TESTIMONY OF RITA M. BOLGER

SENIOR VICE PRESIDENT AND ASSOCIATE GENERAL COUNSEL

GLOBAL REGULATORY AFFAIRS

STANDARD & POOR'S

BEFORE

THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

MARCH 26, 2009

Mr. Chairman, Mr. Ranking Member, Members of the Committee, good morning. My name is Rita Bolger. I head the Global Regulatory Affairs department at Standard & Poor's and I am pleased to appear before you today. These are unprecedented times and we at S&P appreciate the opportunity to work with Congress to address them. My testimony today covers four broad topics:

- The current regulatory regime for credit rating agencies, including S&P Ratings Services, our nationally recognized statistical ratings organization ("NRSRO");
- The SEC's exercise of its oversight authority under the current regime, including our implementation of recommendations made by the SEC following its recent examination;
- Initiatives we have undertaken to help restore market confidence; and
- Our views on potential changes to the current legislative and/or regulatory structure.

Before turning to these topics, I want to state at the outset that we at S&P appreciate the seriousness of the current dislocation in the capital markets and the challenges it poses for the American and global economies. For many decades, S&P has effectively served the global capital markets with high quality, independent, and transparent credit ratings. Today, there are approximately nine million current and historical ratings available on our Web sites and we have ratings outstanding on approximately $30 trillion worth of debt. S&P has a long tradition of — and a strong cultural commitment to — integrity and professionalism. We recognize, however, that a number of our recent ratings in the structured finance area have not performed in line with our historical standards. We have reflected on these events and have made, and are continuing to make, a number of changes to enhance our processes.

Restoring confidence in both ratings and the markets more broadly is critical. Workable solutions will involve both government action and private initiative. Toward that end, we have worked closely with lawmakers on potential measures and will continue to do so. We believe any legislative or regulatory action should reflect a systemic view and address all aspects of the capital markets that have contributed to the type of dislocation we have recently seen. Bringing together representatives from different areas of the capital markets, as the Committee has done in its two hearings on systemic risk, is in our view a productive way to work towards that goal.

As discussed later in my testimony, we have done a lot of thinking about the regulatory framework for rating agencies. Appropriate regulation can provide comfort to investors that the information available to them – including ratings – has integrity, and we support measures towards that end. Having said that, we would be concerned about legislation or regulation that purported to mandate particular analytical approaches, as analytical independence is the hallmark of ratings quality and, in our view, an essential factor in market confidence. As addressed later on, we also believe internationally consistent regulation is critical given the increasingly global nature of the capital markets.

The Current NRSRO Regulatory Regime

Recent calls for regulation of credit rating agencies have arisen in large part out of the poor performance of structured finance securities issued between the middle of 2005 and the middle of 2007, the years in which "subprime" lending reached its peak. It is true that, generally speaking, our ratings on these structured finance instruments have performed worse than we anticipated. Consistent with our commitment to constant improvement, we have taken a long, hard look at the situation and implemented a number of measures in response.

From a regulatory perspective, however, it is important to point out that the world in which virtually all of these structured finance ratings were issued is not the world we find ourselves in today. As the Committee is aware, the Credit Rating Agency Reform Act of 2006 ("CRARA"), passed in September of 2006, is the first comprehensive regulatory scheme for ratings agencies that choose to register as NRSROs. This regulatory regime was the product of several years of consideration and, in our view, reflects a judicious balance between oversight and analytical independence. The SEC's implementing rules took effect on June 26, 2007.

Today, NRSROs such as S&P are subject to a robust regulatory regime. That regime starts with the CRARA, the first comprehensive law focused on rating agencies. The regime has two primary goals:

- Promoting competition in the rating agency industry, thereby furthering ratings quality; and
- Providing for regulatory oversight to promote integrity in the ratings process.

We believe both goals have been significantly advanced in the short time since the CRARA became effective in the second half of 2007. On competition, the number of NRSROs has grown to ten, double what it was at the time the CRARA was enacted. Moreover, the SEC now requires NRSROs to disclose detailed performance data about their ratings, which facilitates comparisons and promotes competition. Going forward, we expect competition among NRSROs to continue to grow under the CRARA.

The current regime also includes a vigorous set of rules. As noted, the first set of SEC rules under the CRARA became effective in June 2007. Those rules addressed a number of topics, including the resources deployed by an NRSRO, potential conflicts of interest, the misuse of non-public information, and potentially abusive and unfair practices. Under these rules, certain practices are prohibited outright, such as issuing ratings for entities that provided the NRSRO with ten percent or more of its net revenue in the most recent fiscal year. Other practices must be disclosed and managed, including receiving compensation for ratings analysis (from either issuers or subscribers) and the provision of non-ratings services to issuers. The rules also include extensive record-keeping requirements and require public disclosure of financial information, including revenues received from large issuers.

The SEC has continued its rule-making under the CRARA since 2007. Among other things, the SEC adopted additional rules earlier this year that:

- Require enhanced disclosure of ratings performance data;
- Require enhanced disclosures related to the rating methodologies employed by NRSROs;
- Require disclosure when ratings deviate from the output suggested by models used in the rating process;
- Prohibit an NRSRO from rating an issuer or security if the NRSRO provided recommendations to the issuer; and
- Prohibit an NRSRO from rating an issue or issuer if it receives gifts of more than *de minimus* value.

We have in place practices and procedures to comply with those rules that are in effect and are actively working to implement additional measures, as needed. We believe that, on the whole, the SEC's rules will further enhance the integrity of the ratings process and overall ratings quality to the benefit of the markets.

The SEC's Exercise of its Oversight Authority
Under the Current NRSRO Regime

Under the current framework, the SEC also has broad oversight and enforcement powers. Not only does the SEC have extensive examination and inspection authority, but it can also take disciplinary action against NRSROs — including censure, fines, or even revocation of their registration in certain circumstances — if it deems such action to be in the interest of investors. This provides a level of accountability that did not exist prior to the adoption of the CRARA.

Since the effective date of the CRARA, the SEC has been exercising its oversight authority over S&P. In the second half of 2007, the SEC began an examination of our practices and procedures, with a focus on our ratings of structured finance securities. The exam, which lasted several months, involved dozens of meetings and interviews and the production of a significant volume of documents.

The exam coincided with an exam by the SEC of two other NRSROs and resulted in a number of recommendations. These recommendations related to the following areas, among others:

- Staffing and resource levels dedicated to ratings analysis, including surveillance of existing ratings;
- Documentation of policies and procedures used to determine ratings on RMBS and CDOs;
- Potential conflicts of interest arising from the "issuer pays" model;
- Securities ownership by NRSRO employees; and
- Internal auditing of ratings practices and procedures.

At S&P, we have been active in implementing the SEC's recommendations:

- With respect to staffing and resource levels, S&P has reorganized the new issue and surveillance groups in its U.S. Structured Finance department, and, more broadly, has developed tools for resource planning and for strengthening the quality of analytical resources;

- It has long been S&P's practice and policy to disclose its ratings processes and methodologies, including its processes and methodologies for U.S. RMBS and CDOs. Nonetheless, consistent with the SEC's recommendation, S&P has initiated a review of its disclosures in those areas, including a review of its criteria administration process, a redesign of its Web site, among other things, to facilitate the publication of criteria, and a review and revision of its policies and procedures concerning the disclosure of ratings process and criteria changes;

- S&P is in the process of implementing new policies that will further insulate its analysts from commercial aspects of our business. In addition to our long-standing prohibition of analyst involvement in negotiating fees or commercial arrangements, analysts will not participate in the process of recording fees on forms, will not have responsibility for retaining engagement letters, and will not participate in business discussions about market share statistics or other financial information such as deal pipelines and financial performance. Commercial activities will be conducted outside of the analytical function by non-analytical business management staff and a centralized group who will handle fee negotiations and contract discussions. In addition, consistent with current practice, no personnel engaged in commercial activities will be permitted to vote in a rating committee.

- S&P is also enhancing its existing personnel policies and procedures, including realigning performance goals for compensation and compensation pools for analytical staff to further diminish any potential commercial influences on analytical processes.

These are just some of the many steps that S&P has taken and is continuing to develop in response to the SEC's recommendations. The SEC has remained in regular communication with us regarding our progress and we have provided the SEC with copies of adopted policies and procedures related to its recommendations. The SEC has also continued to follow up on our progress on the remaining recommendations, including, for example, two telephonic updates in the last 10 days.

S&P's Initiatives To Enhance the Ratings Process and Promote Confidence

The restoration of investor confidence is critical to both the financial markets and global economy. We believe both appropriate government action and meaningful private initiatives are essential to accomplishing that goal. Therefore, it is imperative that all market participants take stock of what has happened and take whatever steps they can to promote market confidence.

At S&P, we have been actively applying lessons from the current crisis to adopt a number of constructive measures. In 2008, we announced a series of initiatives aimed at promoting four broad objectives: (i) ensuring the integrity of the ratings process; (ii) enhancing analytical quality; (iii) providing greater transparency to the market; and (iv) more effectively educating the marketplace about ratings. To date, we have made significant implementation progress. For example, we have:

- Established an Office of the Ombudsman. The Ombudsman will address concerns related to potential conflicts of interest and analytical and governance processes that are raised by issuers, investors, employees and other market participants across S&P's businesses. The Ombudsman has oversight over the handling of all issues, with authority to escalate all unresolved matters, as necessary, to the CEO of McGraw-Hill and the Audit Committee of the Board of Directors;

- Implemented "look back" reviews to ensure the integrity of ratings, whenever an analyst leaves to work for an issuer;

- Instituted a rotation system for analysts;

- Established an enterprise wide independent Risk Assessment Oversight Committee. The Committee will assess all risks that could impact the integrity and quality of the ratings process. This committee will also assess the feasibility of rating new types of securities;

- Increased our analyst training programs;

- Invested significantly in our compliance function;

- Created a separate Model Validation Group to independently analyze and validate all models, developed by S&P or provided by issuers, used in the ratings process;
- Implemented procedures to collect more information about the processes used by issuers and originators to assess the accuracy and integrity of their data and their fraud detection measures so that we can better understand their data quality capabilities;
- With respect to increased transparency, we have published a series of articles addressing certain "what if" scenarios; and
- With respect to investor education, we have published a "Guide to Credit Ratings Essentials" that provides important information about ratings and their role in the markets.

As these measures demonstrate, we believe in being proactive when it comes to taking steps to restore market confidence. S&P has always sought to study events and use the lessons learned to improve. That tradition has been a hallmark of our success over the years and you can expect the same commitment from us going forward.

Potential Regulatory Measures

We also believe legislation and/or regulation can play an important role in restoring investor confidence both in ratings and the markets as a whole. Appropriate regulation can provide a level of comfort to investors that policies are being disclosed and enforced and that there is consistency and integrity in the ratings process.

As noted earlier, we believe any regulatory approach should include "end-to-end" solutions. That is, legislation and/or regulation should cover all aspects of the capital markets that, taken together, contribute in a systemic way to their functioning, and we believe that international consistency, leading to increased transparency is a formula that should be workable for all market participants. With respect to ratings, we believe an appropriate combination of legislation and rule-making should cover not just rating agencies, but also those entities that can play a role in promoting the quality of ratings and their appropriate use. For example, an important factor in ratings quality is the reliability of information available to be analyzed. That information is not generated by rating agencies, but by others – *i.e.*, corporations, mortgage originators, underwriters, and others. Still other entities, such as professional audit firms in the corporate world and third-party due diligence firms in certain structured finance securities, are responsible for reviewing that information and verifying it. In our view, these entities and the roles they perform should be a part of any regulatory approach.

To that end, earlier this month, we published an article entitled "Toward a Global Regulatory Framework for Credit Ratings" that lays out how a regulatory framework for ratings agencies that takes account of their place in the broader markets might work. In it, we highlight those features we think would promote sound, global rating agency oversight. They include:

- Registration. One feature of a globally workable regulatory regime would be to have rating agencies register in the jurisdiction of their principal place of business and only allow registration of those that have in place standards to promote ratings integrity. From its home jurisdiction, a rating agency could be recognized to do business in other jurisdictions pursuant to a notice filing with the local regulator. This "passport" would allow for a streamlined and consistent regulatory approach across all the jurisdictions in which the credit rating agency conducts business. Regulators could consider limiting regulation to agencies whose ratings are used in local laws or regulations.

- Performance Measurement. Another feature would be to require registered rating agencies to publicly issue performance measurement statistics over the short, medium, and long term, and across asset classes and geographies.

- Disclosure of Rating Methodologies. Registered credit rating agencies could also be required to make robust disclosures regarding the analytical bases of their ratings opinions, the type of information used to arrive at ratings, and their internal standards for promoting consistency and for monitoring and updating ratings. With greater transparency of credit rating agency methodologies, investors would be in a better position to assess the opinions.

- Control over Non-public Information and Disclosure of Underlying Data. By having access to non-public information, rating agencies are in a position to provide more informed analysis, thus potentially enhancing the quality of the ratings they provide. Accordingly, any regulatory regime for credit rating agencies should ensure that agencies have policies and procedures requiring their employees to treat non-public information confidentially.

- Organizational Transparency. Registered credit rating agencies should be required to disclose detailed information about their organization's structure, including their resources, their independence from any particular issuer, their ability to train and retain employees, and the independence of commercial from analytical functions. Rating agencies should provide pertinent information about their financial resources to regulators on a confidential basis. This disclosure will allow regulators to assess the viability of agencies.

- Development of Code of Ethics. Rating agencies should develop and disclose to the public a detailed code of ethics, including a description of how that code will be enforced and how it relates to broader principles such as existing industry or regulatory standards. An independent officer or ombudsman should be established to communicate with the public regarding concerns that might arise about the code's enforcement.

- Elimination of Potential Conflicts of Interest. A regulatory regime must include robust standards for analyst and employee independence and the procedures for mitigating potential conflicts of interest in the ratings process. Regulation should require disclosure of such conflicts and prohibit analysts from performing commercial activities and providing consulting or advisory services to entities they rate. In this regard, regulation should require disclosure of the guidelines for analyst and issuer interaction. Regulation should prohibit analysts from being compensated based on the fees paid by the entities they directly rate.

- Prohibitions on Anti-Competitive Activity. A regulatory regime should prohibit unfair, abusive, or coercive activity.

- Transparency of Models. A regulatory regime should require policies and procedures on the use and transparency of models, assumptions, and how agencies check their effectiveness, including through the use of third parties.

- Accessibility. A regulatory regime should require a mechanism for ratings users to raise questions about methodologies and should require registered credit rating agencies to have in place personnel to answer these questions.

- Effective Oversight. A regulatory regime should provide for effective oversight of registered agencies' compliance with their policies and procedures through robust, periodic inspections. Such oversight must avoid interfering in the analytical process and methodologies, and refrain from second-guessing rating opinions. External interference in ratings analytics undermines investor confidence in the independence of the rating opinion and heightens moral hazard risk in influencing a rating outcome.

- Analytical Independence. Regulators must preserve the analytical independence of rating agencies' opinions, analytical processes, and methodologies. This independence is critical to restoring confidence in credit ratings and fostering innovation in financial services.

- Accountability. A regulatory regime should hold registered rating agencies accountable for established breaches of the regulations without undermining analytical independence. Sanctions may include penalties proportionate to the nature and seriousness of any breach, suspending or removing an agency's registration, and disallowing the continued use of that agency's ratings for regulatory purposes.

- International Consistency. Regulatory regimes globally must be consistent in applying standards. Regulators should coordinate in exercising oversight of rating agencies subject to regulation beyond their own borders. This will avoid inconsistent rules and inconsistent handling of infractions that would create uncertainty for analysts and users of ratings. Regulators should commit to sharing information subject to confidentiality undertakings.

- Meaning of Ratings. Rating agencies should clearly explain the meaning of their credit ratings and what elements they do not address: for example, suitability of investments for any particular investor.

- Differentiate New and Complex Ratings. A regulatory regime could require that new and complex ratings, including structured finance products, be differentiated in some manner to put investors on notice that potential volatility or the types of underlying assets/data for rating structured products may be distinguishable from factors affecting corporate and municipal ratings.

Each of these areas can play a meaningful role in restoring market confidence, but I want to highlight again two particularly important points here. The first is analytical independence. At its core, a rating is an analytical determination. It results from a group of experienced professionals analyzing a set of facts and forming a judgment as to what might happen in the future. For the markets to have confidence in those ratings, they must be made independently. That means, of course, that they must be free of undue commercial considerations – and we are fully committed to that principle – but it also means that they must truly reflect the substantive views of the analysts making them, not the dictates of a regulator or other external authority.

The second is the need for international consistency. Ratings are issued and used globally. This reflects one of their many benefits – their ability to provide a common language for analyzing risk. However, it also underscores the importance of a consistent approach to the regulation of ratings around the world. A rating produced under one set of regulations may not mean the same thing or address the same risks as one produced under another if those regulations are not compatible. Inconsistent ratings regulation could actually promote uncertainty in the markets, at a time when it can be least afforded.

Some have also asked whether ratings should be used in regulations and investment guidelines. S&P has never advocated for inclusion of its ratings in any regulation or guideline. However, we do believe that if legislators and regulators choose to incorporate ratings in their rules as benchmarks to measure creditworthiness, then the use of additional benchmarks may also be warranted. For example, there may be additional appropriate benchmarks for market participants to choose from – whether in regulations, investment guidelines, or private agreements – that would protect against "credit cliffs" (*i.e.*, situations in which a deterioration in credit quality can occur quickly and without forewarning.) In short, because ratings speak to creditworthiness, and not other factors that may matter to investors, they have been designed to and should continue to be used only for the important but limited purposes for which they are intended and supplemented with other benchmarks, as appropriate.

Lastly, some have called for the prohibition of the “issuer pays” business model that S&P and most other NRSROs use. We believe that would be a mistake. The “issuer pays” model allows for a number of benefits to the market, particularly with respect to transparency, that are not available under other approaches. The question as we see it however is not whether one model is “good” while others are not, but whether potential conflicts of interest — which can exist in any business model — are appropriately managed so that the rating process employed has integrity. Critics sometimes ignore that any business model under which one entity is paid by another for a service poses the potential for a conflict of interest. The key question is whether the rating agency is capable of producing, and does produce, independent and robust analysis. Thus, the focus of any legislation or regulation should be on taking steps to protect the integrity of the ratings process from all potential conflicts of interest. Many of the steps outlined above and the measures we have undertaken are aimed at precisely that goal.

Conclusion

I thank you for the opportunity to participate in this hearing. Let me also assure you again of our commitment to analytical excellence and our desire to continue to work with Congress and governments, legislatures and policy-makers worldwide as they explore the recent troubling developments and strive to develop solutions to restore stability in the global capital markets. I would be happy to answer any questions you may have.