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# THE RATINGS GAME: IMPROVING TRANSPARENCY AND COMPETITION AMONG THE CREDIT RATING AGENCIES

## HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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# THE RATINGS GAME: IMPROVING TRANSPARENCY AND COMPETITION AMONG THE CREDIT RATING AGENCIES

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**Tuesday, September 14, 2004**

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.*

The subcommittee met, pursuant to call, at 10:04 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Gillmor, Biggert, Capito, Brown-Waite, Kanjorski, Moore, Ford, Lucas of Kentucky, McCarthy, and Scott.

Chairman BAKER. [Presiding.] I would like to call this meeting of the Capital Markets Subcommittee to order.

The purpose of this morning's hearing is to again review the performance and regulatory authority for the conduct of what are commonly known as the credit rating agencies. On April 2, 2003, this committee convened a hearing in the course of its normal review of market sector performance to hear from a representative of the SEC and others concerning the status of and performance of the rating agency community.

To date, there is not clearly established a methodology by which a corporate entity may become recognized as a rating agency. There is no ongoing supervision as to the methodologies utilized in performing their duty, and there is not a method to formally decommission an agency once having been designated.

The purpose of today's hearing is to receive additional comment as to the advisability of either SEC rule or legislative action to provide additional transparency, to provide sufficient disclosure as to methodologies, and to evaluate the very manner by which these agencies engage in their rating practices.

The Investment Company Act requires the maintenance of at least two rating agency analyses before issuance of public debt, and therefore there is a statutory requirement that public corporations utilize the services of these rating agencies. That makes it all the more important for us to make sure that market participants fully understand their function and the methodologies by which these ratings are issued. It is clear, at least to me, that we are a long way from that type of functioning system.

Secondarily, it is extraordinarily important that the agencies engage in and conduct arms-length evaluations to ensure the ratings which are used by many in the market for various purposes are reliable and professional. It is troubling to realize the superficial nature by which many of the ratings have been issued and the reliance that many have placed upon that data. We only have to return to the bursting bubble a few months back and painfully look at the ratings issue just prior to many prominent corporations' announced bankruptcies.

How is it that these events came to pass? What is it that needs to be changed to ensure that it does not occur again in the future? And are there other options available to us to obtain the necessary financial data without perhaps mandatory reliance on the rating agency system as it is structured today?

For all these reasons, the committee meets. We will be pleased to hear the comments of those who have agreed to testify, and would point out that Standard & Poor's, which was invited to participate, notified the committee as of yesterday they would be unable to attend here today. We look forward to hearing from them on another occasion.

With that, I yield to the gentleman from Pennsylvania.

Mr. KANJORSKI. Mr. Chairman, we meet for the second time in the 108th Congress to examine the issue of credit rating agencies.

Entities like Moody's, Standard & Poor's and Fitch have long published their views on the creditworthiness of the issuers of debt securities. The importance of these opinions has grown significantly in recent years as a result of the increases in the number of issues and issuers, the globalization of our financial markets and the introduction of complex financial products like asset-backed securities and credit derivatives.

As you know, Mr. Chairman, I have made investor protection one of my top priorities. I believe that strong regulation helps to protect the interests of America's investors.

Accordingly, I am pleased that we have worked diligently during the last several years to augment the resources available to the Securities and Exchange Commission, enacted sweeping reforms of auditing and accounting practices, restored accountability to investment banking and analyst research, and improved the conduct of business executives and corporate boards. Although credit rating agencies received some scrutiny after the recent tidal wave of corporate scandals, we have not yet mandated any substantive changes in their practices.

Nevertheless, this issue is ripe for examination and action. At hearings before our committee last year, the commission's Director of Market Regulation noted that while credit rating agencies have generally performed their work well for nearly a century, they have also missed some colossal failures in recent years. A Senate investigative report also found that the monitoring and review of Enron's finances "fell far below the careful efforts one would have expected from organizations whose ratings hold so much importance."

After last year's hearing, I was hopeful that the commission would take swift action regarding these matters. It did belatedly issue a concept release to examine the issues surrounding rating

organizations in June of 2003. Since that time, the commission has continued to study these matters without reaching any conclusion. The commission, I should note, has been examining these matters for more than a decade.

Although a formal proposal for improved oversight of credit rating agencies has yet to emerge, a top official at the commission did suggest in a recent speech that additional legislative authority may be needed I this area.

I have previously urged the commission to act promptly and prudently in these matters. It is therefore my expectation that it will move expeditiously in the coming months to finalize its opinions on credit rating agencies and advise us about the most appropriate steps to take in these matters during the 109th Congress.

When we revisit these matters next year, it is also my hope that we will be able to put together a more inclusive and comprehensive hearing. We are fortunate today to have with us two rating professionals. We will also hear from the Association for Financial Professionals, which has taken a leading role in examining the need and identifying ways to improve the oversight of credit rating agencies.

Rather than rushing to hold a hearing, our proceedings would have greatly benefited if we had waited and been able to receive the testimony of the commission, major credit rating agencies, and other interested parties.

In closing, Mr. Chairman, we are at a crucial moment in the evolution of our capital markets. We must act to ensure the continued integrity of the rating agencies and the credit rating process. I also look forward to continuing to work with you as we move forward deliberately on these important matters.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 27 in the appendix.]

Chairman BAKER. I thank the gentleman.

Mr. Scott?

Mr. SCOTT. Thank you, Mr. Chairman.

Due to the development of complex financial products and the globalization of the financial markets, credit ratings have been given increased importance. The credit ratings affect the securities markets in many ways, but the Securities and Exchange Commission has not performed any significant oversight over rating agencies. Several of the large corporate scandals at Enron, WorldCom and other companies were not brought to the attention of regulators by the rating agencies.

Since 1994, the SEC has developed proposed rulemaking to provide better oversight of rating agencies. I believe that it is time for the SEC to try to provide a better standard for oversight of rating agencies. In that regard, Mr. Chairman, I look forward to hearing from our distinguished panel about recommendations for the SEC review of the credit agencies.

Chairman BAKER. Thank you, Mr. Scott.

Ms. McCarthy, did you have a statement?

Mrs. MCCARTHY. Thank you, Mr. Chairman. I will hand in my opening statement. I would rather hear the testimony.

Chairman BAKER. Thank you, Ms. McCarthy.

If we could please have our witnesses come forward, we would like to recognize you at this time. This morning, we are pleased to

have Mr. Sean Egan, managing director of Egan-Jones Rating Company; Mr. James A. Kaitz, President and CEO, Association for Financial Professionals; Dr. Barron H. Putnam, President and chief economist, LACE Financial Corporation; and Mr. Alex J. Pollock, resident fellow, American Enterprise Institute.

Since Mr. Egan is a little behind this morning, we are going to start first with Mr. Kaitz.

Welcome, sir.

**STATEMENT OF JAMES A. KAITZ, PRESIDENT AND CEO, ASSOCIATION FOR FINANCIAL PROFESSIONALS**

Mr. KAITZ. Thank you, Congressman.

Good morning, Chairman Baker, Ranking Member Kanjorski, and members of the committee. I am Jim Kaitz, President and CEO of the Association for Financial Professionals.

AFP welcomes the opportunity to participate in today's hearing on improving competition and transparency among the credit rating agencies. As we have continually noted, AFP believes that the credit rating agencies and investor confidence in the ratings they issue are vital to the efficient operation of global capital markets.

AFP represents more than 14,000 finance and treasury professionals representing more than 5,000 organizations. Organizations represented by our members are drawn generally from the Fortune 1000 and the largest of the middle-market companies from a very wide variety of industries. Many of our members are responsible for issuing short-and long-term debt and managing corporate cash and pension assets for their organizations.

In these capacities, our members are significant users of the information provided by credit rating agencies. Acting as both issuers of debt and investors, our members have a balanced view of the credit rating process and a significant stake in the outcome of the examination of rating agency practices and their regulation.

When I appeared before this committee more than 17 months ago, I shared the results of a survey conducted by AFP in September 2002. In summary, that survey found that many of our members believe that the information provided by credit rating agencies is neither timely nor accurate and that the Securities and Exchange Commission should take steps to foster greater competition in the market for credit ratings and improve its oversight of rating agencies.

AFP is currently conducting an update to the 2002 survey and preliminary results indicate that confidence in the credit rating agencies has not improved. We will be releasing the results of the updated survey later in the fall.

In June of 2003, the SEC issued a concept release on rating agencies and the use of credit ratings under the federal securities laws. That concept release asked 56 questions about the nationally recognized statistical rating organization, designation, recognition criteria, the examination and oversight of NRSROs, conflicts of interest, and anticompetitive, unfair and abusive practices.

The concept release asked market participants to provide answers in less than 60 days. Yet more than 15 months after this concept release and more than a decade after a similar concept re-

lease in 1994, the SEC has yet to provide a single answer of its own.

To address many of the questions raised by the SEC and market participants, the Association for Financial Professionals in April of this year, along with treasury associations from the United Kingdom and France, took the initiative and developed an exposure draft of a Code of Standard Practices for Participants in the Credit Rating Process.

We are currently reviewing comments we received on the exposure draft and intend to release our final recommendations later this year. We developed the draft code in an effort to improve investor and issuer confidence in the credit rating agencies and the ratings they promulgate. This is particularly important in light of the SEC's continued inaction.

I have submitted a copy of the code, along with my testimony. However, I would like to take a minute to summarize the key themes. The code contains recommendations for regulators, as well as rating agencies and issuers. To be clear, the code is a private-sector response intended to complement rather than replace regulation.

Regulatory recommendations in the code of standard practices focus on establishing transparent recognition criteria based on whether a credit rating agency can consistently produce credible and reliable ratings over the long term. Establishing clearly defined recognition criteria is a crucial step to removing barriers to entry and enhancing competition in the credit ratings market.

The regulatory recommendations also include improving ongoing oversight of approved rating agencies to ensure that NRSROs continue to meet the recognition criteria. The code also urges regulators to require that rating agencies document internal controls that protect against conflicts of interest and anticompetitive and abusive practices that may arise from ancillary services such as corporate governance reviews and ratings advisory services.

For rating agencies, the code includes suggestions to improve the transparency of the rating process, protect non-public information provided by issuers, protect against conflicts of interest, address the issue of unsolicited ratings, and improve communication with issuers and other market participants.

Finally, recognizing that the credibility and reliability of credit ratings is heavily dependent on issuers' providing accurate and adequate information to the rating agencies, the code of standard practice outlines issuer obligations in the credit rating process. These obligations are intended to improve the quality of the information available to the rating agencies during the initial rating process and on an ongoing basis, and to ensure that issuers respond appropriately to communications received from rating agencies.

Other organizations have also taken steps to address this critical issue. The International Organization of Securities Commissions, IOSCO, in September 2003 issued a statement of principles regarding the manner in which rating agency activities are conducted. In February of this year, IOSCO also announced the formation of a special task force chaired by SEC Commissioner Campos to develop

a code of conduct for credit rating agencies. We expect IOSCO to issue that code shortly.

In July, the Committee of European Securities Regulators, at the request of the European Commission, issued a call for evidence on possible measures concerning credit rating agencies. The committee intends to review comments, develop a consultation paper, hold an open hearing, and approve and publish its final advice to the European Commission in March 2005, I would note, less than 8 months after the commencement of its activities.

Despite all this activity, the SEC remains silent on the appropriate regulation of credit rating agencies. At hearings before the Bond Market Association in January, a senior SEC official admitted that the commission needs to come up with an approach or "cede the area" to other rulemakers. By its continuing inaction on this issue, the SEC is abdicating its responsibility to capital market participants and potentially subjecting issuers, investors and rating agencies to a fragmented, duplicative and overly prescriptive regulatory regime.

A reasonable regulatory framework that minimizes barriers to entry and is flexible enough to allow innovation and creativity will foster competition among existing NRSROs and those that may later be recognized and restore investor confidence in the rating agencies and global capital markets. Rather than excessively prescriptive regulatory regimes, innovation and private-sector solutions, such as AFP's Code of Standard Practices, are the appropriate responses to many of the questions that have been raised about credit ratings.

Restoring issuer and investor confidence in the credit ratings process is critical to global capital markets. We commend you, Mr. Chairman and the committee, for recognizing the importance of this issue and its impact on all institutional and individual participants in global capital markets. We hope this hearing will motivate the SEC to action.

In addition, regulators should require rating agencies to develop policies to insure against the inappropriate use of nonpublic information to which the rating industries are privy because of their exemption from regulation FD. Recently, the SEC took action against a former credit rating agency employee who used nonpublic information regarding pending mergers for personal enrichment. While we cannot comment on the specifics of this case, this again highlights the need for the SEC to take an active role in the oversight of credit rating agencies.

Thank you.

[The prepared statement of James A. Kaitz can be found on page 31 in the appendix.]

Chairman BAKER. Thank you very much, sir. We appreciate your comments.

Dr. Putnam, please proceed.

**STATEMENT OF BARRON H. PUTNAM, PRESIDENT AND CHIEF ECONOMIST, LACE FINANCIAL CORPORATION**

Mr. PUTNAM. Thank you, Mr. Chairman and other distinguished members of the committee. My name is Barron Putnam and I am President of LACE Financial Corporation. I am a former staff

member of the Federal Reserve Board here in Washington. While I was at the Fed, I chaired the committees that put together—this is a three-interagency bank committee that put together the off-site rating system for the Fed. I also set up the Bank Holding Company Analysis Program for the Fed and I directed for the Fed the surveillance of all banks and bank holding companies for a period of 10 years.

I left the Fed in 1984 and established LACE Financial Corporation. LACE Financial rates approximately 20,000 institutions. We have issued over a period of 20 years about 1.2 million credit ratings. We have never received a complaint from a regulator, be it state or federal or any regulator, nor have we ever had a serious threat of a lawsuit. We have actually rated banks and other financial institutions prior to Moody's and Standard & Poor's entering the market.

I have been in the banking business for more than 25 years. I would like to say that it is an honor for me to sit here today before your committee.

I would like to address two areas of concern to your committee, the NRSRO designation process and the anticompetitive effects that the SEC net capital rules and the NRSRO designation have on a rating company like ours.

First, we submitted our application for NRSRO status back in 1992. Eight years later, we received a phone call from a lawyer at the SEC stating that our application was denied. I asked him what the reason was, and he could not give that to me over the phone. So I said, well, would you put it in writing. He was a little surprised that I asked for that, but they sent it to me and the denial was based on the fact that we only had three financial analysts. I wrote back to them saying this was an error; that in fact we had 10 financial analysts and that eight were involved in the ratings process.

We received another letter, which stated the NRSRO criteria, which I am sure most of you are familiar with. It is very detailed and lengthy. And then they stated at the bottom of the letter that our application had been denied because you did not meet the criteria above. They did not say what part of the criteria. When we saw that Congress was interested in this issue as well as the press we appealed our application. We sent our appeal in and it has been now 2 years and 3 months and we have not heard anything from the SEC.

To me, this is deja vu. I think that given what we have gone through, I do not feel that any person or corporation should go through something in this manner. It is just that an agency of the government should not act in this way. Obviously, there needs to be transparency in this process and the application process needs to be expedited.

I also would like to say that I feel that the SEC staff, and I think it is the policies, not necessarily the staff members, have more of an adversary view towards companies like ours. It should be the other way around. They should be proactive. If a company does not meet the criteria, they should state why and let the company come back and show that in fact what it is that they need so that they can go on and eventually become an NRSRO company.

Now, the other point I would like to speak to the committee on is the effects of both the net capital rules and the NRSRO designation on the ability of a company like ours, a small company, to effectively compete with other NRSRO companies. First, Moody's, Standard & Poor's and Fitch have tremendous name recognition and market share. That is a tough act to compete against. However, from the very beginning, all we wanted was to be on a level playing field with these companies. The problem is, and people at this table know this well, that we are prohibited by law, federal law, the SEC regulations, to compete with these existing NRSRO companies.

The designation and the use in the bylaws of large corporations prohibit companies like ourselves from being able to use these companies as clients. To put it in other words, if the company does not have an investment-grade rating from an NRSRO company, those are the only ratings they can use, either credit ratings or buy securities of those companies. That keeps us, we cannot compete with a very large portion of the AFP members. Although we do have several clients in that organization, many of them are prohibited from using us. I used to get, and finally the gentleman gave up, from GE Capital, an e-mail asking me when we were going to get that status because they want to use us. Finally, he just gave up because I sent him back I was not sure.

But it is a very tough problem. In 1992, about the time we submitted our application, Thompson Bank Watch received NRSRO status. Our revenues prior to that time were growing about 25 or 30 percent a year. For 10 years, they just stopped growing. They stagnated. Only until recently have our revenues starting picking up and growing about 20 percent because we have entered into new security issues. We have kind of broken into that market, but it has taken us 20 years to do so. It is a very tough game for a non-NRSRO company to basically stay in this business.

If you want to bring competition into this industry, you not only have to recognize companies like ours, Sean's company, also there are several others out there that are very credible companies, but they have to aid these companies in becoming larger and better competitors. The NRSRO status is a double-edged sword. It keeps you from competing, but if you receive the designation it will help you a great deal in growing because clients will come your way if you are good and credible. Companies like ourselves have to grow about 40 percent a year to become effective competitors to the NRSRO companies.

Moody's and Standard & Poor's, I do not know exactly, but they are growing about 20 percent a year, about what we are, but our size is so small relative to theirs that we will not become effective competitors unless we grow faster. We cannot do it unless we have the NRSRO status.

Thank you, sir.

[The prepared statement of Barron H. Putnam can be found on page 55 in the appendix.]

Chairman BAKER. Thank you very much.

Welcome back, Mr. Pollock. I think this is your first appearance in your new capacity.

**STATEMENT OF ALEX J. POLLOCK, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE**

Mr. POLLOCK. It is, Mr. Chairman, and thank you very much. Mr. Chairman, Ranking Member Kanjorski, and members of the committee. It is a pleasure to be here to present my views, which focus on the unintended cartel-like effects of the SEC's regulation of rating agencies through its NRSRO designation.

I must say I find Dr. Putnam's comments very convincing. He expresses in a specific case many of the same things I am going to say in a somewhat more abstract way. I then want to talk about what steps might be taken to reduce these barriers to competition.

The theme of my work at the American Enterprise Institute is to examine ways to inject greater economic efficiency and market choice into situations in which the government in one way or another has created noncompetitive structures.

What do we find in the rating agency sector? As Professor Larry White of New York University has written, "The problem concerns the SEC's regulation of the bond rating industry. Incumbent bond rating firms are protected; potential entrants are excluded, and new ideas and technologies for assessing the riskiness of debt, and therefore the allocation of capital, may well be stifled. This entry regulation is a perfect example of good intentions gone awry."

The fundamental source of the problem is that the designation "nationally recognized statistical rating organization" or NRSRO has become embedded in numerous rules of numerous regulators. The only way to get to be an NRSRO is to be designated as one by the SEC, and this involves, as many commentators have pointed out, a practically insuperable Catch-22.

The SEC's own concept release, which was referred to earlier by the ranking member, on the subject states that in order to become a recognized NRSRO, "The single most important criterion is that the rating agency is widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings."

To summarize their position, you cannot be widely accepted by the predominant users unless you are an NRSRO, but you cannot become an NRSRO unless you are already widely accepted. That is the Catch-22. The same SEC release says, "Some commenters believe that the NRSRO designation acts as a barrier to entry into the credit rating business." There seems to be no doubt that these commenters, which include the Department to Justice, are correct.

It seems to me that we should simply consider that when John Moody published his first ratings in 1909, or when Poor's Publishing Company published its first ratings in 1916, or the Fitch Publishing Company published its first ratings in 1924, they were not yet "widely accepted by the predominant users." They all had to discover a market need, and compete their way into becoming nationally recognized in time.

Dr. Putnam also touched on the natural barriers to entry in the credit rating business, which seem to be pretty substantial, including the need to establish reputation, reliability and integrity; a definite prestige factor involved in the purchase of opinions and judgments; and natural conservatism of the users of ratings. To

add to this a "distortionary entry restriction regime," to use Professor White's phrase, ensures a noncompetitive outcome.

What could be done to make this business more competitive? I suggest four possible actions. First, it is clear that what NSRSO really means is "SEC approved rating agency." The term "NRSRO" with its implication that is represents some sort of a market test, which 30 or 40 years ago it did, but it no longer does, should be dropped altogether. If the SEC continues to require its own approval of raging agencies for regulatory purposes, at least we could get the designation accurate and just make it "SEC approved."

Second, if the SEC continues to require its approval of rating agencies, the Catch-22 criterion of having to be "nationally recognized" in advance should be simply eliminated.

Third, the approval of rating agencies for specialized purposes, as the SEC has sometimes done in the past, should be encouraged. Such specialization might be an industry, for example, financial institutions; a country, for example, Japan; or any other logical domain defined by competence and knowledge. This would allow new entrants to create competition based on their skills and where they are best able to compete, to demonstrate in those specialized domains their value, and if they succeed, then to grow organically.

Fourth, in my opinion, in the best case, not only the term "NRSRO" but also the requirement of designation by the SEC would be dropped. Instead, the responsibility to choose among rating agency alternatives should belong to investors, financial firms, securities issuers and other users, in short, the market. Every firm should have among its financial and risk management policies its approved policies for how it uses credit ratings and whose ratings can be used for what.

These policies should be appropriately disclosed, and could be examined by any relevant regulators. Under these circumstances, which rating agencies turn out to be nationally recognized would reflect a true competitive market test, and that competition would provide its normal benefits of innovation, improved services, lower cost, choice and efficiency.

Thank you very much for the opportunity to testify, Mr. Chairman.

[The prepared statement of Alex J. Pollock can be found on page 52 in the appendix.]

Chairman BAKER. Thank you, Mr. Pollock.

I wish to welcome Mr. Sean Egan, managing director, Egan-Jones Rating Company.

Welcome.

**STATEMENT OF SEAN EGAN, MANAGING DIRECTOR, EGAN-JONES RATINGS CO.**

Mr. EGAN. Thank you. I apologize for being late.

Chairman Baker, members of the subcommittee, good morning. I am Sean Egan, managing director of Egan-Jones Ratings Company, a credit ratings firm. By way of background, I am a co-founder of Egan-Jones Ratings, which was established to provide timely, accurate credit ratings to institutional investors.

Our firm differs significantly from other rating agencies in that we have distinguished ourselves by providing timely, accurate rat-

ings and we are not paid by issuers of debt, which we view as a fundamental conflict of interest. Instead, we are paid by approximately 400 firms consisting mainly of institutional investors and broker-dealers. We are based in a suburb of Philadelphia, although we do have employees that operate from other offices.

The rating industry currently is suffering from a severe lack of competition. S&P and Moody's dominate the industry, which has caused the following problems. One, issuers pay too much for capital because they are underrated; and two, investors are not provided with sufficient warning about failing firms such as Enron, WorldCom, and Parmalat.

By way of interest, we receive a lot of publicity for our identifying problem companies. That is because reporters like to report on that. But in reality, we have pointed out many more cases where companies are underrated, that is they are paying too much for capital.

There are few industries where the two major firms do not directly compete, and yet control over 90 percent of the revenues. Since two ratings are needed to issue debt, the two major firms do not compete and therefore are not subjected to the normal checks and balances. Even after the recent credit rating debacles, S&P and Moody's revenues have continued to grow because of their lock on the market.

To put the industry structure in perspective, it is as though there are only two major broker-dealers for corporate securities and the approval of both were required before any transactions could be completed. Some other manifestations of the limited competition include abuses in the use of unsolicited ratings and heavy-handed marketing of related corporate services such as issuer governance ratings.

Regarding Egan-Jones, we have provided warning for the Enron, Genuity, Global Crossing and WorldCom failures. We did not rate Parmalat. Furthermore, we regularly identify improving credits. Most of our ratings have been above S&P's and Moody's over the past 2 years, thereby providing issuers with more competitive capital. Our success has been recognized by the Federal Reserve Bank of Kansas City, which compared all our ratings since inception in December 1995 to those of S&P and Moody's. You can read the quote from that study. It is available online.

Stanford University and the University of Michigan drew similar conclusions. That also is available online. In August 1998, we applied for recognition by the SEC as a ratings firm, i.e. NRSRO status. We continue to provide information to the SEC and hope to eventually be recognized.

To reform the ratings industry, we recommend the following changes. One, recognize some rating firms which have succeeded in providing timely, accurate ratings. Two, wean rating firms from issuer compensation. We think that is a fundamental conflict, just like the equity analyst problem. Three, adopt a code of standard practices for participants in the credit rating process issued by the ACT, AFP, and AFTE. And four, encourage SEC action. This area has been under review since the early 1990s and is in dire need of reform. The costs of delaying the recognition of additional rating firms is far greater than the benefit of additional study.

There are two additional points that I would like to make. That is, one of my colleagues brought up the issue of national recognition criteria being dropped. We disagree with that. We believe that the successful firms can achieve national recognition. We have national recognition. A recent firm that was admitted by the SEC, DBRS, according to outside studies did not have that recognition in the United States. We take issue with the application of those criteria.

The second problem is that it may be worth finding out why it is that there has been such a delay in taking action. We tend to believe that it is because the SEC has bought into the notion offered by S&P and Moody's that more competition in this area would lead to problems. That is, there would be rate shopping. We think in those cases where the rating firm is not paid by the issuers, that is not a problem. But there has to be some fundamental cause for the huge delay in action in this area, and this may be one of them.

Thank you very much.

[The prepared statement of Sean Egan can be found on page 29 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Egan.

I appreciate each of your perspectives on this important issue. It is clear to me there is not an objective standard by which a corporation may comply and be assured it will achieve a NRSRO status. There really is no oversight of an entity once it has received a designation, and there is not an official decommissioning process by which such an award may be removed.

Secondly, it is not very clear as to what standards of review the rating agencies utilize in determining a public corporation's rating; that prior to the rating being made public, the agency can meet with a subscriber and go over the information or release it previously prior to public disclosure; that an agency can send a bill to a public company without having solicited the rating, which creates an interesting problem for the company, I am sure; and that at the end of the day the rating agency performance in the midst of the corporate crisis we faced was frankly marginally, if better at all, than the broader market controls that seem to have failed us generally.

It leads me to the question or the observation, this may be one area where the Congress can actually act and not make matters worse. There is no room for us to go downhill from here. In light of that, we have had a concept release as early as 1994 by the SEC, subsequent concept release, and to date still no recommendation for action either for the SEC or for the Congress.

I am very troubled by this because of the Public Company Investment Act requires the maintenance of at least two ratings prior to issuance of public debt, and there appears to be great reliance on these ratings by many stakeholders without understanding fully the mechanisms by which these ratings are issued.

I even have read of late where Basel is considering utilizing the rating agency determinations for determination of capital adequacy for financial institutions, which is a shocking turn of events given what I think I know about the agency's performance to date.

I know that each of you has suggested that enhanced competition may be the ultimate reform that is most beneficial. But I am very concerned that that potential could have been exercised over the last decade, where resources could have been brought to bear, and as Dr. Putnam's case indicates, the languishing in response from the SEC to be told no for 2 years is not the most professional standard of conduct.

Is there anything short of incentivizing additional competitors? For example, some have suggested that utilization of credit spreads might be more beneficial in getting real critical examination of financials than looking with a retrospective view that apparently the rating agencies use.

What other rating alternatives might there be available to us? Are there any? And is the only hope SEC action and competition? I just make that observation and question to the panel.

Mr. EGAN. Regarding credit spreads, we have a variety of clients including a number of hedge funds. I think if there is a turning to credit spreads as being the rating proxy, it would be fairly easy for sophisticated traders to manipulate it.

Basically what they would do is buy up the company's securities and sometimes the float is not that great so it does not take much time to control the float; move down the spread, which would imply a higher rating; let other institutions get into that security and then move out. You can do that multiple times. It is very, very easy to manipulate a system like that.

Also, there is some suggestion for pure quantitative systems. We started out, probably about 12 or 13 years ago when the firm was founded, as purely a quantitative shop. We found that it did not get us where our clients wanted to go. That is, we were maintaining 95 percent-plus accuracy. With a pure quantitative system, it would be between 85 and 90 percent. Typically, these quantitative systems rely on equity prices, and again you have mixed signals. For example, if a company announces a share buy-back, its share price will go up, but that would be a negative for credit quality.

Chairman BAKER. But in the current circumstance, though, the rating agency to a great extent relies on representations made by management. They do not appear at least to rely on audit or underlying financial examination to a great degree. How assured can we be that the manipulative effects you are concerned about are not already in the market?

Mr. EGAN. Sometimes they are and sometimes they are not. I think that the best safeguard is to have a viable competitive market, which we do not have.

Chairman BAKER. My time has just about expired, and I do have other members, but just one other question that concerns me about the way these markets function. Wouldn't it seem likely, given the way in which the review is now done, that the bigger the corporation the less scrutiny one might receive, and the further down the food chain you go the more likely the rating agency is to actually get involved into the real financials to make their determination?

Mr. EGAN. Sometimes there is greater scrutiny of the larger companies, but they are given the benefit of the doubt.

Chairman BAKER. Thank you.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Egan, you have been here so often you are starting to get the demeanor of a member of Congress.

Mr. EGAN. My wife is wondering about my multiple trips to Washington.

[Laughter.]

Mr. KANJORSKI. Welcome.

I do not know, if I were sitting at the table I sense a great deal of frustration. Am I correct?

Mr. EGAN. Yes.

Mr. KAITZ. Yes.

Mr. PUTNAM. Yes.

Mr. POLLOCK. Yes.

Mr. KANJORSKI. We obviously can give the authority for the SEC to regulate a particular industry or activity, but after that it is in their hands.

Dr. Putnam, you indicated 8 years your application was pending?

Mr. PUTNAM. Yes, sir.

Mr. KANJORSKI. And, Mr. Egan, yours is 6 years?

Mr. EGAN. Ours is since 1998, so yes.

Mr. KANJORSKI. Six years.

Do you think it is time that we throw up our hands and say that obviously the SEC does not want to be the regulatory body and we take the proposals of the professionals and craft authorization and assign it to the Federal Reserve and see if we have a better activity there and maybe you can create competition between the regulators.

If a regulator does not seem to want to assert its authority in a field, let us find another regulator. What is your thought to that?

Mr. PUTNAM. I am from the Fed, so I would look in that direction. But no, I think that the SEC should do it right.

Mr. KANJORSKI. What if we cannot make them? Obviously, 10 years, Doctor.

Mr. PUTNAM. Then it is time for change. There are obviously very serious problems, but it seems so simple, to be able to expedite an application and be more positive.

Mr. KANJORSKI. What do you think the underlying proposition for the delay is?

Mr. PUTNAM. I think it is to maintain the status quo.

Mr. KANJORSKI. I mean, is there restriction of competition? Do they just want the majors in the field and nobody else?

Mr. EGAN. Our feeling is that if the area is not cleaned up; if the SEC cannot take action in the near future, that they should step away from regulating the area. Our relationship with the SEC has gone through different stages. At one point, they would not return our phone calls and simply ignored our requests. At this point, it appears as though we are making progress, but it is very easy to sidetrack that progress.

It is very easy for them to compare us to S&P and Moody's and say you are significantly smaller, and therefore even though you have all these ratings correct, you warned investors about Enron, WorldCom and Global Crossing and Genuity, you still do not look big enough compared to them. At which point, we think that we

would be fairly upset, because neither the investors nor the corporations are being served by the current arrangement.

Mr. KANJORSKI. What do you want? To hang in for another 6 years?

Mr. EGAN. No, I do not have that patience.

Mr. KANJORSKI. What do you want us to do? Myself, I am convinced after the second year of hearings that we will be back next year in the 109th, and we will just have to have larger handkerchiefs.

[Laughter.]

Mr. EGAN. If there is not significant progress in the next 6 months, consider withdrawing their ability to regulate this area.

Mr. KANJORSKI. As I say, why don't we prepare a model statute with the criteria set out of what the regulation should be and what the standards should be, and give them a year to promulgate rules and regulations and act to regulate, or automatic action that the authority transfers to the Federal Reserve.

Mr. EGAN. There are some other changes that are needed, too. The issue of compensation is something that is going to continue to cause problems. There are some issuers that pay multimillion-dollar fees and they are given the benefit of the doubt. If there is a collapse, and there are some problem companies out there right now, it will cause huge problems for investors.

The flip side is that there are some corporations that are being basically shaken down by the major rating agencies for their governance ratings, which is wrong. Also, some issuers are not given the opportunity to respond to ratings.

Mr. KANJORSKI. You have convinced me. You made your argument and you convinced me. Now I am just trying to find a remedy.

Mr. POLLOCK. Congressman, if I could comment from this end. I support your idea that you ought to go ahead and try to take some action, and that more competition on the regulatory front is not a bad idea either.

As I read the history of the NRSRO designation, it was something of an accident. It started off as part of the haircut capital rules for securities firms and which ratings you held in inventory determined how big a capital haircut the position got. It grew into this preferred designation of firms. This looks to me something by historical accident, as other regulators then picked up the theme of whose ratings could count for various regulations.

So I think your notion to do something to move it along is correct.

Mr. KANJORSKI. Mr. Kaitz?

Mr. KAITZ. I would also support that at AFP.

Also the code of standard practice, as we have proposed, as you have suggested, lays out regulatory recommendations for both the issuer as well as the credit rating agencies; talks about transparency in the process; talks about all the issues that have come up here today that need to be addressed by some regulatory body.

But we would very much support Congress pushing the SEC into some action based upon the code of standard practice, with a limited regulatory framework.

Mr. KANJORSKI. Do you sense that if we took such action like that it may reflect on what happened with FASB and the stock op-

tions question? That at that point the regulatory agencies would run up here to the Congress and at least disclose themselves that they want to maintain a monopoly?

Mr. KAITZ. I think you can draw a lot of comparisons to the accounting profession, as well, as has been noted by Sean and the equity analysts on the research side. These are all the same issues of separation of responsibility. They are as critical to global capital markets and U.S. capital markets as those two professions. So I do not know what the SEC would do. Are you referring to the credit rating agencies coming up here?

The other thing you could speculate is that the SEC does not want to address this issue because they realize they do have regulatory authority here and they would have to enforce that authority to more firms. So I do not know what kind of resources that would take, but it seems to me that there has been a compelling case made for the SEC to take action here today.

Mr. KANJORSKI. I am particularly impressed with the fact that you make the point that there is a greater cost for capital because of the failure to have competition in a broader rating agency marketplace. I think that is a very compelling argument. We tend to think that five, 10, 15 basis points do not make a difference.

Mr. EGAN. It is far greater than that.

A typical company would be Nextel. Nextel is a vibrant, exciting company that is changing the telecommunications industry. It is still not rated investment-grade even though, from the traditional measures, just taking them out 6 or 12 months, it is very clear that this is a strong, vibrant company that has a high chance of being bought out by some of the other highly rated companies in the industry.

So the bottom line is that it is not just five or 10 basis points. It is closer to about 50 or 100 or 150 basis points, and you are talking about $5 billion to $10 billion worth of debt.

That is significant, and it is hurting young, growing companies. Sometimes there are older companies that have improved, but it is hurting companies like that, where they do not get a fair chance in the capital markets.

Mr. KAITZ. Also, to the extent that the European countries implement their own regulations, which is likely to happen, you are going to have a fragmented process here, and that is definitely going to raise the cost of capital because a U.S. multinational company that wants to raise debt in other countries is then going to have to comply with multiple rules and multiple companies, and you know who is going to be paying for that.

Mr. KANJORSKI. So you think if we concluded, if the Chairman and I get together and put a piece of legislation together to set up your criteria for a regulation and offer certification of these agencies, that we will either get them to move or appropriately improve the industry.

Is there anyone here at the table that thinks that this would be injurious to the rating agencies?

Very good, thank you.

Chairman BAKER. I thank the gentleman.

Ms. Brown-Waite?

Ms. BROWN-WAITE. Thank you very much, Mr. Chairman.

I would like to ask Mr. Pollock a few questions, and if any of the other gentlemen would like to jump in.

First of all, I am what is called a freshman, a little old to be a freshman, but I moved to this committee. Has the SEC ever revoked NRSRO designations? And what would you anticipate if you could wave a magic wand? What should be the criteria for such revocation?

And also, if I understand this correctly, each of the four SEC-approved rating agencies derives the bulk of its revenues actually from fees charged to the companies they rate. Isn't this a blatant conflict of interest? Am I missing something here? Should we be concerned, as we have been about the conflicts created by equity analysts being compensated based on the investment banking business that they bring in?

I think if the average investor out there had any clue, they would really use the term, a fox watching over the chicken coop. I would just like to hear your views on this.

Mr. EGAN. No rating agency has had its NRSRO designation withdrawn. What has happened in the industry is that the firms have consolidated. As of about 5 years ago, there were about seven NRSROs. Three of them merged into Fitch. That was Thompson Bank Watch, Duff & Phelps and a London firm called IBCA. So there has been no withdrawal of the NRSRO designation or threat of withdrawal.

We tend to think that there should be some basis for threatening that designation. In the case of Enron, it was rated investment-grade 4 days before it went bankrupt. So basically, it just took the time for the bankruptcy attorneys to put together the papers and then it was in bankruptcy. That is outrageous.

What should have happened, in our opinion, is that their license, if you will, in the investment-grade area or else in the energy or utilities area, should have been on probation for 6-, 12-or a 24-month period. There has to be some threat.

There are other horror stories in the manufactured housing area, the securitization whereby AAA ratings had been downgraded to junk in the period of just an hour or so. In that case, it shows clear negligence on the part of the ratings firm. There should be some process where the license is suspended or in some kind of penalty box-type area for a period of time when things like that happen.

Lastly, you mentioned the conflict of interest. That is a problem. It is a huge problem. This industry is basically accepted because of the lack of competition. People throw up their hands and say, well, it is S&P and Moody's; they really designate the ratings; we strongly disagree with that, but they have become the currency, if you will, in this area.

First of all, that should be disallowed. It might take some time. Maybe they have to do it over a 5-year period, but that should not happen. You are waiting for another huge accident. The incentives are in the wrong place.

Secondly, they should not be allowed to use the term "independent." They are not independent. Take it away. You are misleading the people who need the protection the most. They think that these terms are independent and they are being paid huge fees by selected issuers.

So that is our response to those three issues.

Mr. POLLOCK. Congresswoman, I would only add, it would be better to have a competitive market instead of having a cliff-type decision that a regular would have to make. "I am now taking away your license," is a very hard decision for people to make.

The market, if there is poor performance, like the examples just cited, can little by little take the business away if there are in fact alternatives. From an investor point of view, if investors like better the idea of having ratings that the rated entity did not pay for, that they paid for themselves, why then would they gravitate to those ratings. If they thought it was okay to have the issuing company pay for ratings, they could purchase them. But none of that can happen if you do not have alternatives in the market available to the users of ratings, investors and others, to choose from.

Mr. BAKER. Thank you, Ms. Brown-Waite.

Ms. McCarthy?

Mrs. MCCARTHY. Thank you, Mr. Chairman.

I am just curious, Mr. Chairman, are we going to have another hearing with the SEC and find out why this is happening? Or have you had it and I did not see it. I was not here.

Chairman BAKER. We had one about 18 months ago which was particularly painful for the SEC at that time.

Mrs. MCCARTHY. Okay.

Chairman BAKER. I do not see how we can avoid revisiting this subject at some appropriate time. I need to visit further with my chairman and Mr. Kanjorski on any initiatives that might be contemplated. But be assured, this is the beginning, not the end of our process.

Mrs. MCCARTHY. Because again, even though we both came on the committee 18 months ago, I probably had no idea what I was hearing. I am sorry. It takes a while to learn this stuff.

The questions that I was going to ask actually have been answered in a number of give and take back, so I am not going to bother with that. But it has been a real eye-opener for me on a number of things. Let us face it, the majority of people do not understand it. I did not know there was anything else out there, but the two competitions are there. I thought that was just the way it was, so this has been fascinating for me.

I thank you for the testimony and I thank you for bringing this hearing forward.

Chairman BAKER. Thank you, Ms. McCarthy.

Ms. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman.

I, too, think that the really basic questions have been asked, so I will just have a couple of questions. The Northern Trust Company submitted a comment in response to the SEC's concept release in which it stated that the major rating agencies have requested payment for unsolicited ratings, and in some instances paid the invoices in order to preserve the goodwill with the rating agency.

So my question from that is, how would enhanced competition in the rating industry prevent this type of abuse? That would probably be for anyone who would like to answer.

Mr. PUTNAM. I would like to answer that question. First, Northern Trust is a very financially sound organization. It has one of our

highest ratings. However, we are not an NRSRO company, so they cannot divert to that. That competition will help in that area.

I would like, if I can grab the microphone, to make a point that it is not just that some people are paying a very high price for capital. Some of them do not have access to capital markets. The fees charged by Moody's and Standard & Poor's and Fitch are so high for a rating that it may be 5 percent of the issue. Small companies cannot afford to raise capital in that arena. We are providing information to the committee showing that we have rated some companies as small as $23 million in asset size. This is a very serious problem.

Another very serious problem that I do not believe has really been addressed by the SEC is that there are billions of dollars of excessive, and I feel the fees are very excessive, fees that are being paid by municipalities and by corporations for these ratings. Competition can bring these prices down considerably if in fact it can be generated. That I think is a very tough thing to do.

The expertise in a rating agency is very hard to develop. It takes time to do this, and usually these companies, like Sean and myself, we specialize in a certain area. Once you get the NRSRO status, then you can branch out and then hopefully you can bring somebody in that helps you build your company and the SEC or the new regulator allows that to happen. You have to be very proactive in this arena.

Mr. EGAN. The reason why I think Northern Trust paid those fees is because they are afraid of alienating the two, in their mind, only two firms in this industry. It is another manifestation of the lock that they have on this industry. An example might be if your utility in the dead of winter overcharged you $50 or $100 or $200. You are far more likely to pay that additional amount than be faced with the threat of having the utility cut off.

That is the case here. These companies, issuers cannot afford to be cut off. This industry has deteriorated to the point where there are only two firms in many participants' minds, and it is highly unhealthy and it is going to cause some additional Enrons in the future. It is going to cause some other companies to continue to pay much more for capital, so it has to be cleaned up.

Mrs. BIGGERT. Do you think that not only are these firms afraid not to go to these companies, but also do you think that the rating fees then affect the ability of some of the largest rating firms to provide objective rating analysis?

Mr. EGAN. There is no question that they do. There is another problem that comes up with the issuer compensation, and that is, it was about 8 years ago in the municipal area whereby two municipalities refused to pay Moody's. It is in the Wall Street Journal, and I can send the reference in later. It was in the Wall Street Journal where these issuers refused to pay the rating fees that were being charged by Moody's. And Moody's just said, well, you should participate in our process.

The issuer said, no, we are not going to. Moody's said, we have enough information in the public domain and we are going to give you a rating, period. And they gave them what I call a punishment rating, which significantly increased the cost of floating that issue. The municipalities subsequently sued and they were unsuccessful.

They were unsuccessful because Moody's said the ratings are opinions and we are entitled to the freedom of speech. So it is just another indication of this unhealthy industry.

Mrs. BIGGERT. I know that you would like to get into this.

Mr. EGAN. We already are issuing ratings. There are a number of clients that want to use our ratings for regulatory purposes and we told them they cannot until we get the designation.

Mrs. BIGGERT. Okay. But the current NRSROs have already absorbed three companies.

Mr. EGAN. Yes.

Mrs. BIGGERT. So how are you going to do this?

Mr. EGAN. There are two things that distinguish us. One is our success, and no one can match that in flagging Enron, WorldCom and these others, number one. And number two, we do not charge the issuers. We think we can continue our success and do very nicely.

Mrs. BIGGERT. Thank you.

Thank you, Mr. Chairman. I yield back.

Chairman BAKER. Thank you, Ms. Biggert.

I want to just go back for a few brief points. I know other members may have follow-up questions.

As to the elements that possibly should be considered in our construction of some remedy, it would appear to me that requiring an enhanced standard of disclosure for material facts, that it would seem that the agencies today rely to a great extent on representations made by management, without the benefit of a true audit.

To have a requirement on management to disclose to a rating agency in the course of its inquiry any material fact that a reasonable man would assume would have some positive or negative or any impact on shareholder value would be sort of a minimum opening requirement; that in the course of developing whatever standards of review the rating agency determines is appropriate, that the elements that go into a rating determination be made public; the process by which you get from beginning to end.

I also think it is important to disclose whether or not nonpublic information is utilized. Not that you disclose it, but simply the statement that we are using only publicly available information would tell any outside observer, they are only feeding us back what is readily available in the market, or we have insight to information you do not have, therefore this rating is based on that information. I think those are very helpful tools.

And then finally, before reaching the ultimate rating determination, that that decision not be made available to the subscriber before it is being made available to the public. This goes back to our old analyst-investment banker problems where we had people able to get access to important information even hours, much less days ahead of time, seems to be an obvious, well, I hate to say impropriety, but certainly something that needs to be addressed.

Then the rating outlooks that are made available by the agencies are troubling. Now, we are making a determination about current value based on representations of management without an audit. So at best, you can say the critical analysis of present-day value ought to be carefully examined, but we are going to permit a national rating agency to do a forecast for the next 18 months?

There seems to be a little problem here in my mind with just sending someone an invoice for services you did not ask for, and the ability to forecast what you are going to look like 18 months from now. Now, I do not know if that bothers you, but I am from Louisiana and I can see that one coming.

And then lastly, it was an issue in Sarbanes-Oxley, consulting services. It seems to me to be highly questionable as to whether or not you ought to be able to consult with someone for whom you are being asked to issue a public rating on which others may make their investment decisions, which certainly speaks directly to the issue of fees and the appropriateness of fees being paid to great extent for someone who is going to give you your report card.

Any adverse comments about those observations or problematic observations, anyone?

Mr. KAITZ. I would just say that almost all the issues that you addressed, Mr. Chairman, have been included in the code of standard practices, both for the credit rating agencies, as well as the issuers. So we would be very supportive of your framework.

Mr. PUTNAM. I think a very serious problem with the existing NRSRO companies, if they issue ratings, they do not show the date necessarily that the rating was issued, nor do they show the data from which the rating was derived. I think that is very, very important, because if you do that and you show that for many other companies as well, and one rating does not adjust to that data, you can see that something is wrong.

In our comments to your committee, we had made a suggestion that one way, I do not think the fee problem is going to be resolved right away. We do not charge for our credit ratings. We do charge for new issue ratings. You cannot help but do it. The financial analyst involved in this and the discussions with management are just so important.

But one point that you made, I do not think a rating agency worth its salt should ever take what management says they are going to and base a rating on that. You have to judge the financial condition of an institution based on its financial soundness. LACE comes from liquidity, asset quality, capital and earnings. Those are the major determinants of financial soundness.

If you take those and you show these determinants, along with the rating, that helps. Plus, these rating agencies, existing NRSROs should rate more frequently. They charge so much money. The balance sheets and income statements of these companies are put out quarterly. They are generally audited, and you can take that information and you can confirm or deny a rating, rather than just change that rating somewhere in the timeframe of a company. But if you show that information, you are going to bring more credibility to the rating process.

Chairman BAKER. What is it that is gained from a rating company analysis that is not already available from the quarterly statement?

Mr. PUTNAM. Interpretation, analyst interpretation.

Chairman BAKER. So if we went back and looked at the outlook forecast for S&P and compared it to say the analyst community, we ought to be astounded by how well S&P is able to forecast.

Okay, thank you. I think I have exercised all the time I should take.

Any further questions? Ms. McCarthy?

Mrs. MCCARTHY. Thank you.

I think part of the question was answered, because when you said earlier conflict of interest on the pay, and then you came back, because I was sitting here wondering how do you guys make any money.

Mr. EGAN. We get paid by institutional investors.

Mrs. MCCARTHY. Okay.

Mr. PUTNAM. We get paid by subscribers primarily, but about 20 percent of our revenues are derived on new issue ratings, and we do charge for that. But we do, as I have said, show those ratings every quarter. I provided to the committee, on some of the pools that we rate for structured preferred stocks, for community banks.

We will actually follow that pool each quarter, re-rate the pool each quarter, and re-rate every member of the pool each quarter. We have a follow-up rating report that does that. It is the most advanced report in the industry that exists. That has been supplied to the committee. That is what should be done.

Mrs. MCCARTHY. Okay. Thank you.

Chairman BAKER. There being no further questions, I want to express my appreciation to each of you for your participation. You have been most helpful. As I have indicated earlier, this is just another step in our review of this sector. We do have a lot of additional work ahead of us, and we appreciate your contribution.

The meeting is adjourned.

[Whereupon, at 11:20 p.m., the subcommittee was adjourned.]

# A P P E N D I X

September 14, 2004

***Prepared, not delivered***
**Opening Statement**

# Chairman Michael G. Oxley
## Committee on Financial Services

**"The Ratings Game: Improving Transparency and Competition Among the Credit Rating Agencies**

**September 14, 2004**

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Thank you, Chairman Baker, for holding this important hearing this morning. We had a very illuminating hearing on these issues last year and I look forward to this follow-up examination.

Over the past few years, I am proud to note that this Committee has done its part in helping to restore investor confidence in a number of areas, including financial reporting, securities analysis, and mutual funds. So, I welcome the Subcommittee's attention to the role and function of credit rating agencies.

We are all familiar with the vital role credit rating agencies play in our capital markets system.

However, the past few years have not been good ones for the rating industry, or for consumers of such research. The major firms have not remained unscathed during this post-Enron period of corporate re-examination.

The major rating agencies failed to identify pending disasters at Enron, WorldCom, and elsewhere. Indeed, they did not downgrade the debt of these companies until shortly before the companies declared bankruptcy.

Aside from lackluster performance, I am troubled by the conflicts of interest plaguing the major rating agencies. Now, they are offering additional services including consulting and hypothetical rating assessments that could further compromise their independence.

Officials from the Northern Trust Corporation have stated that the major rating agencies have requested payment for unsolicited ratings and strong-armed the company to pay the fees in return for a good rating. Northern Trust is not the only company to register complaint about these practices.

As a free-market conservative, I have some concerns regarding the SEC's oversight of credit rating agencies. There are government-created barriers to entry in this industry which unnecessarily stifle competition. There are only four firms that have received the SEC stamp of approval — in reality, the two major firms have the vast majority of market share.

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The SEC issued a concept release in June of 2003, which prompted numerous thoughtful responses.

I would like to see more competition, more transparency, greater disclosure about the underlying assumptions that influence rating decisions, better recordkeeping, and improved oversight of approved rating agencies.

I look forward to hearing from our distinguished panel.

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September 14, 2004

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Hearing entitled, "The Ratings Game: Improving Transparency and Competition Among the Credit Rating Agencies"

Thank you, Mr. Chairman, for calling this hearing and bringing us together this morning to address the current practices of credit rating agencies.

Section 702(b) of the Sarbanes-Oxley Act of 2002 required the Securities and Exchange Commission (SEC) to publish a report on the role and function of credit rating agencies in the operation of the securities markets. The report was published in January 2003 and a corresponding concept release was issued in June 2003.

The report addressed certain issues such as allegations of anticompetitive or unfair practices, the level of due diligence performed by credit rating agencies when taking rating actions, and the extent and manner of SEC oversight of credit rating agencies, that go beyond those specifically identified in the Sarbanes-Oxley Act. In the concept release, "Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws," the SEC addressed the next phase of its review of this issue, evaluating the appropriate degree of regulatory oversight that should be applied to credit rating agencies. As stated in the concept release:

> At one end of the spectrum, the Commission could cease using the NRSRO designation, exit the business of rating agency oversight, and devise alternative means to fulfill its regulatory objectives. At the other, the Commission could implement, perhaps with additional legislative authority, a much more pervasive regulatory scheme for credit rating agencies that addresses the full range of issues raised in the Report.

As we have yet to see any proposed rules from the SEC responding to the comments received on the concept release, I look forward to hearing from today's witnesses on questions posed in the document and a full discussion of the major issues still outstanding regarding the rules governing credit reporting agencies.

Thank you again, Mr. Chairman, for calling this important hearing and I look forward to an informative discussion.

**OPENING STATEMENT OF**
**RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES**

**HEARING ON THE RATINGS GAME: IMPROVING TRANSPARENCY AND COMPETITION AMONG THE CREDIT RATING AGENCIES**

**TUESDAY, SEPTEMBER 14, 2004**

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Mr. Chairman, we meet for the second time in the 108th Congress to examine the issue of credit rating agencies. Entities like Moody's, Standard and Poor's, and Fitch have long published their views on the creditworthiness of the issuers of debt securities. The importance of these opinions has grown significantly in recent years as a result of increases in the number of issues and issuers, the globalization of our financial markets, and the introduction of complex financial products, like asset-backed securities and credit derivatives.

As you know, Mr. Chairman, I have made investor protection one of my top priorities. I believe that strong regulation helps to protect the interests of America's investors. Accordingly, I am pleased that we have worked diligently during the last several years to augment the resources available to the Securities and Exchange Commission, enact sweeping reforms of auditing and accounting practices, restore accountability to investment banking and analyst research, and improve the conduct of business executives and corporate boards. Although credit rating agencies received some scrutiny after the recent tidal wave of corporate scandals, we have not yet mandated any substantive changes in their practices.

This issue is ripe for examination and action. At hearings before our Committee last year, the Commission's Director of Market Regulation noted that while credit rating agencies have generally performed their work well for nearly a century, they have also missed some "colossal" failures in recent years. A Senate investigative report also found that the monitoring and review of Enron's finances "fell far below the careful efforts one would have expected from organizations whose ratings hold so much importance."

After last year's hearing, I was hopeful that the Commission would take swift action regarding these important matters. It did belatedly issue a concept release to examine the issues surrounding rating organizations in June 2003. Since that time, the Commission has continued to study these matters without reaching any conclusions. The Commission, I should note, has been examining these matters for more than a decade.

Although a formal proposal for improved oversight of credit rating agencies has yet to emerge, a top official at the Commission did suggest in a recent speech that additional legislative authority may be needed in this area. I have previously urged the Commission to act "promptly and prudently" in these matters. It is therefore my expectation that it will move expeditiously in the coming months to finalize its opinions on credit rating agencies and advise us about the most appropriate steps to take in these matters during the 109th Congress.

When we revisit these matters next year, it is also my hope that we will be able to put together a more inclusive and comprehensive hearing. We are fortunate today to have with us two credit rating professionals. We will also hear from the Association for Financial

Professionals, which has taken a leading role in examining the need and identifying ways to improve the oversight of credit rating agencies. Rather than rushing to hold a hearing, our proceedings would have greatly benefited if we had waited and been able to receive the testimony of the Commission, major credit rating agencies, and other interested parties.

In closing, Mr. Chairman, we are at a critical moment in the evolution of our capital markets, and we must act to ensure the continued integrity of the rating agencies and the credit rating process. I also look forward to continuing to work with you as we move forward deliberately on these important matters.

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**Egan-Jones Ratings Company**
Tel. 1-888-837-4878 Research@Egan-Jones.com

*Providing timely, accurate credit ratings to Institutional Investors*

Testimony of Sean J. Egan, Managing Director, Egan-Jones Ratings Co.
Before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Sept. 14 Hearing – The Ratings Game – Improving Transparency and Competition Among the Credit Rating Agencies

Chairman Baker, members of the Subcommittee, good morning. I am Sean Egan, Managing Director of Egan-Jones Ratings Company, a credit ratings firm. By way of background, I am a cofounder of Egan-Jones Ratings Co., which was established to provide timely, accurate credit ratings to institutional investors. Our firm differs significantly from other ratings agencies in that we have distinguished ourselves by providing timely, accurate ratings and we are not paid by the issuers of debt, which we view as a conflict of interest. Instead, we are paid by approximately 400 firms consisting mainly of institutional investors and broker/dealers. We are based in the Philadelphia, Pennsylvania area, although we do have employees that operate from other offices.

The rating industry currently is suffering from a severe lack of competition (S&P and Moody's dominate the industry) which has caused the following problems: i) issuers pay too much for capital because they are under-rated and ii) investors are not provided with sufficient warning about failing firms such as Enron, WorldCom, and Parmalat. There are few industries where the two major firms do not directly compete, and yet control over 90% of the revenues. Since two ratings are needed to issue debt, the two major rating firms do not compete and therefore are not subjected to the normal checks and balances. Even after the recent credit rating debacles, S&P and Moody's revenues have continued to grow because of their lock on the market. To put the industry structure in perspective, it is as though there were only two major broker dealers for corporate securities and the approval of both were required before any transactions could be completed. Some other manifestations of the limited competition in the ratings industry include abuses in the use of unsolicited ratings and heavy-handed marketing of related corporate services such as issuer governance ratings.

Regarding Egan-Jones Ratings, we have provided warning for the Enron, Genuity, Global Crossing, and WorldCom failures (we did not rate Parmalat). Furthermore, we regularly identify improving credits; most of our ratings have been above S&P's and Moody's over the past two years (thereby providing issuers with more competitive capital). Our success has been recognized by the Federal Reserve Bank of Kansas City which compared all our ratings since inception in December 1995 to those of S&P and concluded:

> "Overall, it is robustly the case that S&P regrades from BBB- moved in the direction of EJR's earlier ratings. It appears more likely that this result reflects systematic differences between the two firms' rating policies than a small number of lucky guesses by EJR."
>
> Source: Research Division, Federal Reserve Bank of Kansas City, Feb. 2003
> Link: http://www.kc.frb.org/publicat/reswkpap/RWP03-01.htm

Stanford University and the University of Michigan drew similar conclusions:

> "we believe our results make a strong case that the non-certified agency [Egan-Jones] is the leader and the certified agency [Moody's] is the laggard."
> Link: aaahq.org/AM2004/display.cfm?Filename =SubID_ 1213.pdf&MIMEType =application%2Fpdf

In August 1998 we applied for recognition by the SEC as a ratings firm (i.e., NRSRO status). We continue to provide information to the SEC and hope to eventually be recognized.

To reform the ratings industry, we recommend the following changes:

**1) Recognize some rating firms which have succeeded in providing timely, accurate ratings** - The problems with the current system are a) improving firms have been penalized by paying too much for capital, and b) investors have been hurt by not obtaining warning of deteriorating firms. The recognition of some firms that have succeeded in providing timely, accurate ratings would be of great benefit.

**2) Wean rating firms of issuer compensation** – the crux of the equity research analysts scandal is that analysts were paid by issuers via investment banking fees, thereby corrupting the investment analysis. The same conflicts exist in the credit rating industry.

**3) Adopt Code of Standard Practices for Participants in the Credit Rating Process issued by the ACT, AFP, and AFTE** – the proposed guidelines will assist in increasing the transparency and credibility in the ratings industry.

**4) Encourage SEC action** – this area has been under review since the early 1990's and is dire need of reform. The cost of delaying the recognition of additional firms is greater than the benefit of additional study.

I would be happy to answer any questions.

Statement of James A. Kaitz

President and CEO

The Association for Financial Professionals

Before the House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government
Sponsored Enterprises

The Ratings Game: Improving Transparency and Competition Among
the Credit Rating Agencies

Tuesday, September 14, 2004

Good morning, Chairman Baker, Ranking Member Kanjorski, and members of the Committee. I am Jim Kaitz, President and CEO of the Association for Financial Professionals. AFP welcomes the opportunity to participate in today's hearing on improving competition and transparency among the credit rating agencies. As we have continually noted, AFP believes that the credit rating agencies and investor confidence in the ratings they issue are vital to the efficient operation of global capital markets.

AFP represents more than 14,000 finance and treasury professionals representing more than 5,000 organizations. Organizations represented by our members are drawn generally from the Fortune 1000 and the largest of the middle-market companies from a wide variety of industries. Many of our members are responsible for issuing short- and long-term debt and managing corporate cash and pension assets for their organizations. In these capacities, our members are significant users of the information provided by credit rating agencies. Acting as both issuers of debt and investors, our members have a balanced view of the credit rating process and also have a significant stake in the outcome of the examination of rating agency practices and their regulation.

When I appeared before this Committee more than 17 months ago, I shared the results of a survey conducted by AFP in September 2002. In summary, that survey found that many of our members believe that the information provided by credit rating agencies is neither timely nor accurate and that the Securities and Exchange Commission (SEC) should take steps to foster greater competition in the market for credit ratings and improve its oversight of rating agencies. AFP is currently conducting an update to the 2002 survey and preliminary results indicate that confidence in the credit rating agencies has not improved. We will be releasing the results of the updated survey in the Fall.

In June of 2003, the SEC issued a concept release on rating agencies and the use of credit ratings under the federal securities laws. That concept release asked 56 questions about the nationally recognized statistical rating organization (NRSRO) designation, recognition criteria, the examination and oversight of NRSROs, conflicts of interests, and anticompetitive, unfair and abusive practices. The concept release asked market participants to provide answers in less than 60 days. Yet more than 15 months after this concept release and more than a decade after a similar concept release in 1994, the SEC has yet to provide a single answer of its own.

To address many of the questions raised by the SEC and market participants, the Association for Financial Professionals in April of this year, along with treasury associations from the United Kingdom and France, released an Exposure Draft of a Code of Standard Practices for Participants in the Credit Rating Process. We are currently reviewing comments we received on the Exposure Draft and intend to release our final recommendations later this year. We developed the draft Code in an effort to improve investor and issuer confidence in the credit rating agencies and the ratings they promulgate. This is particularly important in light of the SEC's continued inaction.

I have submitted a copy of the Code along with my testimony. However, I would like to take a minute to summarize the key themes. The Code contains recommendations for regulators, as well as rating agencies and issuers. To be clear, the Code is a private sector response intended to complement rather than replace regulation.

Regulatory recommendations in the Code of Standard Practices focus on establishing transparent recognition criteria based on whether a credit rating agency can consistently produce credible and reliable ratings over the long-term. Establishing clearly defined recognition criteria is a crucial step to removing barriers to entry and enhancing competition in the credit ratings market. The Code also urges regulators to require that rating agencies document internal controls that protect against conflicts of interest and anti-competitive and abusive practices, and ensure against the inappropriate use of non-public information to which the rating agencies are privy because of their exemption from Regulation FD. Regulatory recommendations also include improving ongoing oversight of approved rating agencies to ensure that NRSROs continue to meet the recognition criteria.

For rating agencies, the Code includes suggestions to improve the transparency of the rating process, protect non-public information provided by issuers, protect against conflicts of interest, address the issue of unsolicited ratings, and improve communication with issuers and other market participants.

Finally, recognizing that the credibility and reliability of credit ratings is heavily dependent on issuers providing accurate and adequate information to the rating agencies, the Code of Standard Practices outlines issuer obligations in the credit rating process. These obligations are intended to improve the quality of the information available to the rating agencies during the initial rating process and on an ongoing basis, and to ensure that issuers respond appropriately to communications received from rating agencies.

Other organizations have also taken steps to address this critical issue. The International Organization of Securities Commissions (IOSCO) in September 2003 issued a Statement of Principles regarding the manner in which rating agency activities are conducted. In February of this year, IOSCO also announced the formation of a special task force, chaired by SEC Commissioner Campos, to develop a code of conduct for credit rating agencies. We expect IOSCO to issue that code shortly.

In July, the Committee of European Securities Regulators (CESR), at the request of the European Commission, issued a call for evidence on possible measures concerning credit rating agencies. The Committee intends to review comments, develop a consultation paper, hold an open hearing, and approve and publish its final advice to the European Commission in March 2005, less than eight months after the commencement of its activities.

Despite all this activity, the SEC remains silent on the appropriate regulation of credit rating agencies. At hearings before the Bond Market Association in January, a senior SEC official admitted that the Commission needs to come up with an approach or "cede the area" to other rule makers. By its continuing inaction on this issue, the SEC is abdicating its responsibility to capital market participants and potentially subjecting issuers, investors and rating agencies to a fragmented, duplicative and overly-prescriptive regulatory regime.

A reasonable regulatory framework that minimizes barriers to entry and is flexible enough to allow innovation and creativity will foster competition among existing NRSROs and those that may later be recognized and restore investor confidence in the rating agencies and global capital markets. Rather than excessively prescriptive regulatory regimes, innovation and private-sector solutions, such as AFP's Code of Standard Practices, are the appropriate responses to many of the questions that have been raised about credit ratings.

Restoring issuer and investor confidence in the credit ratings process is critical to global capital markets. We commend you Mr. Chairman and the Committee for recognizing the importance of this issue and its impact on all institutional and individual participants in global capital markets. We hope this hearing will motivate the SEC to action.

# Exposure Draft:

## Code of Standard Practices for Participants in the Credit Rating Process

Association of Corporate Treasurers (United Kingdom)

Association for Financial Professionals (United States)

Association Francaise Des Tresoriers D'Entreprise (France)

**Association for Financial Professionals**

*With the Support of the International Group of Treasury Associations and Euro Associations of Corporate Treasurers:*

This Exposure Draft: Code of Standard Practices for Participants in the Credit Rating Process has been drafted by The Association of Corporate Treasurers (ACT), London, England, The Association for Financial Professionals (AFP), United States, Association Française Des Trésoriers D'Entreprise (AFTE), Paris, France.

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## Executive Summary

### Background

Credit rating agencies (CRAs) play an important role in the efficient operation of the global capital markets. Investors and lenders rely on CRAs to provide a clear measure of the creditworthiness of debt issuers and borrowers, while debt issuers rely on CRAs to issue ratings that accurately reflect the company's relative creditworthiness. Companies also use credit ratings to evaluate trading partners, financial counterparties, and potential business partners; and in many jurisdictions, regulators also rely on CRAs for determining regulatory capital requirements and permitted investments. Yet for the credit rating process to work properly, a critical nexus of transparency and trust must be exhibited by all of these parties – the issuers, the credit rating agencies, and the regulators who oversee both.

During the past two years, however, CRAs, and the credit rating process itself, have been the subject of significant criticism. CRAs have come under fire for failing to warn investors of the dangers and ultimately disastrous collapse of large global companies, including, for example, Parmalat, Enron, and WorldCom. These events have led some to question whether the CRAs are meeting the needs of market participants.

Some have asserted that regulators should take a larger role in regulating the CRAs and should encourage competition in the market for credit ratings. Yet both credit rating agencies and government regulators have been slow to respond to the call for reform. For example, while the U.S. Securities and Exchange Commission (SEC) issued its first concept release a decade ago and a new concept release in June 2003 on rating agencies and the use of credit ratings under U.S. Federal securities laws, it has yet to take any definitive action. Similarly, regulators in Europe have yet to address the issue as well.

As a result of the continuing concerns over the credit rating process, a series of initiatives arose independently. In response to the SEC's June 2003 concept release, the Association for Financial Professionals (AFP) in the U.S. and the Association of Corporate Treasurers (ACT) in the United Kingdom called for improved regulation, improved internal controls and an industry code of practice for all those involved in the credit rating process. At the same time the Association Francaise Des Tresoriers D'Entreprise (AFTE) developed and shared a best practices guide that it had used in conversations with the CRAs and relevant authorities. Recognizing the various efforts and in light of the global need to restore confidence to the credit rating process, it was agreed in September 2003 in Slovakia at the meeting of the International Group of Treasury Associations that AFP, ACT and AFTE would bring forward a single global proposal for improving rating industry practice.

## The Exposure Draft

AFP, ACT and AFTE are jointly releasing this Exposure Draft of a Code of Standard Practices for Participants in the Credit Rating Process. This Exposure Draft is issued to solicit comment from the widest number of those involved with credit ratings, including issuers, users, CRAs, regulators, and others with a professional interest in credit ratings. The Associations, along with the International Group of Treasury Associations (IGTA) and Euro Associations of Corporate Treasurers (EACT), believe that this Code of Standard Practices, coupled with a minimum regulatory framework, is the most efficient and flexible solution to restoring confidence in credit rating agencies and the information they provide to global capital markets.

These Associations are the leading corporate finance organizations in their respective countries, representing nearly 19,000 treasury and finance professionals from many of the largest companies in the world. Treasury and finance professionals rely on the CRAs when their companies issue debt and when they make investment decisions. Their relationship with the CRAs provides them with a unique view on both the strengths and weaknesses of the agencies' practices.

The Code includes three sections: regulatory recommendations, rating agency code of standard practices, and issuer code of standard practices.

For CRAs, the Code includes recommendations to improve the transparency of the rating process, protect non-public information that is provided to CRAs, protect against conflicts of interest, address the issue of unsolicited ratings, and improve communication with issuers and other market participants.

Regulatory recommendations focus on the credibility and reliability of ratings, transparency in the rating agency recognition process and improving ongoing regulatory oversight of approved rating agencies. Regulatory recommendations also include removing barriers to competition in the credit rating agency marketplace.

Finally, recognizing that the credibility and reliability of credit ratings is heavily dependent on issuers providing accurate and adequate information to the CRAs, the Issuer Code of Standard Practices outlines issuer obligations in the credit rating process. These obligations are intended to improve the quality of the information available to the CRAs during the initial rating process and on an ongoing basis, and to ensure that issuers respond appropriately to communications received from CRAs.

This exposure draft is an important, collaborative, and global private-sector response to many of the issues that have been raised about the credit rating process and the agencies themselves. While certain of the points below would

usefully be incorporated into regulation in a jurisdiction where CRAs are regulated, the majority are better incorporated into an industry code of standard practices. In jurisdictions where CRAs are regulated, the Code is intended to serve as a complement to, rather than a substitute for, government regulation.

**Request for Comments**

The Associations welcome comments and suggestions on the concept of a Code of Standard Practices, the Exposure Draft, and the appropriate manner in which to incorporate the final Code into the credit rating process. Comments and suggestions should be directed to any or all of the following:

Jeff A. Glenzer, CTP, Director of Treasury Services, AFP
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John Grout, Technical Director, ACT
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Patrice Tourlière, Treasury and Finance Manager, Lafarge
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Comments should be submitted no later than May 31, 2004. Comments and suggestions received may be made available on the Web sites of the Associations unless they are stated to be confidential and not for public display.

## Introduction

Credit rating agencies (CRAs) play an important role in the efficient operation of global capital markets. In addition to any credit analysis done internally, investors depend on the CRAs to analyze all public information and any non-public information the agency has gathered about a company to form a meaningful assessment of the creditworthiness of the company. These ratings, which are commonly paid for by the issuers, are used by individuals, professional investment managers, and corporate finance professionals when selecting securities for themselves or their organizations and by financial institutions when determining whether to lend to a prospective borrower and, if so, at what terms. CRAs also play an important role for companies when evaluating counterparties for financial transactions, in evaluating actual or potential suppliers or customers for non-financial goods and services, and in similarly evaluating partners, collaborators, or joint venture prospects.

Debt issuers expect the CRAs to understand the company's finances, strategic plans, competitive environment and any other relevant information about the company in order to issue ratings that:

- allow the company to place securities at terms that are reflective of its relative creditworthiness;
- allow others that deal with the issuer to improve their assessment of the issuer as a potential trading partner; and
- are a valuable part of the issuer's external communications with the market.

In many jurisdictions, ratings are also used to determine regulatory capital requirements and permitted investments.

In November 2002, the Association for Financial Professionals (AFP) released its "Rating Agencies Survey: Accuracy, Timeliness, and Regulation[1]." AFP's survey, which received over 700 responses, found that a significant minority of treasury and finance professionals from companies with rated debt believe that their company's credit ratings are neither accurate nor timely. Respondents believe that their company's ratings are more reflective of the industry in which it operates rather than of the company's financial condition[2]. Those responsible for investing or lending money on their organization's behalf also reported a lack of confidence in the accuracy and timeliness of the ratings of the companies in which they invest or to whom they extend credit.

Efforts to improve investor and issuer confidence in the CRAs have been proceeding on multiple fronts. In the United States, the effort has focused primarily on the way in which the Securities and Exchange Commission (SEC)

[1] http://www.afponline.org/pub/pdf/ratings_survey.pdf

[2] The Associations recognize that credit ratings are developed through a combination of quantitative and qualitative factors, not solely the reported or proforma financial statements of an issuer.

regulates the CRAs that it recognizes as nationally recognized statistical rating organizations (NRSRO). AFP submitted a comment letter in response to an SEC Concept Release, "Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws[3]." In the comment letter[4], AFP called on the SEC to remove artificial barriers to entry into the credit ratings market. AFP also recommended that the SEC periodically review each CRA it recognizes in order to ensure that they continue to be issuers of credible and reliable ratings and have in place effective internal controls. AFP commented that the SEC should minimize further regulation and allow market forces to determine acceptable standards for many practices.

In the United Kingdom, the Association of Corporate Treasurers (ACT) in its response[5] to the SEC Concept Release espoused the concept of an industry code of practice as a key factor in CRA regulation and conduct of business. Neither the United Kingdom's Financial Services Authority nor the European Union grants a regulatory imprimatur that parallels the NRSRO designation in the United States. However, the regulation of CRAs by the United States Securities and Exchange Commission affects the practices of the CRAs in the United Kingdom and other jurisdictions, and thus concerns issuers and investors in the UK. The ACT believes that a robust code of conduct to which issuers, investors and CRAs can provide input would serve to underpin regulation, to minimize the need for regulation and help to avoid fragmentation arising from differences in national and regional regulatory regimes.

In March 2003, the French Association of Corporate Treasurers (AFTE) developed and shared with the European Association of Corporate Treasurers (EACT)[6] a best practices guide that it has used in conversations with the CRAs and relevant authorities. The AFTE met with each of the three CRAs in Paris to discuss ways in which it might contribute to improving the relations between CRAs, issuers, and the market. In addition to developing best practices for CRAs, the AFTE has also begun a dialogue to identify the responsibilities of issuers to the agencies in recognition of the important role that the issuers play in the process.

While the tactics of each of these associations have been different, the goal of the three is quite similar. Each is seeking to improve the relationship between issuers and the CRAs, improve the quality of the ratings they promulgate, and restore investor confidence in global capital markets.

At its meeting in September 2003 in Slovakia, the International Grouping of Treasury Associations (which brings together the treasury associations of 26 countries) asked the AFP, ACT and AFTE to bring forward proposals for

[3] http://www.sec.gov/rules/concept/33-8236.htm
[4] http://www.afponline.org/pub/pdf/clkatz072803.pdf
[5] http://www.treasurers.org/technical/papers/resources/actcommentssec.pdf
[6] The EACT brings together the national treasury associations of the Euro currency zone.

improving rating industry practice. This paper puts forth, for the widest discussion, a proposal that reflects the common elements of the stances of the three associations.

We hope that this paper will be a contribution to the development of industry practice. While certain of the points below would usefully be incorporated into regulation in a jurisdiction where CRAs are regulated, the majority are better incorporated into an industry code of standard practices. Such a code of standard practices should, however, incorporate the substance of all the points given that some jurisdictions do not regulate CRAs.

Adherence to the industry code of standard practices could be a recital in rating agency contracts with issuers or a representation to/from issuers, precedent to the contracts.

We note the publication by the International Organization of Securities Commissions (IOSCO) of principles for the regulation of rating agencies[7] and generally support those principles. We believe that regulation should only provide a minimal fail-safe framework for CRA regulation and that the more flexible and adaptable industry code of standard practices must play a complementary role to such regulation.

The Associations look forward to discussing these concepts with CRAs, investors, intermediaries, issuers, regulators and other interested parties.

[7] http://www.iosco.org/news/pdf/IOSCONEWS59.pdf

## Regulatory Recommendations

1. **In jurisdictions where regulators grant recognition or approval to CRAs, the regulators should strive to eliminate unnecessary regulatory burdens and barriers to entry.**

   1.1. Regulators should establish and clearly communicate simple, stringent but attainable criteria that CRAs must meet in order to be recognized or approved. These criteria, along with documented processes and procedures, will eliminate unnecessary regulatory barriers to entry into the ratings market and may stimulate new competition.

   1.2. The criteria that CRAs must meet to receive regulatory approval should be based on whether the agency can consistently produce credible and reliable ratings over the long-term, not on methodology. The determination of whether ratings are credible and reliable may be based on market acceptance, quantitative analysis, or other methods developed by relevant regulators.

   1.3. The criteria for recognition should also require a CRA seeking regulatory approval to document its internal controls designed to protect against conflicts of interest and anti-competitive and abusive practices and to ensure against the inappropriate use of all non-public information to which rating agencies are privy.

   1.4. Regulators should periodically review each recognized CRA to ensure that it continues to meet the recognition criteria.

   1.5. It is unlikely, at least in the short-run, that a newly-recognized CRA could displace an established CRA or make it practical for an issuer to not receive a rating from one of the established CRAs. However, with additional competition or even the threat of additional competition resulting from the removal of barriers to entry, regulators should allow market forces to determine the appropriate frequency of rating reviews, acceptable methodologies, appropriate staffing levels and qualifications, and other points about which there is no wide agreement.

   1.6. Regulators should not prescribe methodologies that CRAs may use, but require that each CRA document and adhere to its chosen, published methodologies, while recognizing that many judgements are involved in arriving at ratings other than purely statistical ratings.

   1.7. Because of their access to non-public information about the companies they rate, regulators should require CRAs to document and implement policies and procedures to prevent the disclosure of

non-public information to outside parties that might benefit from this information.

1.8. In cases where a CRA is a parent, subsidiary, division, joint venture partner or affiliate of any organization that might benefit from non-public information, regulators should require that the CRA document strong firewalls that prevent the disclosure to or use of non-public information by these related or affiliated businesses or their personnel.

1.9. Regulators should prohibit, for a reasonable period of time, analysts and other CRA staff privy to non-public information from working in positions in securities markets or as journalists reporting or commenting on those markets such that they might benefit from this information.

1.10. Regulators should not stipulate a frequency (e.g., annually, semi-annually) with which CRAs must update ratings, but require agencies to disclose the date of the last formal review and when they last updated each rating.

## Rating Agency Code of Standard Practices

**2. Credit rating agencies should take steps to enhance the transparency of the rating process.**

2.1. Each CRA should widely publicize its methodologies on a periodic basis and prior to any changes in such methodologies.

2.2. While recognizing that all credit ratings, apart from purely statistical ratings, involve matters of judgement, a CRA should document and adhere to its published methodologies.

2.3. Each CRA should widely publicize any changes in its methodologies and allow a short period for public comment to the agency prior to the release of any rating announcement that might be the consequence of these changes.

2.4. Each CRA should publish the definition and historical default rates of each rating symbol it uses.

2.5. Each CRA should provide a guide to the methodology applicable to each company it rates prior to the assignment of a rating and preceding the implementation of any changes to the methodology.

2.6. CRAs should publish information on the qualifications and experience of the analyst assigned to a company, as well as the sector(s) and other companies this analyst covers. This information should be updated from time to time as necessary.

**3. Confidential information gathered by CRAs during the development of ratings should be protected and not otherwise be publicly disseminated.**

3.1. Because of their access to non-public information about the companies they rate, CRAs should document and implement policies and procedures to prevent the disclosure of non-public information to outside parties that might benefit from this information.

3.2. In cases where a CRA is a parent, subsidiary, division, joint venture partner or affiliate of any organization that might benefit from non-public information, the CRA should document strong firewalls that prevent the disclosure to or use of non-public information by these related or affiliated businesses or their personnel.

3.3. Analysts and other agency staff privy to non-public information should be required, in so far as is consistent with applicable law on employment and restraint of trade, to sign a pre-employment non-

disclosure agreement that prohibits them from using their access to such information in future employment in securities markets or as journalists reporting or commenting on those markets such that they might benefit from this information.

**4. Credit rating agencies should establish and document policies and procedures to protect against potential conflicts of interest.**

4.1. CRAs should have an ownership structure that is not likely to create opportunities for conflicts of interest to arise.

4.2. There should be strong firewalls between rating analysts and agency staff responsible for raising revenue from solicited ratings.

4.3. There should also be strong firewalls between rating analysts and staff involved in providing rating advisory services.

**5. Credit rating agencies should clearly distinguish between solicited and unsolicited ratings and disclose when a rating was last updated.**

5.1. CRAs should disclose whether each rating was solicited or unsolicited, and whether the issuer participated in the rating process. Whether a rating was solicited or unsolicited should be disclosed each time a rating is published.

5.2. CRAs should disclose whether a rating is based purely on statistical analysis of published information, statistical analysis of published information confirmed through conversations between a qualified analyst and the issuer, or analysis of published information and non-published information gathered during discussions between the CRA and the issuer.

5.3. CRAs should disclose when they last conducted a full review with the issuer and when each rating was last updated. CRAs should conduct a full review with each rated issuer no less than annually.

**6. Rating agencies should improve communication with issuers and the market.**

6.1. Prior to public release, issuers should be given an opportunity to review the text of any rating action affecting their securities to ensure the accuracy of reported information and to remove any non-public information erroneously included in the text.

6.2. The CRA should disclose to the issuer the key assumptions and fundamental analysis underlying the rating action, as well as any other

information that materially influenced the rating action and that could influence future rating actions.

6.3. Any financial figures that are restated by CRAs in public releases should be fully explained to the issuer and reconciled with the public figures reported by the issuer in its financial reports or other published information.

6.4. Long-term and short-term rating actions should be independent and treated as such, with all disclosure and communication requirements and rights of appeal applying to each rating.

6.5. As the analyst's recommendation can be called into question and overridden by members of the rating committee, issuers should have an opportunity to provide feedback to the rating committee on key assumptions and fundamental analysis, as well as any other information that may have materially influenced the rating action.

6.6. CRAs should commit to completing the rating process in a timely manner with consideration given to any stated issuer intentions to issue debt or otherwise access the capital markets. When an issuer communicates to a CRA its intention to access the capital markets without a corresponding request for a new rating, CRAs should avoid any unnecessary rating actions that could hinder the issuer's ability to effectively complete its capital markets operation.

6.7. Within five business days of a rating action, an issuer should have an opportunity, at its own cost, to appeal a rating or an outlook to a new group of analysts, who should meet with management and have access to previously-gathered company information. The result of this appeal should be published as soon as possible, but no later than six weeks following the publishing of the appealed rating.

6.8. Information provided to the CRA during the rating process and in regular meetings should be recorded by the agency, retained and made available to ratings analysts that may later be assigned to the company. As the principal rating agencies normally seek to rate through an economic cycle, records should be retained for at least that period as the agency understands it and some fundamental, structural information should be retained permanently or until it ceases to be relevant. During each formal review of an issuer, CRAs should confirm whether the information on record is still applicable or requires updating to ensure that the CRA is not rating based on outdated information.

6.9. CRAs should be expected to respond to issuer concerns about their rating in a timely and serious manner.

## Issuer Code of Standard Practices

7. **Issuers should commit to cooperate actively with CRAs when a rating is solicited and to providing information to CRAs that will contribute to the initial and ongoing accuracy and timeliness of solicited ratings.**

   7.1. Credit ratings and opinions are forward-looking and involve matters of judgement by the CRAs, and the credibility and reliability of these ratings and opinions are heavily dependent on an issuer's ability to provide adequate and timely information. Therefore, an issuer is responsible for providing information to CRAs that should include:

   7.1.1. The issuer's business strategy;

   7.1.2. The legal and management structure of the issuer and its parent company or subsidiaries, as well as its management processes;

   7.1.3. The risks and opportunities of the issuer's business environment, as well as those peculiar to itself;

   7.1.4. The issuer's approach to risk management and financing;

   7.1.5. The issuer's financial policies;

   7.1.6. Key financial data; and

   7.1.7. Any other information or data that the issuer believes will help the CRAs to better understand its particular circumstances and outlook.

   7.2. Issuers should provide adequate and timely information, in good faith, regarding any material change in the financial situation of the company.

   7.3. Notwithstanding the requirement for full and timely communication to CRAs in 7.2, issuers should hold, at least once a year, a full review with CRAs in order to explain past performance and future prospects on a horizon relevant, in the issuer's opinion, with the nature of its business(es). In doing this, issuers should allow CRAs to access the appropriate level of management within their organization.

   7.4. Issuers should inform CRAs about any corporate actions, including public debt issuances, prior to their launch. Issuers should provide CRAs with all relevant information on these corporate actions in order to allow CRAs to issue their opinion/rating, if any, in a timely manner.

7.5. Issuers should endeavor to address CRAs' questions and requests as quickly as possible and, in case of delayed answers, to inform CRAs accordingly.

7.6. Issuers should seek to react as quickly as practicable to communications submitted to them by a CRA prior to their public release by the CRA. While issuers should, in any case, make reasonable efforts to respond as quickly as possible, the time frame in which companies may review the text should be limited (but not less than four business hours) in order to ensure that investors receive timely information and to minimize the possibility of information leaks.

During this time, issuers should not take any pre-emptive action that would challenge or counter the release by the credit rating agency. In addition, issuers should not take advantage of the delay in the release of the rating action to the market by making any debt issuance other than the refinancing of maturing short-term debt.

**About the Association of Corporate Treasurers**

The Association of Corporate Treasurers (ACT), based in London, England, is an organization of professionals in corporate finance, risk and treasury and cash management operating internationally. Formed to promote the study and best practice of finance and treasury management, it has over 3,300 members and 1,200 students in more than 40 countries. Its education and examination syllabi are recognized by both practitioners and bankers as the global standard setters for treasury education. The ACT represents the interest of non-financial sector corporations in financial markets to regulators, standards setters, trade bodies, etc.

Contact: John Grout, Technical Director, ACT
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Comments on the Code of Standard Practices: ratingcode@treasurers.co.uk
General Queries: enquiries@treasurers.co.uk
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**About the Association for Financial Professionals**

The Association for Financial Professionals (AFP) headquartered in Bethesda, Maryland, supports more than 14,000 individual members from a wide range of industries throughout all stages of their careers in various aspects of treasury and financial management. AFP is the preferred resource for financial professionals for continuing education, financial tools and publications, career development, certifications, research, representation to legislators and regulators, and the development of industry standards.

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**About Association Française des Trésoriers d'Entreprise (AFTE)**

Association Française des Trésoriers d'Entreprise (AFTE), founded in 1976, represents more than 1,400 members, including 1,050 Corporate Treasurers or Financial Managers of approximately 900 industrial and commercial companies; 450 members are based in the provinces. There are also 350 correspondent members. Its development is concentrated on five activities: technical committees, conferences, education, publications and representation of corporate treasurers. AFTE is a founding member of the Euro Associations of Corporate Treasurers (EACT).

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Testimony of Alex J. Pollock

Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Of the Committee on Financial Services

September 14, 2004

Good morning, Mr. Chairman and Members of the Subcommittee. It is a pleasure to present my views on the unintended cartel-like effects of the SEC's regulation of rating agencies through its "NRSRO" designation, and what steps might be taken to reduce government-created barriers to competition and create a more competitive rating agency sector.

I am Alex Pollock, a Resident Fellow at the American Enterprise Institute in Washington, D.C. These are my personal views. The focus of my work is to examine ways to inject greater economic efficiency and market choice into situations in which the government, in one way or another, has created non-competitive structures. An example well known to this Subcommittee is the GSE duopoly in the secondary mortgage market, but the rating agency sector is equally pertinent.

Competitive markets, as it is unnecessary to say, lead to economic growth, efficiency, innovation and customer choice. But what do we find in the rating agency sector? As Professor Larry White of New York University has written:

> The problem concerns the SEC's regulation of the bond rating industry... incumbent bond rating firms are protected, potential entrants are excluded, and new ideas and technologies for assessing the riskiness of debt (and therefore the allocation of capital) may well be stifled. This entry regulation is a perfect example of good intentions gone awry.... ("The SEC's Other Problem," Regulation, Winter 2002-03)

The fundamental source of the problem is that the designation "Nationally Recognized Statistical Rating Organization" or "NRSRO" has become embedded in the rules of various regulators as an essential restriction in investment, financial market and capital regulations. The only way to get to be an NRSRO is to be designated as one by the SEC, and this involves, as many commentators have pointed out, a practically insuperable "Catch 22."

The SEC's own Concept Release on the subject states that in order to become a recognized NRSRO:

> The single most important criterion is that the rating agency is widely accepted in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings. ("Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws," 2003)

You cannot be widely accepted by the predominant users unless you are an NRSRO, but you cannot become an NRSRO unless you are already widely accepted! The same SEC Release says, "Some commenters believe that the NRSRO designation acts as a barrier to entry into the credit rating business." There seems to be no doubt that these commenters,

which include the Department of Justice, are correct.

If you think back to the position of the SEC at the time of its first NRSRO regulation in 1975, it is easy to see why as a first designation of acceptable sources for ratings, it would be attractive to ask which rating agencies had met the market test and were widely accepted or already "nationally recognized." At that point, the concept was an endorsement of the results of market evolution of the past. But going forward, when market evolution would always thereafter be constrained by the regulatory restriction, the logic no longer holds.

Simply consider that when John Moody published his first ratings in 1909, or when Poor's Publishing Company published its first ratings in 1916, or the Fitch Publishing Company its first ratings in 1924, they were not yet "widely accepted by the predominant users." They all had to fill a market need and compete their way into becoming "nationally recognized."

As a matter of corporate strategy, the rating agency business has significant barriers to entry in any case, including the need to establish reputation, reliability and integrity; the prestige factor involved in the purchase of opinions and judgements; and natural conservatism in risk management policies. To add to this a "distortionary entry restriction regime," to use Professor White's phrase, insures a non-competitive outcome.

<u>What Could Be Done?</u>

I suggest four possible actions to move in a pro-competitive direction:

1. It is clear that what "NRSRO" really means is "SEC Approved Rating Agency." The term "NRSRO," with its implication that it represents some sort of a market test (as it did 30 years ago but no longer does) should be dropped altogether. If the SEC continues to require its own approval of rating agencies for regulatory purposes, the designation should express "SEC Approved."

2. If the SEC continues to require its approval of rating agencies, the criterion of having to be "nationally recognized" in advance should be eliminated.

3. The approval of rating agencies for specialized purposes, as the SEC has sometimes done in the past, should be encouraged. Such specialization might be an industry, for example, financial institutions; a country, for example, Japan; or any other logical domain defined by competence and knowledge. This would allow new entrants to add competition where they are best able, to demonstrate their value to the market,and to grow organically if they succeed.

4. In the best case, not only the term "NRSRO," but also the requirement of designation by the SEC, would be dropped. Instead, the responsibility to choose among rating agency services should belong to investors, financial firms, securities issuers and other users—in short, the market. Every firm should have among its financial and risk management policies its approved policies for how it uses credit ratings and whose ratings can be used for what. These policies need to be appropriately disclosed (and could be examined by any relevant regulators). Under these circumstances, which rating agencies turn out to be "nationally recognized" would reflect a true competitive market test, and competition would provide its normal benefits of innovation, choice and efficiency.

Mr. Chairman, thank you for the opportunity to testify today.

# STATEMENT OF
# BARRON PUTNAM, Ph.D.

**President & Chief Economist**
LACE Financial Corporation

*Before the*

House Financial Services Subcommittee on
Capital Markets, Insurance and Government
Sponsored Enterprises

Regarding:

The Ratings Game: Improving Transparency and
Competition Among the Credit Rating Agencies

September 14, 2004

Introductory Remarks before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises concerning the need to improve the recognition criteria to become an NRSRO company and potential conflicts between NRSRO-designated companies and the companies they rate.

Good morning, Chairman Baker and Members of the Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. Thank you for this opportunity to appear before you today.

## NRSRO Criteria and the Application Process

LACE Financial (LF) has attempted to become a Nationally Recognized Statistical Rating Organization (NRSRO) for the last 12 years so that it could be on a level playing field with its competition. It took the SEC eight years before they acted on our first application, which they denied over the phone but gave no reason for the denial. I had to ask them to put the denial in writing and we received a letter stating that the denial was because we had only three analysts. I wrote back and told them we had eight of ten analysts involved in the rating process and supplied their names. We later received another denial letter stating the NRSRO criteria with a statement saying LF was denied NRSRO status because we "didn't meet the above criteria". We appealed our application on the basis that we were denied NRSRO status without being given a clear reason. This appeal has now been before the SEC for 2 years and three months. How

long should this process take? Clearly there is a need for more transparency in the NRSRO application process.

When LF was started in 1984 we had a clear technological advantage over existing NRSRO companies in our credit rating process, which evolved from my doctoral research and from the development of the off-site rating systems by the committees of the three federal bank regulators which I chaired. When Thompson Bank Watch (our main competitor at the time) received NRSRO status, our growth in revenue basically stopped and was stagnant for approximately ten years. In the last two years, we have been growing about 20% per year, due largely to growth in our new issue rating business.

I believe LF would be a far larger company and a significant competitor to the existing NRSRO companies had NRSRO status not been withheld from our company for such a long time. The absence of NRSRO status makes it very difficult for new rating agencies to become established, especially in the United States, and for existing non-NRSRO firms to be effective competitors. Reporters have asked us if Moody's or Standard & Poors use unfair competitive practices against our company. The answer is: No, they don't have to. The SEC performs this function for them though their "Net Capital Rules" and through the withholding of NRSRO status.

LF is in a position to become an effective competitor with existing NRSRO companies because it now issues 80,000 credit ratings and approximately 70 new issue ratings per year. However, NRSRO status is necessary to break down barriers that prevent companies and municipalities from using our services. Lacking these barriers, we would likely be able to grow our revenues in the 40%plus range. That would make us more competitive with the existing NRSRO companies over time.

## Conflicts of Interest that Arise Between NRSRO-designated Firms and the Companies They Rate

The exchange of money for a rating can obviously lead to a conflict of interest and can lead to higher ratings. I have provided to your committee our LACE Foreign Bank Rating Service. Comparison of our credit ratings (for which we do not charge the rated institutions) to those of NRSRO companies will show that NRSRO-designated companies tend to issue higher ratings to institutions that pay to be rated. To bring transparency to the rating process, a file should be required showing all revenues received for each rating issued by any rating agency. The SEC can then review this information if it receives a complaint concerning a conflict of interest in the rating process. I would also suggest that all rating companies provide a price list for all products and services to the SEC on an annual basis to help ensure more equal treatment in the charges for rating services. To help bring transparency to the rating process, all rating companies should show the date the rating was issued and the key data used in determining the rating, along with the rating itself.

By Barron Putnam, Ph.D.
President, LACE Financial Corporation

**Attachments:**

Barron Putnam Bio (Page 5)
About LACE Financial Corporation (Page 7)
Letter to SEC regarding Resona bailout (Page 8)
Release regarding failure of Superior Bank, FSB (Page 11)

## BIOGRAPHICAL SKETCH

**Barron H. Putnam, Ph.D.**

Prior to founding LACE Financial Corporation, Dr. Putnam had oversight responsibility for monitoring the financial condition of commercial banks and bank holding companies for the Federal Reserve System. He chaired the interagency committees of the three bank regulatory agencies that developed the Uniform Surveillance System that provided off-site financial ratings for insured financial institutions. During his sixteen years at the Federal Reserve Boards, he was manager of Surveillance Sections in the Division of Bank Supervision, Assistant Director of the Bank Holding Company Analysis Program, and Economist in the Division of Research and Statistics. Currently he is owner and president of LACE Financial Corporation of Frederick, Maryland which provides financial ratings on approximately 22,000 U.S. banks, savings and loans, credit unions, bank holding companies, and foreign banks. LACE Financial has been in business 20 years and has over 600 clients.

**Research and Articles with the Banking Industry:**

"An Empirical Model of Financial Soundness: A Case Study for Bank Holding Companies," Ph.D. Dissertation, George Washington University, Washington D.C., February 1983.

"Concepts of Financial Monitoring," Dynamics of Banking (Havrilesky, Schweitzer, and Boorman, Harlen Davidson, 1985).

"Evaluating the Financial Condition of Banks, and Managing Bank Stock Prices and Liabilities," Warren, Gorham and Lamont, Inc. Boston 1988.

"Too Big to Fail Doctrine," American Banker, New York, July 1991.

"Analyzing a Bank- A Simplified Approach," Public Investor, Chicago, February 1993.

"Super-regulator Could Reduce Duplication, Uncertainties," American Banker, New York, February 1994.

"Trade-Off: Deregulation for a Chinese Wall," American Banker, New York, March 1995.

"How to Survive Bank Mergers," Corporate Cashflow, Georgia, April 1996.

"Blindsided by Asia," Financial Executive Magazine, New Jersey, November-December 1998.

**Educational Background:**

New York University: B.S., 1962 International Banking and Finance.

University of California, Berkeley: M.S., 1966, Economics.

Stanford University: M.S., 1968, Applied Economics, Demography and Food Research.

George Washington University, Ph.D., 1983, Economics.

## ABOUT LACE FINANCIAL CORPORATION

LACE Financial Corporation rates more financial institutions than any other rating service. Each quarter, LACE Financial Corporation provides their customers financial ratings on roughly 8,000 commercial and savings banks, 1,350 bank holding companies, 900 savings & loans, 1,500 to 9,400 credit unions (depending on the quarter), 200 of the largest foreign banks and 95 title insurance companies (all numbers subject to change). LACE also assigns sovereign ratings for roughly 56 countries. For clients, LACE Financial Corporation will follow/rate approximately 8,000 international banks.

LACE Financial Corporation's name is derived from the four major determinants of financial soundness: Liquidity, Asset Quality, Capital and Earnings. Although the company computerizes much of the information, a team of financial analysts reviews each institution separately. LACE Financial Corporation does not charge institutions for their ratings to avoid any bias in the rating process.

May 22, 2003

Subject: Rating of Resona's large
Bank subsidiaries.

Mr. Mark M. Attar
Special Counsel
Division of Market Regulation
United States Securities
and Exchange Commission
Washington, D.C. 20549

Dear Mr. Attar:

The purpose of this letter is to provide the SEC with information showing that LACE Financial provides far better credit ratings of financial institutions than the existing large NRSRO rating companies.

The three large NRSRO companies missed the failure (bail out) of one of the world's largest financial institutions the Japanese, Resona Holdings, Inc., which owns the $195.7 billion Asahi bank and the $110.4 billion Daiwa Bank. These banks were rated by the three large NRSRO companies with investment grade ratings before the banks failed, shown in the following tables.

Credit Ratings of Large NRSRO Companies of Rezona's Large Subsidiary Banks[1]

| | Fitch | Standard & Poors | Moody's |
|---|---|---|---|
| Asahi Bank | | AA- | Aa3 |
| Daiwa Bank, Ltd. | BBB+ | A-3 | Baa3 |

***Source: Thomson Bank Directory, December 2002- May 2003, page 1978[2]***

LACE Financial provided investors and creditors with at least two years earlier warning that these institutions were likely to fail (with E ratings) and e-mailed an alert letter warning of their failure and suggested they secure their positions. Asahi Bank was rated

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Fitch--BBB+ Obligation for which there is currently low expectation of investment risk (+ means high end of rating scale of BBB).
Standard and Poor's--AA Very high degree of safety with very strong capacity for repayment. (- means low end of rating scale for AA). A-3Short-term Investment Grade- Issues carrying their designation have adequate capacity for timely payment.
Moody's--Aa3 Bonds, which are rated as Aa, are judged to be of high quality by all standards. (3 means to be in the low end of the Aa rating). Baa3 Bonds which are considered as medium grade obligation (i.e. they are neither highly protected nor poorly secured).

Comment: Only the first sentence is used from each companies rating definitions and further information is given to qualify the meanings of the ratings.

an "E"[2] as of March 2001 and Daiwa Bank Limited and "E" [2]as of September 2000 (see attachment 1). We warned our clients on October 1, 2002 concerning the solvency of both banks and "strongly suggested that our clients secure credits" to these banks (see attachment 2).

LACE Financial has been rating U.S. banks and foreign banks before Moody's and Standard and Poors. In evaluating rating companies the SEC might investigate why all three existing NRSRO companies gave Asahi Bank and Daiwa Bank investment grade ratings prior to their failure (bailout). It should be clear to anyone, that with a ratio of nonperforming assets to capital and reserves[3] of 128% for Asahi Bank and 175% for Daiwa Bank that these banks were clearly insolvent.

LACE Financial Ratings of Resona's Large Bank Subsidiaries

**Table 1**

| Resona Holdings, Inc. | TOTAL ASSETS (USD Mil.) | NPA's/ EQT+ RSV. Current Period | NPA's/ EQT+ RSV. Previous Period | EQTY/ T.AST Current Period | ROA | LACE Rating 9/00 | LACE Rating 3/01 | LACE Rating 9/01 | LACE Rating 3/02 | LACE Rating 9/02 | LACE Rating May 20, 2003 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Asahi Bank** | **195,706** | **127.77%** | **91.20%** | **2.97%** | **0.20%** | **C** | **E** | **E** | **E** | **E** | **C+** |
| **Daiwa Bank, Ltd.** | **110,442** | **174.77%** | **98.22%** | **2.67%** | **0.07%** | **E** | **E** | **E** | **E** | **E** | **C+** |

*** Current ratings and data as of September 30, 2002**

***Source: LACE Financial Foreign Rating Service, May 2003, p.15. Current ratings and data as of September 30, 2002.***

With NRSRO Status, LACE Financial will first bring to the financial sector, and later the nonfinancial sector, pressure for better ratings, more frequent ratings on a timely basis and better disclosure of financials for which the ratings are based. In terms of price competition, we have previously stated to the SEC that we can provide new issue ratings for financial institutions at a cost factor of 5 to 10 times less than existing NRSRO companies.

In our survey, where the results were sent directly to SEC's Division of Market Regulation, 100 percent of the respondents stated we were a creditable rating service, 91 percent said we provided early detection in the change in the financial condition of a company, 95 percent said our analysts were responsive to client inquiries and 100 percent said that our analysts were knowledgeable about the institutions we rate. All respondents felt that LACE Financial provided better ratings because we did not accept monies from the companies we provide credit ratings. If this last sentence doesn't ring a bell as to why the large NRSRO companies are providing investment grade ratings to large companies prior to their failure, it should!

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[2] An "E" rating is LACE Financial's lowest rating and means that an institution has a very weak financial condition and is close to failure. Although these institutions can survive on their own, they generally need a capital injection or be restructured with outside help.

[3]

No matter how good we are, its to no avail without NRSRO status, because investors, brokers, and dealers are prevented from using our ratings. The longer the SEC holds up our application, the stronger the market power of the existing NRSRO becomes through name recognition and working relationship's with investment bankers and investors. If the SEC holds up this application long enough or denies it, it becomes questionable as to whether we should stay in this business. The real value of this company can only be attained by an NRSRO company and this is why the rating business has become so concentrated. Is this what the SEC wants? What is sad, is that past actions of the SEC points in this direction.

LACE Financial has been in business 19 years, issued over a million credit ratings and none of these companies have ever complained to a state or a federal regulator and no one has ever threatened to sue us. Approval of our application can only be pro-competitive by putting downward pressure on rating prices and to improve services to the investment community.

Sincerely,

Barron H. Putnam, Ph.D.
President and Financial Economist

BHP/tmf

Enclosures

CC: Mr. William Donaldson, Chairman, Securities and Exchange Commission
Mr. Paul Adkinson, Commissioner, Securities and Exchange Commission
Mr. Roel Campos, Commissioner, Securities and Exchange Commission
Ms. Cynthia Glassman, Commissioner, Securities and Exchange Commission
Mr. Harvey Goldschmid, Commissioner, Securities and Exchange Commission
The Honorable Barbara Mikuski, U.S. Senator
The Honorable Paul Sarbanes, U.S. Senator
Aurora A. Battaglia, Vice President, International Finance
LACE Financial Corporation Website, www.lacefinancial.com

July 30, 2001

## SUPERIOR BANK, FSB FAILURE

The Office of Thrift Supervision shut down $2.3 billion in assets Superior Bank FSB of Hinsdale, IL late on the evening of Friday, July 27, 2001 and the FDIC was named conservator. LACE Financial rated the institution an "E" (our lowest rating) based on data reported to regulators on March 31, 2001 and notified our clients of the problems in a release on July 13, 2001. The insured deposits and most of the assets have been transferred to the newly chartered Superior Federal FSB (New Superior). Deposit customers of Superior Bank, FSB are now customers of the new Superior Federal FSB, and will have immediate access to their insured deposits. Superior Bank, FSB had total deposits of $1.6 billion—potentially $42.9 million of which may be uninsured. As de-facto manager of the new institution, the FDIC plans to contact the uninsured depositors to arrange meetings with claims agents. The FDIC also plans to extend a $1.5 billion line of credit to the new entity to ensure uninterrupted operations.

Superior Bank, FSB has been undercapitalized of late, especially after taking a ($69.9 million) loss during the first quarter of 2001, which helped drop equity capital 76% over the same quarter. LACE Financial notified its clients of this potential danger two weeks ago. Over the last two months, events unfolded that would bring the thrift down. Superior Bank, FSB had accumulated a type of asset known as "residual" interests. Essentially, the bank was originating subprime loans, packaging and securitizing them, and selling these off at a lower interest rate. The potential profit realized from the difference between the interests that Superior was paying versus what it was receiving, was considered an asset called a residual. It was the valuing of these residuals that ultimately hurt Superior Bank, FSB. As the private investors who were prepared to bailout Superior saw the valuations of these subprime residuals drop precipitously over the last two months, they dragged their feet on the bailout deal. The deal collapsed, hence the FDIC action this weekend.

The failure could possibly cost the FDIC's Savings Insurance Fund (SAIF) up to $500 million, with the final figures to be released later. This represents the third FDIC-insured failure this year.

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