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

Legislative Solutions for the Rating Agency Duopoly

Wednesday, June 29, 2005

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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 legislative solutions to the many issues and concerns raised with regard to the credit ratings market. Specifically, my testimony will focus on the recently introduced "Credit Rating Agency Duopoly Relief Act of 2005" and the Securities and Exchange Commission's (SEC) staff legislative framework.

AFP represents more than 14,000 finance and treasury professionals representing more than 5,000 organizations. Our members are responsible for issuing short- and long-term debt and managing corporate cash and pension assets for their organizations.

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's research has consistently shown that confidence in rating agencies and their ratings is low and has continued to diminish over the past few years. Despite this erosion of confidence and more than ten years of examination, the Securities and Exchange Commission (SEC) has yet to implement any meaningful reform to address the concerns of issuers and investors.

In previous appearances before this Committee and the Senate Banking Committee, as well as in comments on the SEC's recent proposed *Definition of Nationally Recognized Statistical Rating Organization* (comment letter attached), AFP has stated that the SEC's existing recognition process has created an artificial barrier to entry to the credit ratings market. This barrier has led to a concentration of market power with the recognized rating agencies and a lack of competition and innovation in the credit ratings market.

To remove this barrier to entry and stimulate competition, AFP has long recommended that the Commission clarify the recognition process. We have recommended that recognition of credit rating agencies be conditioned on whether a credit rating agency can consistently produce credible and reliable ratings based on adherence to published methodologies. We have also urged 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. This past spring, the SEC issued proposed regulations in which it acknowledged the need for a transparent recognition process. The proposed *Definition* attempts to address some of the concerns we have raised. Unfortunately, we do not believe that the SEC proposal would foster a truly competitive market and fails to address the need for ongoing oversight of the credit ratings market.

The Credit Rating Agency Duopoly Relief Act of 2005 would require the SEC to register credit rating agencies within 90 days of application based on the criteria recommended by AFP. By eliminating the ambiguous NRSRO designation process in favor of a more transparent registration process, the Act will foster meaningful competition in the credit ratings market. The recent SEC proposal falls short in this regard. As such, AFP supports the legislative proposal before the Committee today.

The SEC's recent proposal also fails to address investor concerns regarding the ongoing oversight of rating agencies. In nearly thirty years since creating the NRSRO designation, there has been no review of the ongoing credibility and reliability of the ratings issued by the NRSROs. Any effort to address concerns about the credit rating market, either through regulation or voluntary agreement, will be entirely ineffective without an oversight and enforcement mechanism. It is now an appropriate time for Congress to act.

AFP is pleased that the proposed legislation directs the Commission to censure, suspend or revoke the registration of any registered statistical rating organization that violates certain sections of the Act or ceases to meet the registration criteria as recommended by AFP and outlined in the Act.

If the credit ratings market is opened up to competition, it will be even more important for the SEC to take an active role in the ongoing oversight of registered statistical rating organizations to ensure that they continue to merit SEC registration. We believe that the proposed legislation gives the SEC the authority, flexibility, and guidance needed to conduct the necessary oversight without placing an overly restrictive legislative regime on either the Commission or the credit rating agencies.

Ongoing oversight must ensure that registered statistical rating organizations continue to issue credible and reliable ratings. Further, the Commission must periodically verify that registered statistical rating organizations have *and adhere to* policies that protect non-public information and prevent conflicts of interest and unfair and abusive practices.

For the Committee's consideration, we believe there are several key areas where additional clarification will strengthen the Act. The first area relates to "ratings performance measurement statistics." As AFP has consistently suggested, the key criteria for rating agency recognition should be whether the rating agency can consistently produce credible and reliable ratings. The proposal requires a rating agency seeking registration to file performance measurement statistics. We believe that it is imperative that the applicant not simply file statistics, but also demonstrate that its ratings are, in fact, credible and reliable. This is particularly important since NRSROs are currently widely relied upon in regulation and practice. If registered statistical rating organizations will take the place of NRSROs throughout Federal regulation, it is crucial that the Commission ensure that those who are registered serve the regulatory purpose for which the SEC first recognized credit rating agencies.

Market acceptance, which the Commission currently uses when assessing credibility and reliability of credit ratings, is one acceptable measure. However, it should not be the only measure. For example, an analysis of the required performance measurement statistics that shows a high correlation between a rating agency's expected and actual default experience or other quantitative methods should be acceptable for demonstrating credibility and reliability.

The second area in need of clarification is the registration requirement contained in Section 4 of the legislation. The bill requires all rating agencies that meet the definition to register with the SEC, even those that do not seek to have their ratings approved for use by regulated portfolios. There are currently more than 130 rating agencies, many of whom have not sought and may never seek SEC recognition or registration. Further, new rating agencies that may be established may not be able to file long-term ratings performance measurement statistics required for registration, shutting out these new entrants entirely.

AFP recommends that the Act limit registration requirements to those that seek approval for use by regulated portfolios or those that the Commission determines must be registered to protect the public interest. Those that do not seek or obtain SEC registration should not be prohibited from conducting their business as they see fit, unless this prohibition is deemed by the Commission to be in the public interest.

AFP also recommends that the Act explicitly direct the Commission to develop an oversight and examination regime that ensures that registered statistical rating organizations continue to issue credible and reliable ratings and that they have *and adhere to* policies that protect non-public information and prevent conflicts of interest and unfair and abusive practices. Such an oversight framework is described in the Commission's "Staff Outline of Key Issues for a Legislative Framework for the Oversight and Regulation of Credit Rating Agencies", developed at the request of Ranking Member Kanjorski. This type of oversight will protect capital market participants without injecting regulators into the decision making of the rating agencies or impinging on their First Amendment rights.

We believe that the registration process proposed in the "Credit Rating Agency Duopoly Relief Act of 2005" will minimize barriers to entry and foster competition among existing NRSROs and those that may later be registered. This competition will stimulate innovation and creativity in the credit ratings market and improve the quality of information available to investors. The enactment of the bill, along with the development by the Commission of an oversight regime that ensures that registered statistical rating organizations continue to meet the registration requirements, will be meaningful and necessary steps in improving investor confidence in the rating agencies and global capital markets.

We commend you Mr. Chairman, Ranking Member Kanjorski, Representative Fitzpatrick and the Committee for recognizing the importance of this issue and taking action for the benefit of all institutional and individual participants in global capital markets. We hope the Committee will aggressively pursue enactment of the "Credit Rating Agency Duopoly Relief Act of 2005" and its rapid implementation by the Securities and Exchange Commission.

Association for Financial Professionals

June 7, 2005

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: File No. S7-04-05

Dear Mr. Katz:

The Association for Financial Professionals (AFP) welcomes the opportunity to comment on the Securities and Exchange Commission's proposed *Definition of Nationally Recognized Statistical Rating Organization*. We are pleased that the Commission has recognized the need to clearly define the criteria and process used to designate a nationally recognized statistical rating organization (NRSRO), which AFP has advocated for nearly three years. Further, we acknowledge that the Commission has adopted many of the recommendations made by AFP in our comment letter on the Commission's Concept Release *Rating Agencies and the Use of Credit Ratings under the Federal Securities Laws*[1] and in our *Code of Standard Practices for Participants in the Credit Rating Process*[2]. We believe that ambiguity in the recognition criteria and process has served as an artificial barrier to entry into the credit ratings market that has stifled competition.

While AFP is encouraged that the Commission has recognized the need for a definition of NRSRO, we do not believe that the proposed definition will allow market participants to fully recognize the benefits of a truly competitive market. The proposed definition does not adequately accommodate rating agencies that may employ innovative methodologies to produce credible and reliable ratings that are not currently recognized by the Commission. Rather, the proposed definition largely requires methodologies that closely resemble those used by existing NRSROs. As such, it appears to limit competition only to those that look substantially similar to the current dominant market players.

[1] http://www.afponline.org/pub/pdf/clkatz072803.pdf
[2] http://www.afponline.org/pub/pdf/CSP_final.pdf

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We believe that the recognition criteria must be focused on whether a credit rating agency can consistently produce credible and reliable ratings based on adherence to published methodologies, not on a predetermined notion of the methodology and inputs required to do so. In both current practice and the proposed definition, the Commission relies heavily on "national recognition" or "general acceptance" of a credit rating agency when granting NRSRO recognition. However, the proposed definition implies that the Commission believes it is capable of determining the methodology and inputs required for a credit rating agency to issue credible and reliable ratings. AFP believes that the Commission's heavy reliance on market acceptance, coupled with prescriptive input and methodology requirements, will erect an even more formidable barrier to entry into the credit ratings market than already exists. This barrier to entry will further hinder competition and deprive the market of the benefits of innovate rating methodologies that may be developed.

AFP is also very concerned about the lack of any proposal to conduct ongoing oversight of NRSROs. We acknowledge the Commission's determination that it does not have the requisite regulatory authority to do anything more than define nationally recognized statistical rating organization at this time. However, we strongly encourage the Commission to seek the authority needed to conduct limited ongoing oversight of the NRSROs. As we have recommended to the Commission, the Subcommittee on Capital Markets[3] of the House Committee on Financial Services, and the Senate Banking Committee[4], the Commission must ensure that, on an ongoing basis, NRSROs continue to issue credible and reliable ratings. Further, the Commission must periodically verify that NRSROs have and adhere to policies that protect non-public information and prevent conflicts of interest and unfair and abusive practices. We encourage the Commission to actively pursue this authority and will proactively support appropriate authorizing legislation.

The Commission's proposed definition of the term "NRSRO" includes three components. An NRSRO would be defined as an entity (i) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments; (ii) is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings; and (iii) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures. AFP's comments on each of these components, detailed below, are consistent with our comment letter on the Commission's Concept Release[5], AFP's *Code of Standard Practices for Participants in the Credit Rating Process*[6], and Senate[7] and House[8] testimony.

[3] http://www.afponline.org/pub/pdf/091404_kaitz_testimony.pdf
[4] http://www.afponline.org/pub/pdf/pr_20050208_kaitz.pdf
[5] http://www.afponline.org/pdf/clkatz072803.pdf
[6] http://www.afponline.org/pub/pdf/CSP_final.pdf
[7] http://www.afponline.org/pub/pdf/pr_20050208_kaitz.pdf
[8] http://www.afponline.org/pub/pdf/091404_kaitz_testimony.pdf

First Component of Proposed Definition

The first component of the proposed definition would require an NRSRO to issue publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments. AFP opposes the requirement that NRSROs disclose their ratings at no cost. An NRSRO business model that charges subscribers a fee for ratings information and thereby eliminates the potential conflict of issuer payments should not be *per se* restricted. The willingness of a user to pay for credit ratings, especially with the prevalence of freely disseminated ratings, could serve as a powerful endorsement of the credibility and reliability of ratings that are generated without issuer payments. If an NRSRO's methodology is based on issuer payments for ratings, disseminating these ratings at no cost seems to be a reasonable requirement since substantial payment has already been received by the NRSRO. However, requiring a credit rating agency that develops ratings with no compensation from issuers and subsequently discloses those ratings only to subscribers to distribute its ratings at no cost is an unnecessary intrusion into the business model of the prospective NRSRO. Free dissemination would restrict competition and further entrench the market position of the current NRSROs while codifying and implicitly endorsing the business model that some believe is most prone to conflicts of interest. This requirement also seems counter to a free market approach, which bases recognition primarily on whether a credit rating agency issues credible and reliable ratings.

The potential selective disclosure of non-public information obtained by a credit rating agency under Regulation Fair Disclosure (FD), which the proposed definition attempts to address by requiring widespread dissemination at no cost, is already addressed by the Regulation FD exemption[9]. This exemption states that "for the exclusion to apply, the ratings organization must make its credit ratings publicly available." A credit rating agency that does not make its ratings publicly available would therefore not be exempt from Regulation FD and would not be privy to non-public information. Attempting to address the Regulation FD exemption by requiring NRSROs to widely disseminate ratings at no cost unnecessarily links the two issues and may discourage innovative rating methodologies that do not rely on access to non-public information or payments from issuers.

Given the widespread reliance on NRSROs in regulation and practice to assess the risk of default and loss on many types of securities, AFP believes it is appropriate for the Commission to limit NRSRO recognition to those that issue credit opinions on specific securities or money market instruments. While issuer financial strength ratings can be very useful for some purposes (e.g., trade credit), the risk of loss on different debt securities of the same issuer can vary considerably depending on the legal terms of each security. AFP agrees that a single issuer rating would be misleading and inadequate in assessing the risks of specific securities.

[9] http://www.sec.gov/rules/final/33-7881.htm

The Commission also proposes to require NRSROs to actively monitor credit ratings and update them appropriately on a "continuous" basis. While the goal of obtaining current credit ratings is desirable, AFP does not believe that "continuous" monitoring is either practical or necessary. Instead, NRSROs should be required to document and adhere to their published methodologies, which should stipulate the frequency with which ratings are reviewed. Further, NRSROs should be required to disclose the date of the last formal review of credit ratings and when they last updated each rating. We believe that adherence to published methodologies that have been determined to produce credible and reliable ratings is the appropriate standard by which to determine whether an NRSRO's ratings are current assessments of the creditworthiness of specific securities or money market instruments.

Second Component of Proposed Definition

The second component of the proposed definition would require an NRSRO to be generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings. AFP is pleased that the Commission has adopted our recommendation[10] to grant NRSRO status to rating agencies that can demonstrate that they issue credible and reliable ratings for a certain industry or geographic region. However, we are dismayed that the proposed definition largely maintains the status quo and its primary recognition criterion. For nearly three years, AFP has argued that requiring a credit rating agency to be "nationally recognized" in order to be recognized as an NRSRO presents a nearly insurmountable barrier to entry into the credit ratings market. It is difficult to see how the change from "nationally recognized" to "generally accepted" meaningfully addresses this barrier to entry.

The Commission should establish stringent criteria and clear procedures that will eliminate unnecessary regulatory barriers to entry into the ratings market. The appropriate criteria should be based on whether an agency can consistently produce credible and reliable ratings, not simply on whether the market recognizes the credit rating agency's ability to do so. National recognition or general acceptance will be difficult to obtain absent the Commission's recognition. While market acceptance may be one measure of whether ratings are credible and reliable, an analysis of the correlation between an NRSRO's expected and actual default experiences or other quantitative methods may also be acceptable. The criteria should also focus on internal controls designed to prevent conflicts of interest and anti-competitive and abusive practices and to ensure against the inappropriate use of non-public information to which rating agencies are privy through their Regulation FD exemption.

Third Component of Proposed Definition

The proposed definition would also require that NRSROs use systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and have sufficient financial resources to ensure compliance

[10] http://www.afponline.org/pdf/clkatz072803.pdf

with those procedures. AFP is pleased that the Commission has adopted our recommendation that NRSROs be required to document, implement and adhere to policies and procedures designed to ensure against the inappropriate use of non-public information and protect against conflicts of interest and anti-competitive and abusive practices.

In addition to addressing the potential conflicts of interest associated with unsolicited ratings, NRSROs should be required to establish distinct and absolute separation between rating analysts and credit rating agency staff responsible for generating revenue from credit ratings, rating assessment services, corporate governance reviews, or other ancillary services offered by the credit rating agency. Further, the Commission should bar analyst compensation from being linked in any way to revenue generated from credit ratings or any ancillary services. The potential for a credit rating agency or individual analyst to abuse the market power associated with NRSRO recognition to boost revenue or personal earnings is obvious. The stimuli behind new auditor independence and investment research analyst independence rules provide compelling evidence of the need to address these conflicts within the credit rating industry.

Relationships between a rated company and the credit rating agency, its directors, management or staff also present opportunities for conflicts of interest. To address these potential conflicts of interest, any relationship between a rated company and the NRSRO or its directors should be prominently disclosed when a rating is issued. Further, NRSRO management and staff should be barred from having any business relationship with or interest in any company rated by the NRSRO.

With respect to conflicts of interest, AFP also broadly supports the International Organization of Securities Commissions' *Code of Conduct Fundamentals for Credit Rating Agencies*[11]. IOSCO's *Code* closely mirrors the major tenets of AFP's *Code of Standard Practices for Participants in the Credit Rating Process*. Specifically, AFP endorses IOSCO's recommendations regarding the integrity of the rating process, credit rating agency independence and avoidance of conflicts of interest, and the treatment of confidential information. We believe that these recommendations, along with periodic oversight of NRSRO compliance with these requirements by the Commission, would make a meaningful contribution to restoring investor confidence in credit ratings.

AFP supports the proposed requirement that NRSROs must reasonably validate the integrity of all the public and non-public information used in determining a credit rating. However, we are concerned that the proposed definition includes prescriptive structural requirements that reflect a comfort with the status quo, which will hinder the recognition of rating agencies that may employ innovative methodologies. AFP believes that the primary criterion that should be used to determine whether a credit rating agency should be recognized as an NRSRO is whether the agency has published and adhered to methodologies that generate credible and reliable ratings.

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[11] http://www.iosco.org/pubdocs/pdf/IOSCOPD180.pdf

The proposed definition assumes too much about the inputs necessary for credible and reliable ratings. Specifically, the experience and training required of a firm's rating analysts may be quite different for each firm depending on the methodology employed. In some cases, extensive financial analysis training and even certification may be required. However, other methodologies may rely primarily on statistical or quantitative analysis that demands different training and expertise. Where a methodology relies primarily on statistical analysis, the average number of issues covered by analysts may be irrelevant or lack comparability with analysts of more traditional NRSROs. The extent of contacts with the management of issuers may also be irrelevant depending on a credit rating agency's published methodologies. It is ironic that, despite the Commission's assertions to the contrary, many of these proposed requirements would appear to preclude a primarily *statistical rating organization* from obtaining the Nationally Recognized *Statistical Rating Organization* designation. Rather than these highly prescriptive requirements, AFP believes that the Commission should examine whether a credit rating agency soliciting NRSRO recognition has the financial and human resources to adhere to its published methodologies on an ongoing basis, whatever those methodologies may be.

Additional AFP Recommendations

As previously stated, AFP believes that limited ongoing oversight of NRSROs is critical to restoring and maintaining investor and issuer confidence in credit ratings. We do not have an opinion on whether the Commission currently has the requisite authority to conduct ongoing oversight, but strongly encourage the Commission to proactively seek or support appropriate authorizing legislation if it is needed. We are pleased that the Commission staff states in the proposed definition that it intends to include expiration dates in future NRSRO no-action letters, but do not believe that this eliminates the need for a structured ongoing oversight regime.

AFP has recommended[12] that the Commission conduct periodic reviews of NRSROs no less than every five years. These periodic reviews should be limited to ensuring that NRSROs continue to meet the initial recognition criteria. Recognition as an NRSRO should be conditioned upon a credit rating agency publishing and adhering to methodologies that are demonstrated to produce credible and reliable ratings, as well as establishing and enforcing policies to protect non-public information and to prevent conflicts of interest and unfair and abusive practices in the ratings market. Greater regulatory intrusion into the credit ratings market is unnecessary. Such intrusion would likely erode the benefits that would derive from a competitive marketplace for credit ratings.

By clarifying the criteria and process by which it recognizes credit rating agencies and by exercising judicious ongoing oversight as recommended by AFP, the Commission will stimulate competition in the market for credit ratings. This competition will allow for innovative solutions that will improve the quality of information available to investors. A competitive market will also ensure that prices for credit ratings are market driven rather than a result of oligopolistic practices or other inefficient pricing mechanisms that raise the cost of borrowing for debt issuers.

[12] http://www.afponline.org/pub/pdf/040203_kaitz_testimony.pdf

AFP has recommended that the Commission abandon the requirement that a credit rating agency be “nationally recognized” in order to be recognized as a Nationally Recognized Statistical Rating Organization. Consistent with that recommendation, we also propose that the Commission change the name of the designation bestowed upon recognized agencies to reflect the more active role we envisage for the Commission. We recommend that the Commission designate a credit rating agency that meets the suggested recognition criteria as a Registered Credit Rating Agency (RCRA). This designation would more accurately convey the active role we recommend the Commission take in recognizing and overseeing credit rating agencies and reduce investor confusion about the implications of the Commission’s recognition.

AFP believes that rating agencies are critical to the efficient operation of the capital markets. The Commission must take steps to eliminate artificial barriers to entry into the credit ratings market and provide prudent oversight that ensures investor confidence. The Commission must improve its oversight by clarifying the criteria and process it uses to recognize a credit rating agency, and requiring policies to protect non-public information and to prevent conflicts of interest and unfair and abusive practices. By removing the artificial barrier to market entry that it has created, the Commission will foster additional competition in the market for credit ratings, which will result in more accurate and timely ratings. These actions will increase investor confidence in credit ratings and improve the efficiency of capital markets.

We appreciate the opportunity to comment on the Commission’s proposed *Definition of Nationally Recognized Statistical Rating Organization* and urge your consideration of our recommendations. If you have any questions, please contact Jeff A. Glenzer, CTP, AFP’s Director of Treasury Services at 301.961.8872.

Sincerely,

James A. Kaitz
President and CEO