

Testimony of Mr. Yasuhiro Harada
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before the

Committee on Banking, Housing and Urban Affairs
United States Senate

Examining the Role of Credit Rating Agencies in the Capital Markets

February 8, 2005

Thank you, Chairman Shelby, Ranking Member Sarbanes, and members of the Senate Banking Committee for your kind invitation to present testimony at today's hearing entitled "Examining the Role of Credit Rating Agencies in the Capital Markets."

We are very pleased to offer our thoughts on this topic as well as some more specific information about the challenges faced by our firm, Rating and Investment Information, Inc. ("R&I"), a credit rating agency headquartered in Tokyo, as we have sought to clear the hurdles necessary to become an effective new competitor in the U.S. market. Even though R&I is the most recognized credit rating agency in Japan and the broader Asian markets, obtaining designation in the U.S. as a "nationally recognized statistical rating organization" ("NRSRO") has been an exercise in delay and disappointment.

Background Regarding Credit Rating Agencies as NRSROs

Investors and market professionals historically have used securities ratings issued by credit rating agencies to gauge the creditworthiness of a particular issue. The SEC significantly expanded the traditional use of ratings in 1975 when it adopted rule 15c3-1 (the "Net Capital Rule") under the Securities Exchange Act of 1934 ("Exchange Act"). The Net Capital Rule incorporated credit ratings by NRSROs in certain of its provisions. Rather than use securities ratings as a measure of creditworthiness, the Net Capital Rule created the NRSRO concept to measure liquidity. Currently, there are four rating agencies designated by the SEC as NRSROs for purposes of the Net Capital Rule.

Since 1975, however, the use of NRSRO ratings in the federal securities laws and regulations has expanded considerably beyond a measure of a security's liquidity, as has reliance on those ratings by investors and the marketplace. The term "NRSRO" remains undefined in SEC regulations, and the informal process for determining who is an NRSRO remains unchanged – a credit rating agency seeking NRSRO status must "apply" to the SEC's Division of Market Regulation for a no-action letter. Meanwhile, both Congress and the SEC have on numerous occasions incorporated the NRSRO concept for other purposes, primarily as indicia of a security's creditworthiness – the historical and predominant use of securities ratings.

Congress, for example, employed the term NRSRO when it defined "mortgage related security."¹ However, Congressional reliance on the term used in SEC rules is significant because it reflects a recognition that the "term has acquired currency as a term of art."² The SEC also has incorporated the term "NRSRO" in various rulemakings under the Securities Act of 1933, the Exchange Act, the Investment Company Act of 1940, and the Investment Advisers Act of 1940 for purposes well beyond those originally intended under the Net Capital Rule³.

Flaws in the NRSRO Process

In order to compete effectively in the U.S. market, a designation by the SEC as an NRSRO is a critical factor in the industry. In addition to the NRSRO application process having little regulatory guidance and/or an established timetable for agency decision-making, the specific entry barrier for R&I and other companies is the SEC requirement

¹ Section 3(a)(41) of the Exchange Act was added by the Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, §101, 98 Stat. 1689, 1689 (1984).

² H.R. Rep. No. 994, 98th Cong., 2d Sess. 46 (1984) (appending Statement of Charles C. Cox, Commissioner, Securities and Exchange Commission, to the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce, Mar. 14, 1984).

³ The SEC currently employs the NRSRO concept in the following rules: 17 CFR 228.10(e), 229.10(c), 230.134(a)(14), 230.436(g), 239.12, 239.33, 240.3a1-1(b)(3), 240.10b-10(a)(8), 240.15c3-1(c)(2)(vi)(E), (F), and (H), 240.15c3-1a(b)(1)(i)(C), 240.15c3-1f(d), 242.101(c)(2), 242.102(d), 242.300(k)(3) and (1)(3), 270.2a-7(a)(10), 270.3a-7(a)(10), 270.3a-7(a)(2), 270.5b-3(c), and 270.10f-3(a)(3).

that a new NRSRO be “nationally recognized.” In essence, this means that the rating agency must be “widely accepted in the U.S.” as an issuer of credible ratings by predominant users of such ratings *before* it can gain such a designation to enter the U.S. market. As can be seen, this is a circular test. It was precisely this circular standard which the Antitrust Division of the U.S. Department of Justice singled out in 1998 as likely to preclude new competitors in this credit rating market.⁴ Moreover, concern about the lack of new competitors in this market led the Justice Department to recommend to the SEC in 1998 that NRSRO designation be specifically awarded to some foreign rating agencies.

R&I's NRSRO Application

As noted, R&I is the largest and most recognized Asian rating agency. It is headquartered in Japan, the second largest economy in the world. R&I is a respected independent source of financial information for the overwhelming majority of U.S. broker-dealers and financial institutions that conduct operations in Japan, and provides a variety of ratings services to U.S. and foreign companies. Market participants particularly appreciate that R&I calculates and publishes a “broad-definition default ratio” based on a twenty-seven year record which indicates the probability that an issuer that has been given a publicly released rating will fall into default within that given period of time. R&I’s ratings are regularly announced and published by the leading financial electronic and print media in Japan, and in the U.S. as well.

In regard to your Committee’s specific request for a discussion of our agencies’ internal ratings process we present the following overview of the R&I rating team’s procedures. The rating team is responsible for reviewing financial information regarding the issuer and the terms of the instrument to be issued. The team reviews both publicly available information and confidential information obtained from the issuer. Teams

⁴ Letter from Antitrust Division of the U.S. Department of Justice in the matter of File No. S7-33-97 Proposed Amendments to Rule 15c3-1 under the Securities Exchange Act of 1934 (Mar. 6, 1998).

generally review the financials of the issuer from the prior five years, as well as forecasts for the next three years.

R&I staff, including at least one senior analyst, will visit the senior management of the issuer as part of a detailed due diligence exam of the issuer. This on-site due diligence examination typically lasts several days. During the visit, the team meets with the chief executive officer of the issuer, holds various meetings with senior executives in the areas of finance, planning and development, production, sales, and, where applicable, may schedule an inspection of plants and/or other facilities. The meetings include both issuer presentations and detailed, extensive interview sessions with senior management. Particular attention is focused on the issuer's cash flow and overall financial stability. Each rating team considers industry trends, sector volatility, and any relevant geopolitical or economic risk. The rating team also conducts inter-company comparisons, taking into consideration any relevant geopolitical, currency, or economic risk.

Once the initial analysis is complete, each team's written report is scrutinized in R&I's intensive committee review process. The team's report and recommendation initially is submitted to the Rating Committee. R&I has three classifications of Ratings Committees: the Plenary Committee, the Standing Committee, and the Sub-Committee. The Plenary Committee is the most senior committee and serves as an "appellate" body for the other committees, addressing any controversial or novel rating that is under consideration by the other committees. The Standing Committee evaluates the majority of the proposed ratings, and the Sub-Committee reviews ratings that are less likely to change than other ratings, such as ongoing ratings of previously rated issues or issuers. R&I management is generally prohibited from participating in the Rating Committee. In exceptional circumstances, and only with express authorization of R&I's Board of Directors, R&I senior executives may observe the Rating Committee meetings, but cannot vote on any matter discussed by the Rating Committee.

For over a decade, R&I and its predecessors have engaged the SEC in an effort to receive NRSRO designation. This began in October 1990, when the Japan Bond Research Institute ("JBRI") submitted a letter to the SEC requesting designation as an

NRSRO. In January 1991, Nippon Investors Services, Inc. (“NIS”) submitted its request for NRSRO designation. While there was some interaction with the SEC following these applications neither entity received a formal response from the SEC.

On April 1, 1998, NIS and JBRI merged to form R&I and in July of 1998, R&I submitted a follow-up letter to the SEC requesting that R&I be designated as an NRSRO. This led to some discussion with the SEC staff after which R&I submitted an amended request for NRSRO designation in January 2002. The 2002 request was limited in scope in that R&I sought to be recognized as an NRSRO solely with respect to yen-denominated securities. R&I’s expertise in yen-denominated securities is recognized throughout the world’s financial markets and by the leading financial institutions in the U.S. There is past precedent for the SEC to designate limited-purpose NRSROs including the designation of two agencies, in particular, IBCA and Thompson BankWatch, Inc., as NRSROs for limited purposes. Such recognition on a limited-basis was considered appropriate if a rating agency could demonstrate that it possesses unique expertise in rating particular securities, or securities of particular currency denomination. As a practical matter, investors and the marketplace will be significantly deprived of the full benefit of this expertise unless the rating agency is recognized as a NRSRO, at least with respect to those securities issues in which the rating agency has expertise.

Recent Developments

In early 2002, the Senate Committee on Government Affairs held a series of hearings into the collapse of Enron. In a follow-up staff report on Enron, hearings focused, among other things, on the fact that there were only three major NRSRO operating in the U.S.⁵ – a situation which continues to this day. As this Committee is aware, the Sarbanes-Oxley Act of 2002 required that the SEC then conduct a study of the role of credit rating agencies in the U.S. securities markets and submit a report regarding its study to the President and Congress.

⁵ Press Statement, “Financial Oversight of Enron: The SEC and Private-Sector Watchdogs,” Chairman Joe Lieberman, October 7, 2002.

In November 2002, as part of its study, the SEC held two full-days of hearings attended by a variety of academics, credit rating agencies and consumers of ratings reports such as investment companies. R&I submitted written comments to the SEC prior to these hearings. Additionally, I participated in the SEC Roundtable forum on November 21, 2002. In January 2003, the SEC issued its report which included its plans to issue a concept release within 60 days of the report to seek comment on issues that would form the basis of proposed rules with respect to credit rating agencies. In February 2003, shortly after issuing its report, the SEC approved a fourth credit rating agency as a new NRSRO. In June 2003, the SEC issued a concept release on credit rating agencies and the administration of the NRSRO application process. R&I promptly submitted its comments on the concept release. Since publication of the SEC's concept release, there has been additional public action with respect to credit rating agencies including two additional hearings in the House Financial Services Committee,⁶ a three-part series in the Washington Post that focused mainly on the lack of competition in the credit rating industry which appeared in November, 2004, and most recently a white paper on the subject published by the American Enterprise Institute⁷.

Action Sought with Respect to R&I's Application

It is essential that additional qualified credit rating agencies be recognized as NRSROs to increase the quality of the oversight function that such credit rating agencies play in the U.S. securities markets. Each additional NRSRO will benefit investors and the financial markets by improving the availability of important financial information and analysis. Considering the pace and uncertainty of any regulatory change, pending NRSRO applications, including R&I's application, should receive prompt attention.

⁶ House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, "Rating the Rating Agencies: the State of Transparency and Competition," hearing on April 2, 2003, and "The Ratings Game: Improving Transparency and Competition Among the Credit Ratings Agencies," held on September 14, 2004.

⁷ "End the Government-Sponsored Cartel in Credit Ratings" by Alex Pollock, AEI Financial Services Outlook, January, 2005.

Despite the increased interest and attention directed at credit rating agencies since the submission of R&I's January 2002 NRSRO request, there has been no appreciable progress with respect to R&I's application. Eight leading Wall Street investment-banking firms and two major U.S. insurance companies have written to the SEC to support R&I's NRSRO designation. R&I understands that the future regulation of credit rating agencies and the use of the NRSRO designation is in transition, particularly in light of the concept release and continuing Congressional hearings; however, without such designation, we operate at a competitive disadvantage every day under the current regulatory scheme. R&I is well qualified to contribute to the flow of information and expert analysis so valuable to U.S. investors and issuers. Therefore, the lack of progress on R&I's application harms both R&I and investors. If allowed to enter the market, U.S. investors, especially institutional investors such as insurance companies, would benefit from having an additional source of proven credit analyses and U.S. issuers benefit from having more providers of rating services in the Samurai bond market. Until such time as a new regulatory scheme is implemented with respect to credit rating agencies (which could be years away, if ever), we respectfully suggest the SEC should be focusing on approving qualified NRSROs. We encourage the Committee to advise the SEC not to neglect pending NRSRO applications nor require such applicants to await further rule making prior to approval.

Appropriate Type of Regulatory Oversight for Credit Rating Agencies

It would be appropriate and fair to regularly check if rating agencies recognized as NRSROs have been maintaining their original qualification criteria. This can be accomplished by requiring NRSROs to submit reports to the SEC indicating past performance and continuing qualification. Such submissions should be disclosed to the public. If the SEC determines that a particular NRSRO fails to satisfy all of the necessary criteria, such rating agency should be required to immediately rectify the situation. If, after one year's probation period, such an NRSRO still fails to all of the criteria, the NRSRO recognition should be revoked.

The SEC should review an NRSRO's continuing compliance with the original qualification criteria. If there is any reason to believe that an NRSRO has failed to meet any of the original qualification criteria at any time, the SEC should be able to conduct a review of the particular NRSRO in question. The evaluation of the overall quality and performance of NRSROs generally should be deferred to market participants.

If the Committee has any questions regarding R&I, its operations, or its application with the SEC for NRSRO status, we would be glad to respond to any requests for information. We earnestly seek a timely review and a speedy determination regarding R&I's NRSRO application. Thank you for the opportunity to present these views.