TESTIMONY OF GREGORY ROOT
EXECUTIVE VICE PRESIDENT
DOMINION BOND RATING SERVICE

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES OF THE COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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Good morning, Mr. Chairman and members of the Committee. My name is Greg Root, and I am Executive Vice President of Dominion Bond Rating Service. I am pleased to have the opportunity to present DBRS' views on the role and function of credit rating agencies in the capital markets. Without question, credit ratings have become an integral part of the financial markets globally; therefore, it is imperative that there be a clear understanding of the role of rating agencies, how they operate, and how they compete.

I would like to begin with an overview of our company.

Overview of DBRS and Its Credit Ratings

Based in Toronto, DBRS was founded in 1976 by Walter Schroeder, who remains the company's President. DBRS is employee-owned, is not affiliated with any other organization, and limits its business to providing credit ratings and research. DBRS is a "generalist" rating agency, in that we analyze and rate a wide variety of institutions and corporate structures, including government bodies, and various structured transactions. At this time, we rate some 700 different entities and provide credit research on another 250 companies, with most of the latter based in the United States. DBRS has 65 employees, 45 of whom are analysts.

Since its inception, DBRS has been widely recognized as a provider of timely, in-depth and impartial credit analysis. Our opinions are conveyed to the marketplace using a familiar, easy-to-use letter-grade rating scale. These ratings are supported by an extensive research product, which includes detailed reports on individual companies, as well comprehensive industry studies. This information is disseminated through various means, including a proprietary subscription service which is used by more than 3,000 institutional investors, financial institutions and government bodies.

DBRS' credit ratings reflect the company's opinion as to the likelihood of timely payment in full of principal and interest (or the equivalent, with respect to claims-paying or preferred stock ratings). In arriving at these credit decisions, our team of analysts considers a wide range of factors, both quantitative and qualitative. All ratings are processed through a committee system and are reviewed regularly. DBRS strives to consider all factors that could have an impact on the future creditworthiness of the issuer or specific instrument in question. Among the various factors we consider are:

1. A company's financial risk profile, with particular focus on leverage and liquidity;

2. Complexion of the industry in which the company operates and its position in that sector;

3. Quality of management;

4. Core profitability and cash flow; and

5. Other miscellaneous issues which may affect the creditworthiness of the issuer or instrument in question.

As part of the process, we maintain an ongoing dialogue with the managements of the companies we rate. Oftentimes, they provide us with information that may not be publicly available. This information is used strictly for the purposes of arriving at an accurate rating decision. Prior to finalizing our decisions, we discuss our preliminary views with the company, and we allow them to review any releases prior to public dissemination to assure that our ratings are accurate and that we have thoroughly considered all relevant facts. Ratings are reviewed constantly and changes are made whenever we are of the opinion that the relative creditworthiness has changed, positively or negatively.

I would next like to briefly discuss the role of rating agencies in the capital markets.

Role of Credit Rating Agencies in Capital Markets

As the SEC noted in its recent report to Congress on credit rating agencies, over the past 30 years, the SEC and other federal and state regulators have increasingly relied on credit ratings as a way to monitor the risk of investments held by regulated entities. In 1975, the Commission introduced the concept of "nationally recognized statistical rating organization" or "NRSRO" as a means of identifying ratings of market-recognized credible agencies for purposes of applying the broker-dealer net capital rule. From that modest beginning, the NRSRO concept has spread to several other areas of federal securities regulation, as well as federal banking regulation, state laws and rules, and even foreign law. Congress itself has incorporated the term NRSRO into legislation on at least two occasions. In addition to these legislative and regulatory uses, NRSRO credit ratings are also used extensively in debt covenants and other financial instruments between private parties.

NRSROs play a critical role in the complex and volatile debt marketplace, and I am pleased to say that the confidence the regulators and the markets have shown in the rating agencies is not misplaced. While ratings are certainly not guarantees of future performance, studies show that there is a strong positive correlation between ratings and default rates.

However, although DBRS is proud of the role rating agencies play in the global securities markets, we are aware that certain concerns have been raised recently regarding the rating industry. I would now like to turn my attention to three of those concerns: (1) transparency of the ratings process, (2) conflicts of interest and (3) competition and regulatory barriers to entry.

Transparency

We at DBRS are aware of the importance of transparency in the ratings process. At the SEC's rating agency hearings last fall, we heard institutional investors express their desire for a clear understanding of the reasoning behind ratings decisions. DBRS makes every effort to ensure that our ratings are transparent. Among other things, we issue full, detailed reports on individual companies and industries. These reports openly convey our views on both current ratings and on the direction of ratings.

In short, we believe everyone's interests are better served when the reasons behind are ratings are widely known.

Conflicts of Interest

DBRS is very sensitive to the potential for conflicts of interest when it comes to making our ratings decisions, and we have been very diligent in working to minimize that potential. As mentioned earlier, the company is independently owned and operated and is not affiliated with any other organization. Providing credit ratings with supporting research is our only business. Employees are prohibited from purchasing any security issued by companies rated by DBRS and we have policies in place to deal with and monitor a wide range of compliance issues. Our revenues are generated from two sources: fees paid by issuers to rate their securities and the sale of subscriptions for our research.

Rating agencies' practice of receiving fees from issuers has come under some scrutiny for the industry as a whole, and merits a few words here. First, this has been the industry practice for many years. The industry would not play the vital role in the securities markets that it plays today if market participants believed this fee structure were being abused. Second, because no one issuer accounts for a meaningful percentage of DBRS' overall revenues, no one issuer can exert untoward pressure on our rating activities.

Third, analyst compensation is in no way tied to the amount of revenues generated from issuers within the analysts' respective areas. Finally and perhaps most importantly, the success of our business is based on one key factor -- our reputation. If at any point, investors become concerned about the independence of our judgment and therefore the accuracy of our ratings, the demand for our services would greatly diminish. Since we often follow most companies in an industry, an over-rated or under-rated company would show up quickly, and would hurt our reputation if we could not support the relative ratings we have assigned. We have no intention of letting that happen.

Competition and Barriers to Entry

As the rating agency that has most recently been through the NRSRO designation process, DBRS has a somewhat unique perspective on this issue.

Because credit ratings play such an important role in the capital markets from a regulatory perspective, we believe the barriers to entry should be high. That said, the real concern as we see it is not so much that the barriers make it difficult for new competitors to enter the field, but rather that there is no well-defined process by which companies can be designated as NRSROs. The no-action letter process that the SEC currently uses to issue this designation is, in our opinion, ill-suited to this task, because the criteria for designation are not sufficiently defined, the application process is not standardized, and adverse decisions on requests for designation are not subject to appeal.

Based on our recent experience, DBRS believes that there should be a clear definition of what constitutes an NRSRO and a transparent process in place to enable qualified companies to apply for this designation.

Conclusion

In conclusion, I would like to say that overall, I believe that the credit rating system as it exists today works quite well and has helped foster the growth of the financial markets globally. In light of recent events, it is only appropriate that the issues being raised by the Subcommittee be thoroughly reviewed, and we very much appreciate having the opportunity to be part of this process.