



U.S. Securities and Exchange Commission

Testimony: The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets

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Affairs

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Chairman Dodd, Senator Shelby, and Members of the Committee:

I am pleased to be here today to discuss the important work the Securities and Exchange Commission is doing concerning credit rating agencies. In giving the Commission statutory authority in the Credit Rating Agency Reform Act of 2006 (Rating Agency Act) to oversee credit rating agencies registered with the Commission as nationally recognized statistical rating organizations ("NRSROs"), Congress explicitly found that Commission oversight would serve the interest of investor protection by fostering competition, accountability, and transparency in the industry.

The Rating Agency Act grants the Commission broad authority to examine all books and records of an NRSRO. This broad examination authority permits the Commission to examine an NRSRO on a periodic basis for compliance with substantive Commission rules applicable to NRSROs, including rules addressing conflicts of interest and rules prohibiting certain unfair, coercive, or abusive practices. Although the Commission was granted authority to regulate an NRSRO as such, the Act expressly stated that the Commission has no authority to regulate the "substance of the credit ratings or the procedures and methodologies" by which any NRSRO determines credit ratings. In striking this balance, the legislation recognizes an appropriate role for the Commission in promoting competition and policing NRSRO activities such as conflicts of interest, and at the same time declares that it is not our role to second-guess the quality of the rating agencies' ratings.

The Rating Agency Act is still only months old, and it set out an aggressive schedule for implementation. The Commission is ahead of that schedule. The Commission proposed six new rules on February 2, 2007, just four months after the law was signed, and adopted final rules on May 23, 2007, more than a month ahead of the June 26, 2007 statutory deadline. And earlier this week, the Commission issued orders granting registration as NRSROs under the Rating Agency Act to seven credit rating agencies. Each of these applications was swiftly reviewed, evaluated, and determined within the 90-day timeframe specified by the Act. These seven credit rating agencies now are subject to both the provisions of the Act and the Commission's final rules implementing it.

Recent Events Regarding Residential Mortgage-Backed Securities

In recent months, the credit rating agencies have been heavily criticized regarding the accuracy of their ratings of certain structured finance products, especially subprime residential mortgage-backed securities (RMBS). Critics have faulted the rating agencies for initially assigning ratings to those securities that were too high; for failing to adjust those ratings sooner as the performance of the underlying assets deteriorated; and for not maintaining appropriate independence from the issuers and underwriters of those securities.

For their part, the rating agencies generally have stated that incidence of mortgage delinquencies in 2006 far exceeded their original credit loss expectations, particularly for subprime mortgages. In the past, their expectations had been more conservative than the actual loss experience. They have noted several factors that seem to have caused the unexpected losses: fraud in the mortgage origination process; deterioration in loan underwriting standards; and finally, lending standards quickly became more restrictive thereby making it more difficult for over-leveraged borrowers to re-finance.

We have as yet formed no firm views on any of the reasons put forth by the credit rating agencies, but we are carefully looking into each of them in the context of an examination the Commission has begun with respect to NRSROs active in rating RMBS. This examination — which is being conducted on a non-public basis — was commenced in response to the recent events in the mortgage markets. In particular, the Commission is examining whether these NRSROs were unduly influenced by issuers and underwriters of RMBS to diverge from their stated methodologies and procedures for determining credit ratings in order to publish a higher rating. The examination is also focusing on whether the NRSROs followed their stated procedures for managing conflicts of interest inherent in the business of determining credit ratings for RMBS. In this regard, the examination will seek to determine whether the NRSROs' role in the process of bringing RMBS to market impaired their ability to be impartial.

In addition to the Commission's examination of NRSROs, the President has requested that the President's Working Group on Financial Markets examine the role of credit rating agencies in lending practices, how their ratings are used, and how securitization — the repackaging and selling of assets — has changed the mortgage industry and related business practices. As a member of the President's Working Group, the Commission is taking a leading role in this study.

The Commission is also a member of the credit rating agency task force created by the International Organization of Securities Commissions ("IOSCO") and we recently hosted an IOSCO meeting at which the credit rating agencies most active in rating residential mortgage-backed securities made presentations with respect to their role in developing structured finance products, and how they manage the conflicts of interest that arise in providing rating services.

The History and Role of Credit Rating Agencies in the Financial Markets

In considering recent events, it is useful to review the history of credit rating agencies and their role in the financial markets. Credit ratings have

been used to distinguish among grades of debt creditworthiness since early last century. But it was only beginning in 1975 that the SEC began to make explicit reference to credit ratings in its rules, using credit ratings by market-recognized rating agencies to distinguish among grades of creditworthiness for various purposes under the federal securities laws. The Commission originally adopted the term "NRSRO" in 1975 solely for determining capital charges on different grades of debt securities under the Commission's net capital rule for broker-dealers. Over time, however, the NRSRO concept was incorporated into a number of additional SEC rules and regulations, including rules issued under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. Congress, too, began to use the NRSRO concept in legislation, as have other regulatory bodies, including banking regulators both at home and abroad.

Despite the fact that the NRSRO concept was used by the SEC for regulatory purposes prior to the enactment of the Rating Agency Act, no legislation had yet given the Commission statutory regulatory authority over credit ratings agencies as such. Before the Rating Agency Act was enacted, the Commission staff identified credit rating agencies as NRSROs through the no-action letter process. In that process, the staff would review information and documents submitted by the credit rating agency, including how broadly its credit ratings were used in the securities markets, to determine whether the agency had achieved broad market acceptance for its ratings. If in the staff's view that acceptance had been achieved, the staff would issue a letter stating that it would not recommend enforcement action against broker-dealers who used the agency's credit ratings for purposes of complying with the Commission's net capital rule.

The SEC staff previously identified 11 firms as NRSROs under this process. However, several NRSROs subsequently consolidated so that five of the credit rating agencies that were identified under the no-action letter process remained in business at the time that the Rating Agency Act was enacted: A.M. Best Company, Inc.; DBRS Limited; Fitch, Inc; Moody's Investors Service, Inc.; the Standard & Poor's Division of the McGraw Hill Companies, Inc. Two additional NRSROs were identified between the passage of the Rating Agency Act and its implementation: Japan Credit Rating Agency, Ltd.; and Rating and Investment Information, Inc.

The Credit Rating Agency Reform Act of 2006

The Rating Agency Act replaced the no-action letter process with a program of Commission oversight of credit rating agencies that elect to register as NRSROs. Under the Rating Agency Act, a credit rating agency seeking to be registered as an NRSRO must apply for registration with the Commission, make public in its application certain information to help persons assess its credibility, and implement procedures to manage the handling of material nonpublic information and conflicts of interest. Consistent with the statutory mandate, the Commission's implementing rules require disclosure of an NRSRO's conflicts of interest, and proscribe certain conflicts of interest. Key provisions of the Rating Agency Act and the new Commission rules are summarized below.

Disclosure Requirements and Performance Measurement Statistics

The Rating Agency Act and its implementing rules require an NRSRO to disclose in its public filings with the SEC a general description of its

procedures and methodologies for determining credit ratings. In addition, an NRSRO must make public certain performance measurement statistics including historical downgrade and default rates within each of its credit rating categories over the short, medium, and long terms. These statistics are intended to serve as important indicators of the performance of an NRSRO in terms of its ability to assess the creditworthiness of issuers and obligors. Finally, as described in the Commission's adopting release in June 2007 regarding the NRSRO rules, the Commission is studying whether it would be appropriate to require additional types of performance statistics to be disclosed as an alternative, or in addition, to historical default and downgrade rates, such as a credit rating downgrade that occurs long after a significant drop in the value of the securities being rated. We believe that the disclosure requirements of the Rating Agency Act, as implemented now and in the future through our rulemaking, will assist users of credit ratings in assessing the reliability of an NRSRO's ratings over time, and will increase transparency with respect to the accuracy of an NRSRO's ratings.

Conflicts of Interest and Prohibited Practices

The Rating Agency Act requires an NRSRO to disclose the conflicts of interest that are inherent in its business of determining credit ratings and to establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of its business, to address and manage the conflicts of interest. The Rating Agency Act also provided the Commission with authority to prohibit or require the management and disclosure of conflicts of interest relating to the issuance of credit ratings by an NRSRO. Pursuant to this authority, the Commission adopted rules that prohibit an NRSRO from having certain conflicts of interest if it has not complied with the requirements in the Rating Agency Act to disclose and manage them. One of the conflicts in this category is receiving compensation from an issuer or underwriter to rate securities issued or underwritten by the entity. The Commission's rules also prohibit an NRSRO from having certain other conflicts in all circumstances. One of the conflicts in this category is receiving compensation for determining a credit rating where the person paying for the credit rating provided the NRSRO with net revenue in the most recently ended fiscal year that equaled or exceeded 10% of the NRSRO's total net revenue.

Finally, the SEC rules, among other things, also address the handling of material non-public information by an NRSRO and prohibit certain unfair, coercive, or abusive practices by the NRSROs — including modifying or threatening to modify a credit rating or otherwise departing from systematic procedures and methodologies in determining credit ratings, based on whether the obligor, or an affiliate of the obligor, purchases the credit rating or any other service or product of the NRSRO or any person associated with the NRSRO.

Books and Records, Financial Reports, and Examination

In addition to significant disclosure requirements and conflict of interest provisions, the Rating Agency Act and the Commission's implementing rules also require an NRSRO to make and keep certain books and records, including documentation of its established procedures and methodologies used by the NRSRO to determine credit ratings. These recordkeeping rules will allow Commission examiners to review whether an NRSRO is following its stated procedures and methodologies and otherwise complying with the Rating Agency Act. NRSROs also are required to keep external and internal

communications received and sent by the NRSRO or its employees that relate to initiating, determining, maintaining, changing or withdrawing a credit rating.

The Rating Agency Act and implementing rules also require NRSROs to furnish to the Commission, on a confidential basis, certain financial reports, on an annual basis, including audited financial statements. In addition to the audited financial statements, the rules also require NRSROs to furnish separate unaudited financial reports that will assist the Commission in carrying out its statutory responsibilities under the Rating Agency Act.

The Rating Agency Act provides that all records of an NRSRO are subject to such reasonable periodic, special, or other examination by representatives of the Commission as the Commission deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in the furtherance of the purposes of the Securities Exchange Act of 1934.

Prohibition on Regulating Rating Procedures

Finally, in implementing this statute, the Commission is ever mindful of the explicit intent of Congress that we not substitute the Commission's judgment for that of the rating agencies.

I appreciate the opportunity to provide the Committee with this update on the Commission's oversight of the credit rating agencies. I would be happy to answer any questions you might have.

<http://www.sec.gov/news/testimony/ts092607cc.htm>