Testimony of
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Enhancing Investor Protection and the Regulation of Securities Markets - Part II

Introduction

The recent turmoil in the financial markets has shone a spotlight on the way in which various market participants are regulated and the effect of that regulation on investor protection. DBRS is pleased to have the opportunity to address these important issues as they relate to one segment of the financial markets, credit rating agencies. In particular, I would like to discuss four broad areas relating to credit rating agency regulation and investor protection:

1. The importance of competition in the credit rating agency industry to the safety and soundness of the capital markets;

2. The need for uniform rating agency regulation;

3. The need for regulatory stability; and

4. The need for regulatory recognition of the global nature of credit ratings.

In order to put this discussion in context, I would like to begin with an overview of our company.

Overview of DBRS

DBRS is a Toronto-based credit rating agency established in 1976 and still privately owned by its founders. With a U.S. affiliate located in New York and Chicago, DBRS analyzes and rates a wide variety of issuers and instruments, including financial institutions, insurance companies, corporate issuers, issuers of government and municipal securities and various structured transactions. The firm currently maintains ratings on more than 43,000 securities in approximately 35 countries around the globe. Since its inception, DBRS has been widely recognized as a provider of timely, in-depth and impartial credit analysis. DBRS operates on an "issuer-pay" model, which means that our ratings are available to the public free of charge.

DBRS is committed to ensuring the objectivity and integrity of its ratings and the transparency of its operations. To this end, the firm has adopted a wide range of internal controls designed to eliminate conflicts of interest wherever possible, and to disclose and manage those conflicts that cannot be eliminated. DBRS also has adopted a Business Code of Conduct in accordance with the Code of Conduct Fundamentals for Credit Rating Agencies developed by the International Organization of Securities Commissions (IOSCO). In addition to displaying its credit ratings, DBRS' public Web site also discloses the firm's ratings policies and methodologies as well as extensive information about how its ratings have performed over time. As a result of a recent SEC rule, DBRS will soon be making additional information about its ratings history available in a user-friendly, searchable format that will allow investors to compare DBRS' ratings to those of its competitors.

In 2003, DBRS was designated by the staff of the SEC as a full-service nationally recognized statistical rating organization (NRSRO) -- the first non-U.S. based rating agency to attain that designation. Four years later, DBRS became registered as an NRSRO under the regulatory regime adopted pursuant to the Credit Rating Agency Reform Act of 2006

(Rating Agency Act). In addition to its NRSRO registration, DBRS has achieved broad recognition by regulators globally, including recognition as an External Credit Assessment Institution (ECAI) in the U.S., Canada, Switzerland and the European Union.

With that background, I would like to turn my attention to what DBRS sees as an overarching principle that should inform all efforts at regulatory reform, namely, the development of a competitive market for credit ratings.

The Importance of Competition in the Credit Rating Industry

It is no secret that the credit rating industry in the United States is dominated by three players: Standard and Poor's, Moody's and Fitch Ratings. This situation developed over the course of many years, and was no doubt perpetuated by a regulatory system that gave special treatment to NRSRO credit ratings, yet made the process of becoming an NRSRO opaque and hard to navigate. This concentrated structure benefitted neither issuers nor investors, as it left the large NRSROs with tremendous pricing power and provided limited diversity of rating opinions to the market.

Although great strides were made in opening the industry to the possibility of competition when Congress passed the Rating Agency Act in 2006, the actual competitive landscape has been very slow to change. DBRS submits that the continued dominance of the largest rating agencies contributed to the recent turmoil in the structured finance market, when changes in the assumptions underlying their rating models led to rapid and dramatic ratings downgrades over a very short period of time. Concentrating ratings opinions in so few hands had a profound, destabilizing effect on the markets.

As the markets now struggle to regain their footing, more work needs to be done to open the credit rating industry to competition. Unfortunately, although the government can be a catalyst for change in this area, the opposite seems to be occurring.

Recognizing that the securitization markets have ceased to function and that such markets are crucial in providing diversified sources of liquidity to corporations and consumers, the Federal Reserve has created the Term Asset-Backed Securities Loan Facility, or "TALF." The Fed has announced that in order to be eligible for this program, an asset-backed security must receive a AAA-rating from a "major" NRSRO, which it defines as Standard and Poor's, Moody's and Fitch. No explanation has been given for the creation of this new sub-category of registered credit rating agency. The result of this approach is that DBRS - with over thirty years of experience as a rating agency and more than six, as an NRSRO - has been deemed unqualified to rate TALF-eligible securities, even though several issuers have asked it to do so. DBRS is consulting with the Fed about this issue and understands that the discriminatory policy is being reviewed. But while this review takes place, DBRS remains unable to participate in this important recovery effort.

The harmful effects of limiting rating agency competition under the TALF are profound, because for the foreseeable future, the TALF is likely to be the entire securitization market in the United States. Moreover, it is probable that the securitization market that emerges from this crisis will be different from the market that existed in the past. Therefore, by excluding all but the three largest rating agencies from the TALF, the government may be further entrenching the historic oligopoly for years to come. This not only will impede competition among existing NRSROs, but also will discourage the formation of new ones.

The long-term efficiency of the capital markets requires that NRSROs be allowed to compete on the quality of their work, not their size or their legacy. DBRS urges Congress to take whatever steps are necessary to make the promise of competition created by the Rating Agency Act a reality.

The Need for Uniform Regulation

Because fostering competition among rating agencies was one of the primary goals of the Rating Agency Act, the statute contemplates a single regulatory regime applicable to all NRSROS: big firms and small firms; those operating on an issuer-pay model and those operating on a subscriber-pay model;[1] and those who use quantitative methods, qualitative methods or both to determine their credit ratings. DBRS endorses this commitment to neutrality and believes it fosters a diversity of credit rating opinions that benefits the markets.

Unfortunately, cracks have begun to appear in this foundation. One of the most disturbing of these is that unequal regulatory burdens have begun to be imposed on issuer-pay and subscriber-pay NRSROs. In order to provide users of credit ratings, investors and other market participants with the raw data they need to compare how NRSROs initially rated an obligor or security and how they adjusted those ratings over time, the SEC recently adopted a rule requiring issuer-pay NRSROs to publish ratings history information, on a delayed basis in a user-friendly format, on their public Web sites. The SEC did not impose a similar requirement on subscriber-pay NRSROs, because they protested that any public disclosure of their ratings, even with a substantial time delay, would be antithetical to their business model. The Commission now proposes to perpetuate this disparate treatment by adding another disclosure requirement for issuer-pay NRSROs only.

There has been much debate in the past few years about the relative quality and reliability of ratings determined under the issuer-pay and subscriber-pay business models. Questions also have been raised as to whether the conflicts of interest faced by rating

[1] In an "issuer-pay" model, an NRSRO's credit ratings are paid for by the obligor being rated or by the issuer, underwriter or sponsor of the securities being rated. Issuer-paid credit ratings generally are made available to the public free of charge. By contrast, in a "subscriber-pay" model, the NRSRO's credit ratings are paid for and are available only to parties who subscribe to the NRSRO's services.

agencies who are paid by issuers are more pronounced than the conflicts faced by rating agencies who are paid by subscribers, who may also have a stake in how an issuer or instrument is rated.

This debate cannot be resolved so long as investors and other market participants are unable to verify the ratings accuracy claims made by subscriber-based ratings providers. Anecdotal discussions by subscriber-pay NRSROs of "where they got it right" are no substitute for an objective, independent analysis of the universe of their ratings. Although DBRS appreciates the need to protect the commercial value of subscriber-pay NRSROs' real-time ratings, DBRS believes that absolving such NRSROs from all transparency obligations is not in the best interests of investors or the capital markets.

DBRS also has concerns that as more and more obligations are imposed on NRSROs under the Rating Agency Act, the regulatory regime will become skewed in favor of large rating agencies. While the incremental cost of each new rule might seem modest when viewed in isolation, taken as a whole, the costs of complying with the current regulatory regime are substantial. DBRS understands that balancing the need for robust regulation against the need for affordable regulation is a delicate exercise. But DBRS urges this Committee to be mindful of the fact that at some point, more regulation harms investors by driving reputable and credible rating agencies from the market.

The Need for Regulatory Stability

The freezing of credit and the ensuing turmoil in the global financial markets has sent shock waves through investors, market intermediaries, policy makers and regulators. A critical examination of whether the current regulation of credit rating agencies contributed to this crisis is a necessary and healthy exercise. However, any alteration of the existing regulatory approach must be reasoned and likely to improve the safety and soundness of the capital markets. Change for the sake of change will only make things worse.

The regulatory regime established under the Rating Agency Act was implemented in September 2007, when the first group of NRSROs became registered. This regime focuses not on the substance of credit ratings, but rather on the integrity and objectivity of ratings and on the transparency of the NRSROs' operations. It does this by requiring NRSROs to implement extensive internal controls on their conflicts of interest, their use of material nonpublic information and their business practices; and by requiring such firms to publicly disclose the procedures and methodologies they use in determining credit ratings, along with performance measurement statistics regarding those ratings. NRSROs are also obligated to keep an extensive array of records, which enable the SEC staff to examine registered firms' operations in order to ensure compliance with the Rating Agency Act and related rules.

In response to the subprime crisis, the SEC has recently taken steps to fortify the regulation of NRSROs. These steps include new restrictions on conflicts of interest, new recordkeeping requirements and enhanced disclosure requirements regarding ratings procedures, methodologies and default and transition data. An additional set of SEC rule proposals is pending. These latest proposals include a mechanism to discourage ratings shopping with regard to ratings for structured finance products by facilitating the issuance of unsolicited ratings for such products.

DBRS endorses the fundamental characteristics of the current approach to regulating NRSROs and believes that this approach is reasonably designed to protect the safety and soundness of the financial markets. Since this system is barely eighteen months old and since the enhancements to this system have yet to take effect, DBRS also believes that it would be unwise to significantly overhaul or abandon the current regulatory regime at this time.

No superior alternative to the current approach has been identified. Moreover, the costs of complying with the current requirements have been very high, and smaller NRSROs might be driven from the market if they are required to start over under a new compliance regime less than two years after they paid to establish the first one.

DBRS further submits that the regulation of credit rating agencies is most effective when the regulator understands the credit rating industry. For this reason, DBRS sees no benefit in transferring NRSRO jurisdiction from the SEC, which has overseen NRSROs for thirty-four years, to a regulator who has no experience in this area. Interposing a self-regulatory body between NRSROs and the SEC would be the worst idea of all, since it would lead to duplicative regulation by a costly private bureaucracy that may or may not know anything about the industry. A far better approach would be to make sure that the SEC has the resources it needs to effectively examine NRSROs and to take any enforcement actions that may be warranted under the existing laws and rules.

Recognition of the Global Nature of Credit Ratings

Given recent events, there can be no question that the financial markets are interdependent and global in nature. One of the core benefits of credit ratings is they are globally comparable. That is, they are designed to help investors understand risk across borders. Because the ratings activities of NRSROs are not confined to the United States, it is important that U.S. policy makers and regulators endeavor to harmonize NRSRO regulation with the regulatory regimes of other major markets, to the extent this can be done without compromising safety and soundness.

In this regard, DBRS notes that while the Rating Agency Act and the SEC's rules thereunder are not identical to international standards such as the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies, the U.S. law and rules address the

same basic principles as the IOSCO Code and they do so in a way that allows NRSROs to comply comfortably with both.

Ensuring that credit rating agency regulation continues to be as globally consistent as possible will encourage competition in this market among firms of varying size and business models. This, in turn, will help to ensure ratings stability and accuracy and will increase the availability of information to investors for their decision-making. Conversely, a balkanized system of regulation will increase costs and drive smaller rating agencies from the market. The result will be the continuation of the rating agency oligopoly with all the attendant risks to the market that the Rating Agency Act was designed to eliminate.

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I appreciate having the opportunity to present DBRS' views here today and I look forward to answering any questions you may have.