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Testimony Submitted To
The US Senate Committee on Banking, Housing, and Urban Affairs
Hearings on Assessing the Current Oversight and Operation of Credit Rating Agencies
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CreditSights welcomes the opportunity to comment on the evolving framework for credit rating agency oversight. As a growing provider of various credit research and analytical services selling to many of the same customers that use credit ratings services, CreditSights has in the past had the opportunity to provide input into the review of the NRSRO framework. We have noted in past testimony and would like to note again that we have never applied for NRSRO status and have no plans to do so any time soon. From the standpoint of CreditSights, the cost and effort involved was not worth it for our firm given the track record of companies seeking to enter the NRSRO space. While we do compete with some of the NRSROs in providing alphanumeric ratings through our statistical default risk model, our main business line is not "ratings." Operating primarily in independent credit research areas outside of "ratings" was as much a necessity for our own company to achieve growth as it was a strategic need since the current system frustrates expansion in the ratings business, and is likely to continue to do so unless change is brought soon.

Despite the dramatic change that has taken place in the debt markets and all of the opportunities that these changes bring to providers of research, credit ratings, risk management products, and data services, it is striking that there remains virtually no meaningful competition, and the ratings industry has solidified into what has frequently been described as a partner monopoly between Moody's and S&P. The stark contrast with the competitive industry structure in the underwriting business is also very notable. Protracted inaction in reforming the regulatory framework has allowed the incumbent NRSROs to stack their natural barriers to entry even higher during the past period of prolonged debate, with the NRSROs themselves working overtime in their attempts to slow change and keep the status quo in place as long as possible. Since we are in the business of watching how profit-maximizing industries evolve, the desire of the duopoly to hold onto their advantage is certainly understandable. Those are normal economic instincts. It is clear at this point—and after four years of picking over the details since Sarbanes-Oxley—that the NRSRO end game is to slow if not prevent change. We suspect that just slowing it down is a more realistic goal for them, since change is inevitable.

Some action is required soon since a lot of time has been lost in debates and constructive reform measures can be achieved without burdensome or disruptive regulation. Pressure will already be on new market entrants to bring innovation and some incremental quality to the market, but new entrants should not also be faced with the need to hurdle and leapfrog regulatory barriers. It is painful to watch how Moody's and S&P want to shape the criteria process now with the SEC even if in part just to keep the debate going and stall the process. At the same time, they do not want to be formally accountable to anyone but themselves. Our comments below and in past testimony on the template for change revolves around a few key points, and the general themes still apply:

- Immediate and radical lowering of barriers will not bring similarly immediate change in market structure since Moody's and S&P will continue to dominate the ratings industry for some time. It will diminish as the market grows and more competition comes into the market, but it will be a slow process. A revolution in the rules will still simply lead to slow evolution in the credit ratings industry. The continued market share dominance will be based on natural commercial barriers which the incumbent NRSROs—with their deeply imbedded regulatory right of way—have been able to build upon through steady expansion and acquisitions, including moves outside of the ratings business during a period of rapid global growth and product evolution in the debt markets.

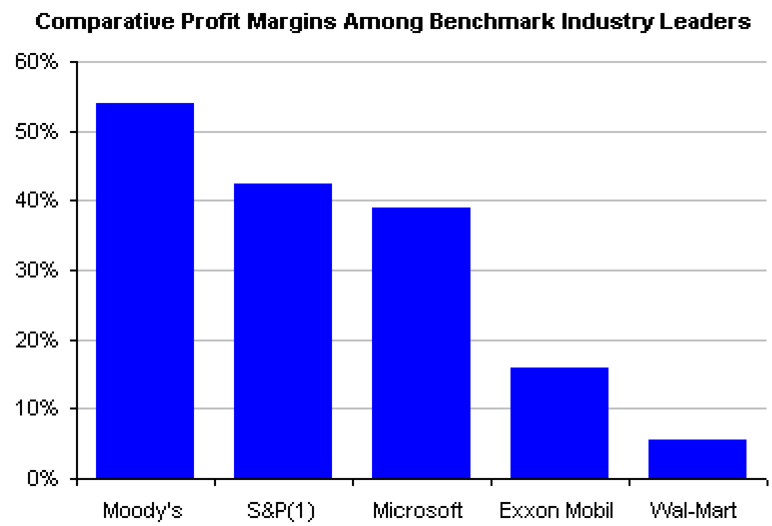
- The next structural evolution for this industry also should open up the avenues for well-capitalized players from the related financial information, technology, and data industry. The NRSRO reform process should not be just about streamlining the "slow queue" and "criteria debate" process that now serves as the Plan B for Moody's and S&P. A system that objectively lowers the barriers will be harder for the incumbent NRSROs to control since it will be based on letting in the markets work. On the other hand, the framework the agencies would applaud is one that can be lobbied and "lawyered" to death by the incumbents to impede meaningful competition from financial firms of global scope. We have already seen samples of this in the SEC Proposed Rule Process.
- Allowing for new market entrants will not be disruptive to the markets for the very reason that Moody's and S&P will still dominate for the intermediate term, and the fact that most investment parameters name them specifically. Minor administrative changes for those who use the NRSRO designation generically is fairly routine and just part of the daily work flow that is normally handled in shareholder proxies, the investment committee process, or standard risk management decisions by investment professionals. Moody's and S&P will throw out the fear of the unknown and use some time-honored fear mongering ploys citing "disruptions" to undermine change.
- The economic inefficiencies and market distortions of the current regulatory structure are too glaring to ignore. Moody's and S&P's pre-tax margins eclipse those of Microsoft and dwarf Exxon Mobil to name a few of the corporations typically tagged as 800-pound gorillas in their respective markets. With all due respect to the ratings business, this is not high tech rocket science, the financial discipline itself is fairly straightforward, there is a growing supply of available research talent not only given the changes on Wall Street but also with each new business school graduating class around the world.
- There has never been a more opportune time for the barriers to come down as Wall Street totally redefines its business strategy and traditional sell-side research starts to unbundle from the underwriting businesses. Moody's and S&P have already been pushing in substance into those businesses with their new suite of product offerings and have come closer being in the buy-hold-sell research business than they ever have been. Without change in the credit ratings sector to open it up to competition, Moody's and S&P will grow even more dominant and market distortions will be even greater.

One thing is certain. If the barriers come down, high quality and well positioned market entrants will come to compete. The opportunities in the global credit markets have never been greater, and global growth in a range of security classes and financial products has never been so attractive. Moody's and S&P can still execute on global expansion in new regions, new products, and new non-ratings services whether from the staging platform of protected NRSRO status or in a truly competitive market. The best outcome is that their growth will not be tied to anachronistic regulation guaranteeing them clients regardless of their performance. They will prosper one way or the other, and their obstructionism around change just reflects their desire to keep the potentially insurmountable head start going for a few more years. More than a quarter of a century was apparently not enough.

That protected status they still enjoy raises risks for potential market entrants including well-capitalized content aggregators that could be looking for horizontal expansion opportunities. It is hard enough competing against entrenched financial giants with inherent commercial advantages (client base, brand power, enormous financial flexibility) without keeping the ratings behemoths on regulatory steroids. There has already been legislation proposed that takes the process out of the hands of Moody's and S&P, who would both like to control the "standards debate" and keep the equivalent of a waiting period in place for a protracted time frame. Just about every recommendation they have made promotes delay and narrows options for entrants. It is getting tired and has been overindulged.

The Artificial Barriers Impair Competition and Efficiency

There is every reason to expect a lot of interest in entering the credit ratings market. According to Economics 101, high profits, high margins, high growth, and high prices in an industry attract market entrants. As we look across similar examples of leading players in other industries, the extraordinary case of Moody's and S&P continues to stand out as an anomaly, and in particular with respect to the absence of competition, the enormous pricing power, the price-insensitive volume growth, and the lack of choice for consumers. In the attached chart we compare the pre-tax margins of Moody's and the financial services business segment of McGraw-Hill (the unit is dominated by S&P) to a few other major corporations sometimes accused of everything from price-gouging to the pursuit of global domination. Even if one feels Exxon Mobil and Microsoft are misunderstood, the comparison is telling. Moody's pre-tax margins dwarf those of Exxon Mobil as well as Microsoft, and Wal-Mart is a comparative pauper in profit margins given that its strategy is based on low prices and low costs and that Wal-Mart serves the more price-sensitive consumer. We would not be taking a risk to say that corporate issuers would be more price-sensitive also if they were in fact given the opportunity to have a choice.



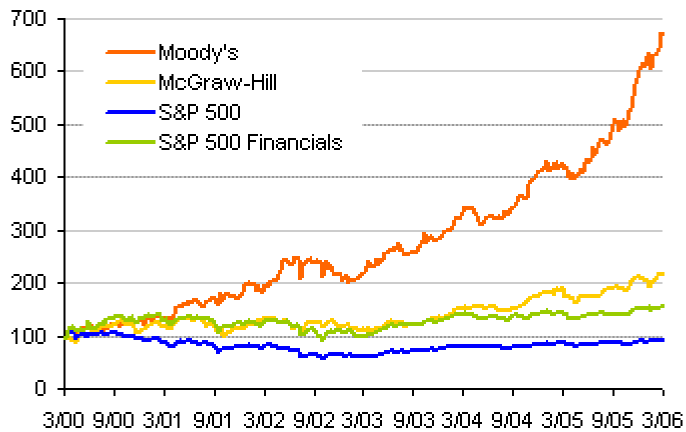
Note: Based on pre-tax margins for most recent trailing 12 month reporting period.
(1) Based on the financial services segment operating income of McGraw-Hill.

Imagine a scenario where the government controlled oil reserves and told Exxon they were the only ones that could drill in those areas. Imagine a no-action letter being required to be a seller of software and Microsoft not only was the only one approved but was still able to spend its massive profit margins on the full array of technologies outside of that limited but very lucrative product segment. Imagine again that a slice of those massive margins could be set aside every year for lawyers to hinder regulatory change. Imagine Wal-Mart being handed the best retail locations by a government oversight body with virtually no other retailers given the right to lease and compete regardless of their business model. Imagine in all of those situations small to mid-sized firms that had competitive products were not given the opportunity to grow or compete due to regulatory hurdles. Or imagine a larger firm looking to enter that market and was prevented from doing so since it would be in effect a new business venture with the theory being you cannot enter a business unless you are already in it. That last one is a difficult equation to solve. In fact, you cannot enter it even if you have the capital and some inherent synergies. Those are ludicrous enough scenarios to see as unrealistic, but absurdly enough there is a high degree of parallel to what the NRSRO duopoly actually has been afforded over the decades.

A Valuable Opportunity Exists Now for Competition

The fact that there have been virtually no meaningful market entrants into the NRSRO space—and in fact a considerable level of consolidation among the NRSRO incumbents and aspiring ratings firms, has all been well covered in prior hearings in Congress as well as at the SEC. The performance of the lead players certainly nonetheless should attract attention from a wide range of market participants in the financial services space. The financial performance of Moody's as the one NRSRO pure play in the market has been nothing short of extraordinary. Since mid-1998, when what later became Moody's was split off to trade largely on its own fundamentals, the total return on Moody's stock has been over 501% vs. only 28% for the S&P 500 and 55% for the S&P 500 Financial Index. McGraw Hill (S&P's parent company) has returned 204% over that same time span. McGraw-Hill's lucrative financial business is housed within a more mature and lower margin pool of other businesses, so it underperformed Moody's but still crushed the overall market.

The NRSROs Have Held Up Well Under The Regulatory Challenge



Source: Bloomberg. Note: 3/3/00-3/3/06. Returns rebased to 100.

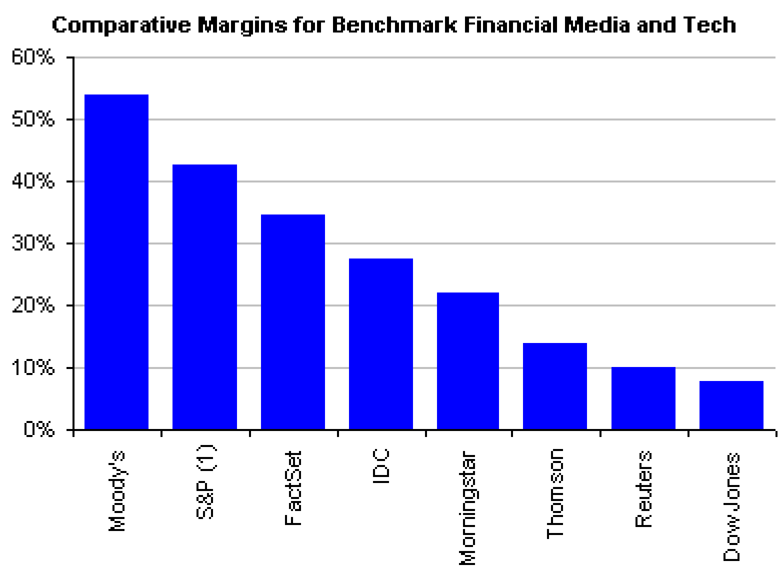
The success of Moody's and McGraw-Hill against this backdrop is hardly a major surprise. The growth prospects for them remain compelling, and they have been able to counter and stall the lowering of barriers with considerable skill. What is most stunning is that such a favorable backdrop has not brought more concerted attempts to enter the space. That is something for the Committee to ponder as they look to institute reform. The lack of new NRSROs has to be clearly laid at the feet of the traditional regulatory framework, and there needs to be rapid change if the policy goal is to promote competition and rid the market of entrenched barriers. The four years since Enron have blown by rather quickly, and there have been a lot of hearings and a lot of testimony filed here and filed there. Some action is long overdue to get the real process of fostering competition on track and out of the discussion stages. The regulatory follow-through itself will necessarily be evolutionary, but the regulatory fear-mongering by the rating agencies is starting to get very repetitive even as it is misleading.

The Path to Real Competition is Straightforward

As regulatory change is being weighed to more rapidly lower barriers and expand competition, we would caution against taking one artificial set of barriers and replacing it with another as some have recommended. If there is one thing we are totally certain about in all of this process, it is that Moody's and S&P are not staying up late at night worrying about small boutiques getting cleared to do business in their space, and they are not even worried about another Fitch or AM Best or two coming along. They are worried about large well-capitalized institutions that offer the market the opportunity for choice across the globe, have capital to invest to buy and/or build competitive capabilities, or have many of the attributes that Moody's and S&P themselves are looking to expand upon as they buy assets and capabilities around the world. Their fears should be a signal to policymakers of how to rewrite the rules so one inefficient structure that impairs real competition is not just replaced with a slightly less inefficient one that just lets in a few minor players. Such a change could also address some of the worries that linger about fly-by-night operations setting up shop and diluting rather than enhancing the quality of information that is being delivered into the marketplace.

In considering what structural evolution in the credit ratings industry will bring on the most rapid change and encourage innovation, we would recommend walking in the shoes of Moody's or S&P for a while. Basically, if it worries them it is probably a good thing. While clearly their wish is for the status quo so they can continue their partner monopoly, face no exposure to liability, and be subjected to no regulation (other than that which keeps competition out that is), their biggest worry is that the new template for competition will also allow a route for well-established, well-capitalized companies in the financial media, technology, and data sectors to rapidly enter the credit ratings space. These types of operators cut across many different subsectors of the financial information and technology industries, and both Moody's and S&P have in part entered or expanded in some of their businesses in recent years. The NRSROs have been able to do so from their protected space in the ratings business while those other firms—with all of their extensive capabilities—have to sit on the sidelines and watch since they have not been in the ratings business. They easily could be with the right reform measures.

The companies that have any combination of global reach, proprietary content, existing distribution networks, established customer relationships, and varying degrees of brand power are the companies that create the real threat to the current ratings duopoly. We should qualify up front that the names of the companies are based on our own theories as to which ones could easily fit into the ratings industry, but the list of potential names could include a range of multi-billion-dollar corporations such as Bloomberg, Thomson, Reuters, Bertelsmann, Morningstar (leading rater of Mutual Funds), FactSet (a leader in financial data and work flow products), IDC (securities pricing, analytics, financial technology), Morgan Stanley Capital International (leader in international indices, owner of Barra in financial analytics), and Dow Jones among others. With the rapid globalization of the credit markets and especially the euro debt markets, international expansion opportunities and more analytically-intensive market segments require proprietary technologies and global reach that many of these companies currently possess.



Note: Pre-tax margins for most recent trailing 12 month reporting period.

(1) Based on McGraw-Hill financial services segment operating income.

We would argue that the fallback position for Moody's and S&P at this point is that if their First Amendment gambit fails to hold back any regulation and fails to scare away legislative initiatives, they will push for a return to the NRSRO criteria debate that can keep eating up years and slowing the process of market entry for such global players as those noted. Those criteria debates can be buried in lobbying and backroom point-counterpoint that can eat up another four years very quickly. The SEC has limited budget and limited manpower, and the ability of Moody's and S&P to frustrate the process has been evident. We certainly have seen that demonstrated since the initial Sarbanes-Oxley legislation and subsequent to the mandated March 2002 Senate hearings on the rating agencies. We suspect that Moody's and S&P would also like a return to the "slow queue" strategy with the SEC where more of these larger strategic players can get pushed further back in line. To the extent that happens, the regulatory uncertainty will keep out most of these companies if not all of them since the uncertainty of "club membership" would be too unpredictable a risk factor. There are simply too many other business initiatives serving the growing markets that can provide an immediate return.

It is clear that streamlining the process for the entry of new, credible and viable providers of credit ratings services will attract new ratings organizations from the current population of small to mid-sized competitors both in the US markets as well as from Europe and the Asia-Pacific region who are looking to establish a global footprint to rate issuers across multiple currencies. The much-discussed chicken-and-egg debate around "nationally recognized" should be put to a market test and move beyond the batteries of lawyers and interest groups that continue to weigh in. There is nothing more consistent with the principle of free, competitive markets than lowering barriers and allowing for new market entrants to bring innovative, high quality products to potential customers. Issuers will have more choices as will investors and consumers of credit risk assessment products and services. In the end, the regulators should let the market decide. If a major institutional investor writes a check to a research company or a rating agency, and then keeps renewing, that ratings provider and research service should be deemed credible. Backroom negotiating, expensive lawyers, and good lobbyists should not be the swing factor. That would allow for more information in the market—not less—and from both large firms and small firms. We have not figured out yet how that can be a bad thing.

For those who want to consider the ratings business from a policymaker's standpoint rather than as an operator in that market, we would also highlight that lowering barriers creates jobs, inherently promotes price competition, and brings efficiency to the market along with choice to the consumer—whether that consumer is an investor or an issuer. We would argue that lowering barriers to allow more ratings agencies to be quickly assembled on a buy-and-build basis by larger firms would also encourage more analysts to take some entrepreneurial risk in this space. That creates jobs and will do so in more states than just the traditional financial hubs.

New Entrants Build Businesses by Selling High Quality Information, Not High Ratings

One of the concerns that has been raised around the lowering of barriers is that more rating agencies will flood into the marketplace and dilute quality, inflate ratings to "buy business," and that the risk to "widows and orphans" will grow if they rely on disreputable firms. In addition, there is the natural worry that quality will be diluted if barriers come down too quickly. We can put aside the debate for now as to what quality starting point we are at now with an industry dominated by a duopoly that in the end is not paid specifically for quality or held to any standards of accountability other than a self-imposed one. We need to judge the "quality risk" factor against what opportunities might be lost. The flip side of the barrier-to-entry debate is that high barriers keep out competition that can bring innovation, highly experienced personnel, specialized skill sets in new areas such as international credit, the non-US corporate sector, securitization, the analysis of structural risks and specialized securities, and also attracts more entrepreneurial organizations that look to cater to the institutional investors demands for high-information-content ratings and research—not just a few letters and numbers that are strung along as a grading of default risk.

We would highlight that even with the creation of a new rating agency that sought to build business with issuers by inflating ratings, we would argue that particular ratings company would face the simple reality that the issuers would not be likely to pay them enough to build a business and that any such operations would be a nonfactor and fade away. Perpetuating the fear of ratings inflation is strategically an old ploy the NRSROs use. It must be partly rooted in the odd assumption that investors want to be lied to and misled and would take any such firm seriously. We would agree it is more the case that issuers want to be flattered in their ratings for corporate ego or for purposes of low cost execution, but with no market clout comes no benefit to the issuer from a grade-inflating upstart. So why pay him? That ratings inflation game worked for a while in the commercial paper business in the 1980's, but the market's sophistication has now moved far beyond that. Ironically some of those ratings inflation shops from the 1980s were later rolled up into other NRSROs in mergers, and they are also kicking around this fear today. So much for no shame.

This theory on a new wave of "ratings shoppers" also ignores the ever-growing base of investors and risk managers that look for information to hedge credit risk on the downside for defensive purposes (the banks, brokerage houses, and a growing base of global institutional investors, corporate users managing customer risk and supplier chain risk, etc.). So new market entrants would be better served by a value-added, investor-based model—not an inflated issuer model that is not likely to bring much revenue anyway. Since a cornerstone of the NRSROs new product strategy is rooted in risk products and serving the needs of the BASEL framework and supplying "warning system" products that flags downside risks, the agencies actually know this line of reasoning is nonsense. They will spin it anyway, since they have an axe to grind to keep out new market entrants. The bottom line is that being early on calling the negative trend is a great way for new players to expand in this business, not the other way around.

The accusation that new rating agencies will be unduly positive also ignores the rapidly growing base of investors (hedge funds, the Wall Street firms themselves) that use negative information for "offense" by shorting securities or in the credit derivatives markets. The derivatives market is a gold mine for the agencies, so the fear of a race to the bottom that they often spin around new market entrants belies the growth opportunities they themselves see. There is revenue to be generated in being right—whether positive or negative.

In the end, investors are not in the habit of wasting their money and for that matter issuers and intermediaries are more than a little realistic around the value of a new upstart in handing out high grades. The path to the current duopoly is littered with those that used a ratings inflation strategy tied to an issuer-pays model. The bulk of such agencies disappeared or were simply rolled up into other NRSROs via the consolidation process we have seen over the past 15 years. Business models that will be most "disruptive" to the traditional issuer-pays ratings model are those business lines that offer value to investors—not issuers. The incumbents have a lock on the issuers for now, and any company that looks to issuers for revenues will face an uphill battle.

New Rating Agencies, the NRSRO Designation and "Market Disruptions"

The NRSROs have been remarkably adept at interpreting support for the "NRSRO concept" as implying that elimination would be highly disruptive to the market. Based on these supposed disruptions, the NRSRO concept must be preserved at all costs since volatility lurks. At least that is how the story goes. The fear of the unknown can be an effective weapon, and the NRSROs are looking to use it to the fullest. Adding more input and innovation, and growing the scope of the human and financial capital and technology directed at this growing market is more likely to be disruptive to Moody's and S&P's margins than the capital markets. Whether the NRSRO framework is streamlined and made more transparent or whether it will be tortured by regulatory bodies looking to reverse engineer a rating agency is the decision point. The incumbent NRSROs would like to keep the ratings agency reform process in the position paper and point-counterpoint process with the SEC, so they can use as much influence, backroom lawyer gamesmanship, and third party lobbying to keep the process flying circles around the main issue—that the market should simply be opened up. That will attract the natural base of well-capitalized competitors with global scale and will also lower the impediments to capital flows into the ratings agency sector from sources of private equity that will fund the growth of new market entrants.

The red herring of "market disruptions" in general is something the incumbent NRSROs like to wave to stall change. We would highlight that taking the barriers down to zero tomorrow will not change the basic competitive playing field for years and Moody's and S&P will still dominate. It is not as if a new definition of NRSRO (or its elimination) will cause Moody's and S&P to dry up and blow away. Put the use of ratings in market context before buying into that rating agency ruse. The bulk of institutional investors have credit ratings parameters that set out requirements for average ratings or minimum ratings for securities they own in their portfolio or for counterparty risks. These parameters usually more often than not *specifically* cite Moody's and S&P and not "any NRSRO." The natural barriers to entry are thus enormous to begin with for any new agency, and it will take a considerable amount of clout to get more banks and securities houses to include a new agency in their underwriting process. Ratings-based pricing grids in bank loan agreements, ratings triggers built into bond and bank loan terms, ratings-based haircuts on loans used in setting margins on debt securities as collateral, over-the-counter swap agreements that include ratings-based termination provisions, internal credit limits by issuer in portfolios, and many other risk management practices cite the specific rating agencies—namely, S&P and Moody's. So even eliminating the NRSRO designation would have scarce effect of the great bulk on those market exposures where the specific agencies are named.

For those mutual funds such as money market funds that have minimum ratings using the more generic term "NRSRO" under Rule 2a7, the process of naming specific agencies could simply be a resolution as part of fairly routine administrative exercises that go into frequent board meetings, proxies, and/or investment committee exercises that include many other items routine voted upon or "gaveled in." For a new rating agency to crack into the "approved list of agencies" at an institutional investor, that ratings provider would need to deliver quality, value, and be an organization that would make such an exercise worthwhile for the customer. As the panic around quality dilution and disruptions are hyped by the incumbent NRSROs, it is worth keeping in mind that organizations that can leap over such organizational hurdles are usually those that deliver a high quality and value-added product. It is the very essence of improving information flows to the market.

A Not-So-Parallel: The Underwriting Industry and the Ratings Agencies

We would guard against taking seriously the market disruption line of reasoning, and would point to the evolution of the corporate debt underwriting industry itself for a guide. There were predictions of doom by the securities industry well over a decade ago when the commercial banks started their concerted moves into the traditional underwriting businesses.

They were playing an old but transparent game of the fear of the unknown. The incumbent securities firms were looking to stave off competition and thought predictions of chaos and trouble might strike a nerve. Having worked at one of those securities firms that was part of the entrenched bulge bracket working overtime to keep out the large banks, it in retrospect can be seen for what it was. The same was true of the banks that wanted to keep the brokerage firms out of commercial lending.

Despite prediction of disruptions then, the opposite came to pass. Now investors and issuers have much more choice of who they want to deal with, pricing is more competitive, the markets are more efficient and despite some bumps the system is stronger and better capitalized. The bad old days of 1990 and 1991 were very scary times. The system handles shocks much better now even in volatile times. The innovation in such areas as the securitization markets, risk management tools in increasingly complex markets, and a broader array of financing options for global issuers has served the US corporate sector well. It is in no small part due to the evolution of the banking and underwriting industry from a small group of a half dozen bulge bracket investment banks to a global bugle bracket of a few dozen major integrated financial service operations. The evolution of the credit markets was about letting competitors compete—and across highly regulated markets no less—and seeing the market benefit from innovation, competition and choice.

The ironic part of the story is that along the way, Moody's and S&P have been able to hitch a ride to the sweeping benefits that came with this intensified competition. Opening up the underwriting markets and allowing competition to flourish put a lot of money in the rating agency pockets. After all, new ratings firms were essentially blocked by a regulatory system that kept market entrants out while not holding the incumbents accountable. In other words, competition brings positive results for the market and the NRSROs win. All in all it was a very sweet deal for the agencies. Wall Street, the investment banks and the securities firms invent new securities and engage in brutal competition to market them. Then Moody's and S&P come in and rate it and reap the benefits of inelastic pricing and no choice.

It is more than ironic that now Moody's and S&P wave the same red flags around market disruptions and hidden risks lurking around the corner that will create problems in the markets. Ignoring those false prophesies last time around in the banking and securities business brought the credit rating agencies windfall profits. We would highlight that their take on the risks sounds a lot like what the investment banks were crying about when the commercial banks and non-US banks came into their space. It is an old ploy and one that has been proven without foundation on multiple occasions. In the case of the banks and brokerage houses, the system in the end benefited, and innovation was everywhere.

The NRSRO Concept

While critical of how the agencies have performed and used their special rights and privileges as an NRSRO, we still endorsed the concept of the NRSRO in our March 20, 2002 testimony before the Senate in the Enron hearings and again as part of the SEC Hearing on the Ratings Agencies on November 15, 2002. We again testified at the Congressional field hearings on the topic this past fall, and it now appears that the first meaningful action could be taken in 2006. Our endorsement of the NRSRO concept in those hearings was more a reflection of the critical role that such ratings providers play in the capital markets, and the need for a regulatory "bar" to clear for such agencies given their extremely important function.

As with most of the market practitioners that are accustomed to regulation, approval of some variation of the NRSRO concept implies regulation. The only problem is that Moody's and S&P believe they can never be regulated. So while Moody's and S&P say those that support some NRSRO framework agree with them, it is a matter of interpretation and could be argued most disagree. The agencies are quick to endorse an approval of the concept of some regulatory framework with an approval of their performance. That is hardly the case. In the past we have endorsed the NRSRO concept or some variant of that framework for the very simple reason that the rating agencies are in fact a major factor in the markets and heavily influence the behavior of securities, the cost of capital for issuers, and even the ability to gain market access. That is a lot of power, and that makes the NRSROs the most powerful unregulated force in the market.

We are not unlike many of the major institutional clients that we speak with who are very frustrated with the lack of options and frequently questionable quality of rationales and analysis of risks. Default histories are very important in the analysis of track records of rating agencies, but so is the manner in which they explain evolving short term risks from structural risks to potential volatility in an issuer's recovery risks. Many major investors are concerned over the outsized influence two dominant agencies can have on the behavior of securities in the markets. It is a parallel to having only a few market makers in the over-the-counter debt markets. More opinions and high quality information flows can smooth that effect and lead to fewer market distortions, just as we have seen in the debt markets themselves with more capital committed by more banks over the past two decades—even as the ratings business stood still structurally. We frequently hear of the lack of options and that there is a requirement to purchase more of the agencies various products because investors see them as so dominant and thus "have to." While the agencies have represented the dissemination of their *ratings* as free, their services are in fact very expensive to purchase.

In endorsing the NRSRO concept in the past, we had also clearly stated that the agencies were in need of some increased regulatory oversight that the current system did not provide. Despite the NRSROs calculated and tactical strategy of stating that they play the role of "journalists" for purposes of their legal strategy to avoid *any* regulation, the NRSROs very much in form, substance, and in execution play the role of a critical part of the underwriting process in all areas except liability, due diligence requirements, professional certification, and accountability. Any other party involved to such an extent in the underwriting chain has at least some checks and balances in place by the SEC or the NASD in the domestic markets—or at least face some accountability under the Securities laws.

All Congress has to do is to get the incumbent NRSROs to admit that they are an integral part of the underwriting process and therefore subject to some regulation. After all, every other party remotely tied to the underwriting process is subject to some checks and balances from sell-side underwriters to secondary market makers. If they are not inextricably part of the underwriting process, it will be news to the market and probably the underwriters.

The First Amendment Strategy

At CreditSights, we see ourselves as also benefiting from First Amendment protection, and we have always been told when we were in the brokerage business at former employers that such rights would be used at least in part in any litigation. Then again, we never were of the impression that First Amendment rights were incompatible with the regulation by the NASD or the SEC that most of our research professionals have been accustomed to through their careers. We do not view regulation under either framework as particularly onerous and in fact just a normal cost and basic responsibility of doing business. The vehement opposition of the NRSROs to any similar oversight is out of line with their actual role in the process.

As Moody's and S&P move closer to being in the buy-and-sell research business and engage in more market-based analysis, we find their ability to press on with the "we are journalists" shell game as borderline insulting to the many analysts that routinely take licensing examinations, work hard to gain professional credentials from the NASD or FSA or who take additional professional education measures such as the CFA. As of right now, the rating agencies have zero professional requirements, in stark contrast to every party along the underwriting chain from the securities industry employee to the CPA and lawyer in the process. It is probably also thus not a major surprise that their margins are also a lot higher.

The NRSROs have devised a business strategy where they cite journalistic immunity from any oversight and all the while riding along the revenue coattails of the necessarily regulated underwriting and market-making service providers and with the NRSRO role a de facto requirement in the process. If the policy decision is to let such inequities continue, then at least allow some meaningful price and product competition to come into the picture on this very sweet deal. We do not doubt the ability of the highly profitable NRSROs to buy the best legal opinions money can buy on the topic, but most of the constituencies in the debt markets see it for what it is. As some other legal commentators have pointed out in the past, if the agency rationale holds water, why not eliminate all oversight of research by the NASD as well?

The IOSCO Voluntary Framework and the Parallels to the US Markets

Moody's and S&P point to the voluntary framework of the IOSCO as the template for how this should be handled. In other words, they want no change. In the end, it is not the IOSCO that created the most innovative and deepest capital market in the world. That was done here in the US with the market forces being allowed to work. Then again the IOSCO also did not create the regulatory quagmire that has evolved out of the NRSRO system. That was created here also and needs to be fixed here.

The far less developed markets in the international credit space also are still largely dominated by large banks, securities houses, and sophisticated institutional investors. The US market is much more advanced in the disintermediation process and relatively more is held at the retail and individual level indirectly through mutual funds and pension funds or directly in individual portfolios. Thus the parallel to the IOSCO is not a great one in terms of what is at risk, and the stakes are higher here. Leaving a partner monopoly in charge of their own policing might not be the most prudent of approaches anyway.

Light-handed regulation does not mean micro-managing the credit ratings process, but the credit ratings industry has never been given the opportunity to evolve the way the banking system has grown up the past two decades. It is time the ratings industry was allowed to catch up with the markets. The NRSROs enjoy their unalienable right to mail issuers a bill for the innovation the agencies have not driven. The policy objectives should keep in mind that such innovation came out of markets that have real competition. That lesson should not be lost in the rating agency reform process.

About CreditSights, Inc.

CreditSights is a leading provider of independent research serving the needs of investors and risk managers across the debt markets, equity markets, and various managers of supply chain and customer risk. CreditSights provides independent credit and equity research services, data products, and default risk models for corporate and sovereign issuers of debt securities in the global markets. Through its BondScore default risk product, CreditSights issues alphanumeric ratings on over 2400 corporate issuers, and has been doing so since inception. With over 600 institutional clients and 4,000 subscribing password users in our institutional client base, CreditSights has grown from a founding group of 8 employees in 2000 to just under 100 employees today. The company is majority-owned by employees. We operate as a Registered Investment Adviser regulated by the SEC in the U.S. In the U.K., CreditSights is an FSA-registered company selling research products to institutional investors across the pan-EU markets. CreditSights only sells research products and does not underwrite securities, manage assets, or take any contingency-based compensation.