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BEFORE THE

U.S. SENATE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

AT A HEARING ON

ASSESSING THE CURRENT OVERSIGHT

&

OPERATION OF CREDIT RATING AGENCIES

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Thank you Chairman Shelby, Ranking Member Sarbanes and Members of the Committee for this opportunity to appear before you today.

My name is Colleen Cunningham and I am the President and Chief Executive Officer of Financial Executives International (FEI). FEI is the leading advocate for the views of senior financial executives, including CFOs, treasurers, controllers, and vice presidents of finance. Our members hold positions of critical importance to the financial stability of their companies, and take their responsibilities – to their employees, their shareholders, and their customers – very seriously. I am pleased to have the opportunity to share our views with you today on the important issue of credit rating agency operations and oversight. My remarks will largely focus on the importance of increased competition among credit rating agencies; the need for greater accountability for credit rating agency operations; and the importance of limiting – and possibly eliminating – potential conflicts of interest.

The Current Environment

Credit rating agencies (CRAs) play a vital role in the U.S. and world financial markets. There are more than 100 CRAs operating worldwide, but only five are designated as Nationally Recognized Statistical Rating Organizations (NRSROs) by the Securities and Exchange Commission. They are: A.M. Best Co. Inc,; Dominion Bond Rating Service Limited; Fitch Inc.; Moody's Investor Service Inc.; and the Standard & Poor's Division of the McGraw Hill Cos. Inc.

These five enjoy a competitive advantage over their peers because the guidelines for many government, mutual fund, and other institutional investment portfolios not only specify

minimum credit ratings for their securities but also require that the ratings come from NRSROs. Because there are so few NRSROs and because the designation criteria remain unclear these incumbent NRSROs have been left with a distinct competitive advantage.

Currently, a CRA achieves NRSRO status be requesting a staff no-action letter from the SEC stating that the SEC will not recommend enforcement action against parties that use the CRA's credit ratings for the purpose of calculations under the SEC net capital rule for broker-dealers. The SEC's criteria for an NRSRO include that it be "widely accepted in the United States as an issuer of credible and reliable ratings." The notion of national recognition was designed to help ensure that the credit ratings used under SEC rules are credible and the marketplace can reasonably rely on them. Before issuing a no-action letter, the SEC conducts an assessment of a CRA's operational capacity and ratings process, including the CRA's organizational structure, financial resources, size and quality of staff, rating procedures, independence from rated companies, and internal procedures to prevent the misuse of nonpublic information.

Since NRSROs were created in 1975, the importance of the NRSRO stamp of approval has grown far more than anticipated. Today, laws, charters, and by-laws often specify minimum credit ratings from NRSROs for securities in pension funds, mutual funds, and other portfolios. State and local governments are usually required by law to invest in securities with specified ratings from NRSROs. Mutual fund managers, to whom investors have entrusted over $8 trillion, typically rely on ratings from NRSROs. Many of them incorporate NRSRO ratings criteria into shareholder disclosures regarding their funds' investment policies and strategies. Loan agreements often require borrowers to maintain certain ratings from

NRSROs; failure to do so can trigger higher interest rates, new bondholder rights, or even default.

The Need for Increased Competition

While the current system has afforded substantial advantages to the handful of CRAs receiving the NRSRO designation, it nevertheless has many shortcomings, not the least of which is limited competition. The two leading NRSROs, Moody's and Standard and Poor's, dominate the credit ratings market, and have built formidable obstacles to competition: their depth of staff, experience, and expertise in rating debt issuers worldwide remain unsurpassed. The large number of issuers they rate – and the long-term relationships they have established with these issuers – will make it extremely difficult for smaller CRAs to satisfy the "widely accepted" criteria necessary for NRSRO designation, which will in turn limit their ability to grow.

The most effective way to increase competition in the credit rating market would be to eliminate the broken "no action" process and replace it with transparent registration requirements which any credit rating agency can understand and aim for. By establishing stringent yet clear criteria for registration, Congress would not only ensure the continued validity of ratings issued by "registered" CRAs, but would also generate more competition in the credit rating market, which would in turn provide more choice for issuers; lower costs for rating services; and higher quality service.

The registration process itself should be straightforward. Congress should direct the SEC to begin by developing clear criteria for registration. CRAs could then apply, demonstrating in their applications and in supporting documents that they satisfy the criteria. The criteria might

include: (a) demonstrating their procedures and methodologies used in developing ratings; (b) demonstrating that they have developed procedures for protecting non-public information; (c) demonstrating that they have developed procedures for addressing – and avoiding -- non-public information; and (d) disclosing the qualifications of those tasked with developing ratings.

A recent FEI report entitled *"Credit Rating Agencies: The Need for Increased Competition"*, written by Hal Davis, further elaborates on the importance of increasing competition in the credit rating market. I would ask that this report be included with my remarks in the hearing record.

Accountability

Another problem with the current system is that there is no mechanism in place to ensure that NRSROs continue to satisfy the criteria necessary to maintain the NRSRO designation. As previously mentioned, SEC staff currently consider two factors at the outset in determining whether a credit rating agency qualifies as an NRSRO. The most important factor is that the rating agency is nationally recognized as an issuer of credible and reliable ratings by the predominant users of securities ratings. The second factor is an assessment by the staff of the operational capability and reliability of each rating organization. This assessment covers six areas: 1) the organizational structure of the rating organization; 2) the rating organization's financial resources; 3) the size, experience, and training of the rating organization's staff; 4) the rating organization's independence from the companies it rates; 5) the rating organization's rating procedures; and 6) whether the rating organization has internal procedures to prevent the misuse of non-public information and whether those procedures are followed.

While I applaud the use of transparent criteria to determine whether a CRA qualifies for special recognition or registration, I believe more emphasis should be placed on regular performance audits to ensure that registered CRAs continue to satisfy these criteria. Currently, once a rating agency has been designated an NRSRO, it is only required to notify the SEC when it experiences material changes that may affect its ability to meet any of these criteria. However, organizations such as rating agencies are constantly changing their business, not to mention their resources, procedures, and policies. And, given the enormous financial impact that a loss of NRSRO designation would have on a rating agency, it is unrealistic to expect NRSROs to police themselves.

In addition to these regular performance reviews, I believe the CRAs should be required to disclose additional information about their operations as part of their registration application with the SEC. As has already been discussed, these disclosures could address such items as the CRAs' policies and procedures for protecting non-public information and for handling conflicts of interest; the training and experience of those individuals tasked with developing ratings; and the extent to which CRA staff met with an issuer's management prior to developing its ratings. This information would help investors differentiate between or among registered CRAs, and might help issuers decide which CRA to retain for rating purposes.

Accountability and transparency are vital components of any successful business operation, and in this instance I believe both issuers and investors would benefit by knowing that registered or recognized CRAs are required to maintain the highest operational standards through a process of regular performance audits.

Conflicts of Interest

Yet another flaw in the current system is that it fails to address the important issue of conflicts of interest. For example, some NRSROs have sold fee-based, advisory services to their rated clients in areas such as risk management, corporate governance, shareholder disputes, and data analysis. The NRSROs offering these services have offered assurances that they have erected adequate firewalls between their rating service and advisory service operations. While this may be true, issuers may nevertheless feel a subtle pressure to purchase advisory services to enhance the likelihood of receiving a good credit rating.

I believe that a simple, bright-line rule similar to the restrictions included in Title II of the Sarbanes-Oxley legislation would solve this problem. As this Committee well knows, Title II of the Sarbanes-Oxley Act addressed the issue of auditor independence, and enumerated specific activities which registered public accounting firms could no longer perform for their audit clients. This list included appraisal or valuation services; actuarial services; and legal service or expert services unrelated to the audit. I believe a similar line should be drawn here: Rating agencies should not be permitted to provide both fee-based, advisory services and rating services to the same issuer. This bifurcation of ratings services and advisory services should help ensure that credit ratings are developed and disseminated based solely on a companies' creditworthiness, and not on any unrelated matters.

In addition to this bright-line rule, rating agencies should be required to identify the types of potential conflicts of interest that arise in their businesses; their procedures for addressing and minimizing or avoiding those conflicts; and how they monitor and verify compliance with their procedures.

However, the rule described above should **not** prohibit preliminary rating assessments. In the regular course of doing business, issuers often hire rating agencies to analyze and explain the rating effect of taking on a certain amount of additional debt for a project or an acquisition. As a result, these preliminary rating assessments fall within the scope of credit rating services, and must continue to be available to those companies wishing to purchase them so they can succeed in the global financial marketplace.

<u>Conclusion</u>

The SEC has suggested that it is limited in its ability to oversee the work of the credit rating agencies because the Securities Act of 1934, which vests the SEC with its authority, does not specifically identify or discuss credit rating agencies. For this reason, I urge Congress to introduce legislation that addresses the three concerns I have discussed above: the need to increase competition in the credit marketplace; the need to increase accountability in CRA operations; and the need to eliminate conflicts of interest.

- Specifying the criteria by which CRAs can register with the SEC will almost certainly increase competition in the credit rating market. More firms, capital, and people will be attracted to the credit rating business. This would lead to greater innovation and new product introduction, providing issuers and investors with more choices.

- Increasing the accountability of the rating agencies through regular performance audits will ensure that registered entities continue to satisfy important operational criteria. These audits, along with increased disclosure requirements for various policies,

procedures, and personnel qualifications, will help issuers and investors make more informed choices.

- Finally, prohibiting issuers from providing fee-based, advisory services to their rated clients will eliminate the potential pressure to purchase such services, and will also eliminate potential rating inflation for those companies that do purchase such services.

That concludes my remarks. I want to thank the Chairman and the members of the Committee for inviting FEI to participate in today's hearings. We view credit rating agency oversight and reform as an exceptionally important matter, and appreciate having the opportunity to share our views. I would be pleased to answer any questions.