have submitted with my testimony—I don't know if you have copies or not—an article I wrote that is forthcoming, in fact, any day now, (in fact, it was published at 2002 University of Illinois Law Review 1), entitled "Private Ordering of Public Markets: The Rating Agency Paradox,"[1] which focuses on whether rating agencies should remain unregulated.

The normative rationale for regulation in an economic context is improving efficiency. There are two ways that regulation could do this: By making rating agencies perform better the tasks they already do, or by limiting the negative consequences of their actions. I conclude in my article that regulation would neither improve such performance nor limit such negative consequences.

Now, having said that, I understand that this Committee session is being held because of the Enron problem, but I believe Enron does not raise a systemic problem for rating agencies. They have, as has been acknowledged, a remarkable track record of success in their ratings and, indeed, recent experience is fairly reliable.

However, most of the information in terms of reliability of ratings looks to see whether defaults have occurred at the time of an investment grade rating; and that can miss situations where default occurs, as happened with Enron, right after a company is downgraded below investment grade.

Nonetheless, there is a recent internal analysis by Standard & Poor's that is publicly available which uses information extracted from its proprietary database on over 9,000 companies with rated debt that confirms the stability of investment grade ratings, find-

[1] The article submitted by Mr. Schwarcz appears in the Appendix on page 175.

ing, for example, that all A-rated companies at the beginning of a given year would have an 87.94 percent chance of maintaining that same rating by year-end.

Now, I agree that Enron is a very visible and dramatic exception to these data. But statistically, the failure to predict Enron's demise does not materially change these data; and, as mentioned, to the extent that failure arose from Enron's providing the rating agencies with insufficient or fraudulent information, then the failure is truly an anomaly.

Now, to get to the issue of NRSROs, there are many countries that make their applicability of laws turn on variants of the NRSRO-type designation. Whether the applicability of law should, as a normative matter, turn on a rating is beyond the scope of my testimony. I do note, as I said, that external credit ratings are being relied on in regulations worldwide. But so long as the applicability of law does turn on such ratings, some form of regulatory approval of rating agencies would appear appropriate. And in this context, I've examined the appropriateness of the NRSRO designation as a rating methodology.

The central question is balancing the protection provided by the NRSRO designation with the goal of ensuring that a sufficient number of rating agencies receive such designation to ensure competition. In this context, it has been proposed by the Antitrust Division of the U.S. Department of Justice that NRSRO designation be awarded to some foreign recognized rating agencies as well as to arm's-length subsidiaries of domestic firms active in evaluating the business and securities of companies. There should be relatively little risk if these entities are well capitalized, have reputations for quality financial analysis in the investment community, and have acceptable business plans to rate securities. Consideration even might be given, for example, to firms that utilize alternative rating approaches such as, as Professor Macey mentioned, credit spreads and stock price volatility. The risk could be further minimized by making any de novo applicants for NRSRO status provisional for some period of time, such as, for example, 12 months.

Now, in this way, the potential anticompetitive effect of NRSRO designation can, consistent with the integrity of that designation, be reduced. This seems to me like a very sensible approach.

In closing, I should simply say that we all need to put these issues into perspective and not be as bent on placing blame as Enron's executives were to find profits.

Thank you.

Chairman LIEBERMAN. Thank you, Professor Schwarcz.

Mr. Reynolds, since that announcement cut you short a bit, let me go to you first to give you a chance to say a little bit more. In your testimony, you have indicated that the credit rating agencies are not using the power that they have to get all the information they need to make full and fair assessments of the companies, and you say—and I agree with you, and I would guess most Members of the Committee do, certainly after the first panel—that another Enron could be prevented if the rating agencies take advantage of that strength.

Let me ask you first why you think they don't use the power they have now.

Mr. REYNOLDS. It may be a practiced behavior. It may be a sense that there's a confidentiality that exists between the rated company and themselves that they're not supposed to step outside those boundaries. Maybe they need a mandate to have the willingness to do that. But one of my concerns—and a lot of the people I speak to regularly who are in the debt markets and default swap markets and equity markets—there is a very unlevel playing field in information flows. They will have access to material inside information, and they're exempted from Reg. FD. But if it's a material risk factor, we're supposed to have this information disclosed to begin with, so they are a very good set of eyes and ears to extract that information, and whether it be within a tighter regulatory framework or just by their own decision to voice conclusions that may not be clearly in the public domain, it would have benefit.

Keep in mind that we are in markets now that are a lot more blurry than they used to be. We have banks actively participating in the tradable debt market. They have access day in and day out to inside information. They're transacting in the credit default swap market, which in turn sends signals to people who watch those markets to see what the banks are thinking, because they know everything the rating agencies know, and a lot more. And they are taking actions which are reflected in pricing.

So there is a way to watch the system at work, but it seems that it's an unlevel playing field skewed towards those institutions which have access to information, and that is not, as we referred to earlier, the Mom and Pop investors.

Chairman LIEBERMAN. Let me ask this: What opportunities do you think, based on what you know of the Enron case, did the credit rating agencies miss that they should have found and pursued?

Mr. REYNOLDS. Well, the existence of off-balance sheet transactions were discussed in some detail earlier, but there is one area that was not, which is the counterparty credit exposures which are generated in a trading operation.

Chairman LIEBERMAN. Describe that a little bit for the record.

Mr. REYNOLDS. Basically, a trading operation enters into a tremendous amount of buy and sell transactions: Swaps, commodity swaps, interest rate swaps. These all give rise to theoretical lines of credit. It's off-the-shelf statistical modeling. Every Tom, Dick, and Harry in the derivatives world could model this for you. It is a line of credit that's generated with a counterparty.

Now, when concerns started to arise in the marketplace with companies who were closest to Enron, there was a serious risk of them pulling in the credit lines and asking for collateral to be posted, and that is the run on the bank that people have been referring to in some of these hearings. The first thing they should have been looking at was that, finding out what those lines were——

Chairman LIEBERMAN. There was enough that they knew that it should have engaged their interest that they should have pursued it more.

Mr. REYNOLDS. It's standard practice in risk management to know your counterparty exposure by every counterparty. Theoretical line of credit, you have either payables or receivables. Standard practice, any brokerage analyst deals with it regularly. It's just not as common with utilities.

So it could have been pursued with some vigor because that at the end of the day is what killed the company. Debt hurts you. Lack of liquidity kills you.

Chairman LIEBERMAN. Right. Commissioner Hunt, let me ask this question about both the initial NRSRO determination made by the SEC and also the reviews that are done in their capacity of investment advisers every 5 years. I wonder, what do you look for in both of those stages? And, particularly, second, do you look at how diligently the credit agency is doing its work?

Mr. HUNT. We look at their capacity to do their work, their internal controls. We do not second-guess their ratings, as we would not second-guess an asset manager's selection of equity securities. But we do look at their internal controls, their capacity to do the work, the kind of personnel they have, the number of personnel they have, and their books and records.

Chairman LIEBERMAN. Let me ask the two law professors here. I think each of you thinks there is a basis for further regulation of credit rating agencies, though I understand you come at it from a different point of view. If you were the SEC or Congress, ideally how would we regulate them better? What more would we ask of them?

Mr. MACEY. I guess the really quick thing, Senator, one, as I mentioned during my testimony, would be this disclosure point——

Chairman LIEBERMAN. Yes, I wanted you to talk a little more about that.

Mr. MACEY. Well, the idea is that, as I think several people have observed, what—the process by which credit rating agencies reach their results is a very opaque process, and it would be—I think it would be useful for investors to know exactly what it is they're relying on.

For example, as I mentioned during my testimony, credit rating agency ratings tend to lag markets. It would be interesting to know the extent to which they look at the market prices, particularly in the securities they rate, to derive ratings, the extent to which they're using non-public information as they are able to do under—with the exemption they have under Regulation FD.

Chairman LIEBERMAN. What would be the best method or mode to make this disclosure?

Mr. MACEY. I think a filing with the SEC would make sense. As Commissioner Hunt mentioned, there are—the agencies are already regulated by the Commission, and I think it would be a natural follow-on to get some kind of exposure.

Chairman LIEBERMAN. What other ideas did you——

Mr. MACEY. The second is—a couple of people have touched on also. I think competition would be a good thing; to have a lot more of these rating agencies would be a good thing, and to have some easy entry and rivalrous competition. And, finally, I think that there should be a hard look taken at what I call the chicken-game problem; that is to say, if you look at the Enron situation, the credit rating agencies really were in a difficult position because pulling the rating, as was discussed in the previous panel, for certain of these private investment vehicles was the death knell for the company. And so you have this idea that these kinds of contractual arrangements allowed the company, in a case like Enron, which is

run by some pretty aggressive folks, apparently, to play chicken with the credit rating agencies and say, Do you really want to be responsible for our death? Who's going to be the first to kind of swerve in this game?

I don't think that's a particularly healthy situation, and I think that it puts the rating agencies in a very difficult situation. I'd have a look at those kinds of——

Chairman LIEBERMAN. It is a very interesting point. We keep pressing on this. We pressed them in the first panel.

Mr. MACEY. Right.

Chairman LIEBERMAN. That they have enormous power that they are not using to get more information, at least. But I suppose the other part of it is that with such enormous power, life and death, you are hesitant to drop the boom. Our hope is they use the power to get more information and report it to us. But how would you qualify that?

Mr. MACEY. Well, I think this problem is—happily, this particular aspect of the problem is rather rare; that is to say, it's my understanding, or at least the credit rating agencies tell us that in most of their rating situations, pulling the rating does not trigger these sort of covenants and is not going to be the death of the company. And so I would isolate those situations like Enron where it is, and I would urge the appropriate agency, obviously, in this case the SEC, to see whether or not there would be some better way of crafting these contractual provisions.

Specifically, my own view is that a far superior way in this limited context would be credit spreads; that is, instead of looking at ratings, we can look at the spread between the yield to maturity on the Enron senior unsecured debt and some similarly structured government bond. And at the initial issuance, we would have a spread of, say, you know, 2 percent or 200 basis points, and if the spread goes to 9 percent or 900 basis points, that should sort of be a clue that there's something going on in the company that maybe we should take a look at.

Chairman LIEBERMAN. Good. Interesting. Professor Schwarcz.

Mr. SCHWARCZ. Yes, thank you. I agree with Jonathan Macey in terms of the fact that there probably should be additional entities designated as NRSROs, and as I mentioned in my testimony, those could include some foreign recognized rating agencies as well as arm's-length subsidiaries of domestic firms active in evaluating the business and securities of companies.

The *Law Review* article I submitted goes into great detail on these possibilities, and I won't bore people now with those details.

I disagree with Jonathan on two points, however.

One is that he indicated that we need a lot more of these NRSROs, and I would be concerned that if we had too many of them, it would create almost a perverse incentive for issuers to shop around for the highest rating they could find. And so I would want to at least keep the number restricted to the very highest quality of these potential new rating agencies or NRSROs.

Second, in terms of credit spreads, there are data that indicate that for a thick market of publicly traded bonds, that credit spreads may be, to some extent, more accurate than ratings. But there also are data that show the opposite, and in my testimony

and in my article I cite at least an IMF study from 1999 that concludes that ratings are much more reliable than credit spreads.

Beyond that, I should say that credit spreads are only effective where you have public trading of securities in a thick market. That means credit spreads have very little application, for example, to new issues of securities where there is no market at all and, therefore, no spreads. They have no application to structured finance deals or other structured deals where the rating depends as much on the legal structure as anything else, and the legal structure is not known to and certainly not fully understood by most market participants. And, third, they have little or no application to privately placed deals unless there's a very thick trading market. So most privately placed deals would not be eligible for the use of credit spreads.

What I suggest, however, in my proposal is to have the foreign recognized rating agencies and other players potentially be appointed on a provisional basis as NRSROs; and that some of these players can be those that have considered credit spreads and stock price volatility as alternative ways to assess creditworthiness. And I think we can then all find out how accurate their ratings will be based on experience.

Chairman LIEBERMAN. Mr. Reynolds, do you have an opinion between the two we have heard on the question of competition, whether if we created a climate in which there were more credit rating agencies, that would encourage all of them to do more aggressive work or whether, as Professor Schwarcz said, there would be a certain amount of shopping around for a good rate?

Mr. REYNOLDS. There historically has been a bit of shopping for higher rates going on among issuers. This has led to some ratings inflation, particularly in the money markets in past years. But a practical matter is that you're not going to see a lot of large-scale market entrants. You have fewer today rather than more. Everyone complains about the lack of new NRSRO designations, but if you look beyond the S&P's and Moody's big two, the other four rolled up into one. So there are significant barriers to entry away from the NRSRO designation scale: Specialized skill sets. It takes a lot to build a credit research company of that scale globally to be taken seriously. So you run the risk that where you get in is to be the proverbial professor in college, the other one that will give the A. And that's certainly not going to help the dialogue.

I think the way we help the dialogue is for all of these agencies to be far more transparent in the information that is factored into their rating, because then the market economy can do an object gut test on the quality and depth of the understanding of the company as well as the industry and as well as what you have in the case of Enron, highly convoluted, financially engineered enterprises.

One of the Senators earlier mentioned the fact that you're acting like analysts. Well, you have to be an analyst because ratings will have absolutely no credibility in the marketplace if you can't get on a conference call with an S&P's and Moody's analyst and grill him on his thought process.

So I think that it's quality of information that is the biggest challenge right now and probably the easiest to solve. It will take 10

years to build another NRSRO unless Warren Buffet has a few billion to put to work. But he has it right now invested in Moody's.

Chairman LIEBERMAN. All right. Maybe that is a good note to end on. We have, of course, let me restate for the record, previously concluded the formal hearing. I thank you very much.

Senator LEVIN. One question.

Chairman LIEBERMAN. I want to let you know, because there has been an objection to us proceeding.

Senator LEVIN. Oh.

Chairman LIEBERMAN. No, no. I adjourned the hearing, but what I hope is not seen as a matter of civil disobedience, I am continuing an informal discussion, since we are not transacting business, among the group of us here who are interested in this subject. So if you would like to enter into that informal discussion——

Senator LEVIN. I don't want to in any way contribute to the delinquency of a Chairman here. [Laughter.]

Senator LEVIN. Being a Chairman myself.

Let me just ask an informal question.

Chairman LIEBERMAN. Yes. I am sure you will get an informal answer.

Senator LEVIN. If I could ask Mr. Hunt, I had a chance to just briefly ask you a question in the back room, and if you haven't been asked this question, perhaps I would do it now. That chart which——

Mr. HUNT. Yes, I saw the chart. It's a wonderful chart. [Laughter.]

Senator LEVIN. And if you haven't been asked——

Mr. HUNT. I have a copy of it. You were kind enough to give me a copy.

Senator LEVIN. Well, we thought we would get another opinion on this. Enron did a huge amount of structured financing deals from 1997 to 2001. Our estimate is $15 to $20 billion a year. And this is one of the many that our subpoenas have uncovered, and this produced investments which were rated by Moody's in this case. What is your reaction, if you would, to that chart? Is that comprehensible?

Mr. HUNT. I think my reaction to—I heard the first panel say that their structured analysts could understand this, and I take them at their word that they could. If you put this in a prospectus for Enron stock and sold it to the public, most of the public wouldn't have the slightest idea what this meant. I mean, it would not be useful to the average investor. It might be useful to somebody who is experienced in analyzing these kind of structures, but in my judgment, while Enron did need to make more disclosure, this kind of disclosure would not have been helpful.

Senator LEVIN. Does that look like it is more intended to obfuscate and hide——

Mr. HUNT. One could argue that, Senator, yes, sir. One could argue that it is needlessly complicated, but since I'm not an expert in structured financing, I don't know whether it's needlessly complicated or just complicated.

Chairman LIEBERMAN. We wanted you to know that, in your absence, Professor Schwarcz made a declaration which may be against his self-interest that he is an expert on structured finance.

Senator LEVIN. Well, I don't know the answer to my question. Were you asked this question?

Mr. SCHWARCZ. I was not asked this question——

Senator LEVIN. If it is clear to you, I assume that it would be clear to any average investor.

Mr. SCHWARCZ. Well, I think there are two issues, I would say. First of all, I have not had the chance to study this chart, nor do I frankly even know whether the chart is accurate in terms of all the players. I can generally guess from the chart, just quickly looking at it, who the players are, that you have the originator on the left and the SPVs or SPEs on the bottom and the investors on the right. But one would have to diagram this out and just double-check it and check the money flows.

There is another part of the problem. I'm writing an article entitled "The Use and Abuse of Special Purpose Entities in Corporate Structures," and one of the things that I'm considering is whether, in fact, some of these transactions are getting so complicated that, indeed, it's impossible to explain them to the ordinary investor. On the other hand, the question is what do you do about that? Do you restrict the structures and thereby really inhibit the flexibility and creativity of American business?

And I have some solutions, some possible things that we can discuss. My thought process is still sufficiently incomplete that I don't want to discuss this in public, but I'd be happy to discuss it in private.

Senator LEVIN. Thank you. Thank you so much.

Chairman LIEBERMAN. Thanks, Senator Levin. Again, thanks to all of you for a substantial contribution to this Committee's efforts.

It is now my unique pleasure to adjourn this informal discussion. Thank you very much.

[Whereupon, at 12:32 p.m., the Committee was adjourned.]

APPENDIX

TESTIMONY OF RONALD M. BARONE

MANAGING DIRECTOR, STANDARD & POOR'S

BEFORE THE COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

MARCH 20, 2002

Good morning, Mr. Chairman and members of the Committee. I am Ronald M. Barone, a managing director in the Corporate and Government Ratings Group of Standard & Poor's. From 1994 until Enron Corporation's bankruptcy in December 2001, one of my roles at Standard & Poor's was to serve as an analyst with respect to Enron. I was the primary Enron analyst from mid-1996 until early 2000 and then became and have remained the manager of Standard & Poor's ratings work for Enron.

On behalf of Standard & Poor's, I welcome the opportunity to appear at this hearing. Standard & Poor's supports the Committee's urgent sense of the need to investigate the circumstances relating to Enron's collapse and to seek responsible solutions that prevent future harm to employees, shareholders, investors and the financial marketplace itself of the sort that has already occurred here.

There were many victims of Enron's deceit and, it appears, fraud. Regrettably, Standard & Poor's and its ability to provide fully informed ratings analysis, as it has been doing for generations, was also victimized. Not only were we not provided with significant amounts of material information that we had requested but, as I will describe, on a number of occasions Enron made what we later learned were direct and deliberate misrepresentations to us relating to matters of great substance. I will describe some of these deceptions in detail later in my testimony, but as a preliminary matter I want to express our desire to assist the Committee in any way we can with these proceedings.

Along with my testimony I have attached four items, the first two of which are publicly available on our website (standardandpoors.com): a brief overview of credit ratings entitled "Understanding Credit Ratings" and a chronology of our rating actions relating to Enron Corporation since October 15, 2001. The last two are copies of materially false and misleading presentations made by Enron to Standard & Poor's during the ratings process that I just mentioned.

I would like to begin by providing you with some background on Standard & Poor's and credit ratings.

Background on Standard & Poor's and the Nature of Credit Ratings

Standard & Poor's began its credit rating activities 85 years ago with the issuance of credit ratings on corporate and governmental debt issues and today is a global leader in the field of credit ratings and risk analysis. Standard & Poor's is — and has always been — independent of any investment banking firm, bank or similar organization. Since 1916, Standard & Poor's has rated hundreds of thousands of issues of corporate, government and structured financed securities through periods of economic growth and recession. Standard & Poor's also assesses the credit quality of, and assigns credit ratings to, managed funds and the ability of insurance companies to pay claims.

Today, Standard & Poor's has ratings outstanding on approximately 150,000 issues of securities of obligors in more than 50 countries. Standard & Poor's rates and monitors developments pertaining to these securities and obligors from operations in 18 countries around the world. Standard & Poor's is committed to objective ratings by independent rating committees comprised of analysts with credit experience in their areas.

Ratings are a key component of the capital markets, which have functioned effectively for decades in the United States, and which are growing and flourishing in many countries abroad. Investors throughout the world look to our ratings to help in their understanding of credit risks. While not all parties may agree with our ratings at all times —

they are, after all, *opinions* about an issuer's creditworthiness at a particular moment in time — Standard & Poor's credit ratings have gained respect and authority throughout the investment community because they are widely understood to be based on independent, objective and credible analysis. Standard & Poor's rates more than 99.2% of the debt obligations and preferred stock issues publicly traded in the United States, and our ratings are generally regarded as a global benchmark for assessing these issues.

I want to say a few words about what a rating is and what it is not. When Standard & Poor's issues a rating of the sort issued to Enron, it is offering its own opinion about a company's medium- to long-term credit risk. In doing so, we try to take into account whatever relevant future events may be anticipated. Because events always occur which are unforeseeable or simply unknowable, Standard & Poor's regularly reviews its analysis.

Standard & Poor's does not perform an audit of the issuer, does not guaranty an issuer's payment on its debt, or provide insurance in case the issuer does not pay the debt. A Standard & Poor's rating does not constitute a recommendation to purchase, sell, or hold a particular security. Nor does a Standard & Poor's rating speak to the suitability of an investment for particular investors. Rather, a rating reflects our opinion as of a specific date of the creditworthiness of a particular company or security based on our objective and independent analysis. Because ratings concerning creditworthiness are not investment advice or recommendations, they are fundamentally different from recommendations made by equity

analysts as to whether investors should "Buy," "Sell," or "Hold" a security. Standard & Poor's also does not rate an issuer's common stock.

When we provide a rating of "A," "BBB" or "C," we are encapsulating our opinion into a letter or series of letters, which may be accompanied by a plus or minus. Our credit ratings also generally include more information about the rationale for the rating and our outlook as to the long term credit quality. Long-term credit ratings are divided into several categories ranging from "AAA," reflecting the strongest credit quality, to "D," reflecting default. Ratings from "AA" to "CCC" may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories, although the categories themselves remain the prime component of the rating. Ratings in the "BBB" category or higher are considered by the market to be "investment grade," a term first used by regulators to denote obligations eligible for investment by institutions such as banks, insurance companies, and savings and loan associations. The term has gained widespread use over time in the investment community.

In addition to issuing letter ratings, Standard & Poor's also uses other well-known and understood indicators and signals to alert the marketplace to noteworthy aspects of its ratings. A rating, for example, can appear on "CreditWatch" signaling the strong possibility of a rating change. CreditWatch actions are normally taken in response to specific events or sudden changes in circumstances that have a high potential to affect

creditworthiness. However, not all rating changes are necessarily preceded by a "CreditWatch" listing because circumstances may call for an immediate rating change. Additional informational tools useful to investors are so-called Standard & Poor's "Outlooks" which offer long-term (one-to-three-year) perspective on credit quality. Outlooks are assigned to all long-term issues.

Standard & Poor's recognition as a rating agency ultimately depends on the credibility of its opinions with investors, importantly, but also with bankers, financial intermediaries, and securities traders. Standard & Poor's believes it is important that all users of its ratings understand how it arrives at ratings and regularly publishes ratings definitions and detailed reports on its criteria and methodology. The article, "Understanding Credit Ratings," which I have attached to my testimony, provides definitions of the different Standard & Poor's credit ratings, a description of the credit rating process, an overview of Standard & Poor's surveillance and review process, and an explanation of the different parts of our credit opinions.

Standard & Poor's places great importance on communication with the public. Our ratings criteria are available to all interested parties on our website. In order to ensure that issuers and investors understand our rating process and analytics, we regularly publish our complete ratings criteria and provide updates as we introduce new ratings innovations or as the market requires. While we are known for our letter grade ratings, we also regularly

publish (as I will refer to in a moment about Enron) reports and rationales that inform the market about an issuer's strengths and weaknesses as well as trends that could affect the issuer's creditworthiness. Around the world, Standard & Poor's annually publishes approximately 10,000 press releases, over 1,100 articles and commentary pieces on sector and industry trends, 51 editions of CreditWeek (our weekly print publication on fixed income securities issues), and 12 sector reports on 19 industry groups. We hold over 200 telephone conferences with investors regarding fixed income topics. We also hold investor forums and conduct hundreds of print and broadcast interviews. All of our published rating actions are available to the public on our free website where we also post approximately 12,000 articles of fixed income-related commentary. In short, thousands of our ratings opinions are subject to market scrutiny every day.

Standard & Poor's Commitment to Objectivity

All Standard & Poor's credit ratings employees are subject to our internal Guidelines and Procedures and Code of Ethics. These policies have been in place for many years and include stringent trading restrictions and reporting requirements. Credit ratings employees are required annually to affirm compliance with these Guidelines and the Code. The Guidelines and the Code stress the overriding importance of objectivity in our ratings process.

In order to ensure maximum objectivity, fairness and in-depth analysis, ratings are assigned by a committee, not by any individual. Moreover, no portion of an analyst's compensation is dependent on or connected with the performance of companies that analyst rates or the amount of fees paid by that company to Standard & Poor's. The record bears out Standard & Poor's emphasis on objectivity and accuracy. There is an exceptionally strong correlation, which has existed for decades, between the ratings initially assigned by Standard & Poor's and the eventual default record. Indeed, independence, credibility and integrity are the foundations of the Standard & Poor's ratings business and they are what ultimately provide value to the marketplace.

Our ratings opinions are based on public information provided by the issuer, audited financial information, and qualitative analysis of a company and its industry sector. We also may have access to certain confidential information of the issuer but only to the extent that the company's management lives up to its obligation to give us complete, timely and reliable information and is willing to provide such information. We use that information and rely upon it. We tell the companies we rate that we rely upon them to provide complete, timely and reliable information — information that includes, but is by no means limited to, the company's financial statements. As we told Enron (and, indeed, every other company we rate): "Standard & Poor's relies on the issuer and its counsel, accountants, and other experts

for the accuracy and completeness of the information submitted in connection with the rating process."

As mentioned earlier, we are not auditors, we do not audit the auditors of the companies that we rate or repeat the auditors' accounting work, and we have no subpoena power to obtain information that a company is unwilling to provide. We expressly rely on the companies we rate not only for current and timely information at the time of the initial rating but on an ongoing basis for the proper conduct of surveillance of the company's creditworthiness. This ongoing obligation includes providing on a timely basis all material changes to information the company has previously provided to Standard & Poor's. Indeed, our entire business and the United States financial system is based on the principle of full and fair disclosure, and this United States model is widely envied and in some cases replicated throughout the world.

As mentioned earlier, studies on ratings trends repeatedly demonstrate that our track record is excellent. There is a clear correlation between initial ratings and the likelihood of default: the higher the initial rating, the lower the probability of default and vice versa. The information below shows cumulative default history over the past fifteen years of issuers rated by Standard & Poor's based upon the rating category they were initially assigned. This clearly demonstrates the very low probability of default of an issue initially rated in the "AAA" category (only 0.52% have defaulted in the past fifteen years) contrasted with the much

greater possibility of default for an issuer initially receiving our lowest rating level of "CCC" (54.38% have defaulted in the past fifteen years):

Rating Category	Percentage of Defaults Initially Rated in the Category
AAA	0.52
AA	1.31
A	2.32
BBB	6.64
BB	19.52
B	35.76
CCC	54.38

These statistics reflect a strong correlation between the initial rating and the likelihood of default. The correlation would be even greater if the dollar volumes of the issues were similarly analyzed.

As might be expected, Standard & Poor's quickly and closely examines cases where defaults occur and reviews its rating criteria on an ongoing basis. While such situations are highly unusual, we examine these defaults very carefully since they may identify new risks or extraordinary circumstances. Clearly, Enron was one of these highly unusual situations.

Enron Corporation

I now turn directly to Standard & Poor's ratings of Enron. From December 1995 until November 1, 2001, Standard & Poor's rating of Enron was BBB+, which we define

as adequate ability to repay debt, but subject to worsening economic conditions. This was by no means the greatest vote of confidence a Standard & Poor's rating can bestow. It placed Enron at the lower levels of investment grade ratings and was well below what Enron repeatedly — and unsuccessfully — sought from Standard & Poor's. High-ranking Enron executives made repeated visits to New York over the years at meetings I attended to urge Standard & Poor's to raise the company's rating to an "A" level. They made detailed presentations to us that were designed specifically to lead us to raise Enron's rating. We repeatedly declined to do so, notwithstanding that the "BBB" level rating we had assigned was not only well below how Enron was often treated when it borrowed money from the market, but consistently lower than the ratings of other companies its size.[1] In fact, according to the Fortune 500, Enron was the seventh largest corporation in the world yet it received a lower rating as of November 27, 2001 than all but two of the current largest fifteen corporations.[2]

---

1 Enron often borrowed from banks, investors, pension funds, etc. at lower interest rates than those usually charged to companies rated BBB+.

2 The fifteen largest corporations on the latest Fortune 500 list (including Enron) and their ratings as of November 27, 2001 are: Exxon Mobil (AAA); Wal-Mart Stores (AA); General Motors (BBB+); Ford Motor (BBB+); General Electric (AAA); Citigroup (AA-); Enron (BBB-); International Business Machines (A+); AT&T (A-); Verizon Communications (A+); Philip Morris (A); J.P. Morgan Chase (AA-); Bank of America corp. (A+); SBC Communications (AA-); Boeing (AA-).

Standard & Poor's rating of Enron in the BBB category was calculated and monitored on an ongoing basis through a thorough analysis of, among other materials, Enron's reported and audited financial statements including, in particular, its cash flow, debt burden, and other key financial metrics relevant to our opinion concerning Enron's creditworthiness. Standard & Poor's also employed a capital adequacy and liquidity review as Enron's businesses focused more on energy trading and marketing. Standard & Poor's also took into account Enron's emphatic and repeated representations, both publicly and to Standard & Poor's, about its strong corporate commitment to maintain its creditworthiness. In fact, Enron had, in the past, backed up its statements with action by issuing sizable amounts of equity to shore up its balance sheet, as necessary, to maintain its credit rating. Moreover, over the years, Enron had proven itself to be swift and effective in managing risk. Enron repeatedly articulated its strong commitment to maintain creditworthiness during personal visits to our offices by the company's CFO's (including Mr. Andrew Fastow) and, in at least one instance, a personal telephone call to me from its Chairman, Mr. Kenneth Lay, who explicitly stated that maintaining Enron's creditworthiness was a top corporate priority.

On their face, Enron's financial statements and credit commitment representations might be thought to have justified a higher rating than what it received. Nonetheless, because of the volatility involved in Enron's businesses and its many high-risk transactions, Standard & Poor's factored additional debt-like burdens into its rating. Although

the additional debt was not legally binding on Enron, it was significant enough to our analysts to justify a lower rating for Enron than the reported and audited financial statements might have otherwise suggested.. Indeed, over the years Standard & Poor's "put back" onto Enron's balance sheet off-balance sheet amounts of between $2 billion and $4 billion in debt-like obligations for purposes of our ratings analysis.

Standard & Poor's made continuous efforts to monitor Enron's credit quality closely over the years. As Enron's troubles began to surface in the second half of 2001, this included close focus not only on Enron's publicly filed documents but through frequent contact with Enron personnel for the purpose of continually assessing the company's financial position and future prospects. We also frequently conducted telephone conversations with Enron counterparties to determine the effect Enron's troubles might have on its core trading businesses. We repeatedly re-evaluated Enron's financial position as new revelations came to light. Throughout all our communications, we asked many probing questions of Enron executives in order to get as clear a picture as possible of Enron's finances. After Standard & Poor's changed Enron's "Outlook" to negative on October 25, 2001, for example, Enron personnel (including its then-President Gregory Whalley and CFO Jeffrey McMahon) came to our offices on October 31, 2001 to present a plan to resuscitate Enron's financial fortunes and stabilize its credit rating. Because our analysis indicated that the proposed plan was not sufficient to allow the company to maintain its credit rating, we were unconvinced and the

next day downgraded Enron from "BBB+" to "BBB" and placed the rating on "CreditWatch Negative" — a clear and public warning by Standard & Poor's about Enron's ratings future. Standard & Poor's specifically noted the uncertainty surrounding Enron in the capital markets, the crisis of investor confidence and Enron's inability to calm investor fears about the strength of its core energy trading business.

During November 2001, Standard & Poor's again downgraded Enron two more times. On November 9th, Enron's rating was lowered to "BBB-" because of concerns about Enron's credit following its restatement of earnings on November 8th. The rating remained on CreditWatch Negative — continuing to signal publicly a possible further downgrade. During this same time period, the financially stronger Dynegy confirmed that it was in merger discussions with Enron. Standard & Poor's expressly stated publicly that without the Dynegy merger, Enron's credit rating would likely fall below investment grade. As Standard & Poor's press release announcing the November 9th downgrade revealed, Enron's "investment-grade rating is predicated on the prospect for improvement of credit quality with the acquisition by the financially stronger Dynegy and the near-term liquidity enhancement, through the injection of $1.5 billion of equity capital, which came with the signing of the merger agreement." On November 28th, the day we determined that the merger was unlikely to occur, yet still before Dynegy publicly called off the merger, Standard & Poor's lowered Enron's rating to "B-", a non-investment grade rating. Our press release regarding this downgrade stated, "[a] collapse

of the Dynegy deal would create enormous pressure on Enron's credit profile . . . Furthermore, Enron faces rising liquidity needs in connection with its trading activities as counterparties demand greater assurances to transact business with Enron. A move by Enron to seek protection from its creditors through a voluntary filing under Chapter 11 of the U.S. Bankruptcy Code is a distinct possibility if the merger falls through."

As I have said, at the heart of the process which leads to a rating being issued by Standard & Poor's is an unambiguous understanding between the company seeking the rating and Standard & Poor's itself: The company is obliged to furnish complete, timely and reliable information to Standard & Poor's on an ongoing basis and we, in turn, use that and other information we gather to assess the creditworthiness of the company and then offer our opinion as to creditworthiness in the form of a rating. But Enron did not keep — it did not begin to keep — its part of this well understood bargain.

1. Enron's Material Misrepresentations to Standard & Poor's

Day-by-day, it becomes ever clearer that Enron, far from providing anything like complete, timely and reliable information to Standard & Poor's, committed multiple acts of deceit and fraud on Standard & Poor's, just as it did to many others with whom Enron dealt. Despite our repeated requests for all information material to our analysis of its creditworthiness, Enron appears, for example, to have intentionally concealed from Standard

& Poor's and others the true nature of its debt obligations by treating in-substance loans it received from various banks as financial hedges. According to the New York Times, from 1992 through 2001 Enron booked $3.9 billion worth of in-substance debt transactions as hedge instruments. $2.5 billion of this total came in the years 1998 through 2001 alone. (See "Enron's Many Strands: Finances; Enron Had More Than One Way to Disguise Rapid Rise in Debt," New York Times, February 17, 2002).

Enron appears to have engaged in a series of "swaps" — derivative — transactions with certain Wall Street firms that allowed Enron to receive large cash infusions and obligated it to pay these same sums along with premiums back to the banks over a period of years. These transactions, all of which were hidden from Standard & Poor's, "perfectly replicated loans." (Id.) Indeed, according to the Times, at least one of the banks actually booked its transactions with Enron as loans. (Id.) It is no surprise the Times article suggested that one of the prime motivations for Enron's practices was to hide its true debt obligations from the rating agencies for the purpose of inflating its credit rating.

These were not the only material and systematic misrepresentations publicly revealed within the last months. On February 1, 2002, The Special Investigative Committee of the Board of Directors of Enron Corp., chaired by William C. Powers, Jr., issued its report regarding Enron's deceptive practices and concealment related to certain off-balance sheet partnerships and special purpose entities ("SPEs"). The Powers Report is necessarily

preliminary in nature, and it may well be that the full scope of Enron's misrepresentations will take many months to be uncovered. But based upon the Powers Report and newspaper articles that have already appeared, there is every reason to believe that the scope of Enron's misconduct was massive — and necessarily had a substantial impact on the rating provided by Standard & Poor's.

The Powers Report focused on four entities: Chewco, LJM1, LJM2, and the Raptor entities. None of these was adequately described in any of the company's publicly reported financial statements, if at all.[3] Nor did Enron provide information — complete or otherwise — about their nature to Standard & Poor's separately. In fact, in a series of presentations, Enron failed to bring these entities to our attention despite explicitly assuring Standard & Poor's that it was providing a "kitchen sink" analysis of its affiliated off-balance sheet entities. The first of these presentations occurred in October 1999 after Standard & Poor's, seeking a better understanding of the financial impact of Enron's relationship to its off-balance sheet partnerships, expressly requested from Enron a full account of the debt obligations of any such partnerships even if Enron was not legally obligated to honor such

---

3 As the Powers Report observes, Enron's financial statements did mention the existence of some of these partnerships. "However, these disclosures were obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships." (Powers Report at 17). See also Powers Report at 200-03.

debts. In response, Enron provided Standard & Poor's with one of the presentations I mentioned at the beginning of my testimony and which I have provided at the conclusion of this statement. This October 1999 presentation explicitly purported to provide an analysis "including the kitchen sink" of "100%" of Enron's "off-balance sheet affiliates." That is what Enron said. But in the chart provided to Standard & Poor's by Enron that lists these affiliates and their debt obligations:

- There is no mention of the Chewco partnership;
- There is no mention of the LJM1 partnership; and
- There is no mention of the LJM2 partnership.

Later, in January 2000, Enron made another presentation to Standard & Poor's, this time as part of one of its many aggressive (and unsuccessful) attempts to persuade us to raise its rating to the "A" or even "AA" (per the presentation) level. I have included this presentation with my testimony as well. This presentation also contained explicit "Kitchen Sink" representations about the extent and nature of the debt obligations of Enron's "Off Balance Sheet Ventures." Under the chart titled "Non-recourse Debt," Enron listed the same entities and debt totals that were contained in the October 1999 presentation referenced above.

Again this chart fails to mention the Chewco, LJM1, or LJM2 partnerships.[4] This presentation contains several other misrepresentations by Enron including, under the heading "Top Ten Reasons Enron is Under-Rated," an assertion that Enron's "[c]ommunication with analysts[,] investors and credit officers is direct and candid - No Secrets Policy."

In these presentations and our other interactions with Enron, Enron also failed to tell Standard & Poor's that Michael Kopper of Enron's Global Finance department managed and had a financial interest in Chewco or of the nature of compensation LJM1 and LJM2 were providing to Mr. Fastow, Enron's CFO. The subsequent creation of the Raptor partnerships was similarly never brought to our attention. Following the 1999 and 2000 presentations, Standard & Poor's requested updates to this information (all issuers are required to update information previously provided) as part of the clear understanding between

---

4 It should be noted that the only difference between this chart and the one presented in 1999 is that under the column heading for the long-term debt totals of these off-balance sheet entities, the 1999 chart reads "1998 LT Debt" while the 2000 chart reads only "LT Debt." One can only assume that this single difference was deliberate. The effect, in any event, was significant. For example, in presenting the 1999 document, Enron might have been able to justify showing only 1998 totals (i.e., pre- LJM1 & LJM2) by claiming these were the only year-end totals available. However, no such justification existed at the time of the later presentation. By omitting the 1998 notation Enron represented that the totals listed were current when, in fact, they were woefully out of date and misleading.

Standard & Poor's and Enron about Enron's obligations to furnish updates. As we now know, however, this "understanding" was based on deception.

The visage of Enron as an entity that engaged in fraudulent misconduct has recently been bolstered by judicial rulings. In one ruling on February 26, 2002, federal district court judge Thomas P. Griese in New York concluded that "sufficiently particularized allegations of fraud" had been made to permit one case to go forward alleging fraud against Enron. In another, on March 5, 2002, federal district court judge Jed S. Rakoff in New York concluded that Enron transactions that took the form of natural gas trades actually "appear to be nothing but a disguised loan."

2. The Impact of Enron's Misstatements and Omissions on Standard & Poor's Rating

A. Financially

As recounted above, Standard & Poor's relied heavily on receiving complete, timely and reliable information from Enron in assigning its ratings. That is what we always do. But complete, timely and reliable information is precisely what we did *not* receive. Had Enron told Standard & Poor's the truth about its financial condition during the ratings process — as it was required to do — the impact on Enron's rating would necessarily have been significant. Though it is difficult to accurately assess precisely what would have occurred in hindsight — our rating decisions, as I have said, are made collectively by

committees — the extremely harmful and material impact on Enron's creditworthiness is obvious.

I referred earlier to the New York Times report that revealed that Enron concealed nearly $4 billion in in-substance loan obligations between 1992 and 2001 by treating them as financial hedges. Enron incurred $2.5 billion of this total in its last three years alone. For a company that actually showed between $8 billion and $10 billion in debt during this period, the effect on Enron's book debt-to-total capital ratio of showing several billion more in debt would have been enormous. Thus, even without considering the obviously material impact of Enron's dealings with SPEs, it is clear beyond dispute that Enron's concealment of its true financial obligations from the rating agencies had a significant and misleading effect on our ongoing review of its creditworthiness.

The qualitative effects of full disclosure on Enron's credit rating would also have been substantial. The very foundation of Standard & Poor's opinion on Enron's credit quality rested on the previously high regard the Standard & Poor's analysts had for the company's risk management oversight and controls. The revelation that Enron was significantly more leveraged than previously thought and was far more lax about its risk management controls than it led Standard & Poor's to believe would have directly undermined this fundamental predicate of Standard & Poor's rating.

B. Loss of Confidence in Enron's Credibility and Honesty

The failure of Enron to provide full, timely and candid disclosure to Standard & Poor's not only has financial ramifications bearing on Enron's creditworthiness. It relates directly to Enron's honesty and thus to the validity of *all* its numbers. A company that fraudulently veils $4 billion of debt simply cannot — to put the point mildly — be trusted.

The Powers Report similarly determined that the off-balance sheet partnerships had been created and designed precisely to conceal from others (including Standard & Poor's) the true picture of Enron's financial status. "These partnerships — Chewco, LJM1, and LJM2 — were used by Enron Management to enter into transactions that it could not, or would not, do with unrelated commercial entities. Many of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve *bona fide* economic objectives or to transfer risk." (Powers Report at 4) In discussing a transaction with the Raptor entities that Enron executives did not disclose to Enron's Board of Directors (or to Standard & Poor's), the Report concludes, "[i]t continued the concealment of the substantial losses in Enron's merchant investments." (Powers Report at 15)

These entities, therefore, not only hid many of Enron's debt obligations from the view of, among others, Standard & Poor's, but were in fact expressly designed and implemented in such a way as to create precisely the opposite impression; namely, that

Enron's debt obligations were in fact not problematic. To that end, and through "creative efforts to circumvent accounting principles" (Powers Report at 5) countenanced by an accounting firm that "did not fulfill its professional responsibilities" (id. at 24), Enron hid its true financial picture — and, more specifically, its true creditworthiness — from Standard & Poor's. (Id. at 15)

The concealed loan-like transactions, the nature and very existence of significant related party off-balance sheet entities and Enron's policy of deliberate non-disclosure regarding them appear to have been designed to keep the true nature of these entities and their transactions with Enron from the view of Standard & Poor's and others. This concealment persisted, notwithstanding repeated requests from Standard & Poor's for any further information to more clearly depict Enron's true financial situation.

Had they been revealed, the clandestine dealings and obfuscatory disclosure practices conducted by Enron's management would necessarily have cast long shadows on the validity of Enron's credibility in general and its financial reporting in particular. While it is difficult to say with certainty all the steps Standard & Poor's would have taken had it known these material facts, Standard & Poor's does have a policy of not issuing ratings at all when it concludes that it does not have enough information to form a clear and accurate opinion of the issuer's creditworthiness. The recent revelations about Enron — with more to come, if the

past days offer any clue to the future — certainly tell us that Enron materially failed to provide Standard & Poor's with the information necessary to form a true and accurate rating opinion.

Conclusion

At Standard & Poor's, we are constantly engaged in a process of reviewing our performance, and the Enron situation has made these efforts all the more timely. We consistently survey investors in order to assess ways in which credit ratings can be more useful and forward-looking to the fixed income investment community. Working with the investment community, we are assessing our policies and procedures in order to implement any appropriate and warranted changes.

Clearly the collapse of Enron has been a terrible tragedy for its employees, shareholders, investors, business partners — in fact, the marketplace and economy as a whole. It has caused many to question the effectiveness of several long-standing and effective components of our capital markets, most of which have functioned effectively for decades. It is vital, however, that we all look to the Enron collapse as an opportunity to consider improvements that can be made to our system, weighing such improvements against the enormous benefits that we have witnessed as the capital markets have grown in size and scope. We at Standard & Poor's are continuously exploring ways in which our ratings can become still more timely, effective and relevant.

Just as we have looked for ways in which we can make the ratings process as effective as possible, Standard & Poor's has long been an advocate for the highest standards of corporate transparency. Because ratings ultimately depend upon information provided by the issuer, we have been a long-time champion of complete, timely and reliable disclosure of financial information and the best means of corporate governance. We have supported, and will continue to support, any regulatory efforts aimed at enhancing these goals.

As I noted at the outset of my testimony, Standard & Poor's publishes thousands of ratings that are subject to market scrutiny every day. We welcome that scrutiny. Our rating opinions are based on an objective and independent process that we consistently disclose and describe to the marketplace.

My job and the job of my colleagues at Standard & Poor's is to make judgments based on information that is full, fair, timely and accurate. Sadly, these baseline standards of integrity were shattered by Enron.

The efforts of this Committee and others to get to the bottom of these matters is most welcome and will help rebuild the confidence and trust required for our capital markets to function and flourish.

Thank you.

Updated Jan 2002

STANDARD
&POOR'S

Understanding Credit Ratings

What is Standard & Poor's Ratings Services

Standard & Poor's Ratings Services is an organization that provides ratings, i.e. opinions regarding the creditworthiness of issuers or capital markets obligations. Standard & Poor's operates on the principles of:

- Independence,
- Objectivity,
- Analytic Integrity, and
- Disclosure

Standard & Poor's operates with no government mandate and is independent of any investment banking firm, bank, or similar organization. A rating does not constitute a recommendation to purchase, sell, or hold a particular security. In addition, a rating does not comment on the suitability of an investment for particular investor. Standard & Poor's recognition as a rating agency ultimately depends on investors' willingness to accept its credit opinion.

Standard & Poor's believes it is important that all users of its ratings understand how it arrives at the ratings, and regularly publishes ratings definitions and detailed reports on rating criteria and methodology. Rating definitions are available on the Standard & Poor's website: www.standardandpoors.com and specific ratings are available through Standard & Poor's Ratings Desk by emailing: ratings_request@standardandpoors.com

What is a rating?

A credit rating is Standard & Poor's opinion on the general creditworthiness of an obligor, or the creditworthiness of an obligor with respect to a particular debt security or other financial obligation. Over the years credit ratings have achieved wide investor acceptance as convenient tools for differentiating credit quality.

Our ratings are based on information provided by the issuer together with other information we consider reliable. Ratings may be changed, suspended or withdrawn because of changes in or unavailability of information. Standard & Poor's assigns both local and foreign currency credit ratings reflecting an issuer's ability to meet financial obligations denominated in the issuer's domestic currency or in external currencies.

A rating does not constitute a recommendation to buy, sell or hold a particular security. It does not comment on the suitability of an investment for a particular investor. Standard & Poor's does not perform an audit in connection with any rating.

Standard & Poor's, 55 Water Street, New York, NY 10041
www. Standardandpoors.com

Issuer credit ratings
Corporate credit ratings, counterparty ratings, and financial strength ratings are forms of issuer ratings and are current opinions of an obligor's capacity to meet its financial obligations.

Issue specific credit ratings
An issue credit rating is a current opinion of the creditworthiness of an obligor with respect to a specific financial obligation or a specific financial program. It takes into consideration the terms and conditions of the obligation as well as the creditworthiness of guarantors, insurers, and other forms of credit enhancement.

Specialized ratings
Standard & Poor's also rates bank loans and private placements, using the same scale as for other debt instruments. Private placement ratings incorporate an evaluation of covenants and collateral packages designed to mitigate the risk of loss, even if a default occurs. Loan ratings serve the syndicated loan and project finance markets, and assess the lender's prospects of recovery after default by examining the value of any collateral or of other protective features commonly provided to lenders. Loans, private placements and other instruments such as secured bonds, if well secured and offering good ultimate recovery prospects, may have a higher rating than the issuer rating. Conversely, instruments that are subordinated to the senior debt of an issuer will normally carry a lower rating than the issuer rating.

Bond and money fund managers use Standard & Poor's fund ratings to differentiate their bond and money funds from those of their competitors. The ratings provide investors with information on the credit quality and volatility of a fund.

What ratings mean

A Standard & Poor's long-term rating reflects a borrower's capacity to meet its financial commitments on a timely basis. Long-term ratings range from our highest category, 'AAA', to the lowest, 'D'. Ratings from 'AA' to 'CCC' categories may also include a plus or minus sign to show relative standing within the category.

A short-term rating is an assessment of the likelihood of timely repayment of obligations considered short-term in relevant markets. Short-term ratings are graded into several categories, ranging from 'A-1' for the highest quality obligations to 'D' for the lowest. The 'A-1' rating may also be modified by a plus sign to distinguish the stronger credits in that category.

In addition to long-term and short-term ratings, Standard and Poor's has specific rating definitions for preferred stock, money market funds, mutual bond funds, financial strength and financial enhancement ratings of insurance companies and program ratings for derivative product companies.

Outlooks
An outlook notation indicates the possible direction in which a rating may move over the next two to three years.

- "Positive" : may be raised

- "Negative" : may be lowered
- "Stable" : unlikely to change
- "Developing" : may be raised or lowered

CreditWatch
A CreditWatch listing highlights the potential for near term change in a credit rating. It signals to investors that further analysis is being performed.

What the "letter" ratings mean

AAA: *Extremely strong capacity to meet financial commitments. Highest rating.*
AA: *Very strong capacity to meet financial commitments.*
A: *Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances.*
BBB: *Adequate capacity to meet financial commitments, but more subject to adverse economic conditions*
BBB- (minus): this is the lowest rating before non-investment grade.
BB: *Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions.*
B: *More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments.*
CCC: *Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments.*
CC: *Currently highly vulnerable.*
C: *A bankruptcy petition has been filed or similar action taken but payments or financial commitments are continued.*
D: *Payment default on financial commitments.*

Ratings in the 'AAA,' 'AA,' 'A' and 'BBB' categories are regarded by the market as investment grade.
Ratings in the 'BB,' 'B,' 'CCC,' 'CC' and 'C' categories are regarded as having significant speculative characteristics.
Ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

The rating process in brief

A Standard & Poor's rating is based on principles of independence, integrity and disclosure - the same standards that underlie market confidence and acceptance of our ratings by investors worldwide. The rating process is open and clear at Standard & Poor's. The process remains consistent across different types of ratings and different markets.

We assign a rating only when adequate information is available. The process includes quantitative, qualitative and legal analysis. We examine key business fundamentals, such as an issuer's industry, prospects for growth and its vulnerability to technological change or regulatory action. For sovereign ratings, important factors include not only the basic underlying economic strength of the country, but also the political system and the social environment. When we receive a rating request we assign an

analytical team comprising analysts with credit expertise in relevant business areas. We appoint a lead analyst who drives the process and serves as the issuer's primary contact. Before a formal meeting the team will review prior financial statements, financial and cash flow projections, transaction documents, supporting legal opinions and other relevant data. All non-public information provided to Standard & Poor's is kept confidential in accordance with our policies.

The analytical team meets with management to review key factors affecting the rating, including operating and financial plans and management policies. This management meeting provides issuers with an opportunity to address qualitative issues vital to the rating decision. The lead analyst then prepares an analytical report that is presented to the rating committee, composed of senior analysts from our global network. All relevant factors concerning the rating are discussed. Each committee member votes and once the committee reaches a decision the issuer will be notified of the rating assigned. An appeal is possible in cases where the proposed rating does not meet the issuer's expectation and where there is additional relevant information for the committee to consider.

Rating changes

When a rating change appears necessary, we undertake a preliminary review that may lead to a CreditWatch listing. The next step is a comprehensive analysis, including, if needed, a meeting with management and a presentation to the rating committee. The rating committee considers the circumstances, comes to a decision and notifies the issuer, subject to the appeal process noted above.

Surveillance

Once a rating is assigned, we maintain on-going review of material factors that could affect the rating, such as changes in the capital structure, an acquisition or other major economic developments. Generally, an issuer credit rating is reviewed formally at least once a year at the time of a meeting with the issuer's management. We expect management to provide to us prompt notice of material financial and operational changes that could affect the rating. Standard & Poor's, reserves the right to change a rating at any time if the information available to us affects our opinion.

Standard & Poor's
ENRON CORP. CHRONOLOGY since October 15, 2001

October 15, 2001: Enron releases earnings, announcing a $2.2 billion equity write-down, including $1.2 billion stemming from the erroneous accounting of various financial partnerships (notably the LJM deals).

October 16, 2001: Standard & Poor's affirms Enron's BBB+ ratings.

Standard & Poor's press release states: "The equity account reductions will have no direct effect on Enron's cash flow. However, the company's financial flexibility may be impaired because of the decline in Enron's equity value, which could lead the company to rely more on debt for its future financing needs. Capital expenditures over the near to medium term are manageable and can be financed out of operating cash flow, which will ease any liquidity concerns and help maintain credit quality. Asset sales, such as the recently announced Portland General Electric Co. deal, should therefore be fully available to enable Enron to strengthen its balance sheet and other credit measures in a timely manner."

October 25, 2001: Standard & Poor's affirms Enron's BBB+ ratings and revises the outlook to negative.

Standard & Poor's press release states: "Despite the negative outlook, several factors supportive of Enron's credit quality have been sustained throughout the uncertainty surrounding the company. The fundamental strength of Enron's energy marketing and trading franchise has remained steady. Standard & Poor's has detected no lapses in the company's risk management practices and trading discipline. No significant deterioration in trading volumes or willingness of counterparties to transact with Enron has been revealed to Standard & Poor's in contacts with major energy market participants."

November 1, 2001: Standard & Poor's lowers Enron's ratings to BBB and places the ratings on CreditWatch Negative.

Standard & Poor's press release states: "The downgrades indicate Standard & Poor's determination that Enron's plan to employ asset sales and other means to repair its damaged balance sheet will be insufficient to restore its long-term credit quality to the historical triple-B'-plus level. The negative CreditWatch listing recognizes the uncertainties that surround the company and its credit quality in the short run due to the possibility of further unanticipated developments in the capital markets.

The company's financial flexibility has continued to diminish. This crisis of investor confidence can be traced, in Standard & Poor's view, directly to the company's inability to calm investors that are unsure about the strength of Enron's core energy marketing business and the viability of the company's plan to restore its credit profile. Standard & Poor's continues to believe that Enron's liquidity position is adequate to see the company through the current period of uncertainty, and that the company is working to provide itself with an even greater liquidity cushion through additional bank lines and pending asset sales."

November 2, 2001: Standard & Poor's hosts a teleconference on Enron's Credit Challenges. With over 1,100 callers dialing in, Standard & Poor's reiterates its analysis for downgrading Enron to BBB/CW-Neg.

November 8, 2001: Enron files an 8K with the SEC disclosing the severity of the non-cash impact to earnings (cumulatively restating earnings going back to 1997 by approximately $600 million), and the negative impact on its balance sheet from the effects of various financial vehicles that should have been consolidated in Enron's financial statements pursuant to GAAP. Following Enron's 8K filing, Dynegy publicly confirms that it was discussing a possible business combination with Enron.

November 9, 2001: Standard & Poor's lowers Enron's rating to BBB- and retains its CreditWatch Negative status.

Standard & Poor's press release states: "The Enron downgrade is prompted by the credit implications of the company's restatement of financial statements going back to 1997 due in part to a legal and accounting review of certain related-party transactions by a special committee of Enron's board of directors. The investment-grade rating is predicated on the prospect for improvement of credit quality with the acquisition by the financially stronger Dynegy and the near-term liquidity enhancement, through the injection of $1.5 billion of equity capital, that came with the signing of the merger agreement."

November 12, 2001: Standard & Poor's hosts a teleconference on Dynegy's pending acquisition of Enron. With nearly 200 callers dialing in, Standard & Poor's reiterates its rationale for downgrading Enron to BBB-/CW-Neg. and noted that, without the Dynegy deal and the accompanying $1.5 billion of accompanying immediate liquidity, Enron's ratings would likely be in the high single-'B' or low double-'B' category.

November 19, 2001: Enron's 10-Q filing is made disclosing a ratings trigger event (at BBB-) involving the acceleration of a $690 million note to Nov. 26, 2001 from 2003.

November 20, 2001: Standard & Poor's publishes a Ratings Bulletin indicating that Enron remains on CreditWatch with negative implications.

Standard & Poor's press release states: "The 10-Q contained information on a ratings trigger event involving an existing minority interest on Enron's balance sheet held by Citibank and a group of other banks that have the right to accelerate the sale of underlying assets, including a $690 million Enron note, to Nov. 26, 2001 from 2003. At this time, the trigger event does not constitute an event of default. However, it does raise liquidity issues for Enron. Standard & Poor's believes, given the alignment of interests between Enron and the banks, that the company's efforts to renegotiate and extend the maturity of the obligation will be successful."

November 21, 2001: Dynegy issues statement on the Enron merger status.

November 28, 2001: Standard & Poor's lowers Enron's rating to B- and places the rating on CreditWatch Developing.

Standard & Poor's press release states: "The rating action is based on Standard & Poor's loss of confidence that the Dynegy merger will be consummated. The willingness of Dynegy to complete its planned acquisition of Enron has been compromised by the continued drop in confidence in the capital markets that the transaction would hold. The market reaction has spread to the energy markets, where Enron's trading and marketing franchise has, in Standard & Poor's

opinion, sustained significant damage that, together with rising potential legal liabilities, weakens Dynegy's commitment to purchase Enron."

November 30, 2001: Standard & Poor's lowers Enron's rating to CC and places the rating on CreditWatch Negative.

Standard & Poor's press release states: "The rating action reflects Standard & Poor's expectation that following the dissolution of Enron's announced merger with Dynegy Inc., burdensome debt restructuring requirements, negligible liquidity, and limited access to capital will likely cause Enron to seek bankruptcy protection. The change in CreditWatch implications to negative reflects Standard & Poor's belief that such a filing in the very near term is probable."

December 3, 2001: Standard & Poor's lowers Enron's rating to D following Enron's December 2, 2001 filing for Chapter 11 bankruptcy protection.

###

Assumptions
"Including the kitchen sink"

- Adjust the 1999 plan originally presented to S&P incorporating the full year impact of:
  - Consolidation of Elektro
  - Sale of Enron Oil & Gas
    - Deletion of assets, debt and cash flows from consolidated results
  - 100% consolidation of off balance sheet affiliates
  - Debt guarantees issued to third parties included as debt on a risk adjusted basis

1999 Agency Plan Proforma

	Agency Plan	Consol Elektro	EOG Trans	Revised Plan
Funds Flow	2,100.0	149.7	(307.3)	1,942.5
Interest	811.5	64.1	(124.7)	750.9
	3.59			3.59
Pre-Tax Income	1,950.8	83.3	(140.0)	1,894.0
Interest	811.5	64.1	(124.7)	750.9
	2.40			2.52
Total Obligations	10,539.0	468.0	(1,873.7)	9,133.3
Total Equity	11,096.0	475.0	(454.2)	11,116.8
	48.7%			45.1%
Funds Flow	2,100.0	149.7	(307.3)	1,942.5
Total Obligations	10,539.0	468.0	(1,873.7)	9,133.3
	20.0%			21.3%
B/S Debt *	9,201.0	718.0	(2,073.7)	7,845.3
Debt/Capital	45.3%			41.4%

* Excludes ACES

"Kitchen Sink"
Hypothetical Analysis for Standard & Poors
1999 Agency Plan Proforma

	Revised Plan	Add Affiliates	Guarantees	Pro Forma
Funds Flow	1,942.5	560.9		2,497.1
Interest	750.9	449.6		1,163.7
	3.59			3.15
Pre-Tax Income	1,694.0	943.2		2,800.4
Interest	750.9	449.6		1,163.7
	2.52			2.41
Total Obligations	9,133.3	7,394.0	21.1	16,548.0
Total Equity	11,116.8	4,275.8		15,392.6
	45.1%			51.8%
Funds Flow	1,942.5	560.9		2,503.4
Total Obligations	9,133.3	7,394.0		16,548.0
	21.3%			15.7%
B/S Debt *	7,845.3	7,394.0	21.1	15,260.4
Debt/Capital	41.4%			47.7%

* Excludes ACES

Non-recourse Debt

Project	Description	Location	ENE O/S	1998 LT Debt
Northern Border	Pipeline	US	12%	974
Atlantic Water	Water	UK	50%	912
CIESA	Pipeline(TGS)	Argentina	50%	835
Citrus	Pipeline	US	50%	755
DPC	IPP	India	50%	605
JEDI	Portfolio	US	50%	550
JEDI II	Portfolio	US	50%	500
ETDL	Distribution	UK	100%	391
Bolivia CV	Pipeline	Bolivia	20%	372
Zond	Renewable	US	50%	346
Seneca	Portfolio	US	95%	253
YPFB	Pipeline	Bolivia	25%	194
Centragas	Distribution	Colombia	38%	143
SECLP & SEOM	IPP	Dominican Republic	49%	128
Brazil CEG	Distribution	Brazil	25%	93
Enserco/Oilfield	Portfolio	US	50%	90
FTV Communications	Communications	US	33%	88
Subic	IPP	Philippines	50%	70
Solar Energy	Renewable	US	50%	31
Trailblazer	Pipeline	US	33%	30
Puerto Quetzal	IPP	Guatemala	50%	25
Bolivia Holdings	IPP	Bolivia	20%	4
Borgogna	Distribution	Brazil	34%	4
Total Non-recourse Debt				**7,393***

* *Amount ties to footnote 9 of annual report which states long-term debt of unconsolidated subsidiaries was $7 621 MM. Schedule above does not include Elektro long-term debt of $832 MM which was consolidated in 1998.*

Guarantees of Unconsolidated Subs

		1998	Risk Adjustment Factor*	Pro Forma	Comments
To Support Letters of Credit	Teeside Power	162,261	0 %	$ 0	Tariff Adjustment
	PQPC	2,750	5.4	150	
	EOTT	44,413	0	0	Crude Oil Collateral
	Total	209,424		$ 150	
To Support Debt & Trade Obligations	**International Projects (non-debt)**				
	Teeside Power Ltd.	66,503	5.4 %	3,630	
	Wing International, Ltd.	6,450	5.4	350	
	Smith/Enron Cogen L.P.	66,833	5.4	3,760	
		144,786			
	Debt				
	American Coal	11,475	5.4 %	62	
	Amoco/Enron Solar	3,700	5.4	200	
	Byers Locate	25,000	5.4	1,360	
	EDC	7,250	5.4	390	
	Int'l Marine Terminal Partnership	8,152	5.4	440	
	Papier Masson	130,000	5.4	7,090	
	Subic Power Corp.	4,046	5.4	220	
	Sutton Bridge	54,200	5.4	2,960	
		243,823			
	EOTT Trade	366,376	0	0	Crude Oil Collateral
	Total	754,985		$ 21,170	

* 3 year average cumulative default rates for Ba2

Enron Corp. Credit Conference
Credit Profile
January 29, 2000

Jeffrey McMahon
Executive Vice President, Finance
and Treasurer

Credit Analysis

- Quantitative
  - Trends
  - Ratios
  - Projections
- Qualitative
  - State of Industry
  - Market Position
  - Management
  - Access to Capital

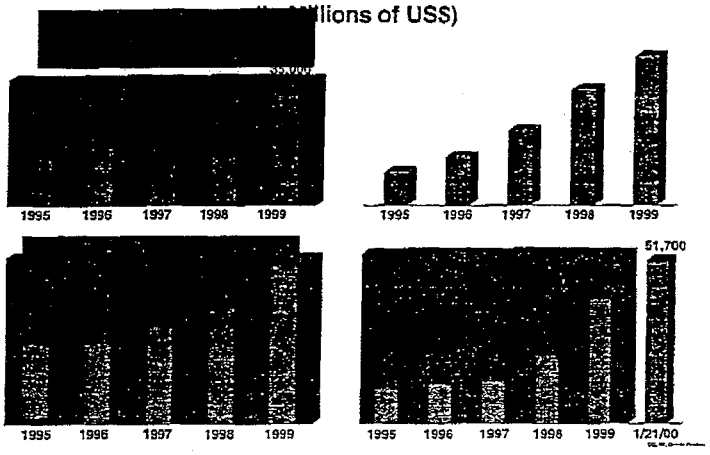
Current Ratings

Commercial

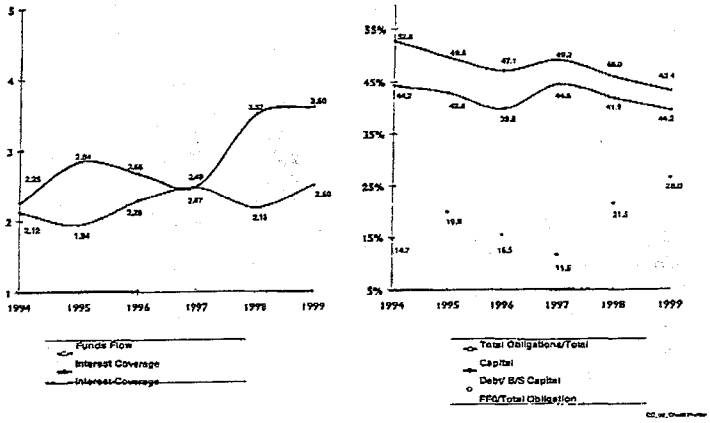
Rating Agency	Long Term	Paper
Outlook		
Duff & Phelps	BBB+	D-2
Positive		
Fitch IBCA	BBB+	F-2
Stable		
Moody's	Baa2	P2
Positive		
R and I(Japan)	A-	n/a
Stable		

Financial Trends

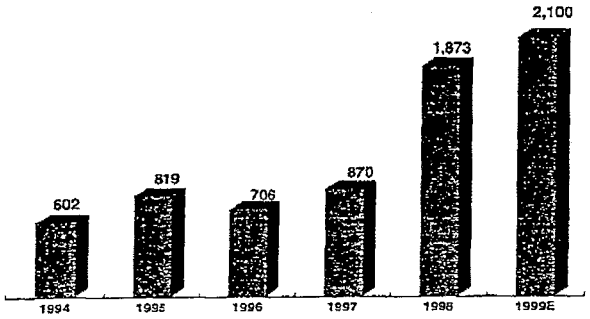
(Millions of US$)

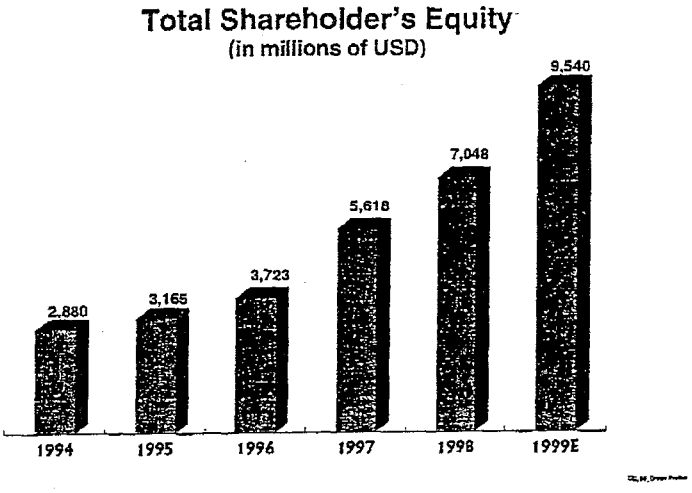


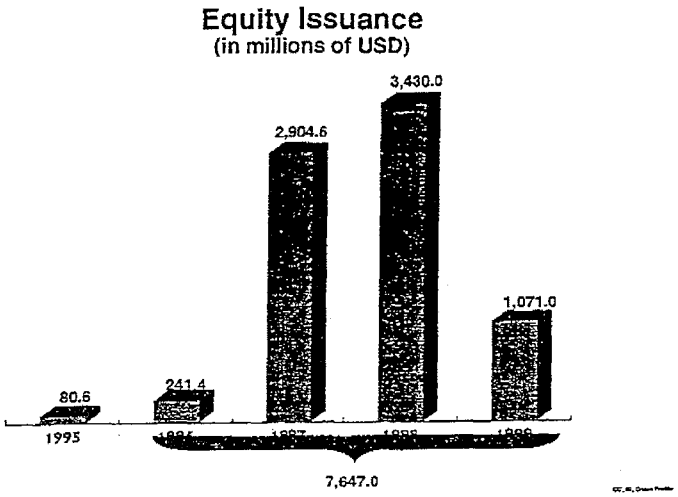
Key Financial Ratios



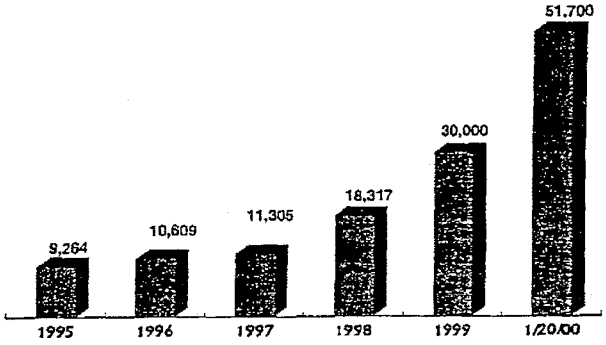
Total Funds Flow from Operations
(in millions of USD)



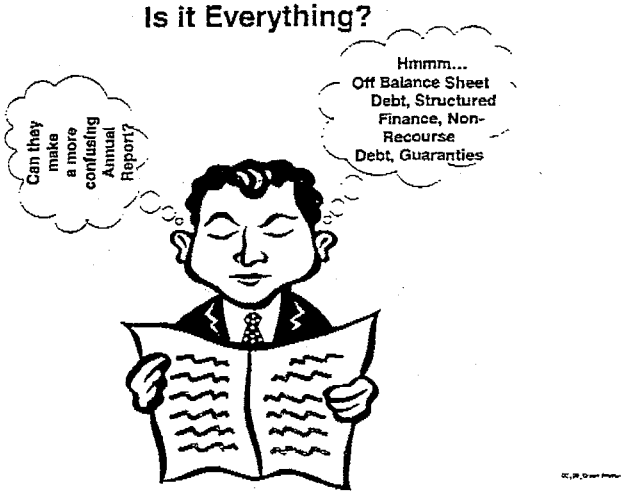

Total Shareholder's Equity
(in millions of USD)
2,880
3,165
3,723
5,618
7,048
9,540
1994
1995
1996
1997
1998
1999E


Equity Issuance
(in millions of USD)
80.6
241.4
2,904.6
3,430.0
1,071.0
1995
7,647.0

Total Market Capitalization
(in millions of USD)



Is it Everything?



Is Non-Recourse Debt Non-Recourse?

YES!

Kitchen Sink Disclaimer

Enron does not recommend using this analysis for anything other than illustrative purposes and for the purpose of concluding that the off-balance sheet obligations are not material to Enron's consolidated credit analysis. Cigarette smoking may be harmful to your health.

Kitchen Sink Analysis
Proforma 1999

	Estimate	Off Balance Sheet Ventures	Guarantees	Pro Forma
Funds Flow	2,100.0	560.9		2,660.9
Interest	807.6	449.6		1,257.2
	3.60			3.12
Pre-Tax Income	2,019.0	943.2		2,962.2
Interest	807.6	449.6		1,257.2
	2.50			2.36
Total Obligations	8,000.0	7,394.0	17.5	15,411.5
Total Equity	10,433.2	4,275.8		14,709.0
	43.4%			51.2%
Funds Flow	2,100.0	560.9		2,660.9
Total Obligations	8,000.0	7,394.0		15,394.0
	26.3%			17.3%
B/S Debt *	7,845.3	7,394.0	17.5	15,256.8
Debt/Capital	39.6%			47.7%

* *Excludes ACES*

SP 039578

Non-recourse Debt

Project	Description	Location	ENE O/S	LT Debt
Northern Border	Pipeline	US	12%	974
Atlantic Water	Water	UK	50%	912
CIESA	Pipeline(TGS)	Argentina	50%	835
Citrus	Pipeline	US	50%	755
DPC	IPP	India	50%	605
JEDI	Portfolio	US	50%	550
JEDI II	Portfolio	US	50%	500
ETOL	Distribution	UK	100%	331
Bolivia CV	Pipeline	Bolivia	20%	372
Zond	Renewable	US	50%	346
Seneca	Portfolio	US	95%	253
YPFB	Pipeline	Bolivia	25%	194
Centragas	Distribution	Colombia	38%	143
SECLP & SEOM	IPP	Dominican Republic	49%	128
Brazil CEG	Distribution	Brazil	25%	93
Enserco/Oilfield	Portfolio	US	50%	90
FTV Communications	Communications	US	33%	88
Subic	IPP	Philippines	50%	70
Solar Energy	Renewable	US	50%	31
Trailblazer	Pipeline	US	33%	30
Puerto Quetzal	IPP	Guatemala	50%	25
Bolivia Holdings	IPP	Bolivia	20%	4
Borgogna	Distribution	Brazil	34%	4
Total Non-recourse Debt				7,393

Amount ties to footnote 3 of annual report which states long-term debt of unconsolidated subsidiaries was $7,221 MM
Schedule above does not include Elektro long-term debt of $532 MM which was consolidated in 1999.

SP 039579

Guaranties of Unconsolidated Subsidiaries
(in $thousands)

Collateralized	Amount		Collateral
Teesside Power	$228,764		PPA Relief
EOTT	410,789		Crude Oil
	639,553		
Uncollateralized			
Third Party Non Affiliates	324,856	x 5.4%*	=$17,542
Total	$964,409		

Represents Average 3 year default rate for BB Bonds

SP 039580

Qualitative Issues

Industry

- 39% Future Growth Rate in North America
- 50% Future Growth Rate in Europe
- Japan's Energy Market is Deregulating
- Retail Segment is a $243 Billion/year Market
- Significant Expansion Opportunities in Pipelines

Qualitative Issues

Market Position

- First in North America
- Continued Outdistancing from Competitors
- Top 3 Position in Europe
- Only National Provider of Energy Outsourcing Services
- Most Efficient Pipeline in North America
- "The" Energy Franchise

Qualitative Issues

<u>Management</u>

- 35 Member Executive Committee
- ROIC Focused
- Decade Old Analyst/Associate Program
- "Credit Conscious Management"

Qualitative Issues

Access to Capital

- Largest Issuer in Lehman Pipeline Index
- Over $50 Billion Market Capitalization
- Stellar Reputation in Bank Markets
- Increasing Presence in International Markets(Euro, Yen, Sterling)

Common Misperceptions

Myth vs Fact

Myth	Fact
Enron operates in a non-rate base trading business which is inherently risky	Enron's cash flows from its non-regulated businesses are stable and predictable
There are massive amounts of debt that is not included in Enron's credit profile	The inclusion of all obligations (without adjustment for non-recourse) does not materially change the financial profile of Enron
The deregulated energy market is so new it is too early to determine who will survive	Enron has been in this segment for over a decade and is the dominant market participant

Common Misperceptions

Myth vs Fact

Myth	Fact
Enron is reluctant to issue equity	Enron has issued over $7 billion of equity since 1994
Management does not communicate its true financial position to the investor community or the rating agencies	Management is extremely accessible to anyone willing to take the time to understand its credit - Banks - Institutional Investors - Rating Agencies
Enron dealmakers worldwide aggressively pursuing new business lines bind the company without centralized approval and control	Risk and Assessment Controls policy requires the approval of Enron Corp Senior Management and the Board of Directors to bind the company
Enron characterized by competitors as being overly aggressive and engaged in "Risky Business" lines	Enron enjoys First Mover status in Network Business creating substantial barriers to entry for competitors

Top Ten Reasons Enron is Under-Rated

10. It's been years since the last rating agency upgrade and EVERY financial metric has improved
    - Ratios
    - Scale and Scope
    - Management Depth
    - Market Share
    - Diversity
    - Book Equity and Market Cap

9. Management has delivered on all credit profile promises and proactively manages its balance sheet to achieve target rating.

8. Enron boasts the premier Risk Management Control System in the industry (over $130 million spent annually).

7. Management has issued over $7 billion of equity over the past several years.

6. Enron's major initiatives are only in those markets in which it can become the number one participant, thereby significantly adding stability to its earnings by having a structural cost advantage over its competitors .

Top Ten Reasons Enron is Under-Rated

5. Over the past 10 years, Enron's performance has demonstrated a low risk business strategy in a highly volatile commodity/energy market.

4. Enron's financial ratios vs peer companies are favorable, especially considering Enron's competitive advantage with respect to market shares and control systems.

3. Bond spreads/bank spreads indicate A- risk weighting.

2. Communication with analysts investors and credit officers is direct and candid - No Secrets Policy

1. Enron's credit rating is critical to the maintenance and growth of its existing dominant market share position.

Conclusion

AA Credit Company with Above Market Yields

Testimony of John Diaz
Managing Director
Moody's Investors Service

Before the
Committee on Governmental Affairs
United States Senate

March 20, 2002

Introduction

Good morning Chairman Lieberman, Senator Thompson and members of the Committee. My name is John Diaz, and I am a Managing Director of Moody's Investors Service. I am pleased to have the opportunity to appear before you today to discuss Moody's, the role that rating agencies play in the financial markets, and Moody's actions in rating the Enron Corporation and its debt instruments.

Moody's Investors Service is owned by Moody's Corporation, a New York Stock Exchange traded company. Moody's is the oldest credit rating agency in the world. Our roots can be traced to 1900, when John Moody & Company first published Moody's Manual of Industrial and Miscellaneous Securities. From its beginning, Moody's Investors Service focused on rating debt instruments—and, as early as 1924, Moody's was rating nearly every bond in the United States bond market.

Moody's and the other rating agencies occupy a niche in the investment information market. Ratings are a simple symbol system to express relative creditworthiness. The heart of our service lies in ratings on long-term fixed-income debt instruments. We also provide, for instance, short-term ratings, deposit ratings for banks, and a variety of rating services in foreign countries. Moody's has nine primary long-term debt rating categories. Investment-grade ratings range from a high of Aaa, down to a low

of Baa. Ratings below Baa are considered speculative-grade, or junk. Moody's applies this long-term scale to ratings on other types of financial obligations and to companies. Moody's also assigns short-term ratings—primarily to issuers of commercial paper—on an independent rating scale that ranks obligations Prime-1, Prime-2, Prime-3 or Not Prime. In all, Moody's ratings are designed to provide a relative measure of risk, with the likelihood of default increasing with lower ratings. The lowest expected probability of default is at the Aaa level, with a higher expected default rate at the Aa level, a yet higher expected default rate at the single-A level, and so on down through the rating scale.

As part of Moody's commitment to predictive ratings, we review the relationship between defaults and our ratings. We publish a study annually, which we call our "default study," which consistently shows that higher rated bonds default less frequently than lower-rated bonds, although the rates of default vary over time. Our default studies show the predictive nature of our ratings. Put simply, as a forward-looking opinion, ratings effectively distinguish bonds with higher credit risk from bonds with lower credit risk.

Our strong record is due in large part to the availability of reliable information. The combination of the financial disclosure regime in the United States, audited accounts, information provided directly to Moody's, and issuers' good-faith dealings have normally been sufficient. Enron was an anomaly, partly in the nature of its activities, and certainly in the disclosure of its activities. As we have come to learn, Enron's public disclosures and its responses to our specific requests for information were misleading and incomplete. Although we do not have investigative authority, our analysts are

encouraged to exercise skepticism with respect to an issuer's claims and promises. That skepticism led us to assign Enron a long-term rating that—at all times—was no better than low investment-grade and contained speculative elements.[1]

Throughout Moody's rating history with Enron, we followed processes and practices that conformed to our established methods of credit analysis—methods that have been proven to predict relative creditworthiness. In the case of Enron, however, that methodology was undermined by the missing information upon which our ratings should have been based and the misleading information on which the ratings were, in fact, based.

That said, my colleagues at Moody's and I wish we had discovered the information that would have allowed us to serve the market more effectively in this instance. We acknowledge that the public bond market looks to us for our opinion forecasts of long-term creditworthiness, and we recognize that the market does not expect a very large issuer of bonds, which we have rated investment-grade, to default very shortly after holding such a rating.

The integrity and reliability of our ratings and rating processes are the essence of our business. We are constantly striving to enhance rating processes and quality and we have examined the circumstances around the Enron bankruptcy to see what lessons can be learned. For example, we are looking more comprehensively at the role of so-called rating "triggers," which can cause payment obligations to accelerate or require posting of collateral based upon a rating downgrade. We have enhanced our analysis of short-term corporate financial capacity, that is, liquidity, reviewing more thoroughly the sufficiency and certainty of an issuer's near-term sources of cash and credit under conditions of stress. We have also contacted the large asset management firms in a coordinated review

[1] Please refer to the rating definition on Page 7.

of their use of ratings in the marketplace. Finally, we commend this Committee, along with Congress in general, for your efforts to ensure the continued health of our financial markets.

About Moody's and credit ratings

Moody's is the oldest credit rating agency, founded more than a century ago by John Moody to rate the creditworthiness of railroad bonds. Today Moody's is a leading global credit rating, research, and risk analysis firm with more than 800 analysts worldwide. Our credit research covers a broad range of debt totaling over $30 trillion, and our analysts publish research covering thousands of institutions. Moody's products include in-depth research on major issuers, industry studies, special reports, and credit-opinions that reach subscribers globally. A Moody's credit rating is a forward-looking opinion that reflects our analysis of the relative quality of fixed income securities, issuers of such securities, and other credit obligations. Ratings are informational tools used by (1) institutional investors to analyze the credit risks associated with fixed-income securities and other debt obligations; (2) issuers seeking access to the capital markets; (3) regulators, for such purposes as measuring the capital adequacy of banks, broker/dealers, and insurance companies; and (4) governments, economists, the media, academics, and other market observers.

Ratings create efficiencies in financial markets by providing reliable, credible, and independent assessments of credit risk. The ultimate value of a rating agency's contribution to market efficiency depends on its ability to offer predictive risk opinions for the universe of rated credits.

The predictive quality of credit ratings is empirically verifiable and is evaluated by Moody's and independent third parties. Our track record is published annually in our default studies. These studies, which examine ratings performance dating back to 1920, consist of a detailed statistical analysis of the relationship between Moody's ratings and issuer defaults. They confirm the predictive nature of our ratings over time.

How Moody's works

Moody's takes a number of steps to ensure the rigor of our ratings process. We assign ratings by committee. Rating committees vary in size and generally include senior and junior analysts and one or more Managing Directors. A Credit Policy Committee (CPC) and credit standing committees under the control of the CPC review ratings practices and policies internally.

We derive over eighty-five percent of our annual revenue from issuers whom we rate. We have done so since the early 1970s, when the scope and complexity of the financial markets evolved to a state where subscription-based sales of "manuals" no longer supported the human resources necessary to conduct global credit analysis competently. Despite the fact that we obtain our revenues from issuers, we maintain our independence and objectivity with issuers, as we recognize that the long-term value of our franchise depends on our reputation. The influence of individual issuers is limited because Moody's does business with over five thousand issuer groups. No single issuer represents more than about one-and-a-half percent of Moody's total annual revenue, and the vast majority represent much less. Last year, for example, fees paid by Enron represented less than one-quarter of one-percent of Moody's 2001 revenues.

Moody's also takes active steps to maintain the integrity of our ratings process. Moody's analysts are not measured or compensated for the revenues associated with the portfolios they rate. Nor are they permitted to hold or trade the securities of the issuers they rate. Finally, Moody's does not create investment products, or buy, sell, or recommend securities to our clients, or invest in securities for its own account.

Ratings are based largely on publicly available information

In making our rating decisions, Moody's analysts largely rely on publicly available information, including SEC filings and audited financial statements. We believe that United States disclosure requirements are strong enough that, in the great majority of cases, we have sufficient public information to express an opinion. The remainder of the information we rely upon comes from macroeconomic analysis, industry-specific knowledge, and issuers' voluntary disclosure of additional information. Although issuers may choose to volunteer nonpublic information to inform our deliberations, we do not necessarily receive all of an issuer's relevant nonpublic information. Importantly, in our experience, most issuers—and for that matter the capital markets—operate in good faith; Enron, with its intentional lack of candor, did not.

Moody's ratings of Enron's debt obligations consistently reflected our caution with respect to the company's credit prospects

Moody's has consistently taken a cautious view in rating Enron's debt obligations. Beginning in 1989, Moody's assigned Enron's long-term debt a rating in the category of Baa, the lowest investment-grade category. Since 1939, Moody's has publicly defined Baa as follows:

> Bonds and preferred stock which are rated Baa are considered as medium-grade obligations (i.e., they are neither highly protected nor poorly secured). Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well.

Beginning in the fall of 1999, Enron began a concerted effort to obtain an upgrade of its long-term debt rating. We asked Enron for information that might justify such a move, including financial data on leverage and the sustainability of the company's cash flow. Enron responded by providing Moody's with what Enron executives termed the "kitchen sink" disclosure, which purportedly presented all significant financial information about the company, including unconsolidated assets and debt. We now know that material information was missing. For example, Enron did not disclose to Moody's the Rawhide, Raptor and Braveheart partnerships. Furthermore, based on recent public disclosures, much of the information that was provided was inaccurate.

After review and analysis of the information provided, Moody's upgraded Enron's corporate long-term debt from Baa2 to Baa1 on March 23, 2000, a rating that placed Enron at the upper range of the lowest investment-grade category.

Enron's deteriorating financial situation prompted Moody's to lower the company's senior unsecured long-term debt ratings in October 2001

Beginning in mid-October 2001, Enron publicly disclosed troubling information that ultimately led to its filing for bankruptcy in early December 2001. During that time period, Moody's representatives requested information regarding the company's deteriorating financial picture. We moved diligently to digest the rapidly changing realities of Enron's deteriorating financial status. When Moody's rates an issuer, we

assess any support that may be provided to that issuer. Therefore, we attempted to gauge the likelihood that a proposed merger with Dynegy Inc. would be consummated. This merger would have justified keeping Enron's debt rating at an investment-grade level. At all times, Moody's endeavored to act prudently and to ensure that it performed the necessary analysis to provide for an appropriate rating determination.

Following the resignation of Jeffrey Skilling in August 2001, Moody's asked senior management at Enron if they anticipated any write-downs or other charges. We were assured that none were forthcoming. Then, on October 16, despite those assurances, Enron announced its third quarter results, which included after-tax charges of approximately $1 billion resulting in a net loss of $618 million. That same day, Moody's placed Enron's long-term debt rating on review for downgrade. After our public announcement, in a number of meetings and phone conversations, Moody's repeatedly requested information from Enron regarding its October 16 disclosures. During the roughly one-month period beginning on October 16 and ending on November 19 when Enron filed its 10-Q for the third quarter, the company revealed to investors that it had misrepresented its financial performance by reporting inflated profits and omitting substantial amounts of debt.

Because of our concerns with the company's financial condition, on October 29 Moody's lowered the ratings on Enron's senior unsecured long-term debt from Baa1 to Baa2, and placed the company's long-term and short-term ratings on review for further possible downgrade. Moody's noted that we would be carefully monitoring the situation and would focus on three key factors: (1) Enron's efforts to line up further liquidity

support and its ability to retain credit availability from its major counterparties; (2) Enron management's asset sale plan; and (3) the company's off-balance sheet transactions.

Moody's maintained Enron's investment-grade rating based on the likelihood of Enron's acquisition by Dynegy and a promised infusion of significant amounts of equity

By early November 2001, Moody's was increasingly concerned that Enron no longer merited an investment-grade rating. At that point, we received word of material information that would have warranted maintaining the company's investment-grade status: Dynegy and Enron disclosed to us their proposed merger. The merger would have resulted in an equity infusion of $1.5 billion from ChevronTexaco through Dynegy, in which ChevronTexaco holds a twenty-six percent stake. The deal also included an additional $1 billion in secured financing from JP Morgan Chase and Citigroup. From this point forward, Moody's focused on determining whether this merger would be consummated, and if so, how we would rate the debt of the new company. This inquiry led to numerous discussions with Enron and Dynegy regarding the details of the merger. Based on our understanding of Enron's financial condition at that time, we came to the conclusion that a merged Dynegy and Enron would likely warrant a marginally investment-grade rating.

Once we analyzed the terms of the merger, however, it became apparent that numerous weaknesses in the merger agreement and in the related financing agreement diminished the probability of the transaction being completed. Specifically, the terms of the merger contained a "material adverse change" (MAC) provision, which would have allowed Dynegy to pull out of the deal under certain circumstances. Moreover, the merger agreement as well as the secured financing agreement contained certain rating

triggers that would allow Dynegy and the banks to walk away from the deal if Enron's ratings were to be lowered to non-investment-grade. These and other provisions caused us to question the probability that the transaction would be completed.

Based on this analysis, Moody's decided to downgrade Enron's long-term debt from Baa2 to Ba2, below investment-grade status, and to keep the company's long-term debt rating under review for further possible downgrade. On November 8, 2001, Moody's called Enron to tell them of this decision. During the call, Enron informed us of an imminent, material change to the Dynegy transaction, in the form of an additional equity infusion of up to $1 billion. On that basis, we made the judgment to withhold the press release until we had more information. In subsequent discussions with Enron's lead banks, and separately with Dynegy and ChevronTexaco officials, we learned that the parties had committed to positive changes to the deal to help facilitate its success. The changes included the addition of $500 million in equity from the lead banks, removal of certain MAC provisions and removal of the rating triggers from the merger agreement and from the secured financing agreement.

Notwithstanding these changes, on the next day, November 9, Moody's lowered Enron's long-term debt rating to Baa3, keeping it under review for possible further downgrade. Importantly, we also lowered the company's short-term debt rating from Prime-2 to Not Prime, a speculative-grade rating and the lowest on our short-term rating scale. Taken together, these actions reflected Moody's belief that Enron's senior debt securities were not investment-grade in the short term although the company might continue to be investment-grade over the longer term. That conclusion reflected our assessment that this transaction was highly likely to occur based on the information we

had received. Over the next few weeks, Moody's actively requested additional information from Enron, Dynegy and the investment banks, in an effort to monitor the progress of the merger transaction and confirm our conclusion that it would ultimately materialize.

Despite the banks' motivation to complete the Dynegy transaction, Enron's credit prospects continued to decline because the company was consuming cash at a significant rate. Moreover, new adverse disclosures in the company's 10-Q filed on November 19 and a required restatement of prior period earnings gave us significant concern. By Thanksgiving, these factors, combined with other negative financial indicators, caused Moody's analysts to determine that the probability of Dynegy completing the acquisition had diminished considerably, warranting a downgrade of Enron's long-term debt to below investment-grade.

On November 25, Enron further communicated that the banks and Dynegy would add an additional $500 million of new equity to the deal, bringing a total of $1 billion to the enterprise, and that the banks were looking to provide an additional $1 billion in lines of credit. The merger price would also be renegotiated to reflect Enron's lower current share price. Yet when Moody's received the term sheet for the deal on the following day, it included troubling and surprising terms, such as a provision for far less than the $1 billion in additional equity that had been promised and a rating trigger. We were further informed that the banks were not willing to provide the $1 billion in lines of credit. We discussed our concerns with Dynegy and Enron, and then, on November 27, Moody's decided to downgrade Enron to below investment-grade status, to B2. The Moody's rating committee voted unanimously in favor of the downgrade and Moody's

disseminated a press release announcing that decision on November 28. Moody's action reflected concerns regarding Enron's financial condition in light of significant cash consumption in its wholesale trading business. In addition, we cited refinancing risk given Enron's substantial near-term debt maturities, concerns relating to the profitability and stability of the company's trading operations and the effective subordination of Enron's senior unsecured notes to an increasing amount of secured indebtedness.

Moody's acted prudently in this deteriorating and rapidly changing situation. Up until our issuance of the downgrade to below investment-grade status, we were aware that the Dynegy deal was being renegotiated and, based on information provided to us, believed that additional equity and debt financing were being pursued. All the parties to the transaction appeared to be highly committed to its success. Prior to our decision to downgrade, we believed that the merger between Dynegy and Enron would be completed.

Where do we go from here?

While our desire to assign and communicate predictive ratings remains unchanged, the bond rating system, like the financial markets themselves, is subject to ongoing evolution. We continue to enhance the content in our ratings and research, and regularly communicate these enhancements to market participants via reports on methodology, trends, and industry outlooks.

In December 2001, we released a report on ratings triggers, which describes how these mechanisms work, why they are employed, and how they can have unexpected—and sometimes highly disruptive—consequences for lenders and borrowers alike.

Moody's has met with over twenty asset management firms this year to seek comments on the role of ratings. These meetings corresponded with publication of the first of two Moody's Special Comments on proposed enhancements to the rating process. The comments received from market participants include the following:

1) Investors want ratings to continue to be a stable signal of medium- to long-term fundamental credit risk.

2) Investors support shorter review periods for reassessing ratings in light of changed company or market circumstances. They use and appreciate Moody's current rating review and rating outlook announcement processes, derive substantial information from them, and desire that the issuer be given an opportunity to act on correctable conditions that could otherwise lead to credit deterioration.

3) They want us to focus more on issues of accounting quality, corporate governance, and disclosure.

Going forward, we are enhancing the ratings process by putting increased focus in several areas. We have substantially intensified our assessment of liquidity risk for issuers with both investment-grade and speculative-grade ratings. We are also focusing on corporate governance and how aggressive or conservative are accounting practices.

Beyond enhancements in the rating process itself, the Enron situation underscores the critical importance of full disclosure for the effective functioning of the marketplace. As a major consumer of financial data and SEC filings, Moody's strongly supports efforts to enhance financial disclosure. We would welcome the opportunity to assist the Committee in this process, and appreciate the chance to appear before you today.

STATEMENT OF RALPH G. PELLECCHIA
SUBMITTED TO
THE COMMITTEE ON GOVERNMENTAL AFFAIRS
OF
THE UNITED STATES SENATE
MARCH 20, 2002

Mr. Chairman and Members of the Committee, my name is Ralph Pellecchia and I am a Senior Director in the Global Power Group of Fitch Ratings. I joined Fitch in July 1989 as an analyst in the natural gas and power sector. I have been the lead analyst following Enron at Fitch since May, 1997. At Fitch, I am the primary analyst for 14 companies in the Global Power sector and one of 15 Fitch analysts covering the North American Global Power sector.

Fitch is in the business of publishing independent ratings and credit analysis of companies around the world. I am responsible for coordinating this activity for the companies assigned to me. My work includes regularly visiting the companies I cover, maintaining contacts with the members of the finance staff and other important personnel at those companies and staying current on events affecting the companies and industry that I follow. I also conduct much of the quantitative and qualitative analysis that Fitch uses to assess the credit of the companies we rate in my area.

Finally, my role as the primary analyst is to synthesize the quantitative and qualitative factors and to propose a rating, with the final rating outcome to be determined by a credit committee. The credit committee is comprised of a minimum of five voting members typically specialists from the industry/sector, but frequently includes members from other groups within Fitch.

In my role as a primary analyst, I am guided by procedures and practices followed at Fitch. The ratings process related to Enron was, in all respects, consistent with those procedures and practices.

The assessment process is itself a blend of quantitative and qualitative factors. Quantitative factors that are parts of the rating process include an evaluation of published financial information, supplemental financial information and peer financial performance. Qualitative factors include business fundamentals, competitive position, growth opportunities, the regulatory environment and our view as to the abilities of management.

Our analysis of Enron followed the rating process described above. Over the past several years, because of a significant shift in its business mix and rapid revenue growth, Enron's reported financial profile (in size alone), as presented in its income statement and balance sheet, changed significantly. Yet, although the market capitalization of Enron increased dramatically over the past several years, the various credit ratios and other factors used by Fitch supported a constant BBB+ rating during the period from 1993 until the fourth quarter of 2001. It should also be noted that of the more than 300 entities rated by our Global Power Group, the senior debt rating of more than 60% of the companies in the sector is above BBB+. BBB+ is in the lowest investment grade category.

In mid-October 2001, Enron released third quarter results that reflected a $618 million third quarter loss, and a $1.2 billion reduction in shareholder equity. Shortly thereafter, adverse press reports appeared, an informal SEC investigation was announced and the CFO was replaced. Following these events, on October 25, 2001 Fitch placed Enron on Rating Watch Negative warning that, "the loss of investor and counterparty confidence, if it continues, would impair Enron's financial flexibility and access to capital markets, therefore, impacting its ability to conduct its business." Eleven days later, on November 5, 2001, Enron's senior debt rating was downgraded to BBB-, the lowest possible investment grade rating, and left on Rating Watch Negative (an indication of the possibility of future downgrades).

On November 8, 2001, Enron restated its earnings for a five-year period, and on November 9, 2001, Enron announced its merger agreement with Dynegy. This announcement caused Fitch to revise the rating watch status to "Evolving." It was Fitch's opinion that Dynegy was a financially viable and knowledgeable purchaser with a sound financial and business profile on a standalone basis supplemented by a strong financial backer and investor through its affiliation with Chevron-Texaco. The merger agreement with Dynegy provided Enron with $1.5 billion in additional cash, which supplied needed liquidity. We also held the opinion that Dynegy, as a direct competitor, was quite familiar with Enron's operations. The Evolving status, however, reflected a high level of execution risk compared with other acquisitions by entities rated higher than the target company. In those cases, Fitch would typically place the target's ratings on Rating Watch Positive. Fitch warned in its commentary accompanying the ratings action of November 9, 2001 that, "If the merger were to terminate, Fitch believes Enron's ability to manage its business would be severely impaired and would expect to downgrade its securities to highly speculative grade. Termination provisions to the merger agreement add an element of uncertainty to completing the merger."

In the three-week period following the merger agreement, Enron disclosed additional liabilities and incurred substantial cash outflows that compromised its financial condition. Fitch commented on these developments on November 21, 2001, stating that in the absence of a merger transaction with Dynegy, Enron's financial condition was "untenable." At the time we published that comment, based on discussions with Enron and Dynegy management, it was our understanding that the parties were committed to the merger, but at revised terms that reduced the value received by Enron shareholders. Based on the inability to execute a revised merger agreement, as well as obtain additional secured bank financing, Enron's ratings were lowered to 'CC' on November 28, 2001, indicating probable default.

TESTIMONY OF
ISAAC C. HUNT, JR., COMMISSIONER
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERING THE ROLE OF CREDIT RATING AGENCIES IN THE U.S. SECURITIES MARKETS

BEFORE THE COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

March 20, 2002

Chairman Lieberman, Senator Thompson and Members of the Committee:

Thank you for the opportunity to testify before you today on behalf of the Securities and Exchange Commission regarding credit rating agencies and the Commission's experience with the credit rating industry.

Introduction

For almost a century, credit rating agencies have been providing opinions on the creditworthiness of issuers of securities and other financial obligations. During this time, the importance of these opinions to investors and other market participants, and the influence of these opinions on the securities markets, has increased significantly, particularly with the increase in the number of issuers and the advent of new and complex financial products, such as asset-backed securities and credit derivatives. The globalization of the financial markets also has served to expand the role of credit ratings to jurisdictions other than the United States, where the reliance on credit ratings largely was confined for the first half of the twentieth century. Today, credit ratings affect securities markets in a number of important ways, including an issuer's access to and cost of capital, the structure of financial transactions, and the ability of fiduciaries and others to invest in particular investments.

During the past thirty years, regulators such as the Commission have increasingly used credit ratings as a convenient surrogate for the measurement of risk in assessing investments held by regulated entities. Specifically, since 1975, the Commission has referenced the ratings of specified rating agencies in certain of its regulations under the federal securities laws. These rating agencies are often referred to as "Nationally Recognized Statistical Rating Organizations" or "NRSROs."

The Use of Ratings in the Federal Securities Laws

The term "NRSRO" was originally adopted by the Commission solely for determining capital charges on different grades of debt securities under the Commission's net capital rule, Rule 15c3-1 under the Securities Exchange Act of 1934.[1] The net capital rule requires broker-dealers, when computing net capital, to deduct from their net worth certain percentages of the market value ("haircuts") of their proprietary securities positions. A primary purpose of the haircuts is to provide a margin of safety against losses that might be incurred by broker-dealers as a result of market fluctuations in the prices of or lack of liquidity in their proprietary positions. The Commission determined that it was appropriate to apply a lower haircut to securities held by a broker-dealer that were rated investment grade by a credit rating agency of national repute because those securities typically were more liquid and less volatile in price than those securities that were not so highly rated. The requirement that the credit rating agency be "nationally recognized" was designed to ensure that the firm's ratings were credible and that the ratings were reasonably relied upon by the marketplace.

Over time, as the reliance on credit rating agency ratings increased, so too did the use of the NRSRO concept. Indeed, the concept has been incorporated into several other areas of the federal securities laws. Several regulations issued pursuant to the Securities Act of 1933,[2] the Securities Exchange Act of 1934,[3] and the Investment Company Act of 1940[4] have incorporated the term "NRSRO" as it is used in the net capital rule. For example, Rule 2a-7 under the Investment Company Act of 1940 limits money market funds to investing in only high quality short-term instruments. Under Rule 2a-7, NRSRO ratings provide minimum quality investment standards for money market funds. A money market fund is permitted to invest in securities rated by an NRSRO in the two highest rating categories for short-term debt. Over $2 trillion of investor assets are held in money market funds meeting the standards of Rule 2a-7. In addition, offerings of certain nonconvertible debt and preferred securities that are rated investment grade by at least one NRSRO can be registered on Form S-3 without the issuer satisfying a minimum public float test. Generally, Form S-3 is a short-form registration statement designed for use by issuers that are subject to periodic reporting requirements under the Securities Exchange Act of 1934.

---

1 See Adoption of Amendments to Rule 15c3-1 and Adoption of Alternative Net Capital Requirement for Certain Brokers and Dealers, Release No. 11497 (June 26, 1975), 40 FR 29795 (July 16, 1975).

2 See, e.g., Regulation S-K (17 CFR 229.10); Rule 436 (17 CFR 230.436); Form S-3 (17 CFR 239.13); and Forms F-2 and F-3 (17 CFR 239.32, 239.33).

3 See, e.g., Rule 101 (17 CFR 242.101) and Rule 102 (17 CFR 242.102).

4 See, e.g., Rule 2a-7(a)(9) (17 CFR 270.2a-7(a)(9)); Rule 10f-3 (17 CFR 270.10f-3); and Rule 3a-7 (17 CFR 270.3a-7).

Congress itself employed the term "NRSRO" when it defined the term "mortgage related security" in Section 3(a)(41) of the Securities Exchange Act of 1934.[5] The term "mortgage related security" was added by the Secondary Mortgage Market Enhancement Act of 1984, and it required that such securities must, among other things, be rated in one of the two highest rating categories by at least one NRSRO.

Finally, other regulatory bodies, including banking regulators both at home and abroad, employ the concept of NRSRO in their regulations.

The System for Designating Rating Agencies as NRSROs

Currently, to determine whether a rating organization is an NRSRO, the Commission staff reviews the rating organization's operations, position in the marketplace, and other criteria. If the Commission staff determines that the NRSRO designation is appropriate, the staff sends a no-action letter to the rating organization stating that it will not recommend enforcement action to the Commission against broker-dealers that use ratings issued by the rating agency for purposes of the net capital rule.

To assess whether a rating agency may be considered an NRSRO for purposes of the Commission's rules, the Commission staff consider a number of criteria. The single most important criterion is that the rating agency is nationally recognized, which means the rating organization is widely accepted in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. Thus the designation is intended largely to reflect the view of the marketplace as to the credibility of the ratings, rather than represent a "seal of approval" of a federal regulatory agency.

The staff also reviews the operational capability and reliability of each rating organization. Included within this assessment are: (1) the organizational structure of the rating organization; (2) the rating organization's financial resources (to determine, among other things, whether it is able to operate independently of economic pressures or control from the companies it rates); (3) the size and experience and training of the rating organization's staff (to determine if the entity is capable of thoroughly and competently evaluating an issuer's credit); (4) the rating organization's independence from the companies it rates; (5) the rating organization's rating procedures (to determine whether it has systematic procedures designed to produce credible and accurate ratings); and (6) whether the rating organization has internal procedures to prevent the misuse of non-public information and whether those procedures are followed. Because credit ratings entail the conveyance of a form of investment advice, the staff also recommends that the rating agency become registered as an investment adviser under the Investment Advisers Act of 1940.

When the Commission first began using ratings in the net capital rule in 1975, the Commission staff, in consultation with the Commission, determined that the ratings of Standard and Poor's Corporation, Moody's Investors Service, Inc., and Fitch Investors

---

[5] Pub. L. No. 98-440, § 101, 98 Stat. 1689 (1984). See 15 U.S.C. 78c(a)(41).

Service, Inc. were used nationally and so these firms should be considered NRSROs for purposes of the net capital rule.[6] Since 1975, the Commission staff has issued no-action letters to Duff and Phelps, Inc.,[7] McCarthy Crisanti & Maffei, Inc.,[8] IBCA Limited and its subsidiary, IBCA, Inc.,[9] and Thomson BankWatch, Inc.[10] These latter firms were subsequently merged or acquired such that presently there are three NRSROs.

Over the course of its history the Commission has considered a number of issues regarding credit rating agencies. Not surprisingly, many of the instances in which either the Commission or Congress reflected on the need for regulation coincided with a large scale credit default such as the Orange County default and the default of the Washington Public Power Supply System ("WPPSS") bonds. Ten years ago the Commission seriously considered the need for oversight authority of credit rating agencies, given their increasing role in the financial and regulatory systems.[11] The Commission at that time did not reach a consensus on the need for regulation.

In 1994, the Commission did, however, issue a concept release soliciting public comment on the appropriate role of ratings in the federal securities laws, and the need to

---

6 See, e.g., Letter from Gregory C. Yadley, Staff Attorney, Division of Market Regulation, SEC, to Ralph L. Gosselin, Treasurer, Coughlin & Co., Inc. (November 24, 1975).

7 See Letter from Nelson S. Kibler, Assistant Director, Division of Market Regulation, SEC, to John T. Anderson, Esquire, of Lord, Bissell & Brook, on behalf of Duff & Phelps, Inc. (February 24, 1982).

8 See Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, SEC, to Paul McCarthy, President, McCarthy, Crisanti & Maffei, Inc. (September 13, 1983).

9 See Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, SEC, to Robin Monro-Davies, President, IBCA Limited (November 27, 1990); Letter from Michael A. Macchiaroli, Assistant Director, Division of Market Regulation, SEC, to David L. Lloyd, Jr., Dewey Ballentine, Bushby, Palmer & Wood, on behalf of IBCA (October 1, 1990).

10 See Letter from Michael A. Macchiaroli to Gregory A. Root, President, Thomson BankWatch, Inc. (August 6, 1991); Letter from Michael A. Macchiaroli to Lee Pickard, Pickard and Djinis LLP (January 25, 1999).

11 See Letters from Representative John D. Dingell to Richard C. Breeden, Chairman, SEC (April 28, 1992 and July 9, 1992); Letter from Richard C. Breeden, Chairman, SEC, to the Honorable John D. Dingell (July 23, 1992); Letter from J. Carter Beese, Jr., Commissioner, SEC, to the Honorable John D. Dingell (August 12, 1992); Letter from Mary L. Schapiro and Richard Y. Roberts, Commissioners, SEC, to the Honorable John D. Dingell (August 12, 1992).

establish formal procedures for designating and monitoring the activities of NRSROs.[12] The Commission specifically solicited comments on: (1) whether it should continue to use the NRSRO concept, and, if so, whether it should define the term "NRSRO"; and (2) whether the current no-action letter process for recognizing NRSROs is satisfactory, and, if not, whether the Commission should establish an alternative procedure. The Commission received 25 comment letters, which generally supported the continued use of the NRSRO concept, but recommended that the Commission adopt a formalized process for approving NRSROs. Commenters generally opposed additional regulatory oversight of NRSROs.

In 1997, the Commission published a rule proposal that would have adopted a definition of the term "NRSRO" that set forth the criteria a rating organization would have to satisfy to be acknowledged as an NRSRO.[13] The proposed amendments would have defined an NRSRO as an entity that (1) issues ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments and is registered under the Investment Advisers Act of 1940 and (2) is approved as an NRSRO by the Commission unless such designation is withdrawn. Generally, under the proposed amendments, the Commission would consider the same criteria currently used in the no-action letter process. To a large extent the proposal was designed to bring greater transparency to the existing process and to provide for a formal appeal process.

The process would have included:

- a procedure in which the Commission staff would approve or reject an application for NRSRO status, unless the Commission objected;
- a procedure for rating organizations that are denied NRSRO status to appeal the Commission staff's decision to the Commission, in which case the Commission may designate a hearing officer to preside over any proceeding; and
- a requirement that NRSROs notify the Commission of material changes and permit the Commission to withdraw NRSRO status if changes affect a rating agency's ability to continue to meet any of the requisite criteria. A rating organization could appeal a final decision by the Commission to withdraw its NRSRO status in federal court.

---

12 See Nationally Recognized Statistical Rating Organizations, Release No. 34616 (August 31, 1994), 59 FR 46314 (September 7, 1994).

13 See Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Release No. 39457 (December 17, 1997), 62 FR 68018 (December 30, 1997).

The Commission has not yet acted on the proposal. Given the recent focus on the larger question of rating agency oversight, the Commission is unlikely to act on the proposal until it is satisfied that it has appropriately addressed the relevant issues.

Competition

A number of observers, including the U.S. Department of Justice, have criticized the national recognition requirement as creating a barrier to entry for new credit rating agencies.[14] Generally, this argument is based on the premise that users of securities ratings have a regulatory incentive to use ratings issued by NRSROs, rather than non-NRSROs, and that this makes it quite difficult for non-NRSROs to achieve the national recognition necessary for Commission designation as an NRSRO. Historically, the Commission has not determined that the national recognition requirement creates a substantial barrier to entry into the credit rating business. Growth in the businesses of several credit rating agencies not recognized as NRSROs suggests that there may be a growing appetite among market participants for advice about credit quality from all credible sources, and that this makes it possible for new entrants to develop a national following for their credit judgments. The Commission has determined to examine the competitive impact of the Commission's use of the NRSRO designation. The Commission also will consider suggestions concerning other market-based alternatives for determining the credibility of credit ratings that might address the competitive concerns associated with the NRSRO framework.

Regulation of Rating Agencies

Each of the current NRSROs is registered with the Commission as an investment adviser under the Investment Advisers Act of 1940.[15] The Advisers Act prohibits fraud, imposes fiduciary duties on advisers with respect to their advice, requires advisers to maintain certain books and records specified by Commission rules, and gives the Commission authority to examine NRSROs registered as investment advisers for compliance with the provisions of the Advisers Act. While the Advisers Act requires these NRSROs to have an adequate basis for their ratings, and prohibits them from having undisclosed conflicts with respect to the ratings, the Advisers Act does not directly address the quality or reliability of NRSROs ratings.

Because of the quasi-public responsibilities of rating agencies, the importance given to ratings by investors and other market participants, and the influence of ratings on the securities markets, a number of observers believe that rating agencies, regardless of whether they are designated as NRSROs, should be subject to greater Commission

---

[14] See, e.g., Comments of the United States Department of Justice in the Matter of: File No. S7-33-97 Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934 (March 6, 1998).

[15] Subject to certain exclusions, the Investment Advisers Act defines an "investment adviser" to include any person who, for compensation, is engaged in the business of using reports or analyses regarding securities.

oversight. The Commission believes that its authority to use NRSRO ratings and the process for designating NRSROs is clear under existing law. If greater supervision of NRSROs is deemed necessary, the NRSRO designation process might provide a basis for increased Commission oversight of NRSROs. In particular, the Commission is exploring whether additional oversight of NRSROs could be applied as a condition to recognition as an NRSRO.

Conclusion

The Commission will engage in a thorough examination, which may include hearings, to ascertain facts, conditions, practices and other matters relating to the role of rating agencies in the U.S. securities markets. It is our intention to call upon a number of experts for their views, including market professionals who rely on credit ratings and academics, as well as the NRSROs themselves. We believe it is an appropriate time and in the public interest to re-examine the role of rating agencies in the U.S. securities markets and to conduct a public examination of the potential need for greater regulation in this area.

Testimony of Jonathan R. Macey,
J. DuPratt White Professor of Law, Cornell Law School,
before the
United States Committee on Governmental Affairs

March 20, 2002

"Nationally Recognized Statistical Ratings Organizations and Investor Protection"

The massive publicity surrounding the collapse of Enron Corporation has given regulators and lawmakers a valuable opportunity to examine, and, hopefully, to correct, some of the pathologies that plague the U.S. financial system. The collapse of Enron should prompt a frank assessment at all of the institutions – corporate boards of directors, corporate board audit committees, accounting firms, stock exchanges, market analysts and credit rating agencies – that investors rely upon for protection against fraud and abusive practices. My testimony today will focus on the role of credit rating agencies, which, over time, have assumed a unique role in society as "Nationally Recognized Statistical Ratings Organizations" (NRSROs).

Most Americans think that the large, well-known credit rating organizations like Moodys and Standard and Poors are purely private enterprises: they are unaware of the fact that these organizations are, in fact, more properly viewed as quasi-governmental entities. The credit rating agencies are quasi-governmental entities because they have been given the power to grant regulatory licenses to various types of businesses. For example, the United States Treasury Department, through the Comptroller of the Currency, adopted credit ratings as the appropriate measure of the quality of national banks' bond portfolios, requiring that banks write-down the value of bonds in their portfolio that did not have sufficiently high ratings, but allowing bonds

with sufficiently high ratings to be carried on the banks' books at cost.[1] Similarly, national banks long have been prohibited by the Comptroller of the Currency from purchasing securities that are not of investment grade, as determined by the rating agencies.[2]

These regulations not only have increased the demand for the services of the credit rating agencies dramatically and artificially, they also have changed the nature of the services provided by credit rating agencies. Prior to the adoption of these rules, the rating agencies rated securities only after they had been issued. These new regulations created demand for the rating agencies to rate securities *before* they were issued, and caused a significant increase in the business of credit rating agencies.[3] This work by credit rating agencies is not only directly attributable to government regulation, it places the rating agencies in the position of performing a delegated governmental function – bank monitoring and supervision – on behalf of the Comptroller of the Currency.

In addition to the banking requirements discussed above, beginning in 1973, a series of governmental regulations have further embedded the use of credit ratings into the regulatory process. The first of these regulations was promulgated by the Securities and Exchange Commission in the form of SEC Rule 15c3-1 in which the U.S. Securities and Exchange Commission stated that "to a limited extent" it had "recognized the usefulness of nationally

---

[1] Frank Partnoy, The Siskel and Ebert of Financial Markets?: Two Thumbs Down for The Credit Rating Agencies, vol. 77, issue no. 3, Washington University Law Quarterly pp. 619-712, at 687 (1999).

[2] United States Comptroller of the Currency, Purchase of Investment Securities, and Further Defining the Term "Investment Securities" as Used in Section 5136 of the Revised Statutes as Amended by the "Banking Act of 1935," Section II (February 15, 1936).

[3] Partnoy, at 689

recognized statistical rating organizations as a basis for establishing a dividing line for securities with a greater or lesser degree of market volatility."[4] Rule 15c3-1 was the first time that the phrase "Nationally Recognized Statistical Rating Organization" (NRSRO) had been used in any regulation.

Rule 15c3-1 states that the percentage of the market value of securities that can be counted towards a broker-dealer firm's net capital requirement will be determined by the credit rating assigned to the securities by the NRSROs.[5] The higher the credit rating assigned by the NRSROs, the greater the percentage of the securities value that can count towards meeting a firm's net capital requirements. Thus, credit ratings can have a significant impact on the profitability (return on capital), as well as on the viability of broker-dealer firms.

The term NRSRO is not defined anywhere, and later regulations have not attempted formally to define the term, stating only that the term should be used "as the term was used" in Rule 15c3-1. As Professor Frank Partnoy has observed, "as the initial source of the term 'NRSRO,' Rule 15c3-1 effectively froze the then-approved credit rating agencies (e.g. S&P, Moody's Duff & Phelps, and Fitch) as acceptable for rating purposes, and severely limited the possibilities for new entrants. These barriers have remained insurmountable."

So, in addition to increasing the demand for the services provided by rating agencies, and changing the nature[6] of the work provided by rating agencies, regulation also has shielded rating

---

[4] Notice of Revision: Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934, release No. 34-10,525, 1973 SEC LEXIS 2309 (Nov. 29, 1973).

[5] 17 C.F.R. Section 240.15c3-1 (1998).

[6] Investment Company Act of 1940, Rule 2a-7, SEC Release No. 33-6,882, Fed. Reg. 8113 (1991).

agencies from competition, creating the comfortable, oligopolistic environment in which the rating agencies currently operate. The most recent major example of the invidious manner in which the credit rating agencies have embedded themselves in the regulatory process concerns Regulation FD.

In the latter part of 2000, the SEC adopted Regulation FD, which bars U.S. companies from excluding the general investing public from the benefits of the information disclosed to analysts, money managers or large shareholders. Regulation FD requires companies to make broad, non-selective public dissemination of material, non-public information.

The credit rating agencies succeeded in procuring for themselves a broad exception to the provisions of Regulation FD, in the form of SEC Rule 100(b)(2). This rule exempts rating agencies from the provisions of Regulation FD as long as the information disclosed is for the purpose of developing a credit rating and the entity's ratings are publicly available.[7] This request for an exemption seems strange, incidentally, in light of the fact that the SEC already had acknowledged clearly that issuers and their officials may properly share material, non-public information with outsiders when those outsiders agree to keep the information confidential.[8]

Other regulations that increase the demand for the work of credit rating agencies include rules that: (a) determine which securities may be purchased by money market mutual funds on the basis of the rating assigned to the securities by the NRSROs (only those securities that have

---

[7] See letter regarding Selective Disclosure and Insider Trading, dated April 17, 2000 from Vickie A. Tillman, Executive Vice-President and Chief Rating Officer, Standard & Poor's Rating Services, to Jonathan Katz, Secretary, Securities and Exchange Commission (asking for an exception to Regulation FD for nationally recognized statistical rating organizations (NRSROs).

[8] See SEC Release Nos 33-7787, 34-42259, IC-24209 (2000).

one of the two highest ratings for short-term debt may be included in the money market fund's portfolio); (b) permit issuers whose securities have been given investment grade ratings from the NRSROs to utilize the streamlined S-3 registration forms when issuing securities;[9] and (c) exempt persons engaged in the distribution of nonconvertible debt securities from certain anti-manipulation rules if the securities being distributed have been given an investment-grade rating by at least one NRSRO (these anti-manipulation rules generally prohibit those involved in distributing securities from buying and selling the securities during the distribution.[10]

It is not just government regulation that gives the rating agencies such power. They also derive power from extensive use in debt covenants and other financial instruments to create conditions of default: the downgrading of a rating by an NRSRO can throw a company into default under the terms of many debt covenants. But the possibility that artificial demand for the services of rating agencies has been created by regulation cannot be ignored.

As Professor Partnoy has observed, the "web of regulation" creating regulatory demand for the work of NRSROs "is so thick that a thorough review would occupy hundreds, perhaps thousands of pages."[11] One of the sad consequences of this onslaught of regulation is that they have had the cumulative effect of removing both market forces and market incentives from the work performed by NRSROs. The NRSROs incentives in today's regulatory environment are to reduce costs as much as possible, knowing that regulation guarantees a fixed, stable demand for their services. The massive fees paid to NRSROs can be viewed as a form of tax, ultimately paid

---

[9] Securities and Exchange Commission Form S-3.

[10] Release No. 34-19,565, 48 Fed. Reg. 10,628 (1983).

[11] Partnoy, at 692.

by investors, but paid in the first instance by banks, mutual funds, insurance companies, securities firms, and issuers as a cost of doing business.

The regulatory subsidies given to credit rating agencies would not be particularly troubling were it not for the fact that credit ratings do not provide useful or timely information about the credit-worthiness of companies in today's markets. Academic studies tend to show that the information in credit ratings is of marginal value at best because the information contained in ratings had already been incorporated into share prices. One well-known study showed that the ratings provided by rating agencies lagged the information contained in securities prices by a full year.[12]

An unfortunate side-effect of the poor quality of credit ratings is that credit ratings have become so entrenched in both regulatory policy and market practices that they threaten to distort the process by which capital is allocated among corporations. In theory, businesses that are well-managed and well-capitalized should be rewarded by being able to obtain capital at favorable rates. Likewise, firms that are poorly managed or thinly capitalized should be disciplined by the market in the form of higher capital costs (or, at the extreme by being cut off from capital).

However, in today's regulatory environment, ratings downgrades are at least partially self-fulfilling prophecies. Securities issued by firms that have been down-graded are worth less

---

[12] George E. Pinches & J. Clay Singleton, The Adjustment of Stock Prices to Bond Rating Changes, vol. 33 Journal of Finance pp, 29-55 at 39 (1978); see also, George E. Piches & Kent A. Mingo, A Multivariate Analysis of Industrial Bond Ratings, vol. 28 Journal of Finance 1 (1973) and Frank K. Reilly & Michael D. Joehnk, The Association Between Market-Dominated Risk Measures for Bonds and Bond Ratings, 31 J. Fin. 1387 (1976), Richard Cantor & Frank Packer, Determinants and Impacts of Sovereign Credit Ratings, Federal Reserve Board N.Y. Economy Policy Review, October 1996, at 45-46; David Zigas, Why the Rating Agencies Get Low Marks on the Street, Business Week, March 12 1990, at 4.

than identical securities that have not been downgraded due solely to regulatory factors. Similarly, firms with high ratings may enjoy lower capital costs due to regulations that make it attractive for institutional investors to keep such higher-rated securities in their portfolios, rather than because they are actually better managed or more strongly capitalized than lower-rated rivals.

It is easy to identify the problems of rating agencies. It is more difficult to craft a workable solution. One of the reasons that the problem is so intractable is that ratings are so convenient to use. They may not provide much information, but they provide it in a convenient format. Clearly, getting rid of the regulatory dependence on rating agencies would make the job of the regulators much more difficult. The regulators would have to craft substitute rules if they could no longer avail themselves of the NRSROs. For example, if money market mutual funds were not allowed to use rating agencies to inform them about what short-term debt instruments they could put in their portfolios, what sort of guide would they use instead?

Several commentators, most notably, Professor Partnoy, have proposed using credit spreads as a substitute for credit ratings (a credit spread is the difference between the yield to maturity on the security being evaluated and the yield to maturity on a risk-free (U.S. government) security of comparable structure and maturity).[13] Credit spreads have the advantage of being more accurate and more objectively determined than credit ratings. However, there are several practical shortcomings associated with the use of credit spreads.

One shortcoming is that, at present, nobody really knows what the credit spread equivalent of the NRSRO ratings is. For example, how close to the yield on riskless securities

---

[13] Partnoy at 705.

such as U.S. Treasury bills must the yield on a particular security be before it qualifies as having a AAA rating? Somebody is going to have to make this call, and there does not appear to be a particularly principled way to do it.

Another shortcoming with the use of credit spreads is that credit spreads exist only for seasoned issues. When a security has never traded before because it has just been issued, it is not obvious how one would ascertain its credit spread. Similarly, it is not obvious how one would determine the credit spread for thinly traded securities, particularly given the danger that market manipulation might occur if credit spreads substituted for credit ratings for thinly traded securities.

An additional problem with the use of credit spreads as a substitute for the ratings issued by NRSROs is that credit spreads reflect the difference between the yield on the security being evaluated and the yield on a risk-free bond of similar structure and maturity. But for many securities it may be quite difficult to find a risk-free bond of similar structure. The risk-free bonds that comprise the base-line measure for determining credit spreads are very simple in structure. In practice, it would be quite difficult to "normalize" the structure of a highly complex derivative security so that it is comparable with a risk-free security for purposes of determining the credit spread.

However, from a public policy perspective, the issue is not whether credit spreads are perfect. The issue is whether they are better than the alternative, which is the continuation of the NRSRO approach. I think it is incontrovertible that the use of credit spreads offers a superior alternative to the use of NRSROs in certain situations, such as in the case of seasoned issues that trade in thick, liquid markets. Their use should be studied further.

My own view is that Congress should commission the relevant regulatory agencies, such as the SEC and the Department of the Treasury, to study those regulations that require the use of NRSROs. The use of such NRSROs to fulfill regulatory functions should be abandoned where possible. Moreover, in many situations, regulations requiring the use of NRSROs can be abandoned. The need for NRSROs has declined over the past thirty years due to developments in information technology that have reduced the size of the informational asymmetries that exist between investors and issuers.

Where it is appropriate to continue the use of NRSROs, issuers and financial intermediaries should be allowed to use credit spreads as a substitute for the ratings currently generated by NRSROs. The precise formula for determining the credit rating equivalent of a credit spread would have to be determined.

Where firms choose to use credit ratings instead of credit spreads to satisfy regulatory requirements, the rating agencies should, at a minimum, be held accountable for their actions. In particular, the rating agencies should be subject to investigation and enforcement action by the SEC where they issue ratings for which there is no valid economic justification. In addition, the SEC should consider whether the rating agencies should be obliged by regulation: (a) to disclose the public documents on which they relied as the basis for their ratings determinations where the ratings are based on public documents; (b) to disclose whether the information contained in their credit ratings is based on anything other than publicly available documents; (c) to disclose whether the ratings are based on non-public interactions with the issuer; and (d) to disclose whether a ratings is being issued despite the fact that the rating agency lacks the information that a reasonable investor would consider relevant to the formulation of the rating; and (d) the extent

to which the ratings they are issuing were actually based on credit spreads.

The market is, by-and-large, unharmed by the poor quality of ratings, because market participants are sophisticated enough to ignore the ratings. The real problem with the declining quality of credit ratings is that regulators are using credit ratings in a wide range of situations as a substitute for regulation. To the extent that ratings are of poor quality, the quality of these myriad regulatory schemes are compromised. The quality of U.S. financial regulation is being compromised by its pervasive reliance on credit ratings.

Glenn Reynolds
CreditSights, Inc,

CHANGES IN THE ROLE OF NRSROs

The debate over the role of the NRSROs has raged for years and we have seen a fair amount of harsh criticism of the economic inefficiency that is created by the protected NRSRO status, the market power they are able to exercise by virtue of the concentrated oligopoly that has been created, and by the lack of accountability to investors who might claim grievance under securities laws. Philosophy and ideology may drive much of the debate, but there is a need to make sure that the cure is not worse than the disease. What the market requires to function properly right now is more useful and reliable information and not weaker rating agencies. The main checks on the issuers that the investing public can look to are the SEC, the accountants, the underwriters, and rating agencies. The SEC cannot be realistically staffed by credit experts in light of the specialized skill sets that are required and the number of people that would be involved. The accountants have a narrower mandate than analysis, and in many cases they have proven as unreliable as the underwriters in taking a hard line on disclosure.

With the possible exception of the underwriters' due diligence team, the rating agencies should be the most effective party in the process at interpreting credit risk, and to revoke NRSRO status at this point would only undermine the one large and well established pool of analysts that are equipped to evaluate risk and share more information in the public domain. The conflicts of interest that one finds in the securities firms and commercial banks is almost self-evident at this point, and the NRSROs private a sound check on the capital markets process.

That said, we believe that regulatory oversight of the rating agencies should be tightened. The SEC has specifically exempted the NRSROs from requirements under Reg FD, which means that the rating agencies are in a unique position to provide important information to both the market and to the SEC itself as part of the course of their routine operations. The immediacy of the challenge and the well-developed infrastructure at the NRSROs make them a very useful starting point to make rapid change. They need to feel much more pressure to upgrade the quality of their services apart from the issuance of ratings. They have the resources and profitability to meet the demands, but it is not entirely clear at this point that they fully recognize where they have failed and what additional steps they need to take. Their next steps have to go beyond just speeding up the rate of downgrades.

RECOMMENDATIONS

1. The SEC should retain NRSRO designations

We have read and heard many of the arguments over the years that say the market does not need NRSROs, that the designation is a violation of the free market, that there is adequate information and expertise in the marketplace now that they are an anachronism. From our own experiences with the debt underwriting process, Wall Street due diligence, and the approach that many companies take to providing disclosure, we could not disagree more strongly. The Enron situation underscores that we need more independent eyes in the marketplace not only as a safeguard, but also to be able to dig into information that could be a sign of material risks that are lurking behind ambiguous disclosure. The rating agencies are extraordinarily profitable and resource rich with manpower and

specialized skill sets. Even if one agrees that they have been delivering a lower quality product to the marketplace, which also is our view, they are at least in a position to take corrective action and to enhance the quality of information in the marketplace in a way that will provide value to investment decision makers.

The debt marketplace has grown more complex and more volatile, and we are now seeing more sophisticated multi-asset-class players engaging in investment strategies that have increased volatility across the capital structure from equities to bank debt and into related markets such as credit derivatives. One of the side-effects of the convergence of more asset classes is that information flows are faster and are often captured by those that can operate across the full array of these assets classes, where they can gain market information that allows them to profitability exploit market inefficiencies. That is just the market at work and we are comfortable with that aspect of the information flows. What we need to be more concerned about is that investors in certain securities classes such as bank debt and a range of privately placed securities will get disclosure that is not broadly available in the public domain. This is most notably the case for investors in bank debt, who routinely gain access to information for companies that is not disclosed in SEC filings. A more activist role for the NRSROs will level the playing field in such information delivery.

2. Set clear and specific criteria for new organizations to become NRSROs

The rating agency industry is a concentrated oligopoly and is likely to remain so even if the NRSRO designation was bestowed on more organizations. We recommend that the

SEC lay out very detailed and very clear criteria for what the requirements are going to be going forward to qualify as an NRSRO. In the unlikely event that investment capital were readily available to start a new major rating agency, it would be useful for the market to have a clear understanding of the requirements. While not likely to happen in the intermediate term, the growth in the global marketplace, the increased use of external rating agencies by a wide range of regulatory oversight bodies, and the likely development of more international rating agencies could set the stage for new market entrants. We consider the barriers to entry as almost insurmountable in the U.S. for a new and effective NRSRO, but the profit margins in the business, and the enormous benefits that accrue to the NRSROs could bring more competitors to the field as a result of mergers or financial sponsorship from a strategic investor. The threat of competition has a tendency to focus organizations on performance, quality, and execution, and would also attract more qualified personnel, so setting clear and objective (albeit challenging) criteria, would set the table for market entrants. If an organization does not have confidence in an objective set of criteria, then it will not be able to attract capital to fund the build-out of resources to qualify as even a limited purpose NRSRO.

We would argue that the struggles over the past decade of Fitch, IBCA, Duff & Phelps, and Thomson Bankwatch to make a meaningful dent in the Moody's and Standard & Poor's (S&P) franchises would not encourage a new market entrant as a general purpose NRSRO. We may see some limited purpose NRSROs start to develop, and we will see more develop globally when the Bank for International Settlements (BIS) moves ahead with its plan to utilize external credit rating agencies into its capital adequacy framework.

The opportunity for the creation of more NRSROs would more likely come from mergers of international rating agencies and limited purpose NRSROs with specialized industry knowledge. The more likely scenario is that the current Big Three NRSROs would acquire them. The potential for competitive pressure driving improved performance by the agencies is not very realistic, since revenue is driven by ratings and not by the quality of the research. That means quality standards will at least have to be regulated more aggressively by those that have blessed these companies with NRSRO status.

3. Require the rating agencies to disclose material risks that they find in the ratings review process even if the information has not been disclosed by management in financial filings.

The exemption from the requirements of Reg FD has left the NRSROs in a position to gain additional information that management may not choose to disclose, either because it is not specifically required to be disclosed or because the company chooses to omit such disclosure by virtue of the overused (and often abused) "materiality" guidelines. More rigorous, standardized disclosure takes time to work its way through the SEC and FASB, but the rating agencies should be able to focus routinely on the economics of unusually risky activities such as Special Purpose Entities (SPEs), counterparty concentrations, contingent liabilities, and rising structural risks in any kind of on- or off-balance sheet financing. These risks show up in a very distinct minority of the corporate sector, but those are the situations where the agencies could add the most value.

The rating agencies have often complained that companies are less likely to share the confidential information with them if they in turn make it public. If a company fails to disclose or discuss material areas of risk, or allow the rating agency to make that assessment on relative materiality, then the NRSRO should feel compelled to at the very least withdraw its ratings. In some cases, it may be more appropriate to even downgrade the company. If the rating agencies had taken a strong stand earlier with Enron to provide more detailed disclosure in the ratings review process, Enron might not have been so aggressive in continuing the shell game of off balance sheet contingent liabilities.

The parties most likely to possess the sensitive information that the agencies would be after are the commercial banks and underwriters on debt securities. We do not need to revisit the inherent concerns over Wall Street objectivity, but we would add that satisfying basic due diligence requirements on underwriting is a different mission than the rating agencies. The commercial banks/underwriters also often have more than a fee to be generated in these transactions. In many cases, the underwriting itself is a risk-mitigating transaction to the extent that a bond transaction is used to take down bank lines. We saw that repeatedly in the Enron transactions and most dramatically in the case of the credit linked notes. In addition, the ancillary fees on derivatives are often very lucrative so disclosure that jeopardizes the execution of the bond deal is not foremost on the priority list.

4. The rating agencies should report to the SEC any material risks that appear to be inadequately addressed in the public disclosure.

While knowledge of wrongdoing requires that the SEC be notified, the more common issue is the quality of disclosure on material risks. The NRSROs right now are exempt from Reg FD, but if they were given an additional mandate they could prove to be a very effective early warning system for the SEC's ongoing goals of improving the quality of disclosure. This is not an enforcement or watchdog role at all. It would be a natural offshoot of the NRSROs overriding mission to monitor the risks of securities and issuers that they have been paid handsomely to rate. Situations of this nature are likely to be few, but it would provide some guidance to SEC personnel who routinely review registration materials as part of the normal course of business. For example, Qwest currently has a shelf registration under review with the SEC. Qwest also has met frequently with the rating agencies and is on watchlist for downgrade by Moody's. It would be a very simple exercise for the rating agencies to send commentary to the SEC on what they have learned in their reviews or what would be useful disclosure for the marketplace. It does not involve additional staffing per se, and is a logical extension of their routine activities. If such actions were taken very early in the game on Enron, they may have been less likely to have kept replaying the SPE technique and making such liberal use of ratings triggers. Enron did not even disclose its bank lines in those days, and the requirement to disclose bank line details may have also raised earlier alarms.

5. The NRSROs should more frequently weigh on the analytical significance of various accounting quality issues.

Accounting quality has been an overriding concern in the aftermath of the Enron debacle and it is likely to remain so. The rating agencies have been notably quiet on the specifics of the accounting issues even though the debates have raged on some topics for long before the Enron problem. The use of fiber swaps and questions over the quality of revenue growth in the telecommunication sector had been in the headlines for months before Enron began to melt down. Similarly, the distortions associated with merger accounting and restructuring charges at Tyco International led to an SEC enforcement review back in 1999-2000 and Tyco has recently had another bout of accounting questions driving heightened volatility. The rating agencies regularly cite the fact that they are not audits, but the fact is that an evaluation of the quality of the accounting is required to make sound risk assessment, and if they do not comment on the small number of very pressing accounting issues then the quality of the ratings will be called into question. In our dialogue with some ratings agency professionals they are quick to point out that they are not accountants. We agree with that narrow view, but would add that their mandate should include commentary on the quality of the numbers they use for their inputs. Otherwise, the quality of the outputs, i.e. the ratings, will be called into question. Hiring qualified staff to address the SEC issues is minor expenditure. Wall Street firms routinely hire accounting experts in their research departments, and there is no reason why the rating agencies are not commenting on such very important issues from their more objective platform.

6. Institute an appropriate registration and certification program for senior ratings agency analysts that have decision-making power on the ratings of securities and companies.

The rating agencies have less rigorous requirements for skill development and continuing education requirements than Certified Public Accountants, Certified Financial Planners, Insurance Agents, and Wall Street debt and equity analysts. There is ample room to require a level of commitment to quality standards and training that will help assure a proper level of focus on new market developments in accounting, financial risk, taxation, and the securities markets. The testing and continuing education could be specific to the broader category of responsibility so a structured products and quantitative research analyst is not looking at municipals or an industrials corporate ratings analyst is not expected to be a derivatives specialist. The CPA, insurance, and financial planners accreditation process lends itself to the subject-specific modular approach to certification and training. In the brokerage industry, the registered representative process is not an appropriate parallel, but the Supervisory Analysts testing process (Series 16) is a useful parallel. For practical purposes, testing and accreditation is a straightforward process one test content has been designed, and the firms pay the testing center for the costs of the examination. In the case of the Series 16 exam, the analytical part of the test can be waived in the event that Level I (of a three-part test) of the Chartered Financial Examination has been passed. This requirement would not be onerous or new, it would be at least consistent with a range of comparable disciplines that require testing, and would

be a step in the right direction in terms of quality control. Tens of thousands of analysts take the CFA exam every year, so the exam taking exercise is not onerous of new. It just may be to many at the NRSROs. Formalizing a process for an examination and certification would not be costly or without ample justification and parallels in the marketplace.

ENRON AND THE RATING AGENCIES

The agencies failed to use their leverage to extract crucial information

As we look back at the performance of the rating agencies in the case of Enron, we are hard pressed to recall a situation where the ratings agencies held so much sway over a company and had such commanding leverage to extract information, and yet were so ineffective at doing so. We were most troubled by the unwillingness of the rating agencies to detail the most important questions that needed to be addressed by Enron, and to clarify for investors exactly what questions the company would or would not address. The fact that Enron came out of various meetings with the rating agencies with its investment grade ratings intact led many investors to believe that many of the crucial questions were addressed. The problem in making this assumption is that the rating agencies only discuss in very general terms the issues that are dealt with and use the "confidentiality" of the issuer relationship as the rationale for not fully disclosing the questions that were satisfactorily answered.

The Enron fiasco has raised a considerable number of questions about the efficacy of the ratings system in flagging potential crisis situations that do not fit as neatly into the traditional analytical framework due to excessive financial engineering, poor disclosure, abuse of the current accounting system, or outright fraud. While it is hard to protect against management teams engaging in fraud, there are many cases where the areas of risk are clear, and the rating agencies are in a position to extract crucial material information on major areas of risk that may not have been made available to investors broadly. The rating agencies' exemption from Reg FD gives them a platform to be demanding of issuers and highlight areas that may be specific to a given issuer or industry and not effectively captured by GAAP requirement or by the often sweeping, general disclosure requirements of the SEC. Often the 10-Q and 10K disclosure gives management considerable latitude to make their own judgment on the level of detail and a threshold of materiality

Critical gaps in the agency commentary on Enron

We would point to a number of areas where the rating agencies failed miserably to highlight and address the risks that were critical to the direction of Enron's credit quality once it became clear that there were some serious problems at Enron. Much of the focus has been placed on the off-balance-sheet partnerships and the wholly inadequate disclosure there and questionable representations on the issue by Enron management. Beyond these areas, however, there are some other key factors that were inadequately addressed by the rating agencies in the weeks after the initial announcement of third quarter earnings on October 16th.

1. **Ratings triggers**- the rating agencies have indicated that one of the lessons from Enron was the need to explore more rigorously the existence of ratings triggers in any company's financing arrangements. Ratings triggers are ratings-based tests that "trigger" puts, the termination of a contract, or revised pricing and structure. They can run the gamut in terms of impact from fatal to modestly restrictive. The information that has come out of the agencies to date on the topic has not been satisfactory, and the fact that ratings triggers were not an integral part of the ratings review process to begin with is disturbing in itself. These were questions raised frequently in the days after Enron released third quarter earnings, and the rating agencies contributed very little to the dialogue on the subject. Even after meeting with Enron on their reviews, the agencies did not discuss the specifics of the questions posed to management. **We would highlight that this also has the impact of creating a very unlevel playing field in information flows since the counterparties on the "trigger" are usually the commercial banks and brokerage houses that are aware of the existence of such structural risks.** They could accordingly make risk management decisions that affect credit availability for Enron while holders of debt and equities remained unaware of such risks. More probing by the rating agencies and open discussion of what questions the agencies were asking would have made it clear to the market that the right issues were being addressed in the rating reviews.
2. **Counterparty credit line availability**- The collapse of Enron has been described frequently now as a run on the bank, and one aspect of the financial crisis that still

has not been very transparent is the extent to which tightening counterparty lines caused the liquidity crisis to accelerate. While we know it to be the case that tighter credit conditions and structural risks in existing contracts required collateral posting and even some contracts to be closed out, the pace and the timing remains unclear. Enron made repeated statements that trading volumes were holding up and that "notional" volumes were strong. The rating agencies added very little to the dialogue here as well, even in simply clarifying the risks that typify such derivative intensive operations. The analytical framework for such exposure is out of the traditional realm of a utility analyst, but there are few organizations outside the brokerage and commercial banking sector that rival the qualifications of the NRSROs in assessing such risks. To the extent that the Enron analyst could not handle the topic, the relevant rating committee should have drawn upon their structured product specialists to aid in such a crisis and bring the quality of the risk assessments to a higher level. There is a well established approach to evaluating theoretical credit lines and mark-to-market exposure by counterparty. It is an integral part of risk management practices in banking and brokerage and Enron was a very sophisticated trading operation. The agencies could have just requested the list of credit exposure to assess both current mark to market exposure by counterparty and any additional analysis that Enron had on maximum potential exposure. Failure of Enron to provide such schedules would have been a red flag but also ample reason to downgrade the company on a more expedited basis.

3. **Off-balance-sheet partnerships**- much is made of what Enron failed to disclose, but Enron also had ample disclosure in the market on the two structured deals that largely were responsible for driving Enron into bankruptcy. The Marlin and Osprey trusts had been major deals that had been rated by the agencies, had transparency in terms of the rating triggers, and had financial disclosure which, though out of date, gave the agencies room to focus on the cash flows and asset protection afforded creditors. Bondholders at those entities would have benefited from a more intensive review of the performance of those units since any shortfall in asset coverage would have fallen on Enron in the event of a downgrade below investment grade. There was also a need to have more detail on the asset sale prospects to reduce debt at these units and that aspect of the credit analysis was being stonewalled by management on conference calls.

It is not the speed ratings move; it is the quality of information

The rating agencies have responded to the Enron criticism by speeding up rating reviews, moving faster to downgrade companies, and by looking more closely at market data to gain more insight into market access and the risks to a company's financial flexibility. The quality and depth of the analysis has not changed noticeably, however, and the move to speed up ratings changes has met a mixed response from the market. Wholesale downgrades coming off a year of record issuance is creating a higher level of volatility since the response appears to be more a byproduct of the damaging criticism than a function of a coherent set of consistent policies. Investment grade credits historically have not been very volatile, and many investors would have purchased securities with a

sense of traditional rating agency behavior. As a result, watchlisting and downgrading securities in only a matter of weeks after a new issue has caused some degree of confusion in the marketplace. The time to take action would be prior to the new issues and not right after the new issue. There is a sense in the market that the rating agencies have gone trigger happy to overcompensate for Enron, and have in effect changed the rule of the game after collecting their record ratings fees in 2001.

ECONOMICS OF THE CREDIT RATINGS INDUSTRY

The credit ratings industry is one of the most lucrative in the financial services or the media sector based on massive profit margins and sustainable growth

Any attempt to put in effect policy initiatives that place greater demands on the NRSROs are certainly reasonable when one looks at the economics of the rating agency industry and considers the enormous financial benefits that have been bestowed upon them by the NRSRO designation. If the word "regulation" in general tends to connote the "carrot and stick," it is clear from the financial performance of the ratings industry that a bushel of carrots have already been awarded to the NRSROs by the regulatory framework and that the use of more "stick" is more than fair. The stick can be more regulatory accountability and a requirement to substantially enhance the quality, quantity, and depth of information that they convey to the marketplace. The rating agency industry is one of the few private sector industries that provide a revenue stream where volume growth is almost guaranteed by a combination of regulatory fiat, the growth and convergence of the fixed income market, and the proliferation of structured products that require NRSRO ratings.

As of now, the economics of their business is heavily weighted toward fees that are paid to the agencies for "rating" companies, structured products, and a range of securities in different asset classes. **By deduction, that means that a disproportionately small portion of the NRSROs revenues are generated by published products and follow-on maintenance research that brings information to institutional investors and the investing public.** Subscription revenues are not crucial to the profitability of the rating agencies. That creates a certain irony in that companies that are in trouble and, by definition, are less likely to be issuing securities due to lack of market access, provide the lowest near term rewards for the rating agencies. It is also those companies that require the most focus.

Moody's provides a window into the profitability of the ratings industry

Currently there are three main general purpose NRSROs that are major factors in the marketplace, but only Moody's is a standalone public company (stock ticker MCO) with detailed financial disclosure. S&P is a division of McGraw Hill and Fitch, the #3 rating agency, is a subsidiary of FIMILAC, a French conglomerate that also operates in such businesses as hand tools and garage equipment. The financial performance of Moody's is very revealing about the relative profitability of the credit ratings business. Moody's is currently generating revenues at an annualized run rate of $884 million based on the most recent results from the December 2001 quarter. Moody's posted operating profit margins (operating income as a % of revenues) in excess of 50% and generated net margins (net income as a % of revenues) of 26.6%. To put those margins in perspective, General

Motors has had a long-standing goal of achieving 5% net margins. Moody's margins have trended higher over the past 5 years and, at the current run rate, revenues and net income have almost doubled. Moody's common stock has a market value of approximately $6.3 billion and the company and had net debt (debt minus cash) of only $125 million at the most recently available balance sheet.

Rapid and profitable recession-resistant growth has been reflected in the company's stock performance and has even drawn the interest of Warren Buffet, who has reportedly accumulated a 15% stake in Moody's. Moody's stock has substantially outperformed the market both recently and over longer time horizons. The company is generating enough cash that it accomplished one $300 million share buyback and has announced another $300 million. We cite Moody's extraordinary financial results not to recommend the stock, but to highlight the benefits of limited competition and strong demand for ratings services. This sets a backdrop for the debates on what type of additional demands can be placed on the NRSROs and their ability to add additional value to the information flows into the markets.

An interesting aspect of Moody's results is that "ratings revenue" comprises 87% of revenues during 2001 while "other revenues" such as risk management services and selling research, only comprised 13% of the company's total revenues. The driver of the company's profitability is ratings and not the rigors of providing high quality, detailed research on issuers and industries. That has raised questions over time on the quality and depth of the monitoring mechanisms that the rating agencies have in place to provide

ongoing critical analysis of issuers since, quite frankly, that is not where they make their money and that is not what drives the company's stock.

Barriers to entry in the ratings agency business are high and getting higher

There have been many arguments made that the NRSRO designation in itself has created an insurmountable barrier to entry by limiting the number of NRSRO's. In theory, the type of profit margins evidenced here would draw market entrants, but the assumption is that the regulatory framework prevents that from happening. We believe that assumption may not fully reflect the reality of the rating agency business since the consolidation within the existing group of NRSROs has significantly narrowed the field. Fitch, which had formerly been a rather distant #3, has closed the gap in recent years by merging with IBCA (1997) and later acquiring Duff & Phelps and Thomson Bankwatch in 2000. We would point out that Fitch, while offering a range of solid products and achieving certain strengths in key sectors such as financial service institutions and structured product, still face a major task in competing with Moody's and S&P. The consolidation of the NRSRO industry reflects a great deal of competitive pressure from Moody's and S&P in penetrating the market and being embraced by mainstream institutional investors in the dominant US market.

While many risk guidelines are structured around the ratings from NRSRO, a great majority of formal and informal guidelines specifically cite Moody's and S&P. This is especially true in ratings triggers in derivative contracts and bank lines. It accordingly is an especially daunting task for new entrants to gain the traction to compete in the

NRSRO business. Even if the status of NRSRO was abolished tomorrow, most governing parameters in fixed income asset management specifically cite the agencies by name.

Strong demand growth is driven by regulatory requirements, firmly established and structurally imbedded portfolio risk parameters, and market practice

Ratings are essentially a requirement for market access, and the failure to gain ratings is costly and in fact would specifically preclude a borrower from reaching the largest pools of investment funds. The economics of issuance would be impaired and secondary liquidity characteristics of the securities would be poor. The ratings requirement spans the yield curve from commercial paper to long terms bonds. For example, prime money market funds are governed by SEC Rule 2a-7, which limits the percentage of assets with ratings below A-1/P-1. Such rules can have a dramatic effect on short term credit availability, and the stakes are even higher when a company loses A-2/P-2 ratings and gets effectively shut out of the commercial paper market. Losing access to the commercial paper market also has a great deal of significance for the risk profile of the banks that have provided back-up lines. We have seen a considerable amount of pressure on lenders such as JP Morgan Chase in connection with such lines being drawn down.

Capital adequacy assessments are also becoming more heavily influenced by NRSRO ratings. In the insurance sector, the NAIC also piggybacks the NRSRO system even though the NAIC does have its own rating system. For global commercial banks, the BIS has proposed the use of external ratings in assessing capital adequacy and this proposal is

still under consideration. Mutual fund prospectuses are often tied to strict NRSRO parameters or explicitly S&P and Moody's by name. It has been a challenge for other NRSROs to get these terms amended to be more inclusive specifically of the smaller NRSROs. As more fixed income products and fund offerings proliferate, the barriers to effective entry by other NRSROs become even greater given the frequency with which the established NRSROs have the names of their firms structurally imbedded in the stated risk parameters of the funds.

NRSROs are now moving into new high margin business lines

The recent acquisition of KMV, a provider of quantitative default risk models, by Moody's for $210 million highlights that there are many new business opportunities for expansion outside the traditional ratings business. The offering of risk management products and services for a substantial fee raises some interesting question that have some parallel to the accounting versus consulting dilemma of the CPA firms. If the rating agencies start to move into the areas of risk management and advisory services, the primary clients will be the commercial bank, brokerage and insurance industry, originators of structured debt products such as collateralized debt obligations. These clients are also highly sensitive to their credit and claim-paying ratings. It will be critical for the SEC to monitor how these services are delivered to make sure that there is not even the hint of conflicts of interest. The rating agencies would be in a position to use some negotiating leverage on issuers that are sensitive to ratings but also have a need for risk management services.

Testimony of Steven L. Schwarcz before the United States Senate Committee on Governmental Affairs, March 20, 2002

I am Professor of Law at Duke University School of Law, Founding Director of Duke's interdisciplinary Global Capital Markets Center, and Adjunct Professor of Business Administration at Duke's Fuqua School of Business. My testimony will be centered around my law review article, *Private Ordering of Public Markets: The Rating Agency Paradox*, imminently forthcoming in the UNIVERSITY OF ILLINOIS LAW REVIEW (Issue #1, 2002). I have attached a final draft of this article to my testimony.

My testimony focuses on whether rating agencies should remain unregulated and, if not, whether it is feasible for individual nations to regulate multinational entities of this type.[1] My testimony does not address non-regulatory issues, such as whether ratings are superior to credit spreads and other rating alternatives as a means of assessing an investment's safety – although it does later suggest an approach by which such alternative approaches could be tested.

I. Introduction

A. The Problem: Investors in domestic and cross-border financial transactions increasingly rely on rating agencies for substantial comfort regarding the risks associated with the full and timely payment of debt securities. Rating agencies, however, are private companies that are not substantively regulated by the United States or any other major financial-center-nation.[2]

---

[1] I further focus on regulation via the administrative system of direct public control. For an analysis of enforcing private tort rights against rating agencies, *see* Gregory Husisian, Note, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411 (1990). Although Mr. Husisian concludes that the private tort system should not be expanded beyond its limited existing state, his rationale – that such expansion would induce rating agencies to create costly "paper trails" that would not produce a better product – does not necessarily apply with the same force to direct public control.

[2] Several non-financial center nations in Latin America (Argentina, Bolivia, Uruguay, Mexico, Paraguay, Chile and Peru) and East Asia (Malaysia, Korea, Taiwan) do, however, regulate the ratings industry through structural requirements, such as capitalization thresholds, employee experience and integrity requirements, and through rating methodology directives. For example, in Argentina and Chile, regulators require rating agencies to submit rating methodology and criteria to a regulatory body for approval, and have established official bodies that oversee and approve ratings. Korea regulates entrance procedures for new rating agencies by imposing capitalization and employee qualification requirements. Taiwan requires rating agencies to partner with an internationally recognized rating agency, and also imposes standards similar to those in Latin America as well as overseeing agency structure by approving its corporate documents (such as the articles of incorporation and corporate bylaws) and any changes thereto. India requires that rating agency applications be endorsed by reputable parties in the financial community, and that agencies must renew their applications every three years. It also imposes a net capital worth threshold, limits the agency's business to credit ratings, and requires that no employee be convicted of any transgression involving moral turpitude or any economic offense.

Several major financial-center nations, however, impose a minimal form of governmental control by giving official recognition to rating agencies that meet certain criteria. This is exemplified in the U.S. by the NRSRO designation. As you know, if a rating agency is designated an NRSRO, its ratings can be used to satisfy rating requirements established by government agencies like the SEC in certain federal regulatory schemes.

Today's hearing is being held largely because of the failure of the rating agencies to predict the Enron melt-down. In this context, I should note that rating agencies have always made their rating determinations based primarily on information provided by the issuer of securities; thus a rating is no more reliable than that information. Ratings also do not cover the risk of fraud. To the extent Enron provided the rating agencies with insufficient or fraudulent information, that would explain their failure to predict Enron's demise.

II. Analysis

The normative rationale for regulation, in an economic context where health and safety are not at issue, is fostering improvements judged in efficiency terms. There are two ways that regulation could improve rating agency efficiency: by making rating agencies perform better the tasks they already do well, or by limiting the negative consequences of their actions. I consider each in turn.

In making this inquiry, it must be cautioned that regulation itself poses intrinsic costs that can offset any efficiency gain.

A. Regulation to Improve Performance: Rating agencies improve the efficiency of securities markets by acting as informational intermediaries between issuers and investors in order to increase the transparency of securities and thereby reduce the information asymmetry. This is especially valuable where individual investors face high costs relative to their investment in assessing the creditworthiness of an issuer's securities. A relatively small number of rating agencies can make this assessment on behalf of many individual investors, thereby achieving an economy of scale. Government regulation could increase this efficiency only by reducing overall costs or by improving ratings reliability.

Presently, there is little reason to believe that rating agency costs are excessive. The fee charged by a rating agency typically is market-driven and varies according to the size and complexity of the transaction being rated. Even if rating agency costs were considered excessive, however, government regulation rarely reduces costs and includes costs of its own, such as the public sector need to administer the regulation and the private sector need to retain counsel to advise on compliance with the regulation.

Likewise, there is little reason to believe that increased regulation will improve the reliability of ratings. Rating agencies have had a remarkable track record of success in their ratings, and recent rating experience is even more reliable:

> In 20 years only one company with an investment-grade rating from Moody's has defaulted on long-term debt -- Manville, a single-A company that went bankrupt voluntarily to protect itself from asbestosis lawsuits. A New Zealand finance company, DFC, defaulted on its commercial paper in 1989 while still carrying a prime rating by S&P. The agency says it relied on a government commitment to provide liquidity, but

the government reneged.[3]

Because most studies only appear to take into account defaults on debt that is highly rated at the time of default, they do not necessarily address ratings stability. However, a recent internal analysis by Standard & Poor's, using information extracted from its proprietary database on 9,169 companies with rated debt, confirms the stability of investment grade ratings, finding for example that "all 'A' rated companies at the beginning of a given year would have an 87.94% chance of maintaining that same rating by year end."[4]

I agree that Enron is a very visible and dramatic exception to these data. But statistically, the failure to predict Enron's demise does not materially change these data. And, to the extent such failure resulted from Enron providing the rating agencies with insufficient or fraudulent information, the failure is truly an anomaly.

The reliability of ratings can be explained by reputational costs: the profitability of rating agencies is directly dependent on their reputations. Inaccurate ratings will impair, if not destroy, a rating agency's reputation. Thus, rating agencies should want to continue to provide accurate ratings, whether or not there is regulation. Regulation, on the other hand, could impair the reliability of ratings by increasing the potential for political manipulation, and by diminishing the importance of reputational costs as would occur, for example, if regulation were based on considerations other than ultimate ratings reliability.

Consequently, government regulation would neither reduce costs nor improve reliability. I therefore turn to the question of whether regulation would limit the negative consequences of rating agency actions.

B. Regulation to Limit Negative Consequences: There are various negatives associated with rating agency actions. First is the perception that rating agencies are not accountable because they are not officially subject to public scrutiny. This would be problematic if, as a result, rating agencies misbehaved or generally issued inaccurate ratings. As the foregoing discussion has shown, however, the lack of official public scrutiny does not appear to affect ratings accuracy because of the de facto accountability of rating agencies through reputation. The failure to predict Enron does not appear to represent a generalized failure of the rating process.

A second potential negative is the conflict of interest inherent in the way that rating agencies are paid. Rating agencies are virtually always paid their fee by the issuer of securities applying for the rating. This raises the possibility that the issuer will use, or the rating agency will perceive, monetary pressure to improve the rating. There nonetheless appears to be little alternative to this arrangement because one rarely can know in advance which investors will purchase a given issuance of securities, and even if one did it would be difficult to persuade those investors to pay their pro rata portion of the rating agency fee directly. The issuer therefore may be the only

---

[3] *Credit-Rating Agencies: Beyond the Second Opinion*, ECONOMIST, Mar. 30, 1991, at 80.
[4] Leo Brand & Reza Bahar, *Corporate Defaults: Will Things Get Worse Before They Get Better*, S&P CREDITWEEK, Jan. 31, 2001, at 15, 27 (also available at http://www.standardandpoors.com/Forum/RatingsCommentaries/CorporateFinance/index.html) (setting forth, *id.* at 23, a table of average one-year transition rates, showing for each initial rating from AAA down to CCC the likelihood that the rating will change during a year).

party realistically capable of paying the rating agency's fee in all situations.

This does not, however, eliminate the potential conflict of interest. Markets are not perfect, and the fact of the issuer's control over paying the fee might tempt it to strategically bargain for a higher rating in any event. In theory, a regulation could require investors to pay this fee, or could require an issuer to pay the fee irrespective of the rating ultimately assigned. Regulation, however, is costly, and the custom already exists that issuers are required to pay rating agency fees irrespective of the rating ultimately assigned. The amount of the fee is also independent of the rating. Coupling this with the fact that reputational costs help to ensure the objectivity and independence of the ratings decision, the aforesaid conflict of interest does not appear to cause any negative consequences.[5]

In summary, then, regulation would neither limit the negative consequences of rating agency action nor improve rating agency performance. There therefore appears to be little theoretical justification for such regulation generally.

As discussed, however, States that make the applicability of their laws turn on a rating often utilize NRSRO designation as a minimal form of regulation. *Whether the applicability of law should turn on a rating is beyond the scope of my testimony.*[6] Nonetheless, so long as the applicability of law *does* turn on ratings, some form of regulatory approval of rating agencies would appear appropriate. In this context, I next examine the appropriateness of NRSRO designation as a regulatory methodology.

C. NRSRO Approach to Regulation: As shown above, regulation is not generally needed to improve rating agency efficiency. And, indeed, the purpose of NRSRO designation does not appear to be to improve efficiency *per se*. Such designation in fact has another purpose: to ensure that where the applicability of specific laws turns on a rating, the issuer of the rating – and thus the rating itself – is a reliable indicator of whether or not to apply those laws.

---

[5] A possible exception is Moody's allegedly issuing artificially low unsolicited ratings in private transactions. It is unclear, however, that unsolicited rating actually constitutes an abuse because whether such ratings are in fact artificially low is just suspicion. Furthermore, Moody's recently voluntarily instituted disclosure for certain unsolicited ratings, in recognition that market participants have shown an interest in knowing which ratings lack the issuer's participation and to help to dispel misconceptions, and increase the credibility and utility of its ratings in the capital markets. Reputational costs alone therefore have been sufficient, even in this context, to help correct rating agency misbehavior.

[6] In this context, however, I note that external credit ratings are increasingly being adopted in regulations worldwide. Although ratings have been employed most extensively by regulatory agencies in the United States, and to a lesser extent in Japan, there has been expanded use of ratings in Latin American and Asian emerging markets, and the Task Force on the Future of Capital Regulation of the Basel Committee on Banking Supervision has proposed using ratings to help determine sovereign and private sector risk weights in a revision of Basel capital requirements. British regulators use ratings to help decide how much capital securities firms should set aside against their bond holdings. Japan's finance ministry allows only highly rated borrowers to sell bonds to Japanese investors. *See* ADAMS, MATHIESON & SCHINASI, INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS 145 (International Monetary Fund survey, Sept. 1999).

This suggests that NRSRO designation must be analyzed in the context of those specific laws. The analysis is simplified, however, by the fact that there appears to be only one category of laws whose applicability turns, or should turn, on a rating: securities laws. This intuitively follows because the purpose of ratings is to assess the risks associated with the payment of *securities*. Conceptually this follows because rating agencies perform the same function as securities law – reducing the information asymmetry between issuers of and investors in securities. NRSRO designation is therefore a component of securities law and should be analyzed in that context.

NRSRO designation at first appears to be a theoretically unusual approach to securities law. In the U.S., for example, the historical debate regarding enactment of securities laws focused on whether those laws should provide for full disclosure or, instead, governmental merit analysis. The consensus was that federal securities laws should not establish a system of merit regulation because investors' ability to make their own evaluations of available investments through the federal regulatory framework of full disclosure obviates any need that some observers may perceive for the more costly and time-consuming governmental merit analysis of the securities being offered.

NRSRO designation, however, constitutes an indirect form of merit regulation of securities. This is because the designation itself, which controls whether or not securities law exemptions become available, is based on governmental merit analysis of the rating agencies. Nonetheless, this form of merit analysis may be superior to full disclosure. The historical rationale for full disclosure – that investors' ability to make their own evaluations of available investments obviates the need for costly and time-consuming merit analysis – is not always applicable. In the case of evolving and complex debt structures, for example, the cost of each investor individually evaluating his or her investment would be excessive. Rating agency evaluation, in contrast, provides an economy of scale.[7] Furthermore, at least as presently performed, the minimal merit analysis needed for NRSRO designation is neither costly nor time-consuming. Thus NRSRO designation, even though a form of merit regulation, may well be appropriate.[8]

---

[7]Ratings thus would be viewed as a de facto substitute for full disclosure to the extent that investors rely on ratings in lieu of disclosed information. Whether this shift in reliance is justified, however, is beyond the scope of my testimony. *Cf.* Revisions to Rules Regulating Money Market Funds, Investment Company Act of 1940 Release Nos. 33-6882; IC-18005, 56 Fed. Reg. 8113 (Feb. 27, 1991) (indicating that investors should not use ratings as a substitute for making informed judgments based on disclosure). Opponents of the shift may argue, for example, that ratings do not cover fraud risks, that rating agencies rely only on information provided by the issuer, and that the integrity and reliability provided by independent professionals such as investment banks and attorneys are discounted where investors read the offering papers less carefully or completely.

[8] This view is supported by commercial law theory. In contrast to the traditional approach of the past two centuries (referred to as transactional regulation) in which public agencies have assumed responsibility for the oversight and direct regulation of the conduct of private parties, a system of commercial law only should require the State to establish the minimal structure necessary to create private institutions that will then operate under market incentives to allocate public resources (an approach known as organizational regulation). The rationale for favoring organizational over transactional regulation derives from actual experience. Organizational

The remaining question is how to balance the protection provided by the NRSRO-designation with the goal of ensuring that a sufficient number of rating agencies receive such designation to assure competition. In this context, it has been proposed that NRSRO-designation be awarded to some foreign recognized rating agencies, as well as to arms' length subsidiaries of domestic firms active in evaluating the business and securities of companies.[9] There should be relatively little risk if these entities are well-capitalized, have reputations for "quality financial analysis in the investment community," and have acceptable business plans to rate securities.[10] Consideration might even be given, for example, to firms that utilize alternative rating approaches, such as credit spreads and stock-price volatility.[11] The risk could be further minimized by making any *de novo* applicant's NRSRO-status provisional for some trial period.[12] In this way, the potential anti-competitive effect of NRSRO designation can, consistent with the integrity of such designation, be reduced. Reducing the anti-competitive effect also would mitigate any theoretical concern that rating agencies will engage in cartel behavior (although the prevalence of split ratings is evidence against present cartel behavior), such as by giving unnecessarily negative ratings or extracting oligopoly profits.

D. Multinational Considerations: My analysis has so far indicated that additional regulation of rating agencies is unnecessary and probably inefficient. This view is reinforced by the fact that rating agencies are multinational entities whose assets are human capital. As such, a rating agency subject to excessive regulation would be more likely than an ordinary multinational company to relocate to a foreign country that does not impose such regulation, assuming the country has the educational infrastructure to supply the ongoing need for analysts.[13] This in turn

---

regulation produces rules that are optimal in light of the costs of the rules because it relies on simple commitment mechanisms, such as reputation. Transactional regulation, however, does a particularly poor job of achieving optimal legal complexity because protecting the legitimacy of the State, not efficiency, is its primary goal. Thus, it treats as absolute the value of the rights at stake while largely ignoring costs. In the commercial context of rating securities, the State's legitimacy is not at issue and the rights at stake need not be treated as absolute. Accordingly, the NRSRO-designation derives its normative authority from being a form of organizational regulation.

[9] Letter from Antitrust Division of the U.S. Department of Justice to the SEC 3 (Mar. 6, 1998) (commenting on the SEC's proposed amendments to Rule 15c3-1 regarding NRSRO designation; and listing investment and commercial banks, insurance companies, and accounting and consulting firms as examples of the types of firms active in evaluating companies' business and securities).

[10] *Id.*

[11] *Compare* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 658 (1999) (arguing that credit spreads are superior to traditional ratings) *with* ADAMS, MATHIESON & SCHINASI, INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS, at 141-43 (arguing that "[r]atings are clearly more stable than market spreads," while both provide the same degree of imperfect foresight). *See also* Jia He, Wenwei Hu, & Larry H.P. Lang, *Credit Spread Curves and Credit Ratings* (forthcoming 2000) (available at http://papers.ssrn.com/paper.taf?abstract_id=224393).

[12] Letter from Antitrust Division to the SEC, *supra* at 3 (proposing a 12-18 month trial period).

[13] Of course, the flexibility to relocate would be less in such dominant markets as the United States, especially to the extent the rating agency desires to continue to have its ratings qualify

might lead to a race to the bottom, in which countries compete to reduce their level of regulation in order to attract rating agencies that wish to relocate. Reputational considerations might mitigate relocation to the extent that a rating agency prefers to comply with the regulation as an additional means of signalling to the market its reliability; but ultimately a rating agency would have to balance the cost of such compliance with the costs of relocating, including any perceived loss of reputation.

A possible solution to this dilemma is to impose regulation on a global scale. However international regulation of rating agencies, like any other form of global regulation, would be inherently costly if not impractical in our primitive system of international law.

Even minimal international regulation, by analogy to the NRSRO-designation, appears unnecessary. A limitation of such a designation is that it is national, not international. Inconsistent designation criteria among countries therefore might create confusion for cross-border financings, which have become increasingly common, and also could create the potential for inconsistent application of bank capital adequacy standards. One therefore may ask whether there should be a *globally* recognized statistical rating organization (perhaps called GRSRO) designation.

I do not believe that global designation is necessary, or that inconsistent NRSRO designations are likely to give rise to confusion. In a given transaction, the only relevant NRSRO designation would be that of the country where the applicable securities are issued. Thus, in a cross-border securitization transaction where, for example, a company in State X sells receivables to an SPV in State Y which in turn obtains financing by issuing securities through an SPV in State Z, only State Z's NRSRO designation would be relevant. There is little room for confusion.

On the other hand, GRSRO designation procedures, even if practical, would be costly because of the political maneuvering needed to achieve international consensus as well as the need to conform national securities laws that presently rely on NRSRO designation to the new designation procedure. Furthermore, a single GRSRO designation might exacerbate the anti-competitive effect of national designation by diminishing the ability of local rating agencies to germinate and grow.

---

for the NRSRO securities law exemptions. Furthermore, a State could attempt to indirectly regulate foreign rating agencies that assign ratings to securities issued in its jurisdiction by directing enforcement at the issuer located in the State, much like a State can tax interest income paid to a foreign lender by requiring a domestic borrower to withhold a portion of the interest payable and turn it over to the State as a withholding tax.

12/06/01draft, forthcoming UNIVERSITY OF ILLINOIS LAW REVIEW (Issue #1, 2002)

PRIVATE ORDERING OF PUBLIC MARKETS: THE RATING AGENCY PARADOX [1]

Steven L. Schwarcz [2]

"The United States can destroy you by dropping bombs, and [rating agencies] can destroy you by downgrading your bonds."[3]

Rating agencies "have the power to destabilize whole national economies, municipal governments, major corporations."[4]

I. Introduction
A. The Problem
B. The Role of Rating Agencies
II. Analysis
A. Regulation to Improve Performance
B. Regulation to Limit Negative Consequences
C. NRSRO Approach to Regulation
D. Multinational Considerations
III. Conclusion

---

[1]Copyright © 2002 by Steven L. Schwarcz.

[2] Professor of Law, Duke Law School; Faculty Director, Duke Global Capital Markets Center; Professor of Business Administration, Fuqua School of Business (by courtesy). E-mail: schwarcz@law.duke.edu. I thank Rita M. Bolger, Francis A. Bottini, James Boyle, Petrina R. Dawson, Kumar Kanthan, Robert Keohane, Kenneth C. Kettering, Frank Partnoy, Paul M. Shupack, and especially Howell E. Jackson, as well as participants in the University of Cambridge Conference on the Challenges Facing Financial Regulation, the Duke University Globalization, Equity, and Democratic Governance workshop series, and the Duke University Global Law & Policy Workshop, for helpful comments on drafts of this article. I also thank Adam Bender, Felipe Guzman, Jeremy Hilsman, Nam H. Le, and Katharine A. Schkloven for valuable research assistance. Finally, I dedicate this article to the memory of my dear friend and colleague, Herbert L. Bernstein.

[3]Thomas L. Friedman, *From Supercharged Financial Markets to Osama bin Laden, the Emerging Global Order Demands a New Enforcer. That's America's New Burden*, THE NEW YORK TIMES MAGAZINE 40, 43 (Mar. 28, 1999).

[4] Saskia Sassen, untitled and unpublished manuscript on the sociology of rating agencies 4 (June 1999) (on file with author) (hereinafter "Sassen, Rating Agencies").
-MB0018

Rating agencies profoundly impact the ordering of global financial markets. They are the universally feared gatekeepers for the issuance and trading of debt securities,[5] and recent proposals by the Basle Committee on Banking Supervision promise to further expand their role internationally. Yet they remain largely unregulated private entities. This article examines whether rating agencies should remain unregulated and, if not, whether it is feasible for individual nations to regulate multinational entities of this type.[6]

Moreover, rating agencies are members of the "new set of [largely, though not exclusively, private] intermediary strategic agents [that] have absorbed some of the international functions carried out by states in the recent past."[7] To this extent, they are representative of a growing trend toward private ordering of traditionally public functions.[8] This article's analysis thus will be shown to have implications for private

---

[5]*See, e.g., The Use and Abuse of Reputation*, ECONOMIST, Apr. 6, 1996, at 18 (noting "little irks companies and governments more than a visit from the man from Moody's" because rating agencies have "huge powers to move markets").

[6]In its largest sense, regulation can be divided into self-regulation and government regulation, and the latter can be further subdivided into the administrative system of direct public control and the judicially-enforced system of private rights. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 13.1, at 367 (4th ed. 1992). I focus on regulation via the administrative system of direct public control. For a thoughtful analysis of enforcing private tort rights against rating agencies, *see* Gregory Husisian, Note, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411 (1990). Although Mr. Husisian concludes that the private tort system should not be expanded beyond its limited existing state, his rationale – that such expansion would induce rating agencies to create costly "paper trails" that would not produce a better product – does not necessarily apply with the same force to direct public control.

[7] Saskia Sassen, De-Nationalized State Agendas and Privatized Norm-Making 9, 11 (2000) (unpublished manuscript, on file with author).

[8] *See also* Gillian Hadfield, Privatizing Commercial Law: Lessons from the Middle and the Digital Ages __ (Mar. 2000) (unpublished manuscript, on file with author; also available at <http://papers.ssrn.com/paper.taf?abstract_id=220252>) (discussing government reliance on private companies, such as TRUSTe and VeriSign Inc., to maintain guidelines, checkpoints and a responsive system to handle disputes surrounding Internet privacy and confidentiality issues; and also arguing that because private firms can develop new practices and adjust to changing environments more quickly than governmental bureaucracy, utilizing the private sector arguably both lowers public sector costs and increases the pace of industry expansion); Gillian E. Metzger, Privatization and the Constitution 2-4 (Oct. 13, 2000) (commenting that although "[p]rivatization of government is not new[,] … there is evidence of a recent turn towards even greater government privatization, and more importantly an expansion in the breadth of responsibility and discretion being delegated to private actors") (unpublished manuscript, on file with author). Even social scientists are beginning to study this trend. *See, e.g.*, Ronie Garcia-Johnson, Beyond Corporate

ordering by non-governmental organizations (NGOs) beyond rating agencies.[9]

I. Introduction

A. The Problem: Investors in domestic and cross-border financial transactions increasingly rely on rating agencies for substantial comfort regarding the risks associated with the full and timely payment of debt securities.[10] A rating agency's assessment of these risks may involve analyzing the structure of the transaction and any underlying collateral.[11] Rating agencies, however, are private companies.[12] They are not substantively regulated by the United States or any other major financial-center-nation.[13] Several of these nations, however, impose a minimal form of

---

Culture: Reputation, Rules, and the Role of Social and Environmental Certification Institutions 9 (Feb, 5, 2001) (unpublished manuscript, on file with author) (analyzing private certification institutions, and observing, *id.* at 3, that "such institutions have been relatively neglected by the social sciences"); Sassen, Rating Agencies, *supra* note XX.

[9] *See infra* notes XX-XX and accompanying text.

[10]Steven L. Schwarcz, *The Universal Language of Cross-Border Finance*, 8 DUKE J. COMP. & INT'L L. 235, 251-52 (1998) (hereinafter *Universal Language*).

[11] *Id.* Professor Sassen describes this assessment as "a complicated mixture of elements. Credit rating agencies ... have specialized in this mix of datums and interpretation. This is a strategic good under conditions of globalization where the number of datums and imponderables to be evaluated has grown enormously compared with close national economies." Sassen, Rating Agencies, *supra* note XX, at 6.

[12]*Universal Language, supra* note XX, at 251-52.

[13] Several non-financial center nations in Latin America (Argentina, Bolivia, Uruguay, Mexico, Paraguay, Chile and Peru) and East Asia (Malaysia, Korea, Taiwan) do, however, regulate the ratings industry through structural requirements, such as capitalization thresholds, employee experience and integrity requirements, and through rating methodology directives. *See* GLOBAL INDEX OF THE USES OF RATINGS IN REGULATIONS AND REGULATIONS AFFECTING RATING AGENCIES, *supra* note XX, at 6-17. For example, in Argentina and Chile, regulators require rating agencies to submit rating methodology and criteria to a regulatory body for approval, and have established official bodies that oversee and approve ratings. *See* GLOBAL INDEX OF THE USES OF RATINGS IN REGULATIONS AND REGULATIONS AFFECTING RATING AGENCIES, *supra* note XX, at 6-17 (referring to Decree 656, Private Debt Securities, Public Offering Regulation, Art. 6(h) (Apr. 28, 1992) (Argentina) and Ley No. 18,045, Article 76 (Chile)). Korea regulates entrance procedures for new rating agencies by imposing capitalization and employee qualification requirements. *See Proposals for Improving Credit Rating* (visited July 17, 2000) <http://www.mofe.go.kr/ENGLISH/Data/E_POLICY_ISSUE/eb_1010.html>

governmental control by giving official recognition to rating agencies that meet certain criteria.[14] Often, though, these criteria are vague or informal,[15] and the recognition is for limited purposes only.[16]

This is exemplified by U.S. law, which contemplates an informal process by which a rating agency can be designated as a nationally recognized statistical rating organization (NRSRO).[17] (I hereinafter will use the term "NRSRO designation"

(requiring rating agencies to employ at least thirty people, of which at least five must be certified public accountants and at least fifteen must have been educated at the Korea Stock Training Institute or at a professional training school; restricting principal shareholders of a rating agency from holding more than 10% of the agency's value; and limiting the agency's business to credit ratings). Taiwan requires rating agencies to partner with an internationally recognized rating agency, and also imposes standards similar to those in Latin America as well as overseeing agency structure by approving its corporate documents (such as the articles of incorporation and corporate bylaws) and any changes thereto. *See Rules Governing Administration of Credit Rating Agencies*, Ref. No. Taiwan-(86)-Finance-16981 (visited July 30, 2000) <http://www.selaw-e.com.tw/scripts/tornado/ShowLaw.asp?law=42>. India requires that rating agency applications be endorsed by reputable parties in the financial community, and that agencies must renew their applications every three years. It also imposes a net capital worth threshold, limits the agency's business to credit ratings, and requires that no employee be convicted of any transgression involving "moral turpitude or any economic offense." Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, S.O.547(E) (visited July 30, 2000) <http://www.sebi.gov.in/>.

[14]For example, Japan, France, Hong Kong, and the United States recognize certain rating agencies for specific legal purposes, but do not substantively regulate those agencies. *See* GLOBAL INDEX OF THE USES OF RATINGS IN REGULATIONS AND REGULATIONS AFFECTING RATING AGENCIES 22, 25, 36 (April 2000). *See also Progress in the Financial System Reform* <http://www.fsa.go.ip/p_mof/english/big-bang/ebb33.htm>(visited July 30, 2000) (describing the Japanese approach).

[15]*See* Amy K. Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies: Well-Placed Reliance or Free-Market Interference?*, 20 SETON HALL LEGIS. J. 293, 323 (1996).

[16]*See, e.g., infra* notes XX-XX and accompanying text (discussing the limited significance of the NRSRO designation in the United States). *See also* CHARLES ADAMS, DONALD J. MATHIESON & GARRY SCHINASI, INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS, PROSPECTS, AND KEY POLICY ISSUES 156-58 (International Monetary Fund survey, Sept. 1999)<http://www.imf.org/external/pubs/ft/icm/1999/index.htm> (visited Aug. 3, 2000) (summarizing the regulatory use of credit ratings in selected countries).

[17]*Universal Language, supra* note XX, at 251 n. 74. For a description of this process, *see* Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies: Well-Placed Reliance or Free-Market Interference?, supra* note XX, at 323.

generically to include any governmental approval of rating agencies, irrespective of the country in which the approval occurs.) If a rating agency is designated an NRSRO, its ratings can be used to satisfy rating requirements established by government agencies like the Securities and Exchange Commission (SEC) in certain federal regulatory schemes. For example, Rule 3a-7 of the Investment Company Act of 1940[18] exempts certain financings from registration and compliance with that Act if, among other requirements, the securities are rated "investment grade" by at least one NRSRO.[19] While there has been debate whether more regulation is necessary, and the SEC itself has called for comments on the NRSRO-designation,[20] some argue that market forces create sufficient checks on rating agencies.[21]

Because government reliance on ratings is swiftly expanding worldwide,[22]

---

[18]15 U.S.C. §§ 80a-1 to 80a-64 (West 1997 & Supp. 1998).

[19]*Id.* at § 80a-6(5)(A)(iv)(I). For examples of other laws that provide exemptions based on ratings, *see* Frank A. Bottini, Jr., *An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies*, 30 SAN DIEGO L. REV. 579, 603-608 (1993); ADAMS, MATHIESON & SCHINASI, INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS, *supra* note XX, at 154-55 (summarizing U.S. regulations that make use of credit ratings). *See also* Bankruptcy Reform Act of 2001, S. 220, 107th Cong. § 912 (2001) (proposing a "true sale" safe harbor for securitization transactions in which at least one class of securities is rated investment grade by an NRSRO when the securities are initially issued).

[20]In 1994, the SEC issued a request for comments on the use of the NRSRO designation in the context of Rule 3a-7. *See* Concept Release on Nationally Recognized Statistical Rating Organizations, SEC Release Nos. 33-7085; 34-34616, 59 Fed. Reg. 46,314 (Sept. 7, 1994). More recently, the SEC issued a proposed rule to amend the net capital rule by formally defining the term NRSRO, but no final rule has been issued to date. *See* Proposed Rule on Capital Requirements for Brokers or Dealers, Exchange Act Release No. 34,39457, 62 Fed. Reg. 68,018 (Dec. 30, 1997).

[21]*See generally* Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies: Well-Placed Reliance or Free-Market Interference?*, *supra* note XX; *Current Status of Rating Agencies*, *supra* note XX.

[22]*See* ADAMS, MATHIESON & SCHINASI, INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS, *supra* note XX, at 145 (noting that "[e]xternal credit ratings are increasingly being adopted in regulations worldwide") & 191 (noting that "[w]hile ratings have been employed most extensively by regulatory agencies in the United States, and to a lesser extent in Japan, there has been expanded use of ratings in Latin American and Asian emerging markets [and] the Task Force on the Future of Capital Regulation of the Basel Committee on Banking Supervision has proposed using ratings to help determine sovereign and private sector risk weights in a revision of Basel capital requirements"). S*ee also The Use and Abuse of Reputation, supra* note XX, at 18: "British regulators use ratings to help decide how much capital securities firms should set aside against their bond holdings. Japan's finance ministry allows only highly rated borrowers to sell bonds to Japanese investors."

this debate is likewise transcending national borders. Most notably, the Basel Committee on Banking Supervision, the "top global banking regulator,"[23] issued a June 1999 report – *A New Capital Adequacy Framework* [24] – proposing new capital adequacy guidelines for banks. The problem with existing guidelines, under which banks must set aside a percentage of their assets to cover the possibility of default, is that they do not differentiate the default risk of different loans.[25] The new proposal would allow banks in conjunction with supervisory authorities to calibrate this risk by using "external credit assessments [i.e., ratings] for determining risk weights."[26] More specifically, with regard to the risk weights applied to claims against sovereign nations, banks, non-central government public sector entities, securities firms, and corporations, the Basel Committee proposes replacing the existing capital adequacy approach with a system that would use rating agency ratings for determining risk weights.[27] Once approved, as expected, the Basel Committee's proposal is likely to be adopted by "most of the world's bank regulatory regimes."[28] That would further focus world attention on the regulatory debate.[29]

My article focuses on this regulatory debate: whether market forces create

---

[23] Alan Cowell, *An International Banking Panel Proposes Ways to Limit Risk*, N.Y. TIMES, June 4, 1999, at C4. The Basel Committee was established by the central bank Governors of the Group of Ten countries in 1975 and consists of "senior representatives of bank supervisory authorities and central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States." *Press Release: Consultative Paper on a New Capital Adequacy Framework*, BASEL COMMITTEE ON BANKING SUPERVISION 3 (June 3, 1999) <http://www.bis.org/press/p990603.htm>. The Committee usually meets at the Bank for International Settlements in Basel, Switzerland. *Id.*

[24] CONSULTATIVE PAPER ISSUED BY THE BASEL COMMITTEE ON BANKING SUPERVISION (June 1999) <http://www.bis.org/publ/bcbs50.pdf> (hereinafter *A New Capital Adequacy Framework*).

[25] Cowell, *An International Banking Panel Proposes Ways to Limit Risk, supra* note XX.

[26] *A New Capital Adequacy Framework, supra* note XX, at 5.

[27] *See id.* at 26-31. Whether this proposal is appropriate is beyond the scope of my article. *Cf.* [cite Howell Jackson's forthcoming article on the appropriateness of the Basel Committee's proposal].

[28] *See Standard & Poor's Official Response to the Basel Committee's Proposal* 1 (Dec. 1999) <http://www.standardandpoors.com/ratings/financialinstitutions/index.htm> (commenting that the existing 1988 Basel accord on capital adequacy was so adopted).

[29] *Id.* at 11 (expressing concern that "an increased use of ratings creates the potential for increased regulatory efforts by various national regulators to influence or control rating agencies").

sufficient checks on rating agencies, or whether more regulation is necessary.[30] Before engaging in this debate, however, it is necessary to define more precisely what rating agencies do.

B. The Role of Rating Agencies: A rating is an assessment of the likelihood of timely payment on securities.[31] Thus only the creditworthiness of an investment, not its economic desirability to investors, is rated.[32] Pure equity securities therefore are not rated because they have neither a specified maturity date nor a contractually-fixed principal amount. Because rating agencies make their rating determinations based primarily on information provided by the issuer of securities, a rating is no more reliable than that information.[33] Ratings thus do not cover the risk of fraud.[34]

Within these constraints, the significance of a rating depends on the reputation among investors of the particular rating agency.[35] At present, the most respected and trusted agencies are Standard & Poor's Ratings Services, Moody's Investors Service, Inc., and Fitch Investors Service, Inc.,[36] all founded in the U.S. but now having offices and providing ratings to investors worldwide.[37]

---

[30] My article does not, however, address non-regulatory issues, such as whether ratings are superior to credit spreads and other rating alternatives as a means of assessing an investment's safety. *Compare* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 658 (1999) (arguing that credit spreads are superior) *with* ADAMS, MATHIESON & SCHINASI, INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS, *supra* note XX, at 141-43 (arguing that "[r]atings are clearly more stable than market spreads," while both provide the same degree of imperfect foresight). *See also* Jia He, Wenwei Hu, & Larry H.P. Lang, *Credit Spread Curves and Credit Ratings* (forthcoming 2000) (available at http://papers.ssrn.com/paper.taf?abstract_id=224393).

[31] *See* Salomon B. Samson & Gail I. Hessol, *Ultimate Recovery in Ratings: A Conceptual Framework*, S&P CREDITWEEK, Nov. 6, 1996, at 25. Although I do not focus on the special case of insurance industry ratings, they have many of the same characteristics described herein. *See Current Status of Rating Agencies, supra* note XX, at 583-84 and articles cited therein at 582 n. 14.

[32] *Universal Language, supra* note XX, at 253 n. 82.

[33] *Id.* at 252 n. 76.

[34] *Id.*

[35] *Id.* at 252.

[36] On June 1, 2000, Fitch IBCA Investors Service, Inc. and Duff & Phelps, Inc. merged to form Fitch. *See* <http://www.fitchibca.com/press_releases/detail.cfm?pr_id=39597>.

[37] *Universal Language, supra* note XX, at 252. Fitch, for example, with headquarters in New York and London, rates entities in seventy-five countries and is wholly owned by the French company, FIMALAC, S.A. *See*

Rating agencies generally assign ratings to a particular issuance of a company's securities, not necessarily to the company itself, because a company could issue different securities having different risk characteristics.[38] Long and short-term debt have separate rating scales, reflecting the different risks associated with long and short-term investing.[39] Using Standard & Poor's ratings as an example,[40] the highest rating on long-term debt securities is AAA, with ratings descending to AA, then to A, and then to BBB and below.[41] The highest rating on short-term debt securities – such as commercial paper[42] is A-1, with ratings descending to A-2, A-3 and below.[43] The higher the rating, the lower the rating agency has assessed the credit risk associated with the securities in question.[44] Hence, a company's senior debt securities almost always would be rated higher than the same company's subordinated debt securities.[45] Ratings below BBB- are deemed non-investment grade, and indicate that full and timely repayment on the securities may be speculative.[46] The term investment grade "was originally used by various regulatory bodies [in the United States] to connote obligations eligible for investment by institutions such as banks, insurance companies and savings and loan associations. Over time, this term gained widespread acceptance

---

<http://www.fitchibca.com/press_releases/detail.cfm?pr_id=39597>. *Cf.* Garcia-Johnson, Beyond Corporate Culture: Reputation, Rules, and the Role of Social and Environmental Certification Institutions, *supra* note XX, at 2 (noting that third-party certification institutions are "emerging at the global level where no coordinating or supervising authority exists, and where multilateral regimes and institutions are difficult to construct").

[38]Recently, however, some rating agencies have been assigning company ratings that apply to any generic issuance of the company's senior unsecured debt securities. *Universal Language, supra* note XX, at 253 n. 80.

[39]All other factors being equal, long-term investing has greater risk because of the greater uncertainty of predicting future events.

[40]Other rating agencies use similar, although not precisely identical, rating nomenclature.

[41]*Universal Language, supra* note XX at 252. Long-term ratings sometimes include "+" and "-" or other modifying designations associated with the ratings. *Id.*

[42]"Commercial paper means short-term debt securities issued by a corporation. 'Typically, only large, quality rated firms issue commercial paper. Issuers like commercial paper because of its maturity, its flexibility and the absence of hard collateral.'" *Id.* at 252 n. 78 (citation omitted).

[43]*Id.* at 252. A-1 is the highest short-term rating for Standard & Poor's, P-1 for Moody's, F-1 for Fitch, and D-1 for Duff & Phelps. *Id.* at 252 n. 79.

[44]*Id.* at 252-53.

[45]*Id.*

[46]*Id.* at 253.

throughout the investment community."[47]

Because a high rating signals low credit risk to investors, a company that issues AAA rated securities can -- other things being equal -- more easily attract investors for its securities than can a company that issues AA or BBB rated securities.[48] Therefore the company with AAA rated securities can pay a lower interest rate on those securities, and still attract investors, than can the company with the lower rated securities. Sometimes an investor may prefer, if it finds the extra risk acceptable, to invest in a BBB rated security rather than a AAA rated security in order to benefit from the higher interest rate.[49]

The existence and almost universal acceptance of ratings make it much easier for investors in the capital markets to assess the creditworthiness of a given issuance of securities. In this sense, ratings can be thought of as a public good.[50] Certain rating agencies even view their ratings as worldwide standards, and not as relative risk standards within countries.[51] Thus, a BBB rating on securities is intended to convey the same level of risk irrespective of the jurisdiction in which the securities are issued.[52] This sometimes creates a problem for companies that would otherwise have high ratings, but which are located in countries that have political or financial instabilities, because the rating on the company's securities usually is limited by the rating of the country itself.[53] On the other hand, the growing need for ratings has the salutary effect of motivating foreign companies, as well as governments, to increase their transparency by providing the type of information needed to support a rating.

---

[47]STANDARD & POOR'S, CORPORATE RATINGS CRITERIA 9 (1998) (hereinafter RATINGS CRITERIA).

[48]*Universal Language, supra* note XX, at 253.

[49]*Id.* at 253 n. 82.

[50] *Cf.* Garcia-Johnson, Beyond Corporate Culture: Reputation, Rules, and the Role of Social and Environmental Certification Institutions, *supra* note XX, at 5 (arguing that "[t]he provision [by certification institutions] of rules, and records of conformance, can be thought of as a public good that is, in a globalized world, often underprovided").

[51]*Universal Language, supra* note XX, at 253 n. 84 (referring to the way that Standard & Poor's views its ratings).

[52]Interview with Petrina Dawson, Managing Director and Associate General Counsel, Standard & Poor's Ratings Services, in Durham, North Carolina (Mar. 11, 1998). *Cf.* Garcia-Johnson, Beyond Corporate Culture: Reputation, Rules, and the Role of Social and Environmental Certification Institutions, *supra* note XX, at 1 (arguing that one of the primary functions of certification institutions is to "make assessments of reputation replicable, more easily transmitted, and much easier to compare").

[53]This is sometimes referred to as sovereign ceiling. *See* RATINGS CRITERIA, *supra* note XX, at 51.

To a large extent, the almost universal demand by investors for ratings makes rating agencies gatekeepers of the types of securities that investors will buy.[54] That, however, can slow down experimentation with inventive transaction structures, especially in the innovative fields of structured finance and securitization.[55] This unprecedented power, and the de facto control of rating agencies over international debt markets, make the issue of whether rating agencies should remain unregulated more urgent.[56]

II. Analysis

To analyze this issue, one must first understand the normative rationale for regulation. In an economic context, where health and safety are not at issue, regulatory policy generally views this rationale as "foster[ing] improvements judged in efficiency terms."[57] An exception might arise, however, where society has objectives in addition to economic efficiency.[58] Where such other objectives arise, they are principally distributional.[59]

Are there any such other objectives in a rating agency context? This is not merely a rhetorical question; even commercial regulation might have other objectives based on indirect social consequences. Consider, for example, the dispute over the proper goals of bankruptcy reorganization law. Some argue that the only goal of bankruptcy reorganization law should be economic efficiency; others argue that there should also be, and in fact are, distributional objectives, such as rehabilitating troubled

---

[54] *Universal Language, supra* note XX, at 253.

[55] *Id. See also infra* note XX (describing securitization and discussing the gate-keeper problem).

[56] *See, e.g.,* Reexamining the Regulation of Capital Markets for Debt Securities, Panel IV: Rating Agencies: Substitute or Necessary Corollary to the Regulation of Debt Markets?, http://www.law.duke.edu/globalmark/conf/BMA%20Conference.html (proceedings of Oct. 18-19, 1999 conference held by Duke University's Global Capital Markets Center in Washington, D.C., co-sponsored by the Bond Market Foundation, raising this same issue).

[57] W. KIP VISCUSI, JOHN M. VERNON, & JOSEPH E. HARRINGTON, JR., ECONOMICS OF REGULATION AND ANTITRUST 9 (3d ed. 2000). *Accord,* Hadfield, Privatizing Commercial Law: Lessons from the Middle and the Digital Ages, *supra* note XX, at 58 (arguing that the "public value at stake in relationships between commercial entities ... is economic efficiency").

[58] *See* EDITH STOKEY & RICHARD ZECKHAUSER, A PRIMER FOR POLICY ANALYSIS 297 (1978) (arguing that "[t]he rationale for government intervention must be either that in particular areas the market is performing poorly or not at all, *or that the society has objectives in addition to economic efficiency*") (emphasis added).

[59] *See id.* (observing that "concern for the distribution of welfare is the principal additional objective").

debtors and ensuring equality of distribution to creditors.[60] To illustrate the controversy, query whether bankruptcy law should permit a fundamentally bad business to reorganize. Some may advocate reorganization, arguing that bankruptcy law "serves an important purpose in rehabilitating firms that, but for bankruptcy protection, would fail. Jobs would be lost and communities damaged, economically and otherwise."[61] Others, however, would allow reorganization only where it is economically efficient:

> If a bad restaurant is replaced by a much better one, employment levels in the city may even increase. Keeping a bad restaurant in business postpones the inevitable and delays a desirable shift of labor and capital to somewhere the inputs can be put to better use.[62]

At least one noted bankruptcy scholar believes this dispute is irreconcilable.[63]

One can imagine this same type of dispute over the goals of rating agency regulation -- some arguing that such regulation should incorporate distributional objectives because ratings affect a company's ability to raise funds and the cost thereof, which in turn can affect the company's ability to hire and retain employees; others arguing that the only goal should be economic efficiency. There are, however, cogent reasons why the latter view should prevail.

The regulatory scheme most analogous to rating agency regulation – securities law – focuses primarily on the goal of economic efficiency in lieu of distributional objectives.[64] The analogy between these forms of regulation is close

---

[60]Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 542-43 (1999) (examining this dispute).

[61]Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L. J. 573, 577 (1998) (illustrating the distributional perspective).

[62]*Id.* at 580 (illustrating the efficiency perspective that firms with inherently bad businesses should be allowed to fail to ensure that their assets are put to the best use).

[63]*Id.* at 596 (concluding that the dispute "is at bottom normative," and hence "[b]ridging the gap between [the disputants] 'must ultimately dissolve into a study of aesthetics and morals'") (quoting R. H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 43 (1960)).

[64] *See, e.g.*, THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 9 (3d ed. 1996) (observing that efficiency is the central goal of the U.S. securities laws); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 751-52 (1984) (arguing that the strongest arguments for the mandatory disclosure system under securities law are based on efficiency, not fairness). Although some have suggested that fairness is also an important goal of securities regulation, fairness might only be relevant in this context as a means of achieving efficiency. *See, e.g., The Bond Price Competition Improvement Act of 1999:*

because rating agencies perform the same function as securities law: reducing the information asymmetry between issuers of and investors in securities.[65] That rating agencies remediate that asymmetry in order to profit, whereas securities law remediates it in order to correct market failure and thereby increase efficiency, is irrelevant; the functions are the same.

Of course, the fact that efficiency *is* the central goal of securities laws does not necessarily prove that it *should be* that central goal for securities law, and hence for rating agency regulation.[66] That result follows, however, because efficiency is also the *normative* goal of securities law: to "develop a global regulatory framework that preserves the efficiencies associated with international capital mobility."[67]

Hearing Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce, 106th Cong. 9 (1999) (statement of Hon. Arthur Levitt, Chairman, Securities and Exchange Comm'n) (testifying that "[i]nformed investors, armed with accurate information, ensure that market prices represent fair values. And fair market prices, in turn, ensure that the markets perform their economic function of efficiently allocating capital resources.").

[65] *See, e.g.,* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 70 (1995) (arguing that the primary function of the federal securities laws is remediation of information asymmetries); MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 1 (1996) ("Undoubtedly, the central focus of the federal securities laws is that of disclosure, thereby providing shareholders and the marketplace with sufficient information to make relevant decisions"). *See also* <http://www.sec.gov/about/whatwedo.shtml> (articulating the U.S. Securities and Exchange Commission's function as ensuring that "all investors … should have access to certain basic facts about an investment prior to buying it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public, which provides a common pool of knowledge for all investors to use to judge for themselves if a company's securities are a good investment.") (visited Mar. 9, 2001).

[66] *See, e.g.,* Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L. J. 1807, 1814-15 (1998) (arguing that, in general, "the appropriate response to an 'ought' claim is an 'ought not' claim, not an 'is' claim").

[67] HAL S. SCOTT & PHILIP A WELLONS, INTERNATIONAL FINANCE 46 (7th ed. 2000). *Accord,* GEORGE J. STIGLER, THE CITIZEN AND THE STATE 88 (1975) (arguing that economic efficiency *should be* the central goal of the U.S. securities laws because "efficient capital markets *are* the major protection of investors") (emphasis in original); Nathaniel Carden, Comment, *Implications of the Private Securities Reform Act of 1995 for Judicial Presumptions of Market Efficiency*, 65 U. CHI. L. REV. 879, 882 (1998) ("the concept of efficiency is a normative goal [for securities regulation]: an efficient market is desirable because it ensures that society's productive assets are transferred to those who can make the best use of them, thereby maximizing aggregate welfare"). *But cf.* Saul Levmore, *Efficient Markets and Puzzling Intermediaries,* 70 U. VA. L. REV. 645, 649-50 & 656 (1984) (arguing that market efficiency alone should

Moreover, if rating agency regulation were based on factors other than economic efficiency, ratings would to some extent reflect those other factors. Investors, who typically look for the highest economic return for a given level of safety, then would be misled, undermining their confidence in the rating system and their willingness to invest in rated securities. In theory, of course, those other factors could be disclosed to investors; but even then, investors would find it costly and difficult to try to determine what the rating would have been absent those other factors.

I therefore conclude that the rationale for regulating rating agencies should be improving efficiency.[68] There are two ways that regulation could do this: by making rating agencies perform better the tasks they already do well,[69] or by limiting the negative consequences of their actions.[70] I consider each in turn.[71]

In making this inquiry, it must be cautioned that regulation itself poses intrinsic costs that can offset any efficiency gain.[72] Even where there is market failure,

---

not dictate policies concerning government regulation of the market without consideration of practical market effectiveness).

[68] That ratings on sovereign debt can affect a State's ability to borrow and the cost thereof should not change this conclusion because market efficiency is desirable even in the sovereign debt context. *Cf.* Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 993, 1009 (2000) (arguing that multinational governmental entities such as the International Monetary Fund should allow the market to work and not act as lenders of last resort to sovereign debtors, even if that means allowing a sovereign nation to default).

[69] In theory, regulation could also compel rating agencies to perform other beneficial tasks that they do not presently perform. I am unaware of what those other tasks would be, and there is no literature suggesting that rating agencies should expand their role. I therefore assume in this article that there are no such other tasks.

[70] *Cf.* Peter P. Swire, *Markets, Self-Regulation, and Government Enforcement in the Protection of Personal Information* 14, available at http://www.ntia.doc.gov/reports/privacy/selfreg1.htm (arguing that government regulation may be appropriate where self-regulation causes externalities).

[71] Rather than focusing on types of additional regulation, my analysis thus focuses on whether the ratings system is broken or can be made to work better. If not, it need not be fixed, irrespective of the types of remedial regulation.

[72] *See, e.g.*, JOHN EATWELL & LANCE TAYLOR, GLOBAL FINANCE AT RISK 19 (2000): "[R]egulation can be expensive and oppressive or even downright wrongheaded. Overly fastidious regulation may result in risks being *over*priced, and hence will stifle enterprise. ... A balance needs to be struck...." *See also* Bottini, *An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such*

"government intervention may not [always] yield a superior outcome."[73] I therefore attempt to offset the costs of regulation against any potential gains.

A. Regulation to Improve Performance: As the prior discussion has shown, rating agencies improve the efficiency of securities markets by acting as informational intermediaries between issuers and investors in order to increase the transparency of securities and thereby reduce the information asymmetry. This is especially valuable where individual investors face high costs relative to their investment in assessing the creditworthiness of an issuer's securities. A relatively small number of rating agencies can make this assessment on behalf of many individual investors, thereby achieving an economy of scale. Government regulation could increase this efficiency only by reducing overall costs or by improving ratings reliability.

Presently, there is little reason to believe that rating agency costs are excessive. The fee charged by a rating agency typically is market-driven and varies according to the size and complexity of the transaction being rated.[74] At least for public transactions, the fee also covers ongoing monitoring of the rating.[75] From the standpoint of the rating agencies themselves, these fees reflect, among other things, the costs of the large staff of experienced analysts needed to assess ratings[76] and the risk that the rating agency will be sued based on a rating that, in retrospect, might

---

Agencies, supra note XX, at 610-11 (observing that "[t]oo much regulation inhibits economic growth by increasing costs and making capital harder to raise").

[73]VISCUSI ET AL., ECONOMICS OF REGULATION AND ANTITRUST, *supra* note XX, at 10. *See also id.* at 13 (observing that "'government failure' may be of the same order of importance as market failure"). *Accord,* STOKEY & ZECKHAUSER, A PRIMER FOR POLICY ANALYSIS, *supra* note XX, at 309-10 (warning that "the history of [government] interventions to deal with market failure is a history of disappointments [and hence one] should recognize that market failure does not mandate government intervention; it just suggests the possibility that such intervention might prove beneficial").

[74]Letter from Leo C. O'Neill, President, Standard & Poor's ratings Services, to Jonathan Katz, Secretary, Securities and Exchange Commission 9-10 (Feb. 27, 1998) (on file with author).

[75]*Id.* at 10.

[76]Rating agencies employ expert analysts who examine and scrutinize public and private information about a company to determine its long term ability and willingness to meet its debt obligations. *See* Moody's Investors Service, *A "Universal" Approach to Credit Analysis* <http://www.moodys.com/moodys/mdyappr.htm>(visited July 26, 2000). Professors Gordon and Kornhauser argue that this approach is a more cost effective way than analysis by individual investors. *See* Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information and Securities Research,* 60 N.Y.U. L. REV. 761, 817 (1985).

appear unjustified.[77] Even if rating agency costs were considered excessive, however, government regulation rarely reduces costs and includes costs of its own, such as the public sector need to administer the regulation and the private sector need to retain counsel to advise on compliance with the regulation.[78]

Likewise, there is little reason to believe that increased regulation will improve the reliability of ratings. Rating agencies have had a remarkable track record of success in their ratings,[79] and recent rating experience is even more reliable:

> In 20 years only one company with an investment-grade rating from Moody's has defaulted on long-term debt – Manville, a single-A company that went bankrupt voluntarily to protect itself from asbestosis lawsuits. A New Zealand

---

[77] *See, e.g.,* LaSalle Nat'l Bank v. Duff & Phelps Credit Rating Co., 951 F. Supp. 1071 (S.D.N.Y. 1996); County of Orange v. McGraw-Hill Companies, No. SA CV 96-0765-GLT, 1997 U.S. Dist. LEXIS 22459 (C.D. Cal. June 2, 1997) (denying Standard & Poor's motion to dismiss lawsuit arising from its investment grade rating of Orange County's bonds, which later defaulted). Nonetheless, rating agencies in the U.S. are generally held to a recklessness, not a simple negligence, standard and have rarely been found liable. *See* First Equity Corp. v. Standard & Poor's Corp., 869 F.2d 175 (2d Cir. 1989) (rating agency not liable for rating that included incorrect description of accrued interest payable upon conversion of debt instruments); Republic Nat'l Life Ins. Co. v. Realty Equities Corp., 387 F. Supp. 902, 905 (S.D.N.Y. 1975) (rating agency has no duty to verify collected statistics used in rating process). For an analysis of whether credit rating agencies should be held to a stricter standard of liability, *see* Husisian, *What Standard of Care Should Govern the World's Shortest Editorials?, supra* note XX (concluding, *id.* at 427, that "an expansion of rating agency liability would impose significant costs on rating agencies without significantly increasing rating agency accuracy").

[78] *See, e.g.,* Swire, *Markets, Self-Regulation, and Government Enforcement in the Protection of Personal Information, supra* note XX, at 5-7 (arguing that even if public officials act perfectly for the public good, regulation will give rise to bureaucratic administrative costs and industry compliance costs, as well as costs arising from the fact that regulatory rules are inflexible and inherently imperfect; and that, moreover, public choice theory shows that public officials do not always act perfectly for the public good). Thus, a recent study by the National Telecommunications and Information Administration comparing market, government, and self regulation to determine the most effective way of protecting consumer privacy included, as limitations on government regulation, "the expense to the government of drafting the privacy rules, administering the rules and enforcing the rules in particular cases. ... The amount of funding can clearly be substantial." CH1 Theory of Markets and Privacy, <www.ntia.doc.gov/reports/privacy/selfreg1.htm> (visited July 26, 2000). *See also* POSNER, ECONOMIC ANALYSIS OF LAW, *supra* note XX, § 13.1, at 369.

[79] *See, e.g.,* W. Braddock Hickman, *Corporate Bond Quality and Investor Experience,* NAT'L BUR. ECON. RESEARCH (1958) (finding that Moody's Aaa-rated debt had a default rate of 10%, whereas Ba-rated debt had a default rate over 40%, during the period 1900-43).

> finance company, DFC, defaulted on its commercial paper in 1989 while still carrying a prime rating by S&P. The agency says it relied on a government commitment to provide liquidity, but the government reneged.[80]

Because most studies only appear to take into account defaults on debt that is highly rated at the time of default, they do not necessarily address ratings stability. However, a recent internal analysis by Standard & Poor's, using information extracted from its proprietary database on 9,169 companies with rated debt, confirms the stability of investment grade ratings, finding for example that "all 'A' rated companies at the beginning of a given year would have an 87.94% chance of maintaining that same rating by year end."[81]

The reliability of ratings can be explained by reputational costs: the profitability of rating agencies is directly dependent on their reputations.[82] Inaccurate ratings will impair, if not destroy, a rating agency's reputation:

> Even more than accountants and lawyers, [rating agencies] must trade on their reputations. If bond investors lose faith in the integrity of rating agencies' judgments, they will no longer pay attention to their ratings; if agencies' opinions cease to affect the price that borrowers pay for capital, companies and governments will not pay their fees. So market forces should make rating

---

[80] *Credit-Rating Agencies: Beyond the Second Opinion*, ECONOMIST, Mar. 30, 1991, at 80. This latter default reflects the view that rating agencies are less accurate in rating country debt, ascribed to "political factors mak[ing] forecasting much more hazardous" and the "alarming tendency [of countries] to default on their obligations." *Room for Improvement: Rating Agencies,* ECONOMIST, July 15, 1995, at 54. Investors, however, compensate for this reduced accuracy; when "pricing government issues," they "consistently demand[] higher yields than the ratings would imply." *Id. Accord,* ADAMS, MATHIESON & SCHINASI, INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS, *supra* note XX, at 137-39 (finding that for corporate securities, "ratings, on average, are a good indicator of relative creditworthiness," but that "[e]valuating the performance ratings in the sovereign sector is more problematic than for corporates").

[81] Leo Brand & Reza Bahar, *Corporate Defaults: Will Things Get Worse Before They Get Better*, S&P CREDITWEEK, Jan. 31, 2001, at 15, 27 (also available at http://www.standardandpoors.com/Forum/RatingsCommentaries/CorporateFinance/index.html) (setting forth, *id.* at 23, a table of average one-year transition rates, showing for each initial rating from AAA down to CCC the likelihood that the rating will change during a year). *Accord*, ADAMS, MATHIESON & SCHINASI, INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS, *supra* note XX, at 139 (noting that "ratings are fairly stable").

[82] *See Credit-Rating Agencies. AAArgh!*, ECONOMIST, Apr. 6, 1996, at 80 (observing that Moody's, "[l]ike all credit-rating agencies, ... depends for its livelihood on its reputation among investors for objectivity and accuracy").

agencies careful of their good names.[83]

Thus, rating agencies should want to continue to provide accurate ratings, whether or not there is regulation.[84] Regulation, on the other hand, could impair the reliability of ratings by increasing the potential for political manipulation,[85] and by diminishing the importance of reputational costs as would occur, for example, if regulation were based on considerations other than ultimate ratings reliability.

Consequently, government regulation would neither reduce costs nor improve reliability. I therefore turn to the question of whether regulation would limit the negative consequences of rating agency actions.

B. Regulation to Limit Negative Consequences: There are various negatives associated with rating agency actions. First is the perception – related to a central question of private ordering, the extent to which it undercuts democratic authority[86] –

---

[83] *The Use and Abuse of Reputation, supra* note XX, at 18.

[84] *But cf.* Howell E. Jackson, _____, *supra* note XX, at __ (arguing that the use of ratings for determining capital adequacy, proposed by the Basel Committee, may place increasing pressure on rating agencies to give favorable ratings). Some workshop participants also suggested that rating agencies sometimes might assign sub-optimal ratings where the appropriate rating falls between categories, such as between BBB (investment grade) and BB (non-investment grade). Behavioral psychology then might predict systematic under-rating, as illustrated by the alleged tendency of weather forecasters to predict rain rather than sun in marginal cases because few complain when a forecasted rainy day turns out to be sunny. Ratings also might be a self-fulfilling prophecy in marginal cases, such as where an investment grade rating allows a company to raise funds and survive whereas the same company, faced with a non-investment grade rating, would lack liquidity and fail. Even if these sub-optimalities sometimes do occur, however, government regulation would not appear to avoid them.

[85] *See, e.g.,* Memorandum from Kenneth C. Kettering, Partner, Reed Smith Shaw & McClay LLP (now Associate Professor, New York Law School) 2 (July 6, 2000) (on file with author) (arguing that "[o]ne serious drawback to government regulation ... is the potential for political manipulation. ... The services provided by rating agencies are ... very largely subjective, and it is hard to see how anyone could tell whether particular ratings are biased").

[86] *See, e.g.,* A. Michael Froomkin, *Wrong Turn in Cyberspace: Using ICANN to Route Around the APA and the Constitution*, 50 DUKE L. J. 17, 168 (2000) (arguing that using a private company, the Internet Corporation for Assigned Names and Numbers, to manage Internet infrastructure has a "pernicious effect … on our democracy"); Robert O. Keohane & Joseph S. Nye, Jr., Between Centralization and Fragmentation: The Club Model of Multilateral Cooperation and Problems of Democratic Legitimacy (Feb. 2001) (unpublished manuscript, on file with author; also available at <http://papers.ssrn.com/paper.taf?abstract_id=262175>) (focusing on the challenges to the legitimacy of the World Trade Organization posed by democratic theory).

that rating agencies are not accountable because they are not officially subject to public scrutiny. This would be problematic if, as a result, rating agencies misbehaved or issued inaccurate ratings. As the foregoing discussion has shown, however, the lack of official public scrutiny does not appear to affect ratings accuracy because of the de facto accountability of rating agencies through reputation.[87] Indeed, whereas government officials may derive the appearance of accountability through an electoral process, their ability to be elected is similarly driven by reputation. To this extent, reputational constraints can be viewed as a normative complement to the democratic process.[88]

A second potential negative is the conflict of interest inherent in the way that rating agencies are paid. Rating agencies are virtually always paid their fee by the issuer of securities applying for the rating.[89] This raises the possibility that the issuer will use, or the rating agency will perceive, monetary pressure to improve the rating. There nonetheless appears to be little alternative to this arrangement because of the collective action problem in coordinating potential investors to pay this fee. One rarely can know in advance which investors will purchase a given issuance of securities,[90] and even if one did it would be difficult to persuade those investors to pay their pro rata portion of the rating agency fee directly.[91] The issuer therefore may be

---

[87] *Cf. infra* notes XX-XX and accompanying text (discussing unsolicited ratings).

[88] *Cf.* Keohane & Nye, Between Centralization and Fragmentation: The Club Model of Multilateral Cooperation and Problems of Democratic Legitimacy, *supra* note XX, at 12 (noting that democratic "accountability is not assured only through elections," and giving examples of "non-electoral accountability). Reputation cannot, however, be a complete *substitute* for democratic accountability in our context because a rating agency's reputation is limited to issuers of and investors in securities. Reputation thus drives only accountability to such issuers and investors, not to a State's entire populace.

[89] *See Credit-Rating Agencies: Beyond the Second Opinion, supra* note XX, at 80 (observing that "[n]ormally issuers invite, and pay, the agencies to rate their debt"). One reviewer of this article has "always suspected that the evolution of the issuer-pay model was basically driven by the rating agencies' agendas: it's easier to extract money from issuers than from investors, and selling the information to investors would raise the threshold of responsibility that the rating agencies would have to investors misled by bum ratings." Memorandum from Kenneth C. Kettering, *supra* note XX, at 1. I argue below, however, that this model may also be driven by collective action considerations.

[90] In a public offering, for example, investors bid to purchase the securities only after the securities are offered for sale. *See* HAROLD S. BLOOMENTHAL AND HOLMES ROBERTS & OWEN, SECURITIES LAW HANDBOOK § 5.01[3] (2000 ed. 1999).

[91] Professor Jackson observes that, in a perfect market, investors would be indirectly paying this fee through the pricing on the securities. Interview with Howell E. Jackson, Professor of Law, Harvard University, in Cambridge, England (July 7, 2000).

the only party realistically capable of paying the rating agency's fee in all situations.[92] This does not, however, eliminate the potential conflict of interest. Markets are not perfect, and the fact of the issuer's control over paying the fee might tempt it to strategically bargain for a higher rating in any event.

In theory, a regulation could require investors to pay this fee, or could require an issuer to pay the fee irrespective of the rating ultimately assigned. Regulation, however, is costly, and the custom already exists that issuers are required to pay rating agency fees irrespective of the rating ultimately assigned.[93] The amount of the fee is also independent of the rating.[94] Coupling this with the fact that reputational costs help to ensure the objectivity and independence of the ratings decision,[95] the aforesaid conflict of interest does not appear to cause any negative consequences,[96] with one possible exception.

One rating agency, Moody's, has allegedly misbehaved by issuing artificially low unsolicited ratings in private transactions.[97] Critics argue that the conflict of interest described above motivates Moody's behavior:

That does not, however, eliminate the potential conflict of interest. Markets are not perfect, and the issuer's control over paying the fee might tempt it to strategically bargain for a higher rating.

[92]Historically, rating agencies had sold subscriptions to their ratings to investors, much like wine experts today (such as Robert Parker with THE WINE ADVOCATE or Stephen Tanzer with his INTERNATIONAL WINE CELLAR) sell subscriptions to their wine rating magazines. *See The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies, supra* note XX, at __; ADAMS, MATHIESON & SCHINASI, INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS, *supra* note XX, at 192. Whether or not a similar approach would generate sufficient income to support the large research staffs needed today by rating agencies, and whether on-line computerized delivery would allow rating information to be sent to investors worldwide on a timely basis, are questions that are beyond this article's scope.

[93]Rating agencies base their fees mainly on the size and type of the security issuance. *See* Richard Cantor & Frank Packer, *The Credit Rating Industry*, FED. RESERVE BANK N.Y. Q. REV. 19 (June 22, 1994).

[94]*Id.*

[95]*See supra* notes XX-XX and accompanying text.

[96]*See* ADAMS, MATHIESON & SCHINASI, INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS, *supra* note XX, at 193 (although "[s]ome market participants have argued that charging issuers for their ratings could offer the agencies an incentive to assign higher ratings than warranted by fundamentals," this study concludes that "[g]iven the overriding incentive for the agencies to maintain their credibility, it seems unlikely that they would trade off their credibility in return for short-term revenue gains").

[97]*See Credit-Rating Agencies. AAArgh!, supra* note XX, at 80. This is also referred to as rating without request.

> Moody's rivals [argue that] [a]gencies earn their keep by charging fees to those who issue bonds, not to the investors who use the ratings. This, they claim, can create perverse incentives. By giving borrowers a low, unsolicited rating, the big agencies may force unwilling issuers to pay for their services in the hope of getting a better one.[98]

It is unclear, however, that unsolicited rating actually constitutes an abuse because whether such ratings are in fact artificially low "is just suspicion."[99] Furthermore, the only court to have considered this question refused to impose liability on Moody's.[100] The court's rationale depended on the protection afforded to public opinions by the First Amendment's mandate that Congress shall make no law abridging freedom of speech or of the press – a protection not always available outside of the United States.[101] On the other hand, there is concern that an unsolicited rating may be based on incomplete information about the issuer.[102]

---

[98]*Id. Accord, Current Status of Rating Agencies, supra* note XX, at 598-600; Anne Schwimmer, *How Far Is Too Far?*, INVESTMENT DEALERS' DIGEST, Feb. 12, 1996, at 14; *Now It's Moody's Turn For a Review*, BUS. WK., Apr. 8, 1996, at 115. Moody's, however, contends that unsolicited ratings are "the market's best defense against rating shopping (which occurs when issuers shop among various rating agencies for the highest ratings and seek to suppress lower conclusions). Under such circumstances, rating agencies risk the moral hazard of competing to provide the highest rating in order to obtain the issuer's business." MOODY'S INVESTORS SERVICE, DESIGNATION OF UNSOLICITED RATINGS IN WHICH THE ISSUER HAS NOT PARTICIPATED 3 (Nov. 1999).

[99]*The Use and Abuse of Reputation, supra* note XX, at 18.

[100]In Jefferson County Sch. Dist. v. Moody's Investor's Services, Inc., 988 F. Supp. 1341 (D. Col. 1997), *aff'd* 175 F.3d 848 (10th Cir. 1999), Moody's issued a statement that, although it had not been asked to rate the bonds in question, the outlook on the issuer's debt was negative and Moody's intended to assign a rating subsequent to the bond sale. 988 F. Supp. at 1343. At the time of its statement, however, Moody's financial information on the issuer was over a year old. *Id.* The statement caused the bond sale to fail, and the issuer was forced to re-price its bonds at a higher interest rate in order to sell them. *Id.* at 1344. The court refused the issuer's demand for damages, reasoning that the unsolicited rating was a mere expression of opinion protected by the First Amendment. (Indeed, the appeals court clarified that this unsolicited rating, *even if retaliatory*, would be protected speech under the applicable state law. 175 F.3d at 858.) The court also refused to allow the issuer to amend its complaint to add antitrust claims, reasoning that First Amendment protected speech cannot be the basis for antitrust liability. 988 F. Supp. at 1347-48.

[101]For a discussion of these First Amendment issues, *see Current Status of Rating Agencies, supra* note XX, at 616-19.

[102]*See* Cantor & Packer, *The Credit Rating Industry, supra* note XX, at 19 (observing that issuers want the rating agencies to have complete information to ensure the most accurate and favorable rating possible). For example, in the *Jefferson County School*

Even if unsolicited rating does constitute an abuse, its scope is limited. It therefore may not justify implementation of a broad regulatory scheme. Instead, targeted remedies, such as requiring disclosure of the fact that a rating is unsolicited, would appear more appropriate. Recently, in fact, Moody's voluntarily instituted such disclosure for certain unsolicited ratings, in "recogni[tion] that market participants have shown an interest in knowing which ratings lack the issuer's participation" and to "help to dispel misconceptions, and increase the credibility and utility of [its] ratings in the capital markets."[103] Reputational costs alone therefore have been sufficient, even in this context, to help correct rating agency misbehavior.[104]

The final negative is that the rating agency system, as presently constituted, is conservatively biased against innovation.[105] This is because the negative reputational

---

District case discussed above, Moody's financial information on the issuer was over a year old. *See supra* note XX. *But cf.* MOODY'S INVESTORS SERVICE, DESIGNATION OF UNSOLICITED RATINGS IN WHICH THE ISSUER HAS NOT PARTICIPATED, *supra* note XX, at 3 (in which Moody's maintains that it does not assign ratings where it lacks "sufficient information to form a useful conclusion").

[103] *Id.* Moody's agreed to identify in initial rating assignments those unsolicited ratings for which the issuer has declined to participate, by including the following statement in the rating assignment press release: ***"This rating was initiated by Moody's. The issuer did not participate in the assignment process."*** *Id.* at 1 (emphasis in original).

[104] One workshop participant queried whether reputation alone will always be sufficient to deter rating agencies from rating too low in order to extract a fee, and suggested that rating agencies be penalized for egregious error. Although some might argue that this type of penalty already exists in limited form, at least in the U.S., through the tort system and possibly through antitrust law (*cf.* Husisian, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability, supra* note XX), the only courts to have considered this issue refused to impose liability. *See* Jefferson County Sch. Dist. v. Moody's Investor's Services, Inc., *supra* note XX.

[105] *See supra* note XX and accompanying text. One commentator has argued, however, that there may be other negatives associated with rating agency action. The most significant, he believes, is that rating agencies are "too slow to downgrade a rating." *Current Status of Rating Agencies, supra* note XX, at 585. His evidence for this, however, is limited to three ambiguous anecdotal examples during an almost twenty-year period. *See id.* at 585-88. He also argues that "rating agencies have ... been accused of influencing and being influenced by politicians." *Id.* at 595. As for the former charge (influencing), his critique is not that rating agencies have used improper influence but that they "often make suggestions to state legislators concerning ways to improve their [state's] rating." *Id.* at 597. He does not, however, indicate whether any states have in fact changed their operations based on these suggestions, nor does he say whether any of these suggestions have been ill-advised. Regarding the latter charge (being influenced), he cites only two anecdotal examples, *id.* at 595-97; both,

consequences of providing a rating that, in retrospect, turns out to be incorrect far outweigh the fee a rating agency can charge for providing that rating. The bias is particularly pronounced in the developing area of securitization, where the securities being rated arise out of complex and innovative transaction patterns. Securitization is "by far the most rapidly growing segment of the U.S. credit markets,"[106] and its "use is rapidly expanding worldwide."[107] In a typical transaction, a company, usually called the "originator," transfers rights to payment from income-producing assets such as accounts receivable, loans, or lease rentals (collectively, "receivables"), or frequently undivided interests in such rights,[108] to a special purpose vehicle, or "SPV." The SPV, in turn, issues securities to capital market investors[109] and uses the proceeds of the issuance to pay for the receivables. The investors, who are repaid from collections of the receivables, buy the securities based on their assessments of the value of the receivables.[110] The most critical analysis in a securitization is whether the SPV and its investors will continue to be repaid in the event of the originator's bankruptcy.[111] If the SPV has ownership of the receivables, the SPV and its investors will continue to

---

however, could be explained by imperfect judgment calls as easily as influence. Finally, although he argues that "the rating agencies have been criticized for being inaccurate and for failing to provide adequate disclosure of important financial information to investors who rely on the ratings," *id.* at 600, he admits, that "[o]n the other hand, many claim that the ratings are accurate." *Id.* at 602. *Compare supra* note XX (listing authorities supporting the accuracy of ratings). Even if these concerns were valid, however, he concludes that "[r]egulation of the entire [rating agency] industry is undesirable" and that all that is "needed is limited regulation directed at the few serious problems afflicting rating agency activity." *Id.* at 610-11.

[106]Lynn M. LoPucki, *The Death of Liability*, 106 YALE L. J. 1, 24 (1996).

[107]Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J. L., BUS. & FIN. 133, 133 (1994) (hereinafter *Alchemy of Asset Securitization*). *See also* Memorandum from William F. Kroener III, General Counsel, James L. Sexton, Director, Division of Supervision, & Mitchell Glassman, Director, Division of Resolutions and Receiverships, Federal Deposit Insurance Corporation ("FDIC") to the FDIC's Board of Directors 3 (July 26, 2000) (on file with author) (noting that "asset-securitization has developed into one of the most significant funding sources for American and international corporations").

[108]1 SECURITIZATION OF FINANCIAL ASSETS § 3.09, at 3-52 - 3-53 (Jason H. P. Kravitt, ed., 2d ed. 1999 & 2000-1 Supplement) (articulating the advantages of the undivided interest structure).

[109]The term capital markets refers to any market where debt, equity, or other securities are or may be traded. Capital markets can be formal or informal. *See* JOHN DOWNES & JORDAN GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 59 (3d ed. 1991) (definition of capital markets).

[110]*See* Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52 STAN. L. REV. 1, 6 (1999). *See also id.* at 6 n. 21 (citing basic sources on securitization).

[111]*Alchemy of Asset Securitization, supra* note XX, at 151.

be repaid; if not, their right to be repaid will be suspended and subject to possible impairment.[112] The SPV will gain ownership of the receivables only if the transfer of those receivables from the originator to the SPV constitutes a sale under applicable bankruptcy law.[113] This is usually referred to as a "true sale."

The inherent gate-keeping bias toward market conservatism arises largely out of conservative rating agency views on what constitutes a true sale. For example, irrespective of the legal criteria governing a true sale,[114] some rating agencies remain skeptical whether an SPV that purports to purchase only an undivided interest in, as opposed to whole, receivables is able to gain ownership of the interest purchased.[115] This makes it more difficult to maximize the statistical diversification of the receivables sold to the SPV, and increases the transaction costs of making purchases.[116] The same conservatism also makes rating agencies reluctant to rate innovative new securitization structures, even where the innovation promises to increase efficiency and reduce transaction costs.[117] Without a rating, however, an SPV

---

[112]STEVEN L. SCHWARCZ, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION 29-39 (2d. Ed. 1993). Thus, in cases where the SPV owns the receivables, the investment decisions often can be made without concern for the originator's financial condition. *See* Schwarcz, *The Inherent Irrationality of Judgment Proofing, supra* note XX, at 6.

[113]*Alchemy of Asset Securitization, supra* note XX, at 135.

[114]For a discussion of those criteria, *see* SCHWARCZ, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION, *supra* note XX, at 28-35.

[115]Interview with Eric P. Marcus, Partner and Chair, Structured Finance and Asset-Based Transactions, Kaye, Scholer, Fierman, Hays & Handler, in New York, N.Y. (May 8, 2000).

[116]For these reasons, undivided interests are widely used in collateralized loan obligation and bank credit card securitizations. Interview with Henry Morriello, Partner, Structured Finance and Asset-Based Transactions group of Kaye, Scholer, Fierman, Hays & Handler, in New York, N.Y.(May 8, 2000). *See also* SECURITIZATION OF FINANCIAL ASSETS, *supra*, § 3.03[A], at 3-13 (noting that the advantage of the undivided interest structure when securitizing pools of medium term receivables is "that one may avoid the transaction costs associated with numerous separate purchases"); at 3-14 (observing that "mortgage-backed securitizations are generally handled using the [undivided interest] structure"); at 3-14 - 3-16 (observing that securitization of credit card receivables also generally uses the undivided interest structure); and at 3-17 (observing that "[t]he most practicable structure [for securitization of trade receivables] has been the purchase of an undivided, fractional interest in a pool of receivables").

[117]*See, e.g., Alchemy of Asset Securitization, supra* note XX, at 145 n. 42 & 152 (discussing that rating agencies are uncomfortable rating innovative new securitization structures, such as the divisible interest structure described therein, absent "case law directly on point," notwithstanding that the divisible interest structure would "permit middle market companies and hospitals to pool their receivables in ways that reduce

will be unable to issue its securities.[118]

Although this bias may be problematic, it is hard to see how government regulation could reduce it. To the contrary, even the limited form of government regulation represented by the NRSRO-designation increases this bias by restricting the number of approved rating agencies, therefore discouraging competition and particularly discouraging the ability of new agencies, which are not nationally recognized, to start up.[119] Rating agencies that have fewer competitive pressures will have less motivation to be innovative and also might charge higher fees.[120] If anything, this suggests that government should consider balancing the need for a rigorous standard for NRSRO designation against the need to ensure that a sufficient number of rating agencies receive NRSRO designation to assure competition.

In summary, then, regulation would neither limit the negative consequences

---

transaction costs and make securitization far more feasible and attractive").

[118]The SPV might, however, be able to issue securities in limited private placements. *Id.* at 145 n. 42. One reviewer of this article asked if the conservative bias is a failure or just things working as they should. It is, I believe, a failure because, absent the need for a rating, investors would independently analyze innovative new structures; whereas if those structures are not rated, investors have no incentive, outside of the aforesaid limited private placements, to engage in such analysis.

[119]*See* Cantor & Packer, *The Credit Rating Industry, supra* note XX (observing that "[g]iven the growing importance of NRSRO status, new entrants in the ratings business who lack this status may find it increasingly difficult to attract a wide following in the investment community"). *Cf.* Garcia-Johnson, Beyond Corporate Culture: Reputation, Rules, and the Role of Social and Environmental Certification Institutions, *supra* note XX, at 19 (arguing that whereas "certification institutions themselves must be trusted, and must develop a reputation for honesty[,] [t]his is a difficult task, especially for new institutions"). Another regulatory approach might be to require greater transparency of the criteria that rating agencies apply in assigning their credit ratings, but this would be redundant. Issuers already are able to discuss these criteria with rating agency analysts, and the major rating agencies already publish these criteria on their websites. *See Ratings Criteria* <http://www.standardpoor.com/ratings/criteria/index.htm>(visited July 27, 2000) (setting forth Standard & Poor's ratings criteria); *Rating Methodologies* <http://www.moodys.com/ratproc.nsf/web/research?OpenDocument> (visited July 27, 2000) (setting forth Moody's ratings criteria). *See also* HUGH G. SHERWOOD, HOW CORPORATE AND MUNICIPAL DEBT IS RATED: AN INSIDE LOOK AT STANDARD & POOR'S RATING SYSTEM (1976).

[120]*See* POSNER, ECONOMIC ANALYSIS OF LAW, *supra* note XX, § 9.3 at 280 (arguing that competition may be an incentive to innovation); F. M. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE, chs. 15-16 (3d ed. 1990) (same). *See also Credit-Rating Agencies: Beyond the Second Opinion, supra* note XX, at 80 (recounting investor perception that Moody's and Standard & Poor's "both have improved their services since they started to face serious competition").

of rating agency action nor improve rating agency performance. There therefore appears to be little theoretical justification for such regulation generally.

As discussed, however, States that make the applicability of their laws turn on a rating often utilize NRSRO designation as a minimal form of regulation.[121] Whether the applicability of law *should* turn on a rating is beyond this article's scope. Nonetheless, so long as the applicability of law *does* turn on ratings, some form of regulatory approval of rating agencies would appear appropriate. In this context, I next examine the appropriateness of NRSRO designation as a regulatory methodology.

C. NRSRO Approach to Regulation: As shown above, regulation is not generally needed to improve rating agency efficiency. And, indeed, the purpose of NRSRO designation does not appear to be to improve efficiency *per se*. Such designation in fact has another purpose: to ensure that where the applicability of specific laws turns on a rating, the issuer of the rating – and thus the rating itself – is a reliable indicator of whether or not to apply those laws.

This suggests that NRSRO designation must be analyzed in the context of those specific laws. The analysis is simplified, however, by the fact that there appears to be only one category of laws whose applicability turns, or should turn, on a rating: securities laws.[122] This intuitively follows because the purpose of ratings is to assess the risks associated with the payment of *securities*.[123] Conceptually this follows because rating agencies perform the same function as securities law – reducing the information asymmetry between issuers of and investors in securities.[124] NRSRO designation is therefore a component of securities law and should be analyzed in that context.

NRSRO designation at first appears to be a theoretically unusual approach to securities law. In the U.S., for example, the historical debate regarding enactment of securities laws focused on whether those laws should provide for full disclosure or, instead, governmental merit analysis. State "blue sky" laws provided for the latter.[125] Unlike these state laws, however, the consensus was that federal securities laws should not "establish a system of merit regulation."[126] The rationale was that "investors' ability to make their own evaluations of available investments [through the federal regulatory framework of full disclosure] obviates any need that some

---

[121] *See supra* notes XX-XX and accompanying text.

[122] *See, e.g., supra* notes XX-XX and accompanying text (discussing securities laws exemptions based on NRSRO-designation).

[123] *See supra* note XX and accompanying text.

[124] *See* text accompanying note XX, *supra* (discussing same).

[125] HAZEN, THE LAW OF SECURITIES REGULATION, *supra* note XX, at 7.

[126] *Id.*

observers may perceive for the more costly and time-consuming governmental merit analysis of the securities being offered."[127]

NRSRO designation, however, constitutes an indirect form of merit regulation of securities. This is because the designation itself, which controls whether or not securities law exemptions become available, is based on governmental merit analysis of the rating agencies. Nonetheless, this form of merit analysis may be superior to full disclosure. The historical rationale for full disclosure – that investors' ability to make their own evaluations of available investments obviates the need for costly and time-consuming merit analysis[128] – is not always applicable. In the case of evolving and complex debt structures, for example, the cost of each investor individually evaluating his or her investment would be excessive. Rating agency evaluation, in contrast, provides an economy of scale.[129] Furthermore, at least as presently performed, the minimal merit analysis needed for NRSRO designation is neither costly nor time-consuming.[130] Thus NRSRO designation, even though a form of merit regulation, may well be appropriate.

This view is supported by commercial law theory. In contrast to the traditional approach of the past two centuries (referred to as transactional regulation) in which "public agencies have assumed responsibility for the oversight and direct regulation of

---

[127] *Id.*

[128] *See supra* note XX and accompanying text.

[129] *See supra* note XX and accompanying text. Ratings thus would be viewed as a de facto substitute for full disclosure to the extent that investors rely on ratings in lieu of disclosed information. Whether this shift in reliance is justified, however, is beyond the scope of this article. *Cf.* Revisions to Rules Regulating Money Market Funds, Investment Company Act of 1940 Release Nos. 33-6882; IC-18005, 56 Fed. Reg. 8113 (Feb. 27, 1991) (indicating that investors should not use ratings as a substitute for making informed judgments based on disclosure); PEACOCK, A REVIEW OF MUNICIPAL SECURITIES AND THEIR STATUS UNDER THE LAW 2037, 2040 n. 22 (1976) (arguing that due to the lack of information available to investors, "ratings have doubtless played too important a role in investors' decision making process"). Opponents of the shift may argue, for example, that ratings do not cover fraud risks, that rating agencies rely only on information provided by the issuer, and that the integrity and reliability provided by independent professionals such as investment banks and attorneys are discounted where investors read the offering papers less carefully or completely. *See Universal Language, supra* note XX at 252 n. 76.

[130] Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies: Well-Placed Reliance or Free-Market Interference?, supra* note XX, at 323. *But compare Current Status of Rating Agencies, supra* note XX at 611-14, which in a U.S. context argues that the SEC should be given explicit statutory authority to establish formal standards for NRSRO designation, require NRSROs to register with the SEC, and promulgate rules governing NRSROs. At some point, however, increased formalization and registration may increase costs beyond the level that justifies merit regulation.

the conduct of ... private parties,"[131] a system of commercial law only should require the State to establish the "minimal structure necessary to create private institutions that will then operate under market incentives" to allocate public resources[132] (an approach known as organizational regulation[133]). The rationale for favoring organizational over transactional regulation derives from actual experience. Organizational regulation produces "rules that are optimal in light of the costs of the rules"[134] because it relies on simple commitment mechanisms, such as reputation.[135] Transactional regulation, however, "does a particularly poor job of achieving optimal legal complexity"[136] because protecting the legitimacy of the State, not efficiency,[137] is its primary goal. Thus, it treats as absolute the value of the rights at stake while largely ignoring costs.[138]

In the commercial context of rating securities, the State's legitimacy is not at issue and the rights at stake need not be treated as absolute. Accordingly, organizational regulation should be legally optimal.[139] The NRSRO-designation then derives its normative authority from being a form of organizational regulation – a minimal governmental structure, relying on the simple commitment mechanism of reputation, in which private institutions (rating agencies) operate under market incentives to allocate public resources.[140] NRSRO designation thus appears, at least conceptually, to be a justifiable form of regulation.

---

[131]Gillian Hadfield, Privatizing Commercial Law: Lessons from the Middle and the Digital Ages, *supra* note XX, at 26. Professor Hadfield argues that this "traditional" approach is really stuck in the nineteenth century: "our historical perspective on the law is too modern [and thus] seems 'necessary' because we do not remember that it was not always as it is now." *Id.* at 10.

[132]*Id.* at 25-26 (referring to this structure as the "constitutional law"). This structure is intended to create "the conditions favorable to the development of efficient private governance regimes for commercial entities, much as the role of the state is to structure the conditions favorable to the development of efficient private mechanisms – i.e., markets – for the production and distribution of goods and services." *Id.* at 36.

[133]*Id.* at 26.

[134]*Id.* at 40-41 (discussing the experience of private legal regimes in trade associations).

[135]*Id.* at 49.

[136]*Id.* at 38.

[137] Recall that in an economic context where health and safety are not at issue, the rationale for regulation is to improve efficiency. *See supra* note XX and accompanying text.

[138]Hadfield, *Privatizing Commercial Law: Lessons from the Middle and the Digital Ages*, *supra* note XX, at 41.

[139]*Id.* at 59.

[140]*See supra* notes XX-XX and accompanying text.

The remaining question is how to balance the protection provided by the NRSRO-designation with the goal of ensuring that a sufficient number of rating agencies receive such designation to assure competition. In this context, it has been proposed that NRSRO-designation be awarded to some foreign recognized rating agencies, as well as to arms' length subsidiaries of domestic firms active in evaluating the business and securities of companies.[141] There should be relatively little risk if these entities are well-capitalized, have reputations for "quality financial analysis in the investment community," and have acceptable business plans to rate securities.[142] The risk could be further minimized by making any *de novo* applicant's NRSRO-status provisional for some trial period.[143] In this way, the "potential anticompetitive effect" of NRSRO designation can, consistent with the integrity of such designation, be reduced.[144] Reducing the anti-competitive effect also would mitigate any theoretical concern that rating agencies will engage in cartel behavior, such as by giving unnecessarily negative ratings or extracting oligopoly profits.[145]

D. Multinational Considerations: This article's analysis has thus far indicated that additional regulation of rating agencies is unnecessary and probably inefficient. This view is reinforced by the fact that rating agencies are multinational entities whose assets are human capital. As such, a rating agency subject to excessive regulation would be more likely than an ordinary multinational company to relocate to a foreign country that does not impose such regulation,[146] assuming the country has

---

[141] Letter from Antitrust Division of the U.S. Department of Justice to the SEC 3 (Mar. 6, 1998) (commenting on the SEC's proposed amendments to Rule 15c3-1 regarding NRSRO designation; and listing investment and commercial banks, insurance companies, and accounting and consulting firms as examples of the types of firms active in evaluating companies' business and securities) (on file with author).

[142] *Id.* Consideration might even be given, for example, to firms that utilize alternative rating approaches, such as credit spreads (*cf. supra* note XX) and stock-price volatility (*see, e.g., Process Reengineering*, OWC Credit Comments, Issue No. 23, at 2 (May 6, 1992) (noting that, for publicly traded companies, stock-price volatility may signal credit troubles earlier than rating agencies become aware of them) (available at http://www.erisks.com/reference/archive/142_23processre.pdf) (visited Apr. 26, 2001).

[143] Letter from Antitrust Division to the SEC, *supra* note XX, at 3 (proposing a 12-18 month trial period).

[144] *Id.* at 1.

[145] This does not, however, appear to be a realistic current concern; indeed, the prevalence of split ratings is evidence against cartel behavior.

[146] *Cf.* RICHARD W. JENNINGS, HAROLD MARSH, JR. & JOHN C. COFFEE, JR., SECURITIES REGULATION 3 (7th ed. 1992) (observing that, because securities markets are increasingly international, "if one jurisdiction regulates more intensively than

the educational infrastructure to supply the ongoing need for analysts.[147] This in turn might lead to a race to the bottom,[148] in which countries compete to reduce their level of regulation in order to attract rating agencies that wish to relocate. Reputational considerations might mitigate relocation to the extent that a rating agency prefers to comply with the regulation as an additional means of signalling to the market its reliability[149]; but ultimately a rating agency would have to balance the cost of such

---

others, it may induce issuers – both domestic and foreign -- to flee 'overregulation' by using a foreign market").

[147]For example, a senior officer of a major rating agency disclosed to the author in confidence in connection with this article that the agency chooses not to open offices in countries where it feels the regulatory environment jeopardizes its independence, objectivity, or ability to develop and apply rating criteria. Confidential e-mail (on file with author). Of course, the flexibility to relocate would be less in such dominant markets as the United States, especially to the extent the rating agency desires to continue to have its ratings qualify for the NRSRO securities law exemptions. Furthermore, a State could attempt to indirectly regulate foreign rating agencies that assign ratings to securities issued in its jurisdiction by directing enforcement at the issuer located in the State, much like a State can tax interest income paid to a foreign lender by requiring a domestic borrower to withhold a portion of the interest payable and turn it over to the State as a withholding tax. *See The Universal Language of Cross-Border Finance*, *supra* note XX, at 249.

[148]In the United States, for example, the term "race to the bottom" generally refers to the tendency of corporations to incorporate in states with the least restrictive regulation, which in turn (because states derive revenue from corporate charters) motivates states to reduce their level of regulation. *See, e.g.,* Ralph K. Winter Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, *in* ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 91, 92-94 (Richard A. Posner & Kenneth E. Scott eds., 1980) (arguing this has led to a "steady lessening of the restrictiveness of state corporation laws"); Joseph W. Singer, *Real Conflicts*, 69 B.U.L. REV. 3, 63-65 (1989) (discussing the "race to the bottom" in relation to comity and the choice of law question in dispute resolution). *But cf.* Joel P. Trachtman, *International Regulatory Competition, Externalization, and Justification*, 34 HARV. INT'L L. J. 47, 49 (1993) (arguing that regulatory competition sometimes can lead to more efficient and innovative practices).

[149] Empirical evidence from the European Union suggests, for example, that to the extent advantageous in issuing securities, companies will comply with market standards that are even more stringent than legally required. *See* Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999 – Part I*, 56 BUS. LAW. 653 (2001) (examining how European Union issuers utilize the flexibility under E.U. law to choose, for preparation of disclosure documents, the securities law of either the issuer's home-State or the State in which the securities are issued, *id.* at 654; and finding, *id.* at 655, that market forces "require European issuers of common stock to disclose more information and prepare disclosure documents more carefully than legal rules formally require").

compliance with the costs of relocating, including any perceived loss of reputation.

A possible solution to this dilemma is to impose regulation on a global scale.[150] However international regulation of rating agencies, like any other form of global regulation, would be inherently costly if not impractical in our "primitive" system of international law.[151] Thus, comprehensive international regulation would be unnecessary, costly, and impractical.

Even minimal international regulation, by analogy to the NRSRO-designation, appears unnecessary. A limitation of such a designation is that it is national, not international. Inconsistent designation criteria among countries therefore might create confusion for cross-border financings, which have become increasingly common, and also could create the potential for inconsistent application of bank capital adequacy standards.[152] One therefore may ask whether there should be a *globally* recognized statistical rating organization (perhaps called GRSRO) designation.

I do not believe that global designation is necessary, or that inconsistent NRSRO designations are likely to give rise to confusion.[153] In a given transaction, the only relevant NRSRO designation would be that of the country where the applicable securities are issued.[154] Thus, in a cross-border securitization transaction where, for example, a company in State X sells receivables to an SPV in State Y which in turn obtains financing by issuing securities through an SPV in State Z, only State Z's NRSRO designation would be relevant. There is little room for confusion.

---

[150]*Compare* EATWELL & TAYLOR, GLOBAL FINANCE AT RISK, *supra* note XX, at 6, 208-39 (arguing for the creation of a "World Financial Authority" to solve the dilemma that "financial markets know no borders. Yet regulatory power remains trapped within increasingly irrelevant national borders").

[151]THOMAS BUERGENTHAL & HAROLD G. MAIER, PUBLIC INTERNATIONAL LAW 19 (2d ed. 1990) ("[v]iewed in terms of law-making, international law is a primitive legal system").

[152]*See, e.g., Standard & Poor's Official Response to the Basel Committee's Proposal, supra* note XX, at 5 (cautioning that "international comparability" of ratings needs to be assured so that "all users understand what different agencies' ratings imply for risk weightings"). The Basel Committee itself notes that, because its approach places "increased reliance by [bank] supervisors on external credit assessment institutions, ... it is therefore important that criteria for recognising these institutions [recognition being done by each national bank supervisory authority] be set at an appropriately high standard." *A New Capital Adequacy Framework, supra* note XX, at 33 (and, at 34, setting forth minimum criteria for such recognition).

[153]Even the Basel capital adequacy proposal contemplates country-by-country NRSRO designation. *See A New Capital Adequacy Framework, supra* note XX, at __.

[154]*See Universal Language, supra* note XX, at 237-38 (discussing that one must consider the *local* regulatory restrictions of countries in which securities are issued).

On the other hand, GRSRO designation procedures, even if practical, would be costly because of the political maneuvering needed to achieve international consensus as well as the need to conform national securities laws that presently rely on NRSRO designation to the new designation procedure. Furthermore, a single GRSRO designation might exacerbate the anti-competitive effect of national designation by diminishing the ability of local rating agencies to germinate and grow.[155]

III. Conclusion

This article focuses on the extent to which rating agencies, which dominate the private ordering of public markets, should be regulated.

In an economic context, the normative rationale for regulation is to improve efficiency. Rating agencies are already motivated to provide accurate and efficient ratings because their profitability is directly tied to reputation. Historical data confirm that the reputational motivation is sufficient. Additional regulation of rating agencies thus would impose unnecessary costs and thereby diminish efficiency.

Theory confirms that reputation can be a substitute for regulation. At least for rating agencies, reputation drives much of the accountability that ordinarily is achieved through the democratic process.

Because rating agencies are somewhat representative of the emerging trend toward private ordering of traditionally public functions, this article's analysis also has implications for private ordering by NGOs other than rating agencies.[156] As mentioned, one of the central questions of private ordering is the extent to which it undercuts democratic authority. This article has shown that reputational constraints can be viewed as a normative complement to the democratic process (although these constraints are not a complete substitute for democratic accountability where, as with rating agencies, the NGO's reputation is relevant to only a subset of the State's populace).

The rating agency model further illustrates that organizational regulation – illustrated in a rating agency context by the NRSRO-designation – sometimes may be preferable to transactional regulation. Organizational regulation would be especially appropriate for NGOs that operate in commercial, financial, and other economic

---

[155] *Cf. infra* note XX and accompanying text (discussing the anti-competitive effect of NRSRO designation). One might argue that a single global standard might help international investors, but markets already are able to judge the quality of rating agencies – indeed, market perception is the primary basis to date of NRSRO determination. *See* Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies: Well-Placed Reliance or Free-Market Interference?, supra* note XX, at 323.

[156] The term NGO referring to any non-governmental organization. *See supra* note XX and accompanying text.

spheres, where protecting the State's legitimacy is not the primary goal.

The rating agency model also provides a reminder that, in a multinational context, NGOs subject to excessive regulation may be more likely than ordinary multinational companies to relocate to foreign States that do not impose such regulation. This is particularly likely where, as with rating agencies, the NGO's assets are human capital and foreign States have the requisite educational infrastructure. Reputational considerations might, however, mitigate relocation to the extent an NGO prefers to comply with regulation as a means of signalling its reliability.

This is not to say that the rating agency model is completely representative of NGO private ordering. To some extent rating agencies constitute a more difficult case because, unlike some NGOs which are really hybrid public-private entities,[157] rating agencies are purely private entities. On the other hand, rating agencies constitute an easier case of private ordering to the extent the normative regulatory goal of efficiency is less controversial in financial markets, where rating agencies operate, than in other domains. When examining other forms of private ordering, one thus must not only examine efficiency but also ask whether other regulatory goals should apply. This article is therefore only a first step in the analysis of a much larger problem.[158]

---

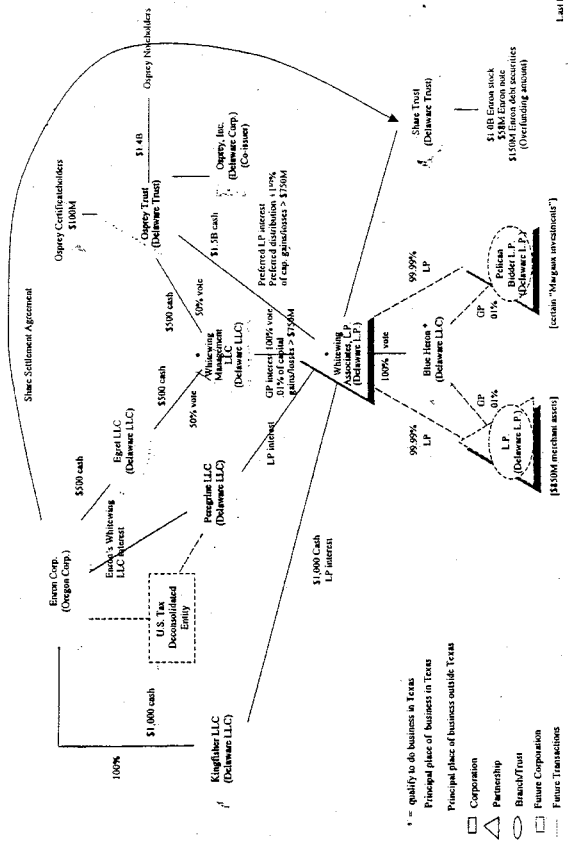
[157] For example, one of the most well-known NGOs, The International Organization for Standardization (ISO), is a "worldwide federation of national standards bodies from some 130 countries," http://www.iso.ch/infoe/intro.htm# (visited Apr. 5, 2001); some of these "national standards bodies" are official governmental bodies, others are private. *See* http://www.iso.ch/addresse/membodies.html (visited Apr. 5, 2001).

[158] I attempt to take additional steps towards that analysis in Steven L. Schwarcz, *Private Ordering* (unpublished manuscript) (analyzing private ordering of commercial, financial, and other economic activities).

PROJECT MARGAUX

Whitewing Associates, L.P. Financing Transaction

September [24], 1999



E 96352

Confidential Treatment Requested By Wilmer, Cutler & Pickering

FitchRatings

Charles D. Brown
General Counsel

One State Street Plaza
New York, NY 10004

T 212 908 0626 F 212 968 8839
E charles.brown@fitchratings.com
www.fitchratings.com

Responses to Questions Posed by Senator Carl Levin
During the Hearing on March 20, 2002
from Ralph G. Pellecchia, Senior Director, Global Power Group, Fitch Ratings

The Honorable Carl Levin
Committee on Governmental Affairs
U.S. Senate
340 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Levin:

As General Counsel to Fitch, Inc. ("Fitch"), I write this letter in response to the three questions for which you requested additional information from Fitch during the Senate Governmental Affairs Committee hearing entitled "Rating the Raters: Enron and the Credit Rating Agencies" conducted on Wednesday March 20, 2002.

The outstanding questions, as we understand them, are set forth below followed by Fitch's responses to each. The information contained in these responses was provided by David Howard, a Managing Director and a senior structured finance analyst at Fitch , who supervised the analyst responsible for following the Enron North America transaction and who participated on the ENA credit committee.

1. *How can your credit rating agency give an investment grade to those [lowest-rated ENA] notes when nobody else would buy them? How does that work?*

The lowest-rated tranche of the Enron North America collateralized loan obligation notes ("ENA CLO") referenced on page 138 of the Powers Report was the $40,200,000 class B-2 notes. Fitch rated this class BB. Securities rated BB are not investment grade and are categorized as speculative, indicating a higher probability of default. Below this tranche in the transaction was an unrated equity tranche.

It is common for equity tranches to be retained by an affiliate of the issuer. Similarly, it is not unusual for one or more of the lowest-rated tranches to be retained by the

issuer or sold to an affiliate of the issuer. Rated securities, particularly those rated below investment grade as was the case here, may not find buyers for a number of reasons including relative illiquidity, complexity, and rating.

2. *Was it known to any one in your agency that there was a purchase guarantee [for the ENA CLO notes]? Was it publicly known that that guarantee existed? If there was a guarantee, would that have affected—assuming it went back to Enron—the value of Enron's stock?*

At the time Fitch first assigned ratings to the ENA CLO in December 1999, Fitch was not aware of any explicit or implicit guarantees made to any investor.

In mid 2000, it became apparent that the loans in the ENA CLO were not performing well. On July 7, 2000, Fitch placed the ENA CLO notes on Rating Watch Negative. Enron subsequently informed Fitch that the $40,200,000 class B-2 notes were owned by an Enron-related entity and requested that the rating on those notes be withdrawn, which Fitch did on August 8, 2000.

Fitch and Enron also had numerous discussions about Enron providing additional collateral to the trust in order to maintain the existing ratings of the A and B-1 class notes. As a result, Enron agreed to make a substantial capital infusion of $113 million to the trust and committed to add even more collateral if needed. This additional support for the portfolio was considered a positive market event. Nonetheless, the performance of the loans continued to deteriorate and in mid 2001 Enron decided to repurchase the notes.

In Fitch's experience, it is not unusual, where a transaction is underperforming and the issuer is made aware of a possible downgrade as was the case here, for that issuer to take remedial measures to improve the portfolio's performance.

Those individuals at Fitch responsible for rating Enron's corporate debt were kept informed of these developments and considered this information in their ratings. In addition, as a result of the poor performance of the ENA CLO, specific inquiries were made of Enron's management by Fitch's analysts as to whether there were any other structured finance transactions arranged by Enron in which the underlying assets were performing poorly or in which Enron was opting to provide additional credit enhancement. Enron responded that there were no such other transactions and that the ENA CLO transaction was unique.

Any possible affect a guarantee may have had on the value of Enron's stock is beyond Fitch's area of expertise.

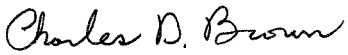
3. Is the Project Margaux transaction a typical structured deal and is it comprehensible?

No one currently employed by Fitch recalls rating Project Margaux or seeing the chart that was used as an exhibit during the hearing. We believe that Project Margaux was reviewed, but not rated, by Duff & Phelps Credit Rating Co. before Fitch acquired it.

Judging from the chart, this is a complicated transaction. One cannot understand the transaction to a reasonable degree of completeness without looking at the underlying documents. With those documents, the chart may or may not be comprehensible. Although Fitch has certain documents related to some of the entities referred to in the chart, Fitch does not have the full set of transaction documents necessary to understand the chart. Nor is Fitch aware if this transaction was ever completed. Although the transaction reflected by the chart is not typical, structured finance transactions can often be exceedingly complicated.

Please let me know if we can provide you any further information.

Very truly yours,



Charles D. Brown

cc: The Honorable Joseph I. Lieberman, Chairman
The Honorable Fred Thompson, Ranking Member
The Honorable Robert F. Bennett
The Honorable Jim Bunning
Mr. Jerry Feierstein
Cynthia Lesser, Esq.

Response to Questions from Chairman Lieberman, after March 20, 2002 Hearing, "Rating the Raters: Enron and the Credit Rating Agencies"
from the Hon. Isaac C. Hunt, Jr.

1) When can we expect some recommendations from the SEC about possible regulations on NRSROs?

As you know, the Commission is conducting a thorough examination, which may include hearings, to ascertain facts, conditions, practices and other matters relating to the role of rating agencies in the U.S. securities markets. It is our intention to call upon a number of experts for their views, including market professionals who rely on credit ratings and academics, as well as the NRSROs themselves. It is currently too soon to estimate when the examination will be complete; however, the Commission has already begun its examination by conducting initial meetings with several credit rating agencies. After the examination is complete, we will promptly inform you of any possible approaches regarding the regulation of NRSROs.

2) Several of the analysts on the first panel indicated that Enron undertook an aggressive campaign to obtain a higher credit rating. What are your thoughts on this?

Because of the Commission's ongoing investigation into the Enron matter, I cannot respond directly to your question regarding Enron. Generally, however, during the Commission's examination of the role of credit rating agencies, the staff will look into procedures used by rating agencies to determine a firm's credit rating, including procedures to ensure that the rating reflects an independent assessment of the firm's creditworthiness and that the rating agencies have sufficient processes to protect themselves from undue aggressive campaigns from company executives.

3) Does there need to be more separation between credit rating analysts and company executives?

The Commission's examination of the role of credit rating agencies in the U.S. securities markets will explore this issue. Accordingly, I believe that it would be premature for me to suggest whether there should be more separation between credit rating analysts and company executives before the Commission has completed its examination. I would note, however, that when the Commission proposed to define the term "NRSRO," the extent of a credit rating agency's contacts with an issuer's management, including access to senior level management, was proposed as a criterion to be evaluated by the staff in connection with a firm's request for NRSRO designation.

Written Responses to Questions for the Record
from Jonathan R. Macey

"Rating the Raters: Enron and the Credit Rating Agencies"

March 20, 2002

Question No. 1: You said that "academic studies tend to show that the information in credit ratings is of marginal value at best because the information contained in ratings had already been incorporated into share prices." Can you elaborate on this?

Response: Academic studies tend to show that the information in credit ratings lags significantly the information contained in share prices in the sense that credit ratings don't change until share after prices demonstrate a significant decline, thereby demonstrating that the market "knows" that a company is in trouble before the credit rating agencies get around to lowering the credit ratings.

Question No. 2: Several of the analysts on the first panel indicated that Enron undertook an aggressive campaign to obtain a higher credit rating. What are your thoughts on this?

Response: With regard to "campaigns" by corporations to obtain higher credit ratings, it is my view that such campaigns are inappropriate only if they involve the improper allocation of gifts or promises of future employment to employees of the credit rating agencies. There also would be a problem if companies conditioned the allocation of additional business to the credit rating agencies on obtaining a certain credit rating. However, if the campaigns simply involve providing information to the credit rating agencies, then there is no problem with such campaigns.

Question No. 3: Does there need to be more separation between credit rating analysts and company executives?

Response: Regarding separation between credit rating analysts and company executives, it is my view that credit rating agencies should have clear rules preventing their employees from working for a company that they have analyzed during their employment at the rating agency for a period of five years. These rules should be in addition to rules preventing such employees from fraternizing with, accepting gifts from or being entertained by the companies that they are rating.

RESPONSES FROM GLYNN REYNOLDS
TO QUESTIONS FOR THE OFFICIAL RECORD
SUBMITTED BY SENATOR JIM BUNNING

"Rating the Raters: Enron and the Credit Rating Agencies"

March 20, 2002

Question 1: Several of the analysts on the first panel indicated that Enron undertook an aggressive campaign to obtain a higher rating. What are your thoughts on this?

Glenn Reynolds: Enron was well known as a very hands-on, activist management team when it came to placing their bond deals and various financings in the marketplace, so it is not a surprise that they took an approach with the rating agencies that mirrored their behavior patterns with their relationship banks. It is not uncommon for companies to meet regularly with the rating agencies to "make the case" for improved ratings, and it is even more common for funding-sensitive issuers. That description usually fits brokerage firms, finance companies, and banks. The fact that, in Enron, we had a power company with that degree of earnings sensitivity to its credit ratings was an anomaly, and was in many ways a reason to meet them more frequently to examine this unusual business model. Enron was well within its rights to make their case. The rating agencies also would be well within their rights to demand much more rigorous disclosure from the company to merit consideration for higher ratings. For the agencies, it was important to raise the bar for Enron as the company pressed them for an upgrade, and this became more important for the agencies as other power companies started copying aspects of the Enron business model.

For Enron, an upgrade to the singe A tier from the BBB tier was crucial to their credit-intensive business model. The reason is that many financial and trading institutions have more stringent exposure limits and more onerous terms for BBB companies in extending counterparty credit lines (swaps, trading lines, etc.). Enron's strategic focus on being a trading shop and running an "asset lite" business required access to much greater credit lines, and the single A rating would have made that possible. That would in turn drive their earnings and stock price, so the single A designation was a compelling priority. Justifying that rating also may have been an additional impulse for their bad behavior and desire to mask their contingent liability risks. In the end, it is no surprise that they were very actively marketing the agencies for an upgrade. If Enron had been able to get to single A tier for whatever reason, we accordingly might have had an even bigger disaster on our hands today as that much more credit exposure would have been in the marketplace from their derivative ledger.

Question 2: Does there need to be more separation between credit rating analysts and company executives?

Glenn Reynolds: If the goal is to improve the information flows and provide better safeguards for the investor in the marketplace, there should be more interaction between the analysts and management, not less. Less interaction would lead to less informed analysts, and that would be a disaster for the quality of the ratings system. It would also lead to the rating agency analysts being the weakest link in the marketplace. The rating agencies carry a big stick and have a unique pulpit in the market, so they need to use it more effectively, not shrink from management interaction. At the end of the day, they have something the companies want (an upgrade or the absence of a downgrade), so they have clout.

With an exemption from Reg FD, the agencies have a regulatory free reign to gather confidential information to benefit the marketplace indirectly or, hopefully in the future, more directly. They are exempt from liability under the securities laws, and they have the ability to use their leverage to lean on management to extract information that others cannot. Where others can gain such information, such as with the investment banks, the information is gathered in the role of "issuer advocate" and is not used for the benefit of clarity in the marketplace. The agencies could not be better armed by virtue of their mandate to deal with management teams, so it would make little sense not to encourage a more aggressive posture and more interaction with the executives of volatile companies that lack transparency. Having more barriers between management and the analysts would not have helped in the Enron case, and will not reduce the risk of future Enrons. The analysts and their ratings committees have to be up to the job, which a quality-of-performance issue and a separate topic. They need to have the ability to do their jobs, however, and steady interaction with management is an intrinsic part of that job.

RESPONSES FROM STEVEN L. SCHWARCZ
TO QUESTIONS FOR THE OFFICIAL RECORD
SUBMITTED BY SENATOR JIM BUNNING

"Rating the Raters: Enron and the Credit Rating Agencies"

March 20, 2002

Question 1: "Several of the analysts on the first panel indicated that Enron took an aggressive campaign to obtain a higher credit rating. What are your thoughts on this?"

Response: In my (quite extensive) experience, every company aggressively tries to obtain a higher credit rating. Indeed, it would be foolish not to. It is therefore up to the rating agencies to maintain arm's length objectivity and independence. Prior to becoming a full-time academic six years ago, I spent years representing issuers in obtaining ratings. As hard as my clients tried to influence ratings, I have never seen rating agencies behave other than objectively and with arm's length independence.

Questions 2: "Does there need to be more separation between credit rating analysts and company executives?"

Response: I don't believe so, at least not by government regulation. The rating agencies themselves, in my experience, maintain very high internal standards of independence and objectivity. Moreover, as my recent article ("Private Ordering of Public Markets: The Rating Agency Paradox," 2002 U. Illinois Law Review 1 (2002), the final version of which is attached for your convenience) illustrates (see text accompanying notes 83-87, 91, & 97), the actual or even perceived failure of rating agencies to maintain and observe these standards would seriously impair their reputational credibility, seriously damaging them.

○