Testimony of

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EXAMINING PROPOSALS TO ENHANCE THE REGULATION OF CREDIT RATING AGENCIES

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

My name is Mark Froeba and I am a lawyer based in New York City. I am pleased to be here today and it is an honor to testify before you on the important topic of rating agency reform. Thank you for giving me this opportunity.

Let me give you a brief summary of my background. I am a 1990 graduate of the Harvard Law School. In 1997, I left the tax group at Skadden, Arps in New York, where I had been working in part on structured finance securities, to join the CDO group at Moody's. I worked at Moody's for just over ten years, all of that time in the CDO group. I left Moody's in 2007 as a Senior Vice President. At that time, I was Team Leader of the CLO team, co-chair of most CLO rating committees and jointly responsible for evaluating all new CLO rating guidelines.

Since the beginning of the subprime crisis, there have been many proposals for rating agency reform. Most of these proposals are well-intentioned and would probably do little harm. However, few seem likely to accomplish real reform. Real reform must achieve two clear policy goals:

- PREVENT another rating-related financial crisis like the sub-prime crisis;
- RESTORE investor confidence in the quality and reliability of credit ratings.

In my opinion, the rating agency reform provisions of the Investor Protection Act of 2009 are not sufficient — in themselves — to accomplish either of these goals. However, the Act's rule-making authority could be used to expand their effectiveness. Why are the reform provisions in themselves insufficient?

First, they are not the product of a complete investigation into what actually happened at the rating agencies. If you repair damage to a ceiling caused by a leaky roof but don't repair the roof, the damage will just keep coming back. In this case, as long as we do not have a precise understanding of how things went so wrong, we cannot really be confident the reform proposals will do what is needed to prevent things from going wrong again. (Of course, this cuts both ways. Just as we do not know without an investigation whether the reform proposals go far enough, we also do not know whether they go too far.)

It is true that some work has been done to discover what actually happened at each of the rating agencies, but much could still be learned, especially from the analysts who assigned the problem ratings. Any thorough investigation must include confidential interviews with as many of these analysts as possible from each of the major rating agencies. By these interviews, investigators will gain an intimate knowledge of how each rating agency actually worked, not how it was supposed to work on paper. More importantly, they will uncover exactly what the people closest to the process think caused so many ratings to be so significantly wrong. What questions should be asked?

- Who is responsible for what happened and why?
- Was there ever any pressure exerted upon you or your colleagues, direct or indirect, to subordinate rating analysis to business considerations?
- If so, how was the pressure exerted?

Even if these questions seem to insinuate malfeasance, they are questions the rating agencies will welcome because the answers they expect will do much to restore confidence in their integrity.

In summary, without a proper investigation of what happened — not conducted on a theoretical level, or in discussions with senior managers but with the analysts who actually assigned the ratings in question— we cannot be sure the proposed legislation provides solutions designed to fix the real problems.

The best way to illustrate my second reason for questioning the sufficiency of this proposal is to ask you a simple question. If Investor Protection Act of 2009 had been enacted, just as it is, five years ago, do you think it would have prevented the subprime crisis? In my view, the answer to this question is very clearly "No." That does not mean that these proposals are bad. It just means that they do not advance what should be one of the central policy goals of rating agency reform: preventing a future crisis in the financial system triggered at least in part by problem credit ratings.

If these reform proposals are uncertain to prevent a future crisis and to restore confidence in the credit ratings, what reforms could achieve these goals?

To answer this question, we should first consider the regulatory context in which the rating agencies found themselves just before the subprime crisis. First, they enjoyed an effective monopoly on the sale of credit opinions. Second, and more importantly, they enjoyed the benefit of very substantial government-sanctioned demand for their monopoly product. (A buggy whip monopoly is a lot more valuable if government safety regulations require one in every new car). Third, the agencies enjoyed nearly complete immunity from liability for injuries caused by their monopoly product. Fourth, worried about the monopoly power created by the regulations of one branch of government, another branch encouraged vigorous competition among the rating agencies. This mix of regulatory "carrots" and "sticks" in the period leading up to the subprime melt-down may have contributed to making it worse than it might have been. Thus, a third goal of rating agency reform should be to untangle these conflicting regulatory incentives. Here are some proposals that I believe will help with all three reform goals.

First, put a "fire wall" around ratings analysis. The agencies have already separated their rating and non-rating businesses. This is fine but not enough. The agencies must also separate the rating ***business*** from rating ***analysis***. Investors need to believe that rating analysis generates a pure opinion about credit quality, not one even potentially influenced by business goals (like building market share). Even if business goals have never corrupted a single rating, the potential for corruption demands a complete separation of rating analysis from bottom-line analysis. Investors should see that rating analysis is virtually barricaded into an "ivory tower," and kept safe from interference by any agenda other than getting the answer right. The best reform proposal must exclude business managers from involvement in any aspect of rating analysis and, critically also, from any role in decisions about analyst pay, performance and promotions.

Second, prohibit employee stock ownership and change the way rating analysts are compensated. There's a reason why we don't want judges to have a stake in the matters before them and it's not just to make sure judges are fair. We do this so that litigants have confidence in the system and trust its results. We do this even if some or all judges could decide cases fairly without the rule. The same should be true for ratings. Even if employee stock ownership has never actually affected a single rating, it provokes doubt that ratings are disinterested and undermines investor confidence. Investors should have no cause to question whether the interests of rating agency employees align more closely with agency shareholders than investors. Reform should ban all forms of employee stock ownership (direct and indirect) by anyone involved in rating analysis. These same concerns arise with respect to annual bonus compensation and 401(K) contributions. As long as these forms of compensation are allowed to be based upon how well the ***company*** performs (and are not limited to how well the ***analyst*** performs), there will always be doubts about how the rating analysts' interests align.

Third, create a remedy for unreasonably bad ratings. As noted above, the rating agencies have long understood (based upon decisions of the courts) that they will not be held liable for injuries caused by "bad" ratings. Investors know this. Why change the law to create a remedy if bad ratings arguably cause huge losses? The goal is not to give aggrieved investors a cash "windfall." The goal is to restore confidence — especially in sophisticated investors — that the agencies cannot assign bad ratings with impunity. The current system allows the cost of bad ratings to be shifted to parties other than the agencies (ultimately to taxpayers). Reform must shift the cost of unreasonably bad ratings back to the agencies and their shareholders. If investors believe that the agencies fear the cost of assigning unreasonably bad ratings, then they will trust self interest (even if not integrity) to produce ratings that are reasonably good.

My former Moody's colleague, Dr. Gary Witt of Temple University, believes that a special system of penalties might also be useful for certain types of rated instruments. Where a governmental body relies upon ratings for regulatory risk assessment of financial institutions — e.g. the SEC (broker-dealers and money funds), the Federal Reserve (banks), the NAIC (insurance companies) and other regulatory organizations within and outside the US — the government has a compelling interest and an affirmative duty to regulate the performance of such ratings. Even if other types of ratings might be protected from lawsuits by the first amendment, these ratings are published specifically for use by the government in assessing risk of regulated financial institutions and should be subject to special oversight, including the measurement of rating accuracy and the imposition of financial penalties for poor performance.

Fourth, change the antitrust laws so agencies can cooperate on standards. When rating agencies compete over rating standards, everybody loses (even them). Eight years ago, one rating agency was compelled to plead guilty to felony obstruction of justice. The criminal conduct at issue there related back to practices (assigning unsolicited ratings) actually worth reconsidering today. Once viewed as anticompetitive, this and other practices, if properly regulated, might help the agencies resist competition over rating standards. Indeed, the rating problems that arose in the subprime crisis are almost inconceivable in an environment where antitrust rules do not interfere with rating agency cooperation over standards. Imagine how different the world would be today if the agencies could have joined forces three years ago to refuse to securitize the worst of the subprime mortgages. Of course, cooperation over rating analysis would not apply to business management which should remain fully subject to all antitrust limitations.

Fifth, create an independent professional organization for rating analysts. Every rating agency employs "rating analysts" but there are no independent standards governing this "profession": there are no minimum educational requirements, there is no common code of ethical conduct, and there is no continuing education obligation. Even where each agency has its own standards for these things, the standards differ widely from agency to agency. One agency may assign a senior analyst with a PhD in statistics to rate a complex transaction; another might assign a junior analyst with a BA in international relations to the same transaction. The staffing decision might appear to investors as yet another tool to manipulate the rating outcome. Creating one independent professional organization to which rating analysts from all rating agencies must belong will ensure uniform standards — especially ethical standards — across all the rating agencies. It would also provide a forum ***external to the agencies*** where rating analysts might bring confidential complaints about ethical concerns. An independent organization could track and report the nature and number of these complaints and alert regulators if there are patterns in the complaints, problems at particular agencies, and even whether there are problems with particular managers at one rating agency. Finally, such an organization should have the power to discipline analysts for unethical behavior.

Sixth, introduce "investor-pay" incentives into an "issuer-pay" framework. Students of the history of rating agencies know that, at one point, rating agencies were paid by investors not by issuers of the securities rated by the agency. Investors subscribed to periodic rating reports and these subscription fees paid for the ratings. By the late 1960s this business model was not working and the agencies gradually shifted away from an investor-pay model to an issuer-pay model. In this model, the party or entity applying for a rating pays for the rating.

Critics fault this model because it shifts the attention (and allegedly, the allegiance) of the rating agencies not only away from the ultimate consumer of the rating, the investor, but also toward the party whose interests may strongly conflict with the investor, the issuer. According to this view of the process, the power of the issuer to take the rating business to a competitor became the tool by which the rating agencies were induced to compete with each other ***on rating standards***. For example, an issuer tells rating agency (X) that its competitor (Y) has lowered its subordination levels for some structured security, e.g. from 4.5% to 4.3%. The issuer urges X to change its standards or lose the issuer's business. Of course, at the same time, the issuer is telling Y that X has lowered subordination levels and urging Y to adopt the lower standards. It isn't hard to see how a spiral of declining rating standards could be triggered under this model.

There are those who believe that real rating agency reform requires a return to an investor-pay model. But there may be a third way, a business model that preserves the issuer-pay “delivery system” (the issuer still gets the bill for the rating) but incorporates the incentives of the investor-pay model. How would this work?

First, issuers seeking a credit rating would be required to provide the same information to every rating agency that has “registered” to rate a particular type of security or transaction. Thus, if there are five rating agencies registered to rate CDOs, all five would receive exactly the same information about a new CDO from the issuer. Second, the potential investors in the new security or transaction would decide which agencies get paid to rate the security. During the marketing phase of the transaction, investors would compare the ratings proposed by all of the rating agencies and the investors would then select the agencies to rate the transaction. It would be at this point that the rating agencies would once again be competing with each other for the interest of the investors. The issuers’ power to corrupt the process by selecting the rating agency would be eliminated. Finally, every rating agency would be free to publish ratings of the transaction, regardless of whether it was selected to be paid for the rating by investors.

It would also be possible to use such a system to create demand for ratings from new rating agencies. To do so, investors (or issuers if they are still making the selection) would be required to pick two agencies for every transaction: (1) only one from the list of agencies with more than 50% market share for the asset type in question and (2) one or more from the list of agencies with less than 50% market share for the asset type in question. In this way, newer agencies would have an easier time breaking into a business with extremely high barriers to entry.

These and other reforms are necessary not only to restore investor confidence in ratings (without regard to whether they actually redress past malfeasance) but also to prevent future ratings-related financial crises.