TESTIMONY OF KATHLEEN A. CORBET PRESIDENT OF STANDARD & POOR'S, A DIVISION OF THE McGRAW-HILL COMPANIES, INC.

BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

FEBRUARY 8, 2005

Mr. Chairman, Members of the Committee, good morning. I am Kathleen A. Corbet, President of Standard & Poor's ("S&P"), a division of The McGraw-Hill Companies, Inc. On behalf of S&P and S&P Ratings Services, the S&P unit responsible for assigning and publishing credit ratings, I welcome the opportunity to appear at this hearing to discuss the important role of credit rating agencies in the capital markets. By way of background, I joined S&P as President almost one year ago. While I may be a new face at the table today, I have spent more than 20 years in investment management where I was responsible for fixed income research and bond portfolio management for institutional and mutual fund investors. Accordingly, my comments this morning are based on my perspective as S&P President, as a capital markets participant and as a former rating agency customer.

Today, I would like to address five topics:

1) S&P Ratings Services' rigorous and market-tested ratings process, which is designed to ensure that our ratings are objective, independent, transparent and credible;

2) S&P Ratings Services' Code of Practices and Procedures which, along with other similar measures, addresses potential conflicts that may arise in the ratings process;

3) S&P Ratings Services' responses to recent corporate misconduct;

4) S&P Ratings Services' support for greater transparency in the Securities and Exchange Commission's (the "Commission") NRSRO designation process and for reduction of barriers to entry in the credit rating industry; and

5) S&P Ratings Services' responsiveness to U.S. and international markets and regulators with respect to the ratings process.

Background on S&P Ratings Services and the Nature of Credit Ratings

Before turning to these topics, I would first like to provide some background on S&P Ratings Services. S&P Ratings Services began its credit ratings activities almost ninety years ago, in 1916, and today is a global leader in the field of credit ratings and risk analysis, with credit rating opinions outstanding on approximately $30 trillion in debt representing 745,000 securities issued by roughly 42,000 obligors in more than 100 countries. S&P Ratings Services has established an excellent track record of providing the market with independent, objective and rigorous analytical information in the form of credit rating opinions. A rating from S&P Ratings Services represents our opinion, as of a specific date, of the creditworthiness of either an obligor in general or a particular financial obligation. Unlike equity analysis, a credit rating opinion:

- is not recommendation to buy, sell, or hold a particular security;
- is not a comment on the suitability of an investment for a particular investor or group of investors;
- is not a personal recommendation to any particular user; and
- is not investment advice.

More detail on the nature of our rating opinions is available on our Web site: www.standardandpoors.com.

Credit ratings are an important component of the global capital markets and over the past century have served investors extremely well by providing an effective and objective tool to evaluate credit risk. Credit ratings provide reliable standards for issuers and investors around the world, facilitating efficient capital raising and the growth of new markets. Indeed, credit rating opinions have supported the development of deeper, broader and more cost effective global debt markets. S&P Ratings Services has made significant contributions to this development by taking credit research into new markets and new asset classes; it is through this process that there is more information, a wider array of tools for understanding credit risk and far greater transparency in the marketplace today than ever before.

Critical to a credit rating agency's ability to serve this role in the market is its commitment to, and achievement of, the highest standards of independence, transparency and quality. At S&P Ratings Services, these principles are the cornerstones of our business and have driven our longstanding track record of analytical excellence. Indeed, studies on rating trends have repeatedly shown that our ratings are highly effective in alerting the market to both deterioration and improvement in credit quality. For example, over the past 15 years, less than one percent (1%) of issuers initially rated in the "AAA" category have defaulted while approximately sixty percent (60%) of those initially rated in the "CCC" category have failed to meet their obligations. Moreover, out of 36 S&P rated issuers that defaulted in 2004, every one was rated in speculative grade categories prior to default, and most from inception.

The Credit Rating Process

At the heart of this market-tested and accepted track record is a process by which S&P Ratings Services arrives at a particular credit rating. Our rating and editorial process begins with analysts being assigned to a particular issuer. The analysts gather economic, financial and other information directly from the issuer, from public filings and from other sources deemed to be reliable. As part of our rating process, we press issuers to respond to comprehensive questions that help our analysts develop a full picture of the issuer's true credit quality. That said, our analysts are not auditors and do not perform an audit of information provided by a rated company: indeed, one important informational component is the public information available about an issuer. Accordingly, we support the actions taken by Congress in enacting the Sarbanes-Oxley Act of 2002 to strengthen the process by which financial information is audited and provided to the market. Our analysts also rely expressly and necessarily on issuers to provide timely and accurate information. We may, depending on the circumstances, decline to issue a rating or even withdraw an existing rating if an issuer refuses to provide requested information.

Our rating analysts examine information carefully as it is gathered. When sufficient information to reach a rating conclusion has been received and analyzed, we convene a rating committee comprised of S&P Ratings Services personnel who bring to bear particular credit experience and/or expertise relevant to the rating. A lead analyst makes a presentation to the rating committee that includes an evaluation of the issuing company's strategic and financial management, its business and operating environment, an analysis of financial and accounting factors and the issuer's business and financing plans. Our rating committee meetings involve serious and lengthy discussion that includes frank, and often animated, exchanges.

Once a rating is determined by the rating committee, the issuer is notified and S&P Ratings Services disseminates it to the public. Along with the rating, we publish a narrative rationale explaining to the marketplace the key issues considered in the rating.

Similarly, when a rating change occurs, our analysts report on the change and the rationale for it. We have a longstanding policy of making our public credit ratings and the basis for those ratings broadly available to the investing public as soon as possible and without cost. Public credit ratings (which constitute 99% of our credit ratings in the United States) are disseminated via real-time posts on our Web site, and through a wire feed to the news media as well as through our subscription services. Members of the investing public receive credit ratings at the same time as subscribers.

Management of Potential Conflicts of Interest

S&P Ratings Services has a longstanding commitment to ensuring that any potential conflicts of interest do not compromise our analytical independence. To that end, S&P Ratings Services has had in place for many years a significant number of policies, procedures and structural safeguards. In September 2004, these policies and procedures were updated, aggregated into one document and released publicly in S&P Ratings Services' Code of Practices and Procedures ("Code of Practices and Procedures"). The Code of Practices and Procedures provides, for example, that:

- rating opinions must be assigned by rating committees, not by an individual;
- at least two analysts must attend all meetings with the management of an issuer;
- analysts are not to be compensated based upon the ratings assigned to issuers they cover;
- analysts are prohibited from engaging in negotiations with issuers about fees or other business matters; and
- analysts are prohibited from engaging, directly or indirectly, in any Standard & Poor's activities with respect to non-ratings businesses, including any cross marketing of non-ratings services.

Consistent with the recent "Code of Conduct Fundamentals" published by the International Organization of Securities Commissions ("IOSCO"), S&P Ratings Services' Code of Practices and Procedures requires strict separation of marketing and analytical activities and contains tight restrictions on securities ownership and trading so as to minimize any conflicts of interest in the conduct of the credit ratings process. The Code of Practices and Procedures, which we have previously provided to the Committee, is available on our Web site and is attached to this testimony (see Appendix 1).

S&P Ratings Services has also established strong infrastructure designed to safeguard the integrity of our credit rating process. Our Analytics Policy Board, chaired by S&P Ratings Services' Chief Credit Officer, monitors and ensures consistent application of our criteria and methodologies. The Analytics Policy Board also examines significant downgrades to determine if any changes in criteria or methodology are warranted.

S&P Ratings Services believes that these measures contribute to our objectivity and independence and the market's acceptance of S&P Ratings Services as a credible publisher of credit ratings. Indeed, in the Commission's January 2003 "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets," prepared pursuant to Congress' direction in the Sarbanes-Oxley Act of 2002 and following an extensive review of credit rating agencies, the Commission found that market participants generally believed that any potential conflicts of interest have been "effectively addressed by the credit rating agencies." Likewise, two Federal Reserve Board economists recently concluded after intensive study that S&P Ratings Services and the other rating agencies consider their reputations in the marketplace to be of "paramount importance" and, in fact, are "motivated primarily by reputation-related incentives."[1]

Response to Recent Corporate Misconduct

The unprecedented corporate misconduct that has been revealed in recent years has resulted in constructive responses by market participants, including rating agencies such as S&P Ratings Services. Like many other market participants, S&P Ratings Services was misled by parties who committed fraud. In the Enron case, for example, key Enron personnel have now expressly admitted their role in deliberately misleading S&P Ratings Services and other rating agencies. It was their intention, they said, to defraud the rating agencies by making false representations and failing to disclose material facts related to Enron's financial position and cash flow.[2]

While at S&P Ratings Services we continuously review and enhance our processes, these events led us to examine our practices from top to bottom. We have concluded, after careful thought and examination, that our credit rating process works well and effectively. This view is reflected in many of the public comments filed with the Commission, IOSCO, and the Committee of European Securities Regulators, or "CESR".

---

1 *See* Daniel M. Covitz and Paul Harrison, *Testing Conflicts of Interest at Bond Ratings Agencies with Market Anticipation: Evidence that Reputation Incentives Dominate*, The Federal Reserve Board Finance and Economics Discussion Series (December 2003), at 1, 3.

2 In a statement attached to his Oct. 5, 2004 Cooperation Agreement, Enron's former assistant treasurer Timothy Despain admitted, among other things, that "[i]n communicating with representatives of the rating agencies, I and others at Enron did not truthfully present the financial position and cash flow of the company and omitted to disclose facts necessary to make the disclosures and statements that were made to the rating agencies truthful and not misleading." Similarly, in his January 14, 2004 Plea Bargain Agreement, former Enron CFO Andrew S. Fastow, stated, among other things, that "[w]hile CFO, I and other members of Enron's senior management fraudulently manipulated Enron's publicly reported financial results. Our purpose was to mislead investors and others about the true financial position of Enron and, consequently, to inflate artificially the price of Enron's stock and *maintain fraudulently Enron's credit rating*." (emphasis added).

Indeed, in April 2003 testimony before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Entities, the Director of the Commission's Division of Market Regulation, observed that "in general the credit rating agencies have done remarkably well."

The recent cases of issuer misconduct underscore how important it is to the ratings process that issuers provide accurate and reliable information to the marketplace and S&P Ratings Services. S&P Ratings Services believes that the initiatives of Congress and the Commission to improve the quality, transparency, and timeliness of disclosures by public companies such as those included in the Sarbanes-Oxley Act were an important and necessary response to these instances of corporate misconduct. Such measures should promote timely and accurate disclosure by issuers. Recent accounting standard initiatives should likewise result in better accounting information available to the market, including S&P Ratings Services.

As part of our commitment to continuous improvement and in order to ensure that ratings are responsive to evolving market needs, S&P Ratings Services has recently initiated a broad range of actions that support our mission to provide high-quality, objective and rigorous analytical information to the marketplace. These initiatives have included:

- additional specialized forensic accounting expertise including new chief accountants in both the United States and Europe;
- expanded liquidity analysis and recovery assessment in our ratings analyses;
- enhanced use of quantitative tools and models in the rating and surveillance process;
- increased commentary on issuers and industry sectors;

- enhanced focus in our criteria and practice on the role of corporate governance practices in credit ratings analyses;
- expanded training programs; and
- consolidated and updated codes of policies and practices.

We will, of course, continue to take appropriate steps to enable us to continue to provide rigorous analytical information to the marketplace.

SEC Regulatory Oversight

The concept of a nationally recognized statistical rating organization ("NRSRO") was first utilized by the Commission in 1975. S&P Ratings Services was designated as an NRSRO in 1976 (though did not affirmatively seek that status) and is now one of four designated NRSROs. The Commission is currently in the process of reviewing the NRSRO system and considering possible changes. The initial phase of this review included the Commission's January 2003 report mentioned earlier, prepared pursuant to Congress' direction under the Sarbanes-Oxley Act. Following this report, the Commission issued a Concept Release in June 2003. One of the key questions raised by the Concept Release is whether to continue the use of the NRSRO framework and, if so, how best to designate NRSROs. Based on the public comments by market participants, which generally favored retaining the system, the Commission may well conclude that abandoning the NRSRO concept could increase costs to the capital markets and disrupt current efficiencies in the regulatory system, without any increase in investor protection.

If the Commission does retain the NRSRO system, S&P Ratings Services believes that the Commission should provide greater transparency in the designation process and reduce regulatory barriers to entry into the credit rating industry — a view expressed in many public comments. One way to accomplish this goal would be to extend NRSRO status to firms that limit their rating opinions to particular sectors of the capital markets or particular geographic regions. S&P Ratings Services supports increased competition in the credit rating industry. We believe, however, that the key criterion for designation must continue to be that a firm is widely accepted by users of credit rating opinions as a provider of credible and reliable ratings.

The Commission is also considering whether and to what extent it should enhance regulatory oversight of NRSROs if the designation system is retained. S&P Ratings Services believes that it is imperative for the Commission to avoid overly intrusive supervision of NRSRO firms, particularly supervision that may suggest a substantive role for government in either the business operations of credit rating agencies or the ratings process itself. Because there is no one model or methodology for producing sound credit rating opinions, regulatory regimes focused on the credit rating decision process could have a number of adverse effects, including:

- compromising the independence of the credit ratings process;
- encouraging firms to standardize their approaches and thereby deterring diversity and innovation in credit analysis;
- creating the impression that rating opinions have governmental approval; and
- encouraging issuers to provide less information to credit rating agencies.

Moreover, regulatory oversight involving governmental intrusion into how and why a rating agency forms a particular rating opinion could chill the robust analytical process that has served the markets extremely well for nearly a century for fear of governmental "second guessing." Governmental intrusion also risks interfering significantly with the strong First Amendment protections that courts have applied to the ratings process of gathering and analyzing information, forming opinions and disseminating those opinions broadly to the marketplace.

International Review of Credit Rating Agencies

The capital markets are increasingly global in nature and the same is true of the credit ratings business. As a result, IOSCO and CESR (as requested by the European Commission) have initiated their own independent reviews of credit rating agencies. S&P Ratings Services has been an active participant in these reviews and believes that many of the initial conclusions of these bodies, and the public commentary they have received, can and should inform the consideration of these issues by this Committee, the Commission and others.

As noted, IOSCO released its "Code of Conduct Fundamentals" for rating agencies this past December. After months of deliberation and an extensive market comment period, IOSCO determined that its Code of Conduct Fundamentals should be flexible, allowing rating agencies to incorporate its principles into their own respective codes of conduct, but not creating rigid, universally applicable regulations. Roel Campos, SEC Commissioner and the Chairman of the IOSCO Task Force, said that IOSCO's flexible approach would be "more effectively enforced than would be the case if IOSCO had drafted a universal code for all credit rating agencies to sign on to." Commissioner Campos explained that a degree of flexibility was appropriate because rating agencies vary considerably in size, business model and rating methods. S&P Ratings Services agrees that IOSCO's flexible approach will both preserve the independence and integrity of the credit rating process around the world and better serve investors and the marketplace as a whole far better than rigorous regulation.

CESR is preparing a response to the European Commission's request for advice concerning credit rating agencies. At a public hearing held by CESR in Paris last month, the overwhelming majority of participants, including representatives of issuers and users of ratings, called on CESR to advise the European Commission to allow market forces to operate and not to impose intrusive regulation. In particular, most of those speaking at the meeting expressed support for an approach which allows rating agencies to develop their own practices and procedures based on the IOSCO Code of Conduct Fundamentals and expressed concerns that detailed regulation would increase barriers to entry.

Conclusion

History reflects that credit rating opinions and credit rating agencies have served the markets extremely well for nearly a century. The key drivers of this success have been the independence and objectivity of credit rating agencies. S&P Ratings Services believes that its policies and procedures, established through decades of experience and innovation, address the potential challenges to that independence and objectivity. Great care should be taken to ensure that the principles and structures that have so greatly benefited the market for so many years are not compromised.

On behalf of S&P Ratings Services, thank you again for the opportunity to participate in these hearings. I'd be happy to answer any questions you may have.