FitchRatings

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before a hearing of the
United States Senate
Committee on Banking, Housing, and Urban Affairs
on

Examining Proposals to Enhance the Regulation of Credit Rating Agencies

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While overall macro-economic conditions remain difficult, it seems the period of the most intense market stress has passed. This is due to both a variety of government initiatives here and abroad aimed at restoring financial market stability as well actions taken by companies individually to shore up their balance sheets and reduce risk. Having said that, important sectors in the fixed income markets remain effectively closed and certain sectors, such as commercial mortgage-backed securities, are experiencing greater performance strain on their underlying assets.

During this time, the focus of Fitch Ratings has been on implementing a broad and deep range of initiatives that enhance the reliability and transparency of our rating opinions and related analytics. More specifically, our primary focus is on vigorously reviewing our analytical approaches and changing ratings to reflect the current risk profile of securities we rate. In many cases, that continues to generate a significant number of downgrades in structured securities, but also affects other sectors, such as banks and insurance. We are releasing our updated ratings and research transparently and publicly and we are communicating directly with the market the latest information and analysis we have.

In parallel, we have been introducing a range of new policies and procedures – and updating existing ones – to reflect the evolving regulatory frameworks within which credit rating agencies operate globally.

In each of these areas, we have been as transparent as possible and broadly engaged with a wide range of market participants, including policy makers and regulators. We are happy to expand upon any of these topics.

That said, the primary focus of today's hearing is to examine proposals to enhance the regulation of credit rating agencies, or "where do we go from here." Clearly, credit rating agencies continue to be a topic of interest in the market and in the regulatory communities. Senator Reed has introduced a bill this year – the "Rating Accountability and Transparency Enhancement Act of 2009." The House Financial Services Committee held a hearing in May 2009 on topics similar to today's hearing. The SEC has issued new rules and considered many important questions in its roundtable discussion in April. Most recently the Treasury sent legislation to Congress that reflected the Administration's perspectives on credit rating agency reform. Outside of the U.S., the EU recently enacted a registration and oversight system and related rules for credit rating agencies. Other nations are considering similar measures.

As this Committee considers these topics, we would like to offer our perspective on several important issues. The bodies referenced above have touched on many of these themes in their proposals and discussions. Let me reiterate that Fitch is committed to engaging on all of these matters in a thoughtful, balanced, constructive and non-self serving manner. At the same time, some perceptions and proposals continue to circulate that warrant further consideration, clarification, or in some cases "reality checking."

Managing Conflicts of Interest. The majority of Fitch's revenues are fees paid by issuers for assigning and maintaining ratings. This is supplemented by fees paid by a variety of market participants for research subscriptions. The primary benefit of this model is that it enables Fitch to be in a position to offer analytical coverage on every asset class in every capital market – and to make our rating opinions freely available to the market in real-time, thus enabling the market to freely and fully assess the quality of our work. Fitch has long acknowledged the potential conflicts of being an issuer-paid rating agency. Fitch believes that the potential conflicts of interest in the "issuer pays" model have been, and continue to be, effectively managed through a broad range of policies, procedures and organizational structures aimed at reinforcing the objectivity, integrity and independence of its credit ratings, combined with enhanced and ongoing regulatory oversight. In recent months, Fitch has introduced new policies, and revised many existing ones, focused on these issues. A few examples of our relevant policies and procedures are below:

- Business development is separated from credit analysis, to keep each group focused on its core task.
- Employees involved in the assignment of the resulting ratings do not handle fees discussions for an issuer or transaction.
- No analyst or group of analysts is directly compensated on the revenues related to their ratings.
- Rating analysts are prohibited from advising issuers and underwriters on structuring transactions and focus solely on developing and communicating our opinion on the credit fundamentals associated with a given structure.
- Ratings are determined using a committee structure, not by a single analyst. These committees include a mandatory independent member.
- Cross-group committees and an independent internal review function review all ratings criteria.
- Fitch has introduced the new role of group credit officer in each of its rating groups.
- Fitch has established and enforces a Code of Conduct (consistent with IOSCO's and updated in February 2009) and ancillary policies to specifically address potential conflicts.
- Fitch has relocated all of its non-rating operations into a separate division, Fitch Solutions, which operates behind a firewall.

No payment model would be completely immune to conflicts of interest, whether from investors, issuers, governments or regulators. An "investor pays" model also contains direct conflicts, given that most major investors have a vested financial interest in the level of ratings and many are rated entities. A move to a complete "investor pays" model, by definition making the ratings a subscription product, could also remove ratings from the public domain. This would conflict with investor and policymakers' call for ratings to be broadly available, thereby allowing the market to openly judge ratings performance.

Disclosure of Ratings Methodologies. The definitions for all of Fitch's ratings and rating scales are regularly reviewed and updated, publicly disclosed and freely available on our website. The most recent update to our ratings definitions is set forth in a March 2009 report entitled "Definitions of Ratings and Other Scales." In addition, the criteria that details Fitch's analytical approach to rating issues and issuers in every region and asset class are also regularly reviewed and updated, and freely available on our website on a centralized "criteria homepage." In select cases where Fitch is considering what it believes to be a material shift in our thinking regarding our analytical approach to a given sector, we normally release our thinking to the market as an "exposure draft." In such a case, we solicit feedback from market participants and engage in transparent discussions about our approach – such as one-on-one meetings, webcasts and conference calls – and we have done so repeatedly in the last few years. In addition, the processes we follow internally in developing and approving such methodology updates are also fully codified, consistent with SEC and IOSCO rules, and freely available. Finally, we develop and publish an enormous number of rating commentaries (over 15,000 in 2008) and research reports that summarize our opinions on issues, issuers and market sectors as part of our efforts to ensure the market is aware of our perspective. Those in the market that allege that our ratings are a "black box" must not be fully aware of the information we make available, or they do not fully appreciate the concept that the rating itself is not a simplistic mathematical output, but rather a committee decision based on a range of quantitative and qualitative factors. For every rating action we take, we publish the corresponding rationale and make that freely available to the market. We do not believe that everyone will agree with all of our opinions, but we are committed to ensuring the market has the opportunity to discuss them.

Issuer Disclosure and Due Diligence in Structured Finance. Some market participants, in reviewing the performance of ratings in structured finance markets, have noted that limits on the amount of information that is disclosed to the market by issuers and underwriters has made the market over-reliant on rating agencies for analysis and evaluation of structured securities. The argument follows that the market would benefit if additional information on structured securities (such as asset specific data on residential and commercial mortgage backed securities) were made broadly and readily available to investors, thereby enabling them to have access to the same information that mandated rating agencies have in developing and maintaining our rating opinions. Fitch fully supports the concept of greater disclosure of such information. A related benefit of additional issuer disclosure is that it addresses the issue of ratings shopping. Greater disclosure would enable non-mandated NRSROs to issue ratings on structured securities if they so choose, thus providing the market with greater variety of opinion and an important check on any perceived "ratings inflation." We also believe that responsibility for disclosing such information should rest fully with the issuers and the underwriters, *not* with rating agencies. Quite simply, it is their information on their transactions, so they should disclose it.

Furthermore, Fitch notes that the disclosure of additional information is of questionable value if the accuracy and reliability of the information is suspect. That goes to the issue of due diligence. While rating agencies have taken a number of steps to increase our assessments of the quality of the information we are provided in assigning our ratings, including adopting policies that state that we will not rate issues if we deem the quality of the information to be insufficient, due diligence is a specific and defined legal concept. Due diligence is not currently, nor should be, the responsibility of credit rating agencies. Consistent with existing securities laws, the burden of due diligence belongs on issuers and underwriters. In that regard, we support the concept that issuers and underwriters ought to be required to conduct rigorous due diligence on the underlying assets that comprise asset backed and mortgage backed securities offered or sold in the U.S. Fitch believes Congress should consider amending the securities law to require such due diligence on underlying assets for all ABS and MBS securities offered or sold in the US, whether or not the securities are registered under Section 5 or sold pursuant to an exemption from such registration. Congress ought not to hold rating agencies responsible for such due diligence or for requiring that others do it. Rather, Congress should mandate that the SEC enact rules to require issuers and underwriters to perform such due diligence – make public the findings – and enforce the rules they enact.

Regulation and Transparency. Stated simply and clearly, Fitch supports fair and balanced oversight and registration of credit rating agencies and believes the market will benefit from globally consistent rules for credit rating agencies that foster transparency, disclosure of ratings and methodologies and management of conflicts of interest.

The dialogue on changes to rating agency regulation continues to follow two primary – and not necessarily consistent – themes. The first is the imposition of additional rules and regulations that are manifested in a range of new or enhanced policies and procedures. This has been the primary thrust of recent SEC rulemaking and of the recently passed EU rules. Fitch is or will be fully compliant with these new rules.

At the same time, a number of commentators have spoken on the topic of the market's perceived over-reliance on credit ratings. To a certain extent, we agree with this premise, in so far as some market participants clearly used ratings as a substitute for – as opposed to a complement to – their own fundamental credit analysis. One proposed remedy for this is to eliminate the use of ratings in regulation or to eliminate the NRSRO concept altogether. While deceivingly simple, we believe this proposal warrants several comments. Ratings have been used constructively in many places in regulation, as they are an important common benchmark. From a regulatory point of view, the question of what would be used in place of credit ratings is rarely answered satisfactorily. Simply having regulators "do it themselves" has a range of practical implications and unintended consequences. As does the notion of allowing regulated financial entities to assess the credit risk of the securities completely on their own without reference to any independent external risk benchmarks. In many cases, if you eliminate the use of "NRSRO" ratings in regulation, company and industry participants will likely develop or maintain their own guidelines and use credit ratings anyway. We believe they will default to the largest "brand name" rating agencies (Moody's and S&P), which is not a positive if one of your objectives is increasing competition and thereby fostering a better work product. Note that the SEC proposed a variation on this theme in 2008 with respect to money market funds and their use of ratings but chose not to move forward, in part based on significant feedback supporting the use of ratings in money market regulations from the fund industry itself. Some have suggested replacing ratings with market prices for debt – either bond spreads or CDS spreads. While these may reflect the market's sense of price at a given point, recall from the events of the last two years that not all securities are liquid, that bid-ask spreads can widen materially in times of stress and that market prices by definition are inherently more volatile than a fundamentally driven credit rating. However, if one is serious about eliminating ratings in regulation, we suggest you transition to elimination over an intermediate time frame with careful consideration of each regulation, rather than wholesale elimination. A better solution is continued recognition and oversight of NRSROs with the goal of improving the performance and usefulness of ratings.

Speaking of competition and regulation, the SEC also has approved a wide range of new NRSROs. Some are established with global reach, resources and coverage, while others are focused geographically or by sector, have modest resources, and/or coverage and ratings history that are more limited. Given the divergent profiles, it is quite a challenge to consider the issues we are discussing today. For example, we do not believe the definitions and meanings of ratings are all the same among NRSROs, let alone the levels of the ratings themselves. We also believe it is significant that a verifiable record of performance is not publicly available from all NRSROs and that not all ratings are publicly available in real-time. Specifically, the market benefits from the differences of opinion as expressed by the different ratings assigned by credit rating agencies. Usually, the initial rating assigned by Fitch will be proven reliable. The same is of course true of any other agency. However, if some NRSROs need not disclose all of their ratings, that dynamic merely allows them to "cherry-pick" the selected ratings where they believe they were "first" or "better" without the obligation to provide the information that enables the market to fully compare and contrast the opinions and performance of the NRSROs based on *all* of their ratings. If a goal is improvement of the reliability of credit ratings through increased competition and transparency, we believe all oversight requirements should be applied consistently and equally to all NRSROs.

A final point on regulation: The Treasury's proposal includes the concept of mandatory registration for credit rating agencies. Fitch, along with the other recognized NRSROs, is already registered and subject to explicit SEC regulatory oversight. We believe the mandatory registration concept is unnecessary and unwarranted and is not consistent with basic free speech principals.[1]

Accountability and Liability. While we understand and agree with the notion that we should be accountable for what we do, we disagree with the idea that the imposition of greater liability will achieve that. Some of the discussion on liability is based on misperceptions, and those points are noted below. More fundamentally, we struggle with the notion of what it is that we should be held liable for. Specifically, a credit rating is an opinion about future events – the likelihood that an issue or issuer will meet its credit obligations as they come due. Imposing a specific liability standard for failing to accurately predict the future in every case strikes us as an unwise approach.

[1] *See* Written Statement of Eugene Volokh, Gary T. Schwartz Professor of Law, University of California, Los Angles, School of Law before Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Committee on Financial Services at *Approaches to Improving Credit Rating Agency Regulation*, May 19, 2009 at pages 9-10 available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/volokh.pdf ("Professor Volokh Statement").

The first misconception is that rating agencies are free from liability and hide behind the First Amendment to shield them from legitimate securities law liability. Rating agencies may be held liable for securities fraud just as any person or entity may be (including accountants, lawyers, officers, directors and securities analysts) to the extent that a rating agency intentionally or recklessly makes a material misstatement or omission in connection with the purchase or sale of a security. Of course, a plaintiff must prove securities fraud against a rating agency just as against any other defendant. The reality of U.S. securities law is that any plaintiff may make a claim against a rating agency under the antifraud provisions of the securities law, just as they can against accountants, lawyers, officers, directors and securities analysts, but they must prove their claims to the standard required under the securities law.

Some also have criticized rating agencies for what they perceive as taking undue advantage of the First Amendment and its protection of free speech. We believe this is an overblown argument that fails to acknowledge key facts about the nature of ratings. We publish all of our ratings, accompanied by detailed published commentary about the companies and securities we rate. Fitch's ratings are available free to anyone who has access to the Internet. The companies and securities we rate are of significant interest to investors of all types and other parties interested in the securities and the capital markets. Hundreds of investors, fiduciaries, government entities and other interested parties subscribe to our published commentary and thousands access our website daily. We believe Fitch enjoys the same free-speech rights as any other person or entity to comment on matters of public interest and to "make informed, thoughtful predictions about the future. That is no different from what newspapers or scholars do."[2] We further believe that the manner in which we are paid and the nature of the securities we rate do not affect the essence of what we do or the free-speech rights we enjoy in connection with our work.[3]

A second misconception centers on where the responsibility for full and complete disclosure about companies and securities, and appropriate due diligence to ensure the accuracy and adequacy thereof, should be placed. As discussed above, these obligations are today, and have been since the enactment of the earliest U.S. securities law, the sole responsibility of issuers, their officers and directors and underwriters. The obligation to enforce these responsibilities falls squarely on the shoulders of the Securities and Exchange Commission and the courts.

Some have proposed that rating agencies should be liable not merely for material misstatement, but for the investigation of rated securities and the verification of information. In one proposed bill, rating agencies would be liable for knowingly or recklessly failing to conduct such investigation or verification, which will cause rating agencies to be judged by whether, in hindsight, they could have reasonably done more. Because a plaintiff could base a claim on "you had to have known more could be done," the effect is negligence based private rights of action. Even a requirement to plead with particularity might not be at all protective in this context. In hindsight, it will always look like a rating agency could have reasonably foreseen future problems with different assumptions and stress testing.

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[2] Nathan Koppel, "Credit Raters Plead the First; Will It Fly?" The *Wall Street Journal,* April 21, 2009, C1 (quoting Professor Eugene Volokh).

[3] *See* Professor Volokh Statement at pages 2-3.

While we believe some proposals are ill advised, Fitch has been and will continue to be constructively engaged with policy makers and regulators as they consider important ideas and questions about the oversight of credit rating agencies. Fitch has taken a number of important analytical and procedural steps already and we acknowledge there is more to do. We remain committed to enhancing the reliability and transparency of our ratings, and welcome all worthwhile ideas that aim to help us achieve that.