Oversight of Nationally Recognized Statistical Rating Organizations

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

Thank you for inviting me to speak today to discuss the work of the Securities and Exchange Commission concerning credit rating agencies.

Introduction

When Congress passed the Credit Rating Agency Reform Act ("Rating Agency Act") and President Bush signed it into law in late 2006, its purpose was to improve ratings quality by fostering accountability, transparency, and competition in the credit rating industry. In passing the Rating Agency Act, the Congress acted presciently in response to the latent concerns that policymakers, regulators, and market participants had begun to raise about the reliability of ratings and the ratings process. The law's sponsors noted that the global industry is dominated by a very few major players, and that conflicts of interest may have led to various abusive practices. Among the abuses cited in congressional hearings were instances of sending a company unsolicited ratings along with a bill, tying ratings to the purchase of additional services, and the practice of discounting (so-called "notching") the ratings of other credit rating agencies when rating structured products, where firms allegedly used the lure of higher ratings for the asset-backed securities packages in return for obtaining the business to rate the underlying assets.

The enactment of this law marked a major increase in the responsibilities and authority of the Securities and Exchange Commission. Prior to the Rating Agency Act, credit rating agencies were essentially unregulated by the federal government, and the SEC had no authority to make rules governing their business, or to subject them to examinations as nationally recognized statistical rating organizations ("NRSROs"). With the passage of the Act, the Commission became their regulator, and has devoted considerable new resources to this responsibility. We have done so with a great sense of urgency, given the many and serious market impacts that problems with credit ratings on billions of dollars worth of residential mortgage-backed securities ("RMBS") and collateralized debt obligations ("CDOs") have produced in the broader marketplace.

Implementing the Rating Agency Act

The Rating Agency Act provided that, in order to put its authority into effect, the Commission must write enabling rules, subject to the public notice and comment process of the Administrative Procedure Act. Under the new law, the entire process was to be completed in no more than 270 days. The Commission promulgated final rules in advance of that deadline, with the result that a formal regulatory program for NRSROs was established in June 2007.

The provisions of the law and the new rules provided that, once the rules were in place, credit rating agencies were required to register with the SEC if they wished to become NRSROs. Following their registration, they would then immediately become subject to various Commission authorities, including the SEC's right to examine their books and records and to take enforcement action against an NRSRO. Such action could include placing limitations on an NRSRO's activities, censuring the NRSRO, or revoking or suspending the registration of the NRSRO. The law required the Commission to review and act on any such registration applications within 90 days. Initially, seven firms applied to become NRSROs, and the Commission approved all seven registrations within the time allowed by the Rating Agency Act. As a result, as of the end of September 2007, seven credit rating agencies – including those that were most active in rating subprime RMBS and CDOs – became subject to the Commission's new oversight authority, and subject as well to our newly adopted rules.

The Commission's Ongoing Examinations

In the six and one-half months since the Commission's authority over the NRSROs went into effect, the Commission has aggressively used its authority to examine the adequacy of their public disclosures, their recordkeeping, and their procedures to prevent the misuse of material nonpublic information. Our examinations are also focusing on how the firms manage their conflicts of interest, as well as their approaches to preventing unfair, abusive, or coercive practices. In addition, during the last six months two additional rating agencies have registered with the Commission as NRSROs.

Even before these credit rating agencies were registered with the Commission and subject to its oversight authority, the Commission staff began to assess their activities based on the information then available to us. Since then, staff from the Commission's Division of Trading and Markets, the Office of Compliance, Inspections and Examinations, and the Office of Economic Analysis have initiated on-site examinations of the largest credit rating agencies.

The review process has included hundreds of thousands of pages of the rating agencies' internal records and email relating to their ratings of subprime RMBS and CDOs. Additionally, the staff is reviewing the rating agencies' public disclosures relating to the ratings process for subprime RMBS and CDOs. In addition, Commission staff has analyzed the ratings history of thousands of structured finance products. These extensive examinations have involved approximately 40 SEC staff members. The examinations are ongoing.

The focus of the staff's examinations is whether the credit rating agencies diverged from their stated methodologies and procedures for determining credit ratings in order to publish higher ratings, and whether they followed their stated procedures for managing conflicts of interest inherent in the business of determining credit ratings. Much has been accomplished already on these examinations, but there is still more work to be done. The Commission expects that the report describing the staff's observations from examinations will be issued by early summer.

At this stage, with more examination work to be completed and the staff's across-the-board inferences not yet drawn, it is premature to describe the results. I can say that it appears the volume of the structured finance deals that were brought to the credit rating agencies increased substantially from 2004 to 2006. In addition, during the period of time under examination, the structured products that the rating agencies were being asked to evaluate were becoming increasingly complex, with many employing derivatives such as credit default swaps to replicate the performance of mortgage backed securities. At the same time, the loan assets underlying these securities shifted from primarily plain vanilla 30-year mortgages to a range of more difficult-to-assess products, such as adjustable rate and second lien loans.

We are evaluating whether credit rating agencies adapted their rating approaches in this environment. The staff is observing that the ratings process used to rate these products may have been less quantitatively developed, particularly as the products became more complicated and involved different types of loans, than was generally believed. This is of significance because the Rating Agency Act strikes a very careful and wise balance in expressly providing that the Commission may not regulate the substance of credit ratings or the procedures and methodologies by which an NRSRO determines credit ratings. Requiring the Commission to engage in substantive regulation would be antithetical to the Commission's traditional disclosure-based mission. Accordingly, the Act required us instead to focus on the adequacy of disclosures about such procedures and methodologies. The staff is currently working to assess whether, and if so the extent to which, these factors contributed to the volume of eventual downgrades, and whether other factors – such as the desire to maintain or increase market share – may have caused the credit rating agencies to be less conservative than their disclosed methodologies otherwise would have indicated.

We expect the results of these staff examinations will provide significant and useful new information that will help not only the SEC, but also issuers and users of credit ratings in this country and around the world, to address the problems we have seen with ratings of subprime-related products.

Basis for New Rulemaking

Because the Commission's authority over NRSROs took effect over six months ago, the SEC is already far along in preparing for a second round of rulemaking that would be based on the information provided by the staff's ongoing examinations of these firms, and informed by a multitude of empirical analyses provided by regulators, industry groups, academics, and multinational organizations – to many of which the SEC has itself contributed.

Our work in this area has included participation with the Department of the Treasury, the Federal Reserve, and the Commodity Futures Trading Commission in the President's Working Group on Financial Markets, as well as with the International Organization of Securities Commissions ("IOSCO") and the Financial Stability Forum ("FSF"), in their respective examinations of the role that credit rating agencies have played in the current market turmoil. We have also conducted an active dialogue with other supervisors on both the underlying issues and potential measures to address the perceived problems with the issuance and use of credit ratings for subprime-related products.

As a member of the President's Working Group on Financial Markets, the Commission actively participated in drafting the Working Group's "Policy Statement on Financial Market Developments" issued last month. This policy statement discusses, among other topics, the impact of credit rating agencies on lending practices, how their ratings are used, and how securitization has changed the mortgage industry and related business practices. We also continued working with our international counterparts through institutions such as the FSF and IOSCO. In March of this year, IOSCO's Technical Committee, of which I serve as Vice Chairman, released for comment a report prepared by its Task Force on Credit Rating Agencies. The report contains a number of recommendations for amending IOSCO's Code of Conduct for Credit Rating Agencies to address concerns raised by the credit market turmoil. In April of this year, the FSF released its report on Enhancing Market and Institutional Resilience.

Each of these statements and reports has noted that ,over the course of the past year, delinquency and foreclosure rates for subprime mortgage loans dramatically increased, throwing into turmoil the markets for securities collateralized by such loans, including subprime RMBS and CDOs backed by or referencing subprime RMBS. There is also general agreement that the high credit ratings on billions of dollars worth of RMBS and CDOs contributed to the increase in market acceptance of these structured finance products.

As performance on subprime mortgage loans deteriorated, the credit rating agencies issued downgrades to their recent ratings of RMBS and CDOs, recognizing that the securities' likelihood of default had changed significantly for the worse. The rating agencies' performance in rating these structured credit products has called into question their credit ratings generally as well as the integrity of the ratings process as a whole. In an era of interconnected worldwide financial markets, the impact of the turmoil in subprime RMBS and CDOs has been widespread, adversely affecting the strength and stability of credit markets on a global scale.

Because so much has been said and written about the genesis of the credit market turmoil, it may be useful very briefly to summarize what both the SEC and most of our fellow regulators believe to have been contributing factors. The first and most basic cause was the relaxation of loan underwriting standards. This occurred coincidentally with the growing practice of financial institutions using the credit risk transfer markets not just as a tool for managing risk, but as a way to generate substantial revenue. In consequence, the practice of packaging and selling mortgages as securities – which had been carried on by both government-sponsored enterprises and private originators – expanded greatly beginning in the early 2000s. At the same time, the complexity of such products and their collateral increased, driven by innovative products such as credit default swaps and CDOs designed to transfer credit risk from one party to another.

For financial institutions to use the credit risk transfer markets as a new source of substantial revenue, they had to find ways to sell RMBS and CDOs to a wide range of investors such as mutual funds, pension funds, hedge funds, banks, structured investment vehicles, and state government-operated funds. That meant getting these securities rated by the credit rating agencies, because many of these investors would purchase the securities only if they carried very high ratings.

Over time, increasingly higher-risk loans were packaged into these securities. This included loans underwritten with limited documentation to verify the borrower's income, and loans secured by second liens on the property. The trusts issuing these securities were structured so that the largest tranches could obtain a triple-A credit rating.

Ultimately, financial institutions began issuing synthetic CDOs composed of credit default swaps on RMBS, or hybrid CDOs made up of a combination of credit default swaps and actual RMBS. The issuers and underwriters for these securities also called upon the credit rating agencies to issue ratings that would enable them to be sold to investors.

The steady rise in housing prices from 2002 to 2006 ensured that the loans underlying these securities performed as well as, or even better than, projected by the credit rating agencies and other market participants. In the middle of 2007, however, conditions changed dramatically. As housing prices trended downward, delinquencies in subprime mortgages began to rise. This then, in part, caused the credit rating agencies to reevaluate their ratings of the subprime RMBS and CDOs. Ultimately, they downgraded many of their initial ratings.

Indeed, the number of credit rating downgrades of RMBS and CDOs is unprecedented:

- As of February 2008, Moody's had downgraded at least one tranche of 94.2% of the subprime RMBS issues it rated in 2006, including 100% of the 2006 RMBS backed by second-lien loans, and 76.9% of the issues rated in 2007. Overall, Moody's has downgraded 53.7% and 39.2% of all of its 2006 and 2007 subprime tranches, respectively.[1]

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[1] "U.S. Subprime RMBS 2005-2007 Vintage Rating Actions Update: January 2008," Moody's Investors Service, February 1, 2008..

- As of March 2008, S&P had downgraded 44.3% of the subprime tranches it rated between the first quarter of 2005 and the third quarter of 2007. This included 87.2% of securities backed by second lien mortgages.[2]

- As of December 2007, Fitch had downgraded approximately 34% of the subprime tranches it rated in 2006 and in the first quarter of 2007.[3] In February 2008, Fitch placed all of the RMBS it rated in 2006 and the first quarter of 2007 backed by subprime first lien mortgages on Ratings Watch Negative.[4]

The downgrades of the RMBS necessarily led to downgrades of the CDOs collateralized or referencing the RMBS. This widespread downgrading of subprime-related securities contributed to the concern among market participants that the risk of owning these securities was much greater than originally thought. This concern was particularly acute among those investors who relied uncritically on the credit ratings in making investment decisions.

Anticipated Subjects of New Rulemaking

What we are learning from the staff examinations of NRSROs that are the major credit rating agencies, from our extensive participation in regulatory collaborations, and from our ongoing review of the multitude of analyses of the role of credit rating agencies in the current market turmoil is informing the development of proposals for additional rules. I expect the Commission will issue rule proposals for public comment in the near future. However, I must note that the internal development process of the Commission is still very much ongoing. Consequently, while I am able to provide you with an outline of the rulemaking areas under consideration, I must do so with the caveat that what will go into the proposed rules has not been decided yet.

Since the purpose of the Rating Agency Act is to improve ratings quality by fostering accountability, transparency, and competition in the credit rating industry, the Commission's goal in our forthcoming rulemaking is to propose rules that would advance these important objectives. I will cover each of them separately.

Accountability

To strengthen accountability, the new rules that the Commission will soon consider may include requirements for enhanced disclosures about ratings performance. This would enable market participants to better compare one NRSRO with another. If the Commission were to propose rules in this area, we would need to be careful not to

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2 Transition Study: Structured Finance Rating Transition And Default Update As Of March 21, 2008," Standard & Poor's Ratings Services, March 28, 2008.

3 "U.S. RMBS Update," Fitch Ratings, February 20, 2008.

4 Update on U.S. Subprime and Alt-A: Performance and Rating Reviews," Fitch Ratings, March 20, 2008.

prescribe performance measures that would bias the ratings process, indirectly prescribe ratings methodologies, or conflict with the Act’s goal of increasing competition in the development of more accurate credit ratings.

To ensure NRSRO accountability for the management of their conflicts of interest, the new rules that the Commission will soon consider may include specific prohibitions on certain practices, as well as the establishment of requirements designed to address potential conflicts that could impair the process for rating structured products. Among the conflicts of interest that could be addressed in this way are the provision of consulting services by credit rating agencies to the issuers of securities they rate, and rating structured securities that the NRSRO itself helped design. To enhance the responsibility of the NRSROs’ designated compliance officers, the proposed rules that the Commission will soon consider may include requirements that the firms furnish the Commission with annual reports describing their internal reviews of how well they adhere to their procedures for determining ratings, manage conflicts of interest, and comply with the securities laws.

Transparency

To enhance transparency, the Commission may soon consider new rules that would require the disclosure of information about the assets underlying the mortgage-backed securities, CDOs, and other types of structured finance products they rate. This would allow market participants to better analyze the assets underlying structured securities, and reach their own conclusions about their creditworthiness. This data availability could particularly benefit subscriber-based NRSROs, who could use it to perform independent assessments of the validity of the ratings by their competitors who use the “issuer pays” model.

Further improvements in transparency could be considered in the form of enhanced disclosures about how NRSROs determine their ratings for structured products. This disclosure could include the manner of analysis of the mortgages' conformance with underwriting standards, and the firms' procedures for monitoring their current credit ratings.

The Commission may also consider rules requiring the disclosure of ratings information in a way that makes it possible for investors to readily distinguish among ratings for different types of securities, such as structured products, corporate securities, and municipal securities.

Competition

The rules that the Commission will soon consider may also include provisions designed to ensure that enhanced disclosure about a firm’s ratings performance affords other credit rating agencies, including newly recognized NRSROs, an opportunity to identify flaws or opportunities for improvement on their competitor's approach, or to demonstrate to investors that their credit ratings perform better.

The Commission is also reconsidering its extensive reliance on, and reference to, NRSRO credit ratings in its own rules. The Commission's intent is to promote greater due diligence by market participants. Investors would use NRSRO ratings that they deemed to be credible, along with other information, in conducting their due diligence. This could induce greater competition among rating agencies to produce the highest quality, most reliable ratings.

Finally, the Commission may soon consider ways to enhance competition through rules designed to ensure that all NRSROs have access to the information underlying credit ratings. Thus, regardless of whether the NRSRO follows the "issuer pays" or the subscriber-based approach, there would be no competitive disadvantage based on lack of access to the information on the assets underlying the structured credit product. To the extent both models were to flourish in a competitive marketplace, each could act as a healthy competitive check on the other. In addition, given the dominance of the "issuer pays" model currently, such rules could create an equal opportunity for NRSROs that were not paid by issuers to rate securities to issue their own unsolicited ratings – and, thereby, to develop a track record for rating these products. Of course, because this planned proposed rulemaking is ongoing, there could and undoubtedly will be other subjects covered in the draft rules that the staff will present to the Commission for its consideration.

In closing, Mr. Chairman, I want to emphasize that the Commission is very much open to ideas from the Congress, as well as the general public, on this proposed rulemaking, given the salience of this topic for you and all of your constituents. We especially welcome ideas from this committee, as you are the authors of the Credit Rating Agency Act, and it is your intent in writing the law that the Commission is working to fulfill. I appreciate this opportunity to provide the Committee with this update on the Commission's new oversight and regulatory responsibility for the NRSROs, and I would be happy to answer any questions you might have.